DIRECT INVESTMENTS IN CROATIA IN THE FORM OF PERSONAL COMPANIES – TAX RELATED ISSUES

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The bilateral economic relations between Austria and Croatia are of prime importance to both countries: more than one quarter of foreign investments realised in Croatia stem from Austrian sources. Indeed, Austria is the largest investor in Croatia. Although the Croatian legal framework provides for several investment possibilities, Austrian residents prefer to invest in Croatian capital companies. However, especially from the perspective of Austrian residents, substantial tax benefits may result from the pursuit of entrepreneurial activities in the form of Croatian personal companies. This is mainly due to the different tax systems applied in Austria and Croatia that treat personal companies in fundamentally different ways. Nevertheless, diverging tax systems can trigger qualification and allocation conflicts in treaty law and may result in double (non-)taxation. The open questions are how to ascertain tax benefits despite these conflicts, i.e. how these conflicts can be solved by virtue of the double tax treaty concluded between Austria and Croatia. This paper illuminates the qualification and allocation conflicts which occur from participations of Austrian residents in Croatian personal companies and provides solutions for such conflicts. Moreover, the tax benefits resulting from investments in Croatian personal companies are identified and highlighted.

Keywords: Double Tax Treaty Austria-Croatia, Austrian Income Tax, Croatian Profit Tax, personal companies, limited partnerships, OECD Partnership Report

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I. INTRODUCTION

This paper aims at contributing to the debate over qualification and allocation conflicts which are a key issue in tax treaty law and have been a matter of discussion in international tax law for more than a decade. Due to the high practical relevance of these conflicts and necessary solutions to them, the OECD published the so-called Partnership Report 17 years ago.[1] This report was aimed at providing specific solutions based on provisions of double tax treaties to qualification and allocation conflicts and was incorporated into the OECD model tax convention commentary. On a worldwide level the report encountered positive and negative response.[2] Beside a number of other authors, *Lang* criticized the OECD approach taken in the report. The criticism was mainly based on inconsistent solutions and the high dependency of the residence state on the source state and its interpretation of the double tax treaty provisions when it comes to resolution of qualification conflicts.[3] Other scientific contributions of the recent years illustrated that these conflicts occur owing to different qualifications of an entity as a taxpayer[4] and thus, under-

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[1] OECD, *The Application of the OECD-Model Tax Convention to Partnerships*, Issues in International Taxation no. 6, OECD Publishing, Paris, 1999.

[2] International Fiscal Association, *Cahiers de Droit Fiscal International, Qualification of Taxable Entities and Treaty Protection*, Sdu Uitgevers, Amsterdam, 2014; Danon, R., *Qualification of Taxable Entities and Treaty Protection*, Bulletin for International Taxation, no. 4/5, 2014, pp. 192 – 201; Canete, B.; Eckerstorfer, M., *SWI-Jahrestagung: Vermögensverwaltende kroatische Hybrid-Personengesellschaft (EAS 3087)*, SWI - Steuer- und Wirtschaft International, no. 5, 2010, pp. 203 – 206; Gupta, V. K., *Conflicts of Qualification and Conflicts of Allocation of Income*, in: Burgstaller, E.; Haslinger, K. (eds.), Conflicts of Qualification in Tax Treaty Law, Linde, Wien, 2007., pp. 39 ff.; Gassner, W.; Lang, M.; Lechner, E. (eds.), *Personengesellschaften im Recht der Doppelbesteuerungsabkommen,* Linde, Wien, 2000.

[3] Lang, M., *Zurechnungskonflikte im DBA-Recht: Unterschiedliche Auffassungen des österreichischen Finanzministeriums und der OECD*, Internationales Steuerrecht, no. 22, 2012, pp. 857 – 896; Lang, M., *Qualifikations- und Zurechnungskonflikte im DBA-Recht*, Internationales Steuerrecht, no. 4, 2010, pp. 114 – 118; Lang, M., *Qualifikationskonflikte bei Personengesellschaften*, Internationales Steuerrecht, no. 5, 2000, pp. 129 – 134; Schuch, J.; Bauer, J., *Die Überlegungen des OECD-Steuerausschusses zur Lösung von Qualifikationskonflikten*, in: Gassner, W.; Lang, M.; Lechner, E. (eds.), *op. cit.* in fn. 2, p. 40.

[4] Danon, R. J., *op. cit.* in fn. 2; Gassner, Lang, Lechner (eds.), *op. cit.* in fn. 2; Lang, M.; Staringer, K., *General Report*, in: International Fiscal Association, *op. cit.* in fn. 2, pp. 17 ff.

pinned the corresponding theses of the Partnership Report. The scientific results presented by *Gupta*, *Lampert* and *Loukota* showed that such a different qualification results in a situation where the same item of income is attributed to different taxpayers in two or more jurisdictions.[5] *Seevers* and *Gstöttner* demonstrated that a qualification conflict may cause the contracting states to consider diverging distributive rules of a double tax treaty with respect to the same item of income.[6] The analysis conducted by *Seevers* also illustrated that the application of diverging distributive rules leads to the problem of taxation rights of the contracting states being allowed or restricted in different manners. Loukota conducted research in the field of potential effects of qualification conflicts and came to the conclusion that qualification conflicts may be divided into three categories: positive conflicts leading to double taxation, negative conflicts resulting in non-taxation of income, and artificial conflicts which have no effect on taxation.[7] Numerous scientific publications of the past years revealed that qualification and allocation conflicts still constitute challenging and controversial problem areas in treaty law despite the publication of the OECD Partnership Report and its incorporation into the OECD Model Tax Convention Commentary.[8]

In recent years courts of various countries have also followed their own line, because they regard many proposals of the OECD Partnership Report as questionable.[9] Many authors who conducted research in this field came to the

5 Loukota, H., *Der OECD-Report zur Anwendung des OECD-Musterabkommens auf Personengesellschaften*, in: Gassner, Lang, Lechner (eds.), *op. cit.* in fn. 2, p. 9; Gupta, *op. cit.* in fn. 2, pp. 41 ff.; Lampert, S., *Doppelbesteuerungsrecht und Lastengleichheit*, Nomos, Baden-Baden, 2010, p. 41.

6 Seevers, M. H., *Taxation of partnerships and partners engaged in international transactions: Issues in cross-border transactions in Germany and the U.S.*, Houston Business and Tax Law Journal, 2002, pp. 145 – 231; Gstöttner, K., *Hybride Gesellschaften in der EU*, LexisNexis, Wien, 2014, p. 141.

7 Loukota, H., *Lösung internationaler Qualifikationskonflikte*, SWI - Steuer- und Wirtschaft International, no. 2, 1999, pp. 70 – 78.

8 Dziurdzź, K.; Fuentes, F. H.; Pinetz, E., *Case Studies on Partnerships and Other Hybrid Entities*, Bulletin for International Taxation, no. 3, 2014, pp. 148 – 153; Kofler, G.; Lüdicke, J.; Simonek, M., *Hybride Personengesellschaften – Umsetzung des OECD PartnershipReports in Deutschland, Österreich und der Schweiz*, Internationales Steuerrecht, no. 10, 2014, pp. 349 – 384; Schmidt, Ch., *Personengesellschaften im internationalen Steuerrecht nach dem OECD-Bericht "The Application of the OECD Model Tax Convention to Partnerships" und den Änderungen im OECD-MA und im OECD-Kommentar im Jahre 2000*, Internationales Steuerrecht, 2001, pp. 489 – 497.

9 For example Italian Supreme Court, Corte Suprema di Cassazione, Sentenza no. 4600, 26. 2. 2009; Canadian Tax Court, Canadian Tax Court, 8. 4. 2010, 2010

conclusion that qualification conflicts should be solved on the basis of an autonomous treaty interpretation instead of relying on national law and subjecting the residence state on treaty interpretations of the source state.[10] Owing to the significant practical relevance of qualification conflicts the International Fiscal Association (hereinafter: IFA) put this topic on the agenda of the IFA Congress 2014 in Mumbai. At the Congress the different approaches of certain countries with regard to the conflicts have been presented.[11]

For more than a decade academic research has shown that the problem with qualification conflicts in general is that they may result in double taxation or double non-taxation. Moreover, a further significant issue of those conflicts is the fact that tax treaties may fail to avoid double taxation.[12] This issue can be (un)favourable for the taxpayers and tax administrations involved. Further, practical experience shows that there is a wide variety of possible qualification conflicts.

