

FINANCIAL SERVICES AND VALUE ADDED TAX IN CROATIA**FINANCIJSKE USLUGE I POREZ NA DODANU VRIJEDNOST U
REPUBLICI HRVATSKOJ**

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Abstract: *This paper presents value added tax treatment of financial services. We investigated status of financial services in VAT system in Croatia till 1st January 2010 and after 1st January 2010 in order to reveal changes. Results show that Croatia is still in adjustment process of its legislation (tax treatment of financial services) with the European Union provisions. Our paper thus provide description of problems in implementation of VAT on financial services as well as possible solutions towards greater legal safety and efficiency for entrepreneurs.*

Key words: *financial service, value added tax, tax exemption, Croatia*

Sažetak: *U ovom radu prezentiran je tretman financijskih usluga porezom na dodanu vrijednost. Istražen je položaj financijskih usluga u sustavu PDV-a do prvog siječnja 2010. godine i nakon prvog siječnja 2010. godine u cilju utvrđivanja promjena. Rezultati pokazuju da je Hrvatska još uvijek u procesu usklađivanja legislative (poreznog tretmana financijskih usluga) sa odredbama Europske unije. Ovim radom ukazuje se na probleme pri implementaciji PDV-a na financijske usluge kao i na moguća rješenja u cilju veće pravne sigurnosti i efikasnosti za poduzetnike.*

Ključne riječi: *financijska usluga, porez na dodanu vrijednost, porezno izuzimanje, Hrvatska*



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1. Introduction

Today the value added tax is the most dominant type of general sales taxation in many countries. Value added tax is calculated and it has to be payed in all phases of production and sales cycle in way that in each phase only the amount of newly created value is taxable. That is the reason why the synonym "net all phase general sales tax" is used for value added tax [1]. Value added tax has many advantages by comparison with retail sales tax and other types of sales tax [2]. Those are neutrality of value added tax in entrepreneurial field, credit method of tax collection and decrease of tax evasion, absence of cumulative effect and wide tax base and revenue abundance. The neutrality of value added tax in entrepreneurial field is defined by its transfer on end consumer. One of the advantages of value added tax by comparison with other types of sales taxation is far wide volume of taxable transactions.

1.1. Types of value added tax

Depending on tax treatment of assets which the entrepreneur is buying from a supplier, there are three types of value added tax [1]: production type, income type and consumption type. By first type of value added tax the amount spent for fixed assets (machines, buildings) is not deducted from tax base. Tax base consists of personal consumption and gross investments. In that way this tax type is not stimulated for investments in capital goods. Disability of deduction leads to double taxation of capital goods: once when those goods are purchased and second time when final products are sold to the final consumer. By income type of value added tax personal consumption is taxable as well as net investments. Although negative effects are smaller by comparison with production type, they are still present. Tax base by consumption type of value added tax is a total personal consumption. That type has a positive impact on fixed assets increase and also on the entire economic activity of national economy.

1.2. Methods of value added tax calculation

When calculating tax base of value added tax further methods can be used [2]: deduction method, summation method and credit method or method of indirect summation. By the first method tax payer is calculating a tax base in way that he deducts the total amount of its consumption from the total amount of sales and multiply with the prescribed tax rate. By second method of value added tax calculation all elements of price are summed up. In this case added value is determined directly. By credit method of value added tax calculation the invoice is a base for value added tax collection. The main advantages of this method are decreased possibility for tax evasion, determining tax base for each transaction and ensuring quality base for control of tax calculation and payment.

2. Status of financial services in VAT system

In almost all countries which apply VAT, financial services are usually exempted from VAT taxation. Croatian system of VAT applies tax exemptions on financial services

deliveries, but in a different way. That specific tax treatment of financial services in Croatian system of VAT last from 1 January 1998 till 31 December 2009.