This paper is dedicated to identifying conflicts of qualification in the field of personal companies between Austria and Croatia. In particular the tax consequences stemming from possible qualification and allocation conflicts for Austrian residents participating in Croatian personal companies are investigated. The idea is to provide, on the one hand, an outline of the crucial issues which give rise to such conflicts and, on the other hand, it is attempted to deliver solutions for such conflict situations on basis of the double tax treaty Austria-Croatia (hereinafter: DTT A-C). In this context, the author addresses the question whether the solutions published by the OECD and the DTT A-C constitute an effective tool in the prevention of qualification conflicts. Further, it is aimed to ascertain possibilities for the use of Croatian personal companies as tax planning instruments for Austrian residents. Moreover, this article compares the tax effects resulting from participation in Croatian personal com-

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TTC 186; Income Tax Appellate Tribunal of Mumbai, Income Tax Appellate Tribunal, 16. 7. 2010.

10 Lang, M., *Steuerlich transparente Rechtsträger und Abkommensberechtigung*, Internationales Steuerrecht, no. 1, 2011, pp. 1 – 6; Lüdicke, J., *Personengesellschaften im Internationalen Steuerrecht*, in: Dötsch, F.; Herlinghaus, A.; Hüttemann, R.; Lüdicke, J.; Schön, W. (eds.), Die Personengesellschaft im Steuerrecht - Gedächtnissymposion für Brigitte Knobbe-Keuk, Dr.OttoSchmidt, Köln, 2011, pp. 95 – 138.

11 International Fiscal Association, *op. cit.* in fn. 2; Burgstaller, E.; Haslinger, K. (eds.), *Conflicts of Qualification in Tax Treaty Law*, Linde, Wien, 2007; Croatia was not included.

12 See for example Seevers, *op. cit.* in fn. 6, p. 217.

panies and from shares in Croatian capital companies for Austrian residents. The aim is to shed light on international taxation issues in connection with Croatian personal companies and to demonstrate their potential for providing tax benefits for Austrian investors and other foreign investors resident in the countries applying the transparency principle to personal companies. Thus, this paper contributes to the clarification of taxation problems in connection with personal companies between Austria and Croatia, making a valuable contribution to the topic of personal company taxation in international tax law.

In order to do so, this paper provides a brief description of personal companies under Austrian and Croatian company law followed by an outline of the tax treatment of personal companies under Austrian and Croatian tax law. Afterwards a case study dealing with the Croatian personal company, i.e. a limited partnership (komanditno društvo; hereinafter: k.d.) will be presented. The case study focuses on practical cases. The first case deals with the treatment of profits generated by a k.d. and is followed by a case presenting the treatment of profit distributions. The third case shows the tax effects resulting from alienations of stakes in a Croatian k.d. Thereafter, the tax consequences resulting from participations of Austrian residents in a Croatian k.d. and a limited liability company will be compared and analysed. Finally, the paper is concluded by referring to the main findings of the case study.

II. PERSONAL COMPANIES UNDER AUSTRIAN AND CROATIAN COMPANY LAW

The Austrian Business Code (Unternehmensgesetzbuch) as well as the Croatian Companies Act (Zakon o trgovačkim društvima; hereinafter ZTD) distinguish between personal companies with individuals closely associated with the business and capital companies aiming at associating capital rather than persons. The ZTD was modelled upon the Austrian and German company law. Not surprisingly, the legal structure of Croatian companies is comparable to the legal structure of Austrian companies.[13] The types of companies which may be established are limited by the *numerus clausus* of the legal forms of companies in Austria and in Croatia. According to Austrian and Croatian company law personal companies include both general partnerships (Austria: Offene Gese-

[13] Barbić, J., *Anpassung des Gesellschaftsrechts der Transitionsländer an das europäische Recht - Beispiel Kroatien*, in: Kalss, S.; Nowotny, Ch.; Schauer, M., Festschrift Peter Doralt, Manz, Wien, 2004, pp. 51 – 75.

llschaft, OG; Croatia: javno trgovačko društvo, j.t.d.) and limited partnerships (Austria: Kommanditgesellschaft, KG; Croatia: komanditno društvo, k.d.).[14]

It is important to point out that the term partnership is used in Austria and Croatia, but it does not have a universal definition.[15] As stipulated by the ZTD the Croatian general and limited partnership have the status of independent legal entities[16] and possess a legal capacity of their own[17], which is not the case in the Austrian system, where the law confers a separate legal status to a general and limited partnership, though they are not legal entities.[18] There is a clear difference between Austria and Croatia in regard to the legal status of general and limited partnerships: Croatia regards general and limited partnerships, i.e. all companies covered by the ZTD as incorporated businesses, meaning that all company types are considered as legal entities. Contrary to Croatia, Austria regards personal companies as unincorporated businesses. At this point it shall be stated that the Croatian Obligations Act (Zakon o obveznim odnosima) regulates a concept of a personal partnership (ortaštvo).[19] Unlike general and limited partnerships which have a legal personality and are covered by ZTD, personal partnerships neither have a legal personality nor do they fall under the general discipline of ZTD. They can be described as a contractual relationship between persons who pursue a common goal. Further, personal partnerships are fiscally transparent and consequently income generated by them is taxed in the hands of the partners participating in personal partnerships. The information provided in connection with personal partnerships serves the

[14] Sections 105 and 161 Bundesgesetz über besondere zivilrechtliche Vorschriften für Unternehmen, Bundesgesetzblatt, no. 43/2016; Article 2 Zakon o trgovačkim društvima, Narodne novine, no. 111/93 – 110/15.

[15] That is the case in numerous countries. There are substantial differences between various countries regarding definitions and characteristics of partnerships. As regards Croatia and the terminological difficulties regarding partnerships please refer to Sladoljev Agejev, T.; Pecotić Kaufman, J., *Legal English in an Advanced Business English Course in Croatia: Identifying and Resolving Ambiguities*, in: Sočanac, L.; Goddard, C.; Kremer, L. (eds.), Curriculum, Multilingualism and the Law, Nakladni zavod Globus, Zagreb, 2009, pp. 407 – 426.

[16] All companies covered by the Croatian ZTD (j.t.d., k.d., d.o.o., d.d., g.i.u.) are legal entities.

[17] Barbić, *op. cit.* in fn. 13, pp. 51 ff.; Article 2 ZTD.

[18] Section 105 in conjunction with Section 119 Bundesgesetz über besondere zivilrechtliche Vorschriften für Unternehmen; Toifl, G.; Schuchter, Y., *Österreich*, in: Wassermeyer, F.; Richter, S.; Schnittker, H., Personengesellschaften im Internationalen Steuerrecht, Dr.OttoSchmidt, Köln, 2010, pp. 1174 – 1217.

[19] Article 637 Zakon o obveznim odnosima, Narodne novine, no. 35/05 – 78/15.

avoidance of ambiguities and terminological confusion. Due to the limitations of this paper, this study only examines personal companies or in other words general and limited partnerships according to ZTD.

III. TAXATION OF PERSONAL COMPANIES UNDER AUSTRIAN AND CROATIAN TAX LAW

Austria and Croatia do not only differ in the field of company law. In fact, the treatment of personal companies under Austrian and Croatian tax law could not be more diverse: under Austrian tax law personal companies are not separate taxpaying entities. They are considered fiscally transparent. Although profits are computed at the level of such companies, Austrian personal companies serve as mere conduits in which the income and losses flow through to individuals participating in those companies and are taken into account on their individual income tax returns as well (i.e. transparency principle). Therefore, the profits of personal companies are taxed at a progressive income tax rate – as far as natural persons are concerned – in the hands of the individuals associated with the company. Each individual is personally liable to income tax on the respective share of the personal company profit, regardless of actual distribution. In sum, under Austrian tax law, shares in personal company profits may be taxed only in the year the profit was earned by the personal company, i.e. year 1. Hence, profit distributions made in subsequent years, e.g. in year 2, are viewed as non-taxable profit withdrawals that had already been taxed in the previous year(s). Consequently, individuals participating in the company are not liable to tax on their profit shares in subsequent years.[20]

In contrast to Austrian tax law, Croatian tax law regards personal companies as opaque entities. Therefore, personal companies are treated as separate taxable entities with the consequence that income is computed and taxed at level of the company. The nature of the personal company tax treatment is equal to the taxation of capital companies in Croatia (e.g. limited liability companies and companies limited by shares). This approach comes as no surprise, because all companies, capital and personal companies regulated by the ZTD,

[20] Mayr, G.; Blasina, H.; Schlager, Ch.; Schwarzinger, M.; Titz, E., *SWK-Spezial Körperschaftsteuer 2014/15*, Linde, Wien, 2014, p. 24; Doralt, W.; Kauba, A., *Section 23*, in: Doralt, W.; Kirchmayr, S.; Mayr, G.; Zorn, N. (eds.), Einkommensteuergesetz Kommentar, 17th ed., Facultas, Wien, 2014, m.no. 283; Doralt, W.; Ruppe, H. G., *Steuerrecht*, Vol. I, 11th ed., Manz, Wien, 2013, m.no. 525; Austrian Ministry of Finance, Express Answering Service, no. 3303 (BMF 23. 11. 2012, EAS 3303).

are separate legal entities and liable to corporate income tax charged on their net profits. Hence, Croatian personal companies are subject to a flat tax rate of 20%.[21] Individuals participating in personal companies are liable to income tax on their share in the profit earned by the companies only after the profit has been distributed to them (i.e. opacity principle). These profit shares constitute income from capital.[22] Therefore it can be stated that Croatian tax law foresees two taxation levels: in the first step, profit realisation is taxed at the level of personal companies in the year the profit is earned; in the second step, profit distribution is taxed in the hands of individuals participating in those companies (i.e. partners).[23]

In conclusion, Austria and Croatia apply different domestic rules governing the tax treatment of personal companies and the classification of entities: while Austria considers personal companies as transparent, non-taxable entities and attributes the income of such companies to individuals participating in them, Croatia treats personal companies similarly to corporations, which means that under Croatian tax law personal companies are considered as opaque and taxable entities.

The different positions of Austria and Croatia with respect to the tax treatment of personal companies have a substantial influence on cross-border transactions. Basically, cross-border transactions between Austria and Croatia require the application of the double tax treaty Austria-Croatia. However, at the level of treaty law, the so-called allocation and qualification conflicts emerge frequently owing to diverging domestic tax laws.

IV. EFFECTS OF DIVERGING TAX SYSTEMS ON THE TREATMENT OF PERSONAL COMPANIES IN TREATY LAW

The following case study aims at identifying how the different tax systems of Austria and Croatia affect the treatment of personal companies in treaty law. The study is based on an example of a Croatian k.d. with an Austrian partner and consists of three parts. First, the treatment of retained profits is demonstrated. Second, the taxation of distributed profits is set out and finally,

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21 Article 2(1) Zakon o porezu na dobit, Narodne novine, no. 177/04 – 50/16; Articles 2 and 4 ZTD.

22 Articles 5, 6 and 30 Zakon o porezu na dohodak, Narodne novine, no. 177/04 – 136/15.

23 The similar taxation principle is applied to capital companies and shareholders of capital companies.

the tax consequences resulting from the alienation of a stake in the k.d. are shown. Although the case study addresses only the participation of Austrian residents in a k.d., the analysis can be applied to participations of Austrian residents in Croatian general partnerships (javno trgovačko društvo) as well and leads to the same results.

Facts of the case:

- A k.d. is established under Croatian law and situated in Croatia.
- The k.d. is founded by two partners: C, the general partner and A, the limited partner. Each partner holds a stake of 50% in the k.d.
- Both partners are natural persons. A resides in Austria and C in Croatia. Under Austrian as well as Croatian tax law unlimited tax liability depends on the domicile of persons. Hence, A has unlimited tax liability in Austria. The same can be concluded for C with regard to Croatia. Consequently, the world-wide income received by A is taxed in Austria.[24] In contrast to the income of A, the world-wide income of C is subject to tax in Croatia.[25]
- The k.d. is engaged in trade and business and has a permanent establishment situated in Croatia.
- A has a share in the profit of the k.d. of EUR 100,000 in year 1 wherein the profit was realised.
- Profit distribution takes place in the following year. Thus, A receives his profit share in year 2.

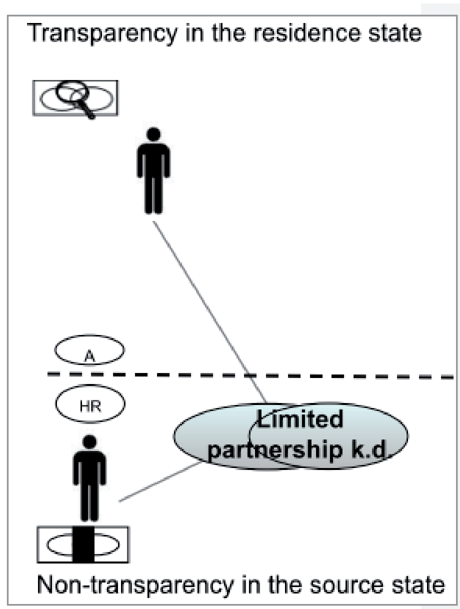

Figure 1: Interest in a Croatian partnership (facts of the case)

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[24] Sections 1(1) and 2 Bundesgesetz vom 7. Juli 1988 über die Besteuerung des Einkommens natürlicher Personen, Bundesgesetzblatt, no. 163/2015.

[25] Articles 2, 3 and 6 Zakon o porezu na dohodak.

Case 1: Taxation of retained profits

a. Treatment of retained profits under Austrian and Croatian tax law

On the basis of the comparability test[26] applied to foreign entities in Austria with the aim of establishing their tax status, the k.d. is classified as a partnership and treated as a transparent entity for Austrian taxation purposes. The reason for this is that the k.d. is comparable to an Austrian limited partnership and thus it is treated in the same way as a domestic entity, i.e. an Austrian limited partnership.[27] Since the k.d. engages in trade and business and therefore generates income from business, it is regarded as a co-entrepreneurship according to Austrian tax law. For Austrian income tax purposes the k.d. is not considered as a separate taxable entity. Hence, the profit of the k.d. is passed through to the partners and is taxed in their hands regardless of actual profit distribution (transparency principle).[28] Due to the fact that the k.d. pursues a commercial activity, the profit shares of the partners are classified as income from other trade or business pursuant to Section 23 of Austrian Income Tax Act (Einkommensteuergesetz; hereinafter EStG). By virtue of Section 1 in conjunction with Section 2 EStG the profit share derived by A – the limited partner – is subject to taxation in Austria in accordance with the principle of world-wide income (unlimited tax liability).[29] Further, this profit share is taxed at a progressive tax rate pursuant to Section 33 EStG, because A constitutes a natural person and a co-entrepreneur under the terms of Section 23(2) EStG.[30]

[26] Austrian Ministry of Finance, Express Answering Service, no. 1756 (BMF 20.11.2000, EAS 1756); no. 2633 (BMF 5.7.2005, EAS 2633); no. 2683 (BMF 21.12.2005, EAS 2683); Körperschaftsteuerrichtlinien (Administrative Guidelines to the Austrian Corporate Tax Act) m.nos. 133 and 1204.

[27] Austrian Ministry of Finance, Express Answering Service, no. 3087 (BMF 21.9.2009, EAS 3087); no. 3303 (BMF 23.11.2012, EAS 3303).

[28] Section 23(2) Bundesgesetz vom 7. Juli 1988 über die Besteuerung des Einkommens natürlicher Personen; Einkommensteuerrichtlinien (Administrative Guidelines to the Austrian Individual Income Tax Act) m.nos. 5802 ff.

[29] Sections 23, 33, 1 and 2 EStG.

[30] Pursuant to Section 23(2) EStG income from other trade and business also includes profit shares of partners of partnerships whose partners are to be regarded as co-entrepreneurs. However, it has to be considered that income derived from a partnership constitutes only business income if the partners are to be regarded as co-entrepreneurs. According to the Austrian Supreme Court of Administration (Verwaltungsgerichtshof; VwGH) this is the case if the partners take risk and/or participate in the decision-making process (for further information see VwGH 23

According to Croatian tax law, the k.d. is considered as a legally independent company for taxation purposes. This means that it is regarded as a separate taxable person. Since the k.d. is situated in Croatia, it is subject to unlimited tax liability by virtue of Article 2 in conjunction with Article 3 of the Croatian Corporate Profit Tax Act (Zakon o porezu na dobit; hereinafter: ZPD).[31] Thus, the profit generated in the financial year is allocated to the k.d. and taxed at a flat profit tax rate of 20%.[32]

In the exercise of their autonomy in the field of income taxes, Austria and Croatia may allocate the profit to the persons regarded as the profit recipient under their tax laws. The problem in this case is that the same item of income – business profit – is allocated to different taxpayers: in accordance with Austrian tax law the profit is attributed to the Austrian resident directly in the proportion of his stake in the k.d. In contrast to Austria, Croatia allocates the profit directly to the k.d. These different approaches, which are rooted in the diverging tax regulations of Austria and Croatia, lead to an allocation conflict with the risk of economic double taxation.