2.1. Status of financial services in VAT system till 1st January 2010

Croatian approach to tax exemption of financial services was presented in June 1995 when Croatian parliament brought the VAT Act, by which the mentioned tax was introduced in Croatian tax system. Bank services, savings banks services, insurance and reinsurance companies' services have been exempt from VAT. That exemption was extended on Croatian national bank and the exemption is conditioned just for those institutions whose business is arranged by special regulation [3]. If financial services are made by entrepreneurs that are not a bank, savings bank or insurance and reinsurance companies, those are taxable. The essence of institutional exemption is providing financial services and not the character of the financial service. The consequence of those regulations is that the identical service is sometimes taxed and sometimes not. For example, the advisory service that was provided by "regular" nonbanking company is taxable while it was provided by bank, it is exempt. In order to be competitive to institutional exempted companies, other companies can decide to decrease their own profitability for that tax burden. In both ways it is evident that institutional exemption puts in preferential tax position financial institutions. When it is about deliveries to business subjects, the VAT is neutral for entrepreneurs – delivery receivers due to fact that they can deduct VAT receivables. But despite that, that is additional financial burden for entrepreneur and has impact on its liquidity. That is the reason why entrepreneurs are liable to identical bank deliveries. When we consider deliveries to nonresidents it is evident that bank and regular company as service suppliers are in the same situation. The delivery from bank is not taxable issue no matter who is on the side of service receiver. On the other side the service delivery of regular company to nonresidents in most cases is not taxable. That means that the mentioned service will be taxed in the country of service receiver, which is foreign business subject – receiver has to apply the reverse charge mechanism of taxation and calculate VAT on received service, no matter by whom service was provided. All above mentioned can be applied in case of interests, but with some additional specificities. In fact, the interest as a fee for financing was taxable till 31 December 2009. Tax base consisted of interest and if it was lower than 6%, tax basis was the interest of 6% annual. From January 2006 that percentage was decreased on 4%. But the interest taxation depends on tax status of the person that charges the interest, that is if interest is charged by tax payer, it will be taxable, and vice versa. Exception from this rule exists in case of financial funds investments in banks and savings banks from tax payers. In this case the interest is not taxable. It is about logical exception for interests by deposits of tax payers. As a consequence of prescribed institutional exemption, banks and savings banks haven't been considered as a permanent tax payer and weren't recorded in the register of tax payers. So, mentioned institutions didn't have possibilities to deduct VAT receivables. There are significant distortions caused by institutional exemptions in practice. One of the key principles of VAT is that the same service has to be taxed in the same way. By previously mentioned problems the neutrality of VAT is degraded.

2.2. Status of financial services in VAT system after 1st January 2010

Possibly the most important novelty that arise from the new VAT Act is about cancellation of institutional exemptions of financial services. In accordance with the Directive 2006/112/EC functional exemptions of financial services were introduced into Croatian tax system. That means that for tax exemption the character of financial service is important. Following is exempted from VAT payment loan approval, contracting of credit guarantees, transactions in connection with current accounts, savings accounts, shares etc., and services of investment funds management [4].

3. Problems in implementation of VAT on financial services and possible solutions towards greater legal safety and efficiency

Due to institutional exemption there was no need for considering of financial services. Obscurity of regulations and the absence of practical experiences, represented additional burden to financial institutions and other providers of financial services by implementing functional exemption of financial services. Two main problems in that process should be isolated. Firstly determination of correct tax status of financial services and secondly the question of VAT deduction. When we talk about possible solutions in order to improve existing position of financial services in Croatia, the key role and responsibility in this process should be transferred to tax authorities. The approach should include more active role of tax authorities in finding solutions which will help business subjects. As possible solutions, in order to ensure higher level of legal security and efficiency for suppliers of financial services but also for tax administration, there are following measures [5]:

- adopting of new regulation or procedures which will define tax exemptions for financial services in detail,
- allow abjuration from the right to deduct vat receivables without legal penalty,
- enable the right to deduct vat receivables for financial services provided in foreign countries,
- introduce the arrangements of cost distribution,
- extend the option for taxation, and
- enable the creation of VAT classes.

Creation of one collective document which will define the application of tax exemptions is logical solution towards increased legal security of financial services providers. That type of document will significantly contribute to cost reduction. All parties should be involved in creation of that document. They should investigate economic essence of financial transactions and analyse foreign practice and solutions. Providers of financial services should be allowed to give up from the right to VAT receivables deduction. Smaller financial institutions are affected by current solution because they are forced on additional administrative costs which exceed financial effects of VAT receivables deduction. Expected positive effects on government revenues should encouraged tax authorities to bring that measure. In order to equal

position of Croatian providers of financial services with European competitors it should be able to Croatian subjects the right to deduct VAT receivables for financial services that are provided in foreign countries. By this, competitiveness of Croatian providers on global financial market will be increased. Expected negative impact on national budget, will be replaced by increased engagement of Croatian subjects in foreign countries. Current regulations about taxation possibilities are very tight and with too many restrictions. Introducing taxation possibilities on the basis of certain transaction will help providers to optimize their right for VAT receivables deduction and the cascade tax effect will be minimized. The main positive effect will be the increased base for direct taxes calculation. The most of those measures is already incorporated in national tax systems of many EU member countries, or it is foreseen as a part of tax treatment of financial services reform. By adopting of this measures Croatia would enter the group of countries with stimulating legal framework for financial services providing. It would be a country that manage and develop actively it's the most abundant tax form.