However, taking into consideration the position of Croatia, it can be stated that this is merely a domestic issue: Croatia simply taxes the domestic source income of a resident taxpayer. Therefore, from the perspective of Croatia, the question regarding the application of the DTT A-C does not arise due to a missing cross-border income flow.

As opposed to Croatia, Austria views the issue as a cross-border transaction that demands the application of the DTT A-C; a person resident in Austria derives income from a source in Croatia which is subject to Austrian income tax and to Croatian corporate profit tax as well. Taking into consideration the application of the DTT A-C, it can be stated, that the case at hand is covered by the DTT A-C, as it falls within the personal and material scope of the treaty.[33]

February 1994, 93/15/0163 = VwSlg 6870 F/1994; 29.06.1995, 94/15/0103. Generally partners of general and limited partnerships are considered as co-entrepreneurs.

[31] Article 2 in conjunction with Article 3 ZPD.

[32] Article 28 ZPD.

[33] Articles 1 – 4 Abkommen der Republik Österreich und der Republik Kroatien zur Vermeidung der Doppelbesteuerung auf dem Gebiete der Steuern vom Einkommen und vom Vermögen samt Protokoll, Bundesgesetzblatt, no. 119/2001.

b. Treatment of retained profits in treaty law

In order to address the question of the proper distributive rule, the nature of the business activity of the k.d. or, more precisely, the type of income, has to be considered because the distributive rule hinges directly on the income type. Since the k.d. derives business income from the engagement in a commercial activity, Article 7 DTT A-C has to be applied. As a result, from the perspective of Austria, Article 7 DTT A-C would also be applicable to the profit share derived by the Austrian resident A from its participation in the Croatian k.d.[34] Owing to the transparency-principle, Austrian tax law looks through the k.d. and regards the two partners as carrying on the enterprise instead of the k.d. This means that both, the limited partner A and the general partner C are viewed as the persons carrying on the enterprise and maintaining proportionate permanent establishments in Croatia.[35] In other words, each partner is regarded as having a permanent establishment in Croatia, provided the permanent establishment carries out a business activity and meets the requirements of Article 5 DTT A-C.[36] Moreover, from the point of view of Austria, the k.d. constitutes also an Austrian enterprise within the meaning of Article 3(1)(d) DTT A-C, as the limited partner A carries on the enterprise and resides in Austria.[37] Therefore, Austria would also have the right to tax the profit generated in the k.d. However, the application of Article 7 DTT A-C assigns the taxation right in connection with the profit share of the limited partner A to Croatia, because the profit share is attributable to a permanent establishment situated in Croatia.[38] In application of the exemption with the progression method,

[34] Lang, M., *Personengesellschaften und Doppelbesteuerungsabkommen*, in: Bertl, R.; Eberhartinger, E.; Egger, A.; Kalss, S.; Lang, M.; Nowotny, Ch.; Riegler, Ch.; Schuch, J.; Staringer, C. (eds.), Die Personengesellschaft im Unternehmens- und Steuerrecht, Linde, Wien, 2013, p. 229.

[35] Verrechnungspreisrichtlinien 2010 (Administrative Guidelines to Transfer Pricing 2010) m.no. 276; Austrian Ministry of Finance, Express Answering Service, no. 3303 (BMF 23.11.2012, EAS 3303); Articles 7(1) and 8 DTT A-C.

[36] Austrian Ministry of Finance, Express Answering Service, no. 3217 (BMF 18.04.2011, EAS 3217); Bendlinger, S., *Personengesellschaften im Recht der Doppelbesteuerungsabkommen*, SWI - Steuer- und Wirtschaft International, no. 1, 2000, pp. 16 – 24; Toifl, G., *Personengesellschaften im Recht der Doppelbesteuerungsabkommen unter besonderer Berücksichtigung der gemeinschafts- und abkommensrechtlichen Diskriminierungsverbote*, Linde, Wien, 2003, p. 137.

[37] Lang, M.; Wimpissinger, Ch., *Die Einkünfte von Gesellschaftern einer Personengesellschaft aus abkommensrechtlicher Sicht*, in: Gassner, W.; Lang, M.; Lechner, E. (eds.), *op. cit.* in fn. 2, p. 92; Bendlinger, *op. cit.* in fn. 16, pp. 20 ff.

[38] Article 7(1) DTT A-C.

Austria as the residence state of A, exempts the share in the profit of the Croatian k.d. from taxation and considers this profit share solely for the calculation of the amount of tax on the remaining income of A in Austria.[39]

c. Tax consequences

Basically, the allocation conflict, which was provoked through the diverging tax treatment of the k.d. in Austria and Croatia, would result in a double taxation of the profit share earned by the Austrian limited partner A. Nevertheless, the limited partner does not face double taxation owing to the permanent establishment which produces a "shielding effect" and deprives Austria from taxing the income attributable to this permanent establishment. Article 7 in conjunction with Article 23 DTT A-C ensures that the profit share is exempted from taxation in Austria and thus leads to a consistent taxation of the profit share in Croatia despite an allocation conflict. In effect, the profit share of the Austrian limited partner – apart from the consideration of this profit share for the calculation of the amount of tax on the remaining income in Austria – is solely subject to a Croatian profit tax in the amount of 20%.

Case 2: Taxation of distributed profits

As mentioned above, the profit share of the Austrian limited partner amounted to EUR 100,000 in year 1. However, after a deduction of the Croatian profit tax in the amount of EUR 20,000 (20% of the profit share), the Austrian partner receives a net profit share of EUR 80,000 in the following year (year 2):

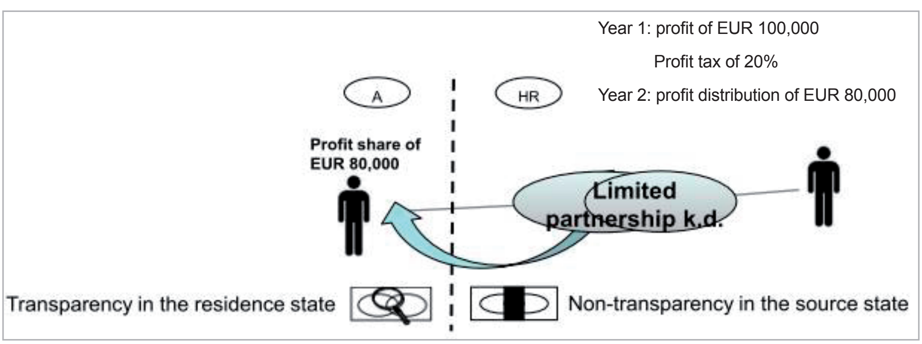

Figure 2: Profit distribution

[39] Article 23(1) DTT A-C.

a. Treatment of profit distributions in Austrian and Croatian tax law

Looking at the things from the perspective of Austria, the profit distribution in year 2 is viewed as a profit withdrawal seeing as the share in the profit of the k.d. had already been considered in the hands of the limited partner A in year 1 (see preceding case). According to the EStG no tax is levied upon the profit withdrawal pursuant to Section 4 EStG in a subsequent year.[40] Consequently, there is a non-taxable event in year 2 in Austria, simply because Austria only taxes one event and that is the earning of profits.

In the perspective of Croatia, the k.d. distributes a profit share treated in the same way as dividends and profit distributions made by corporations, because the k.d. constitutes a legal entity under the ZTD and is treated as a taxable entity under Croatian tax law.[41] Due to the fact that the current Croatian Income Tax Act (Zakon o porezu na dohodak; hereinafter ZPDoh) applies the classical system of corporate taxation, in the event of a profit distribution a tax is levied a second time. Namely the distributed profit share is taxed in the hands of the limited partner A at a flat rate of 12%.[42] As a consequence, the Austrian partner A derives income from capital and is subject to limited tax liability in Croatia.[43]

The diverging taxation concepts of Austria and Croatia do not bear the risk of double taxation in cases of profit distributions made by Croatian personal companies. This results from the fact that Austria views such profit distributions as profit withdrawals upon which no tax is levied. Notwithstanding, the question regarding the applicable Article of the DTT A-C arises, since there is a cross-border transaction between Austria (the residence state of the income recipient) and Croatia (the source state of the profit share respectively the

[40] Austrian Ministry of Finance, Express Answering Service, no. 2683 (BMF 21.12.2005, EAS 2683); no. 3303 (BMF 23.11.2012, EAS 3303); no. 3040 (BMF 11.2.2009, EAS 3040); no. 3018 (BMF 18.11.2008, EAS 3018); no. 2633 (BMF 5.7.2005, EAS 2633).

[41] Schmidt, Ch., *Steuergestaltung bei Direktinvestitionen in Mittel- und Osteuropa durch Einschaltung von Personengesellschaften*, Internationale Wirtschafts-Briefe, no. 2, 1998, pp. 1331 – 1342; Schmidt, Ch., *Steuergestaltung bei Direktinvestitionen in Mittel- und Osteuropa mittels Personengesellschaften*, Internationale Wirtschafts-Briefe, no. 18, 2011, pp. 696 – 704; Dörfler, O.; Pokrovac, Z.; Madl, M., *Vorteilhafte Steuergestaltungen für deutsche Investoren in Kroatien*, Internationale Wirtschafts-Briefe, no. 21, 1997, pp. 1019 – 1024.

[42] Articles 30 and 51 ZPDoh.

[43] Article 4 ZPDoh.

income from capital). Further, in such situations the issue in connection with a credit of the Croatia withholding tax of 12% in Austria is crucial and has to be discussed.

b. Treatment of profit distributions in treaty law

Usually, in cases where dividends are paid to residents of one contracting state by a resident company of another contracting state, Article 10 of the OECD Model Tax Convention (hereinafter OECD MTC) is applied. Due to the fact that the DTT A-C was framed in accordance with the OECD MTC in the version of 1992, Article 10 DTT A-C regulates the taxation rights concerning dividends, i.e. profit distributions between Austrian and Croatian taxpayers. In applying Article 10 DTT A-C, Croatia as the source state may levy a tax at a maximum rate of 15%.[44] As mentioned before, Croatia imposes a tax of 12% on outbound dividends under its domestic law. Since the source tax in Croatia does not exceed the prescribed 15% limit of the DTT A-C, Croatia taxes the dividends in accordance with treaty law.[45]

Despite the classification of the profit distribution as a profit withdrawal under Austrian tax law, Austria is required to apply Article 10 DTT A-C, as well. Strictly speaking, Austria has to follow the position of Croatia regarding the classification of the profit distribution. The reason for this approach lies in the fact that the law of the state of which the company making the distribution is a resident – in the case at hand Croatian law – determines whether the profit distribution constitutes a dividend within the meaning of the DTT A-C.[46] Therefore, the issue whether the requirements of Article 10 DTT A-C are fulfilled has to be analysed under Croatian tax law:[47]

- The k.d. qualifies as a company pursuant to Article 3(1) DTT A-C, because it is treated as a company for tax purposes in Croatia. Hence, the

44 Article 10(2) DTT A-C.

45 Articles 30(11) and 51(4) ZPDoh in conjunction with Article 10(2) DTT A-C.

46 Tischbirek, W.; Specker, G., *Article 10*, in: Vogel, K.; Lehner, M. (eds.), Doppelbesteuerungsabkommen: DBA, 6th ed., CH. Beck, München, 2015, m.nos. 23 and 27; Austrian Ministry of Finance, Express Answering Service, no. 1416 (BMF 8.2.1999, EAS 1416); no. 1228 (BMF 24.7.1998, EAS 1228); no. 1059 (BMF 21.4. 1997, EAS 1059); OECD, *Model Tax Convention on Income and on Capital*, Condensed Version, OECD Publishing, Paris, 2014., Article 10 m.no. 27.

47 Croatian Ministry of Finance, Tax Administration, broj klase 410-01/12-01/3245, urudžbeni broj: 513-07-21/13-2 (Porezna Uprava 12.7.2013).

profit distribution can be classified as dividends within the meaning of Article 10 DTT A-C.[48]

- A cross-border dividend payment within the meaning of the DTT A-C is realised: a separate taxable entity which is regarded as a company pursuant to Article 3(1)(d) DTT A-C and is resident in Croatia pays a profit share to a natural person resident in Austria. In this context the concept of dividends within the meaning of the OECD MTC and the DTT A-C constitutes the decisive element. In order to fall within the scope of Article 10 DTT A-C, a profit-sharing right must possess the nature of a corporate right. In other words, the prerequisite to apply Article 10 DTT A-C is on the one hand the existence of a company and on the other hand, there must be a participation in that company.[49] In the case discussed the profit distribution is caused by a participation in a Croatian personal company which represents a legal entity under Croatian company law. Thus, the Austrian resident is conferred entitlement to the profit share on grounds of his stake in the k.d.

In view of the analysis above, it can be concluded that all prerequisites for the application of Article 10 DTT A-C are fulfilled. Accordingly, Article 10(3) DTT A-C requires Austria to view profit distributions that are made by Croatian personal companies as dividends within the meaning of Article 10 DTT A-C. Consequently, Austria as the residence state of the limited partner entitled to the distributed profit is assigned the taxation right by virtue of Article 10 DTT A-C. Further, Croatia has a limited taxation right, as it constitutes the source state.[50] Nevertheless, Austria is not in a position to exercise the taxation right resulting from the DTT A-C by reason of its domestic provisions which classify the profit distribution as a non-taxable profit withdrawal.[51]

Generally, Austria is bound to credit any withholding tax levied in accordance with Article 10 DTT A-C.[52] However, the classification of the profit dis-

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48 Avery Jones, J. F. *et al.*, *The Definitions of Dividends and Interest in the OECD Model: Something Lost in Translation?*, World Tax Journal, vol. 1, no. 1, 2009, pp. 5 – 45; Aigner, H.-J.; Züger, M., *Sind Entnahmen aus Personengesellschaften abkommensrechtlich "Dividenden"?*, SWI - Steuer- und Wirtschaft International, no. 6, 2000, pp. 254 – 258.

49 OECD, *op. cit.* in fn. 26, Commentary on Article 10 m.nos. 1 ff.; Lang, M., *Introduction to the Law of Double Taxation Conventions*, 2nd ed., Linde, Wien, 2013, pp. 99 and 100.

50 Article 10(1) DTT A-C.

51 Austrian Ministry of Finance, Express Answering Service, no. 3040 (BMF 11.2.2009, EAS 3040); no. 3303 (BMF 23.11.2012, EAS 3303); no. 3018 (BMF 18.11.2008, EAS 3018); Bendlinger, *op. cit.* in fn. 16, p. 24; Lang, *op. cit.* in fn. 14, p. 247; OECD, *op. cit.* in fn. 1, m.no. 137.

52 Article 23(1)(b) DTT A-C.

tribution as dividends in treaty law does not affect the classification of such profit distributions at the level of national law. Strictly speaking, the classification of the profit distribution at the level of treaty law, cannot reclassify the profit distribution as dividends at the level of Austrian national law. The DTT A-C does not constitute a legal basis for the creation of new taxation rights. By reason of this fact, there is no possibility to treat the profit distribution as a dividend or to subject it to taxation in Austria. While the DTT A-C would allow Austria to levy tax on the profit distribution made in year 2, such taxation would be inconsistent with Austria's general tax treatment of personal company income and therefore, it is not permitted by Austria's national law. Under the EStG, there is a non-taxable event, namely a withdrawal from a personal company. As a result, the maximum amount for a tax credit is zero in Austria. Although Austria is bound by the DTT A-C to credit any withholding tax levied according to the treaty, there is no tax against which such a credit would be possible.[53] To conclude, profits distributed by Croatian personal companies to Austrian residents are only taxable in Croatia at a rate of 12%.

c. Tax consequences

In view of the above analysis, the tax consequences for the Austrian partner A, which result from the profit share derived from the Croatian k.d., are summarised in the following tables.

Legal form: Personal company (k.d.) with a seat in Croatia	
Net income before taxes	**100,000**
Profit tax 20%	- 20,000
Profit after tax/amount payable to partners	**80,000**
Withholding tax 12%	-9,600
Net profit share	**70,400**
Total tax burden	**29,60%**

Table 1: Tax consequences in the year of profit distribution in Croatia (year 2)

Legal form: Personal company (k.d.) with a seat in Croatia
Tax-neutral transaction
Profit distribution = non-taxable profit withdrawal
The profit shares attributable to a permanent establishment in Croatia, are exempted from taxation.
The DTT cannot create taxation rights not given under domestic law.