4. Conclusion

Croatia can't be satisfied with the general consideration of VAT system functioning regarding financial services. Initially the good VAT system was constantly deteriorated instead upgraded with solutions that will follow practical needs of tax payers and simplify its application. Since VAT was introduced in Croatian tax system financial services had special tax treatment. Despite all negative characteristics of institutional exemptions of financial services, after twelve years of application the exemption of financial services under functional principle was introduced. It is very unexplainable that in situation when European Union proposes new regulation towards modernization of existing financial services tax treatment, Croatia adjusts its legislation with provisions from 1977. Instead Croatia can learn from foreign experiences and mistakes, Croatia attempts to learn on its own mistakes. Considering the region, Croatian financial sector is considered the most developed. In forthcoming period, and especially when Croatia will enter European Union, it is expected further development of financial industry and increase of its portion in Croatian GDP (gross domestic product).

5. References

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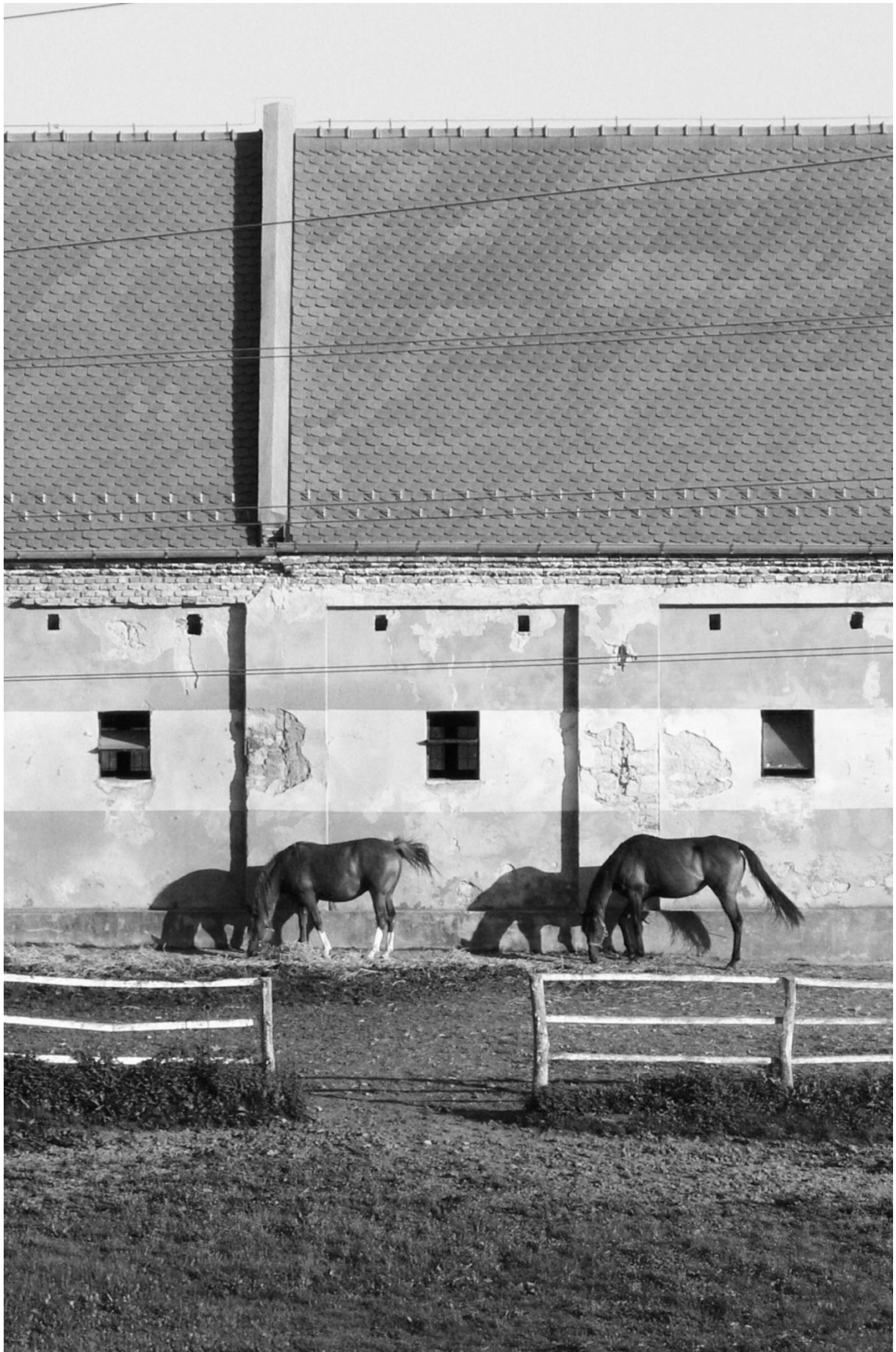


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