Table 2: Tax consequences in the year of profit distribution in Austria (year 2)

[53] Austrian Ministry of Finance, Express Answering Service, no. 3018 (BMF 18.11.2008, EAS 3018); no. 3040 (BMF 11.2.2009, EAS 3040); Bendlinger, *op. cit.* in fn. 16, p. 24; Kofler, G.; Moshammer, H., *Zurechnungskonflikte bei Personengesellschaften*, SWI - Steuer- und Wirtschaft International, no. 1, 2013., pp. 6 – 17.

Considering the total tax burden which results from participation in a Croatian k.d., it can be concluded that an Austrian limited partner faces a tax expense of 29.6% in the event of profit distribution. Owing to the fact that it is not possible to credit the Croatian withholding tax in Austria, Austrian limited partners are subject to a low Croatian withholding tax of 12% compared to the Austrian tax of 27.5% on dividends.

Case 3: Taxation of alienation of a stake in a k.d.

In the case at hand, limited partner A sells his stake in the k.d. to a natural person resident in Croatia. From this disposal A realises a capital gain in the amount of EUR 100,000.

This scenario is illustrated in the following chart:

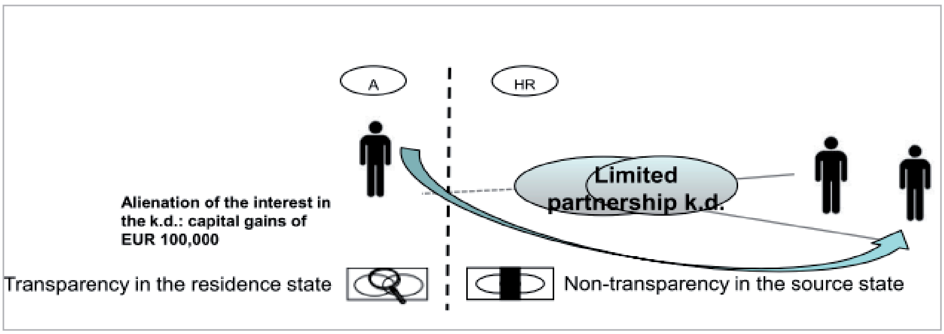

Figure 3: Disposal of the stake in the k.d. by the limited partner

a. *Treatment of alienation of a stake in a k.d. according to Austrian and Croatian tax law*

As already mentioned above, Austria views the partners as carrying on the enterprise and having a permanent establishment in Croatia.[54] Thus, from the perspective of Austria the alienation of the stake constitutes a direct alienation of immovable property forming part of the business property of a permanent establishment situated in Croatia.[55] Hence, Austria regards the capital gain as

[54] Verrechnungspreisrichtlinien 2010 (Administrative Guidelines to Transfer Pricing 2010) m.no. 276.

[55] Doralt, W., *Section 24*, in: Doralt, W.; Kirchmayr, S.; Mayr, G.; Zorn, N. (eds.), *op. cit.* in fn. 20, m.no. 78; Austrian Ministry of Finance, Express Answering Service, no. 2694 (BMF 6.2.2006, EAS 2694); Loukota, H., *Lösung internationaler Qualifikationskonflikte*, SWI - Steuer- und Wirtschaft International, no. 2, 1999, pp. 70 – 78;

attributable to this permanent establishment. By virtue of Section 23 in conjunction with Section 24 EStG, capital gains are subject to Austrian income tax. Due to the fact that the k.d. carries out a commercial activity, the capital gain is classified as income from other trade and business in accordance with Section 23 EStG and taxed at a progressive income tax rate in the hands of the partner.[56] Finally, the partner is entitled to a proportionate tax allowance amounting to EUR 7,300[57] or to certain benefits under the terms of Section 37 EStG.[58]

Conversely, Croatia treats the k.d. as a corporate entity and regards the alienation of the stake in the k.d. as an alienation of a share in a company. Capital gains resulting from the alienation of stakes in a k.d. are regarded as income from capital and taxed at a rate of 12%, provided the capital gains are realised within the speculative period of three years after the acquisition of the stake.[59] Alienations outside the speculative period do not trigger any tax-consequences.

Similar to the foregoing case, a cross-border transaction comes into existence. Both the residence state Austria and the source state Croatia claim a taxation right with respect to the capital gain. However, Austria and Croatia deviate from each other with respect to the classification of the capital gain.

b. Treatment of alienation of a stake in a k.d. in treaty law

For purposes of the DTT A-C, Austria considers the alienation of the stake in the k.d. as a proportionate alienation of the underlying assets of a permanent establishment maintained by the partner in Croatia.[60] Following this line of reasoning and due to the authoritativeness of national law[61], Austria applies

Toifl, G.; Schuchter, Y., *op. cit.* in fn. 18, p. 1187; Austrian Ministry of Finance, Express Answering Service, no. 2846 (BMF 14.5.2007, EAS 2846); no. 3300 (BMF 25.9.2012, EAS 3300).

56 Sections 23, 24 and 33 EStG.

57 Section 24(4) EStG.

58 Section 37 EStG.

59 Article 30(22) ZPDoh.

60 Loukota, *op. cit.* in fn. 34, p. 73.

61 Principles of interpretation according to Article 3(2) DTT A-C; Jirousek, H., *Methodische Ansätze zur Konfliktvermeidung bei der Anwendung von Doppelbesteuerungsabkommen*, in: Lang, M.; Jirousek, H. (eds.), Praxis des internationalen Steuerrechts, Linde, Wien, 2005, pp. 178 ff.

Article 13(2) DTT A-C. For the sake of completeness, it should be mentioned that in the event of alienation of immovable property forming part of a permanent establishment, Article 13(1) DTT A-C would be applicable. As a result, Croatia is attributed the taxation right concerning capital gains derived from the alienation of underlying assets of a Croatian permanent establishment. Austria as the residence state of the alienator generally would have to exempt the capital gain from taxation according to Article 23 DTT A-C. In sum, Croatia would be entitled to tax the capital gains.

Croatia, on the other hand, regards the alienation of the stake in the k.d. as akin to the alienation of a share in a company. Therefore, capital gains from the alienation of stakes in personal companies fall under Article 13(4) DTT A-C (property other than that referred to in paragraphs 1, 2 and 3 of Article 13 DTT A-C). Hence, in Croatia's view, Austria has the exclusive right to tax the capital gain, because it constitutes the residence state of the alienator of the stake in the k.d. according to Article 13(4) DTT A-C.[62]

The differences in the treatment of the stake alienation result in the fact that Austria and Croatia apply different distributive rules with respect to the same item of income. Consequently, a so-called classification conflict arises. In contrast to the foregoing cases the case at hand would lead to double non-taxation of the income in question.

Although, the avoidance of double non-taxation cannot be considered as a clear objective of a DTT at the moment[63], it is a key objective of the Austrian as well as Croatian administrative practice of tax authorities to combat double non-taxation.[64] Moreover, Article 23(1)(d) DTT A-C contains a subject-to-tax clause for the purpose of elimination of double non-taxation.[65] However, since the publication of the OECD Partnership Report and the following revised commentary, the avoidance of double non-taxation can be derived from Article 23(1) DTT A-C as well.[66] The OECD commentary on the Model Tax Con-

[62] OECD, *op. cit.* in fn. 26, Commentary on Article 13 m.nos. 29 ff.; Friganovic, M., *Otuđenje kapitalne imovine*, Računovodstvo i porezi u praksi, no. 11, 2007, pp. 15 – 22.

[63] Lang, M., *Die Vermeidung der Doppelbesteuerung und der doppelten Nichtbesteuerung als DBA-Auslegungsmaxime?*, Internationales Steuerrecht, 2002, pp. 609 – 613.

[64] Austrian Ministry of Finance, Express Answering Service, no. 2694 (BMF 6.2.2006, EAS 2694); no. 3304 (BMF 23.11.2012, EAS 3304); Croatian Ministry of Finance, Tax Administration, broj klase 910-01/14-01/193, urudžbeni broj: 513-07-21-11/14-02 (Porezna Uprava 3.9.2014).

[65] Article 23(1)(d) DTT A-C.

[66] OECD, *op. cit.* in fn. 26, Commentary on Article 23A and 23B m.nos. 32.6 ff.

vention serves as an interpretation aid in connection with double tax treaties for both, Austria and Croatia.[67] Therefore, both countries deal with qualification conflicts in agreement with the OECD commentary.[68]

Even though the allocation conflict is induced by the differences in the domestic provisions of Austria and Croatia[69], it can be eliminated according to the explanations in the OECD commentary and by applying Article 23(1)(a) DTT A-C. Article 23(1)(a) DTT A-C provides the following:

"Where a resident of Austria derives income or owns capital which, in accordance with the provisions of this Agreement may be taxed in Croatia, Austria shall, subject to the provisions of subparagraphs b) to d) and to paragraph 3, exempt such income or capital from tax."

This paragraph is interpreted in the sense, that the capital gains may not be taxed in Croatia in accordance with the provisions of the DTT A-C. This is due to Article 13(4) DTT A-C which prevents Croatia from taxation. Austria is obliged to exempt the capital gains from taxation only in the event that those gains may be taxed in Croatia in accordance with the DTT A-C. However, in the scenario addressed, this is not the case and the qualification conflict would lead to a double non-taxation of the capital gain. Consequently, Austria is not required to exempt the capital gains from taxation.[70] In the light of those argu-

[67] Jirousek, H., *Doppelbesteuerungsabkommen Österreich-Kroatien*, Österreichische Steuerzeitung, no. 22, 2000, pp. 661 – 663; Lang, M.; Simader, K.; *Doppelbesteuerungsabkommen Österreich-Kroatien*, Linde, Wien, 2012, Protokoll, Auslegung des Abkommens m.nos. 12 ff.; Loukota, H.; Jirousek, H., *Internationales Steuerrecht*, Manz, Wien, 2015, I/1 Anhang pp. 293 ff.; Jirousek *op. cit.* in fn. 40, p. 182; Austrian Ministry of Finance, Express Answering Service, no. 1728 (BMF 5.10.2000, EAS 1728); no. 1441 (BMF 15.4.1999, EAS 1441); no. 3338 (BMF 24.9.2013, EAS 3338); no. 2899 (BMF 29.10.2007, EAS 2899); Croatian Ministry of Finance, Tax Administration, broj klase 410-01/14-01/706, urudžbeni broj: 513-07-21-01/14-02 (Porezna Uprava 1.4.2014); broj klase 410-01/13-01/2326, urudžbeni broj: 513-07-21-01/13-2 (Porezna Uprava 16.9.2013); Polanec, M., *Porezni tretman dohotka u ugovorima o izbjegavanju međunarodnog dvostrukog oporezivanja koje je zaključila Republika Hrvatska*, Pravnik, vol. 39, no. 81, 2005., pp. 101 – 112; Houška, M., *Prekogranične dividende i udjeli u dobiti*, Porezni vjesnik, no. 6, 2012, pp. 82 – 94.

[68] Austrian Ministry of Finance, Express Answering Service, no. 3087 (BMF 21.9.2009, EAS 3087); no. 3071 (BMF 23.6.2009, EAS 3071); Cipek, K.; Uljanić, I., *Metode za izbjegavanje dvostrukog oporezivanja u sustavu poreza na dohodak*, Porezni vjesnik, no. 11, 2012, pp. 37 – 53.

[69] Art 3(2) DTT A-C.

[70] OECD, *op. cit.* in fn. 26, Commentary on Article 23A and 23B m.nos. 32.6 ff.; Austrian Ministry of Finance, Express Answering Service, no. 2846 (BMF 14.5.2007,

ments, it can be stated that the approach taken by the source state constitutes the decisive element when the question of the exemption of certain income in the event of qualification conflicts arises: in the case the source state is prevented from taxation, the residence state does not have to exempt the income from taxation and *vice versa*.

c. Tax consequences

As set out above, the qualification conflict is resolved by a teleological reduction of Article 23(1) DTT A-C. As a consequence, Austria retains the taxation right with regard to the capital gain. This leads to taxation of the capital gain at a progressive tax rate pursuant to Section 33 in conjunction with Section 23 and 24 EStG.[71] From the perspective of Austrian residents, this means that they are exposed to the higher Austrian tax rates compared to the Croatian withholding tax of 12%. Even in the case of alienation outside the Croatian speculative period and the related non-taxation in Croatia, the same scenario would result as the decisive element in such a case, as well, is the fact that the DTT A-C deprives Croatia from the right to tax the capital gain. The question whether Croatian domestic law provides for taxation of the capital gain, or not, is irrelevant in this context.[72]

V. COMPARISON OF TAX BURDENS RELATED TO DIRECT INVESTMENTS IN CROATIAN PERSONAL AND CAPITAL COMPANIES

A substantial part of Austrian residents conduct business activities in the form of capital companies situated in Croatia.[73] However, despite the risk of liability with respect to stakes in personal companies and unresolved issues

EAS 2846); no. 3300 (BMF 25.9.2012, EAS 3300); no. 3304 (BMF 23.11.2012, EAS 3304); Pamperl, E., *Die Methoden zur Vermeidung der Doppelbesteuerung in den österreichischen DBA (Art 23 OECD-MA)*, in: Lang, M.; Schuch, J.; Staringer, C. (eds.), Die österreichische DBA-Politik, Linde, 2013, p. 322; Kofler, G.; Lüdicke, J.; Simonek, M., *Hybride Personengesellschaften – Umsetzung des OECD Partnership Reports in Deutschland, Österreich und der Schweiz*, Internationales Steuerrecht, no. 10, 2014, pp. 349 – 366.

[71] Austrian Ministry of Finance, Express Answering Service, no. 2611 (BMF 6.5.2005, EAS 2611).

[72] Austrian Ministry of Finance, Express Answering Service, no. 2846 (BMF 14.5.2007, EAS 2846); no. 2375 (BMF 21.11.2003, EAS 2375).

[73] *Advantage Austria*, http://www.advantageaustria.org/hr/Oesterreich-in-Kroatien.de.html (1st February 2016).

regarding the treatment of such companies in international tax law, a personal company situated in Croatia may yield substantial tax benefits compared to shares in Croatian corporations.

1. Profit distribution

The tax benefits which can be enjoyed by Austrian natural persons by way of participation in Croatian personal companies are listed in the table below. It demonstrates the tax burden in the case of a stake in a Croatian k.d. and the tax consequences resulting from a share in a limited liability company situated in Croatia.

Legal form	**Croatian limited partnership (k.d)**	**Croatian limited liability company (d.o.o)**
Net income before taxes	**100,000**	**100,000**
Croatian profit tax 20%	- 20,000	-20,000
Profit after tax	**80,000**	**80,000**
Payable amount	80,000	80,000
Croatian withholding tax 12%	-9,600	-9,600
Austrian income tax	0	-22,000 (80.000 x 27.5%)
Creditable Croatian tax	0	9,600
Net profit share	**70,400**	**58,000**
Total tax burden	**29,600 (29.6%)**	**42,000 (42%)**
Tax burden in Austria in the event of alienation of a partnership stake	Progressive tax rate (0% – 50%)[74]	Special tax rate 27.5%

Table 3: Comparison of tax burdens related to direct investments in Croatian personal and capital companies

To begin with, profit shares paid by a Croatian limited liability company to Austrian natural persons are regarded as income from capital and are subject to a flat rate of 27.5%.[75] Croatian tax provisions stipulate that profit distribu-

[74] Austrian Income Tax Law provides also for an income tax rate of 55%. However, this tax rate is applied only to income exceeding EUR 1 million for the period between 2016 and 2020.

[75] Sections 1, 27, 27a and 93 EStG.

tions are taxed at a flat rate of 12%. This withholding tax may be credited in Austria, provided Austrian tax law foresees a tax liability for such profit distributions. This is exactly the case when Austrian residents derive profit shares from Croatian corporations. Such profit shares are subject to Austrian tax at the rate of 27.5%.[76] As a result, Austrian partners face a tax burden amounting up to 42% (20% Croatian profit tax and 27.5% Austrian income tax). An examination of the calculation above reveals that there are clear tax benefits from participation in a Croatian personal company: owing to the fact that Austrian tax law treats profit distributions made by Croatian personal companies as tax-neutral profit withdrawals, Austrian partners realise a tax benefit in the amount of 12.40% compared to shares in profits from investments in Croatian corporations.

Second, in the event of alienations of stakes in Croatian personal companies, Austrian partners are subject to taxation at a progressive income tax rate. However, when realising capital gains from the alienation of shares in Croatian corporations, the special tax rate of 27.5% is applied.[77] Thus, in the case of high capital gains derived from the alienation of stakes in Croatian personal companies, Austrian partners may face significant additional tax expenses in comparison to alienations of shares in Croatian corporations.

2. Croatian personal companies *versus* capital companies

As mentioned at the beginning, Croatian capital companies are a popular vehicle for Austrians investing in Croatia. Basically, this results from liability limitations in connection with those entities. However, in many respects using a Croatian personal company for an investment may be beneficial. For example, setting up a personal company is simple. Further, Croatian personal companies are comparable to Austrian personal companies (partnerships) with respect to their structure and economic purpose.[78] Moreover, a combination of different types of entities (capital and personal companies) is also permitted in Croatia. Hence, Croatian law recognises also the most common type of combined entities in Austria which is the GmbH & Co KG (limited partnership with a corporate general partner). Therefore, members – natural persons

[76] Article 23(1)(b) DTT A-C.

[77] Sections 27(3) and 27a EStG.

[78] Barbić, *op. cit.* in fn. 13, p. 51; Rimac, L., *Unternehmensgründung in Kroatien*, Eastlex, no. 1, 2004, pp. 4 – 7.

– of Croatian personal companies can limit their liability for the debts of the personal company by including another company (e.g. limited liability company) acting as the general partner. Such a personal company with a corporate general partner is regarded as co-entrepreneurship in Austrian tax law. As a consequence, in practice members may profit from interesting tax planning opportunities.[79]

From a tax point of view there are no differences between capital and personal companies in Croatian tax law. However, as shown by the examples above, Austrian residents may achieve significant tax benefits from investments in Croatian personal companies.

VI. CONCLUSION

Foreign direct investments in Croatian personal companies cause qualification and allocation conflicts if the foreign investments stem from countries treating personal companies as transparent and thus non-taxable entities for taxation purposes, which, for example, is the case in Austria. On the one hand, the results obtained from the study above indicate that from a company law perspective Austria and Croatia do not differ regarding the structure and legal status of personal companies. However, in terms of tax law, there is a substantial difference between the two countries, because Austria treats personal companies as non-taxable entities, whereas Croatia regards personal companies as taxable entities. This difference in the tax treatment of personal companies is the main trigger for qualification and allocation conflicts in cross-border transactions. On the other hand, the findings reveal that qualification and allocation conflicts can be solved by applying the corresponding provisions of the DTT A-C as well as considering the interpretation given in the OECD commentary on certain provisions. Moreover, the study demonstrated that foreign investors may take tax benefits of qualification and allocation conflicts. Based on these results, my assertion is that qualification and allocation conflicts stemming from participations in Croatian personal companies should be taken into account by Austrian, i.e. foreign investors when compiling tax planning strategies.

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79 Wiedermann, K., *Die GmbH & Co KG im internationalen Steuerrecht – Ausgewählte Fragestellungen in der ertragsteuerlichen Praxis*, in: Arnold, N., *et al.*, Die GmbH & Co KG, Gedenkschrift für Wolf-Dieter Arnold, Linde, Wien, 2011, p. 303; Mayr *et al.*, *op. cit.* in fn. 20, p. 21.

Despite the qualification and allocation conflicts Croatian personal companies offer advantageous tax planning opportunities for Austrian investors: allocation conflicts arise in years when Croatian personal companies earn profits and retain them, due to the fact that the same profits are allocated to different taxpayers under Austrian and Croatian tax laws. Nevertheless, such allocation conflicts do not have consequences for Austrian residents, provided that profits are attributable to a permanent establishment situated in Croatia. In such a case Austria is required by the DTT A-C to exempt those profits from taxation.

Further, at the level of national tax laws, qualification conflicts occur in the event of profit shares derived by Austrian residents from Croatian personal companies. Croatian tax law views such profit shares as income from capital, which is subject to withholding tax of 12%. In contrast to Croatia, Austria regards such profit shares as non-taxable profit withdrawals. However, at the level of treaty law a qualification conflict does not come into existence, because the law of the state in which the personal company distributing the profit is situated determines whether the profit share constitutes a dividend according to treaty law. The state of the income recipient has to follow the income classification of the personal company state. Therefore, Austrian residents who derive profit shares from Croatian personal companies benefit from the Croatian withholding tax of 12%.

The analysis above has unveiled that the different approaches taken by Austria and Croatia in connection with the tax treatment of personal companies may lead to negative qualification conflicts as well. The avoidance of negative qualification conflicts is often connected to a subject-to-tax clause leading to taxation of income in Austria. Considering the relatively high Austrian tax rates compared to Croatian tax rates, such scenarios may cause substantial tax disadvantages for Austrian residents. In particular, this is true of capital gains derived by Austrian residents from the alienation of stakes in Croatian personal companies.

It can be said that in certain constellations, Croatian personal companies can serve as tax planning instruments for Austrian residents. The DTT A-C as well as the favourable Croatian tax conditions open up possibilities for Austrian investors to profit from substantial tax savings through participations in Croatian personal companies. There are still practical taxation issues in connection with qualification and allocation conflicts, but in the light of the results presented above, it can be concluded that the DTT A-C in connection with the OECD commentary grants legal certainty to a large extent.

At the level of company law Croatian personal companies create many benefits for Austrian residents: due to the similarities between the company law of Austria and Croatia, on the whole, the legal structure and the founding process of Croatian personal companies are well known to Austrian residents. Croatian personal companies are subject to the same corporate tax rate of 20% as Croatian capital companies. Consequently, there is no difference in the tax treatment of those companies in Croatia. However, the setting up of personal companies in comparison to capital companies is less expensive, due to the fact that Croatian company law does not foresee capital requirements for the foundation of personal companies. In this context it should be considered that investors having a stake in a personal company generally bear unlimited liability for the debts of the company, whereas in the case of stakes in a capital company investors are commonly not personally liable for the debts of the company. This disadvantage of personal companies, however, may be compensated, for example, by establishing a mixed personal company, where a limited liability company acts as the general partner bearing unlimited liability, whereas Austrian investors act as limited partners. In such a case Austrian investors only bear limited liability to creditors of the personal company.

Finally, another advantage of direct investments in Croatian personal companies is the offset of tax losses under Austrian tax law. Namely, there is the possibility to offset losses incurred by Croatian personal companies against other income in Austria provided the losses are not taken into account in Croatia for taxation purposes.

Sažetak

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IZRAVNE INVESTICIJE U HRVATSKA DRUŠTVA OSOBA – POREZNA PITANJA

Bilateralni ekonomski odnosi između Austrije i Hrvatske iznimno su važni za obje države: više od četvrtine stranih izravnih investicija u Hrvatskoj potječe iz Austrije. Austrija je najveći ulagač u Hrvatskoj. Iako hrvatski pravni okvir nudi različite mogućnosti za investicije, austrijski rezidenti preferiraju ulaganja u hrvatska društva kapitala. Austrijski rezidenti koji obavljaju poduzetničku djelatnost u obliku društava osoba osobito mogu steći znatne porezne pogodnosti. Razlog za porezne pogodnosti su austrijski i hrvatski porezni sustavi koji se u temelju razlikuju što se tiče poreznog tretmana društava osoba. Unatoč poreznim pogodnostima, različiti porezni sustavi mogu izazvati različite sukobe u slučaju primjenjivanja ugovora o izbjegavanju dvostrukog oporezivanja, takozvane qualification and allocation conflicts*. Nadalje mogu prouzrokovati dvostruko oporezivanje ili situaciju u kojoj obje države ne oporezuju prihod. U tom kontekstu je otvoreno pitanje kako ustanoviti porezne pogodnosti unatoč problemima vezanim uz primjenjivanje ugovora o izbjegavanju dvostrukog oporezivanja. U radu se prikazuju sukobi koji nastaju primjenjivanjem ugovora o izbjegavanju dvostrukog oporezivanja između Austrije i Hrvatske u slučaju ulaganja austrijskih rezidenata u hrvatska društva osoba. U radu su detaljnije prikazana rješenja za sve pronađene vrste sukoba i porezne pogodnosti koje rezultiraju ulaganjem u hrvatska društva osoba.*

Ključne riječi: Ugovor između Republike Hrvatske i Republike Austrije o izbjegavanju dvostrukog oporezivanja, austrijski porez na dohodak, hrvatski porez na dobit, društva osoba, komanditno društvo, OECD Partnership Report

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