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Screening report

Croatia

Chapter 16 – Taxation

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I. CHAPTER CONTENT

The **indirect taxation** *acquis* consists primarily of harmonised legislation in the field of Value Added Tax (VAT) and excise duties. *Value Added Tax* was first introduced in the Community in 1967, eventually leading to the Sixth VAT Directive from 1977 and still in place today. It includes the application of a non-cumulative general tax on consumption. This is levied on all stages of production and distribution of goods and services. The VAT *acquis* provides for an equal tax treatment of domestic and non-domestic (import) transactions. VAT is also based on the neutrality principle whereby the tax applied is proportional to the price, whatever the number of intermediate transactions.

In the field of *excise duties* the *acquis* contains harmonised legislation as regards energy products, tobacco products and alcoholic beverages. Community legislation establishes the structure of the duty that should be charged, together with a system of minimum rates for each product group. Goods are subject to duty when they are produced within the Community or imported from a third country. However, in principle, the duty is payable only to the Member State in which the goods are released into consumption (with certain limited exceptions), and at the applicable rates in that Member State. The EU legislation lays down provisions on production, holding, movement and monitoring of excisable. As a result of the introduction of the single market, all systematic fiscal controls at the Community's internal frontiers were abolished by 1 January 1993. As regards excise products, their holding and movement for commercial purposes within the Internal Market continued to be closely monitored to establish the chargeability of the duty.

The *acquis* in the area of **direct taxation** concerns certain aspects of profit taxes and capital duty. The focus is on eliminating distortions for cross-border economic activities between enterprises within the Union. It also includes provisions to ensure effective taxation of income from savings in the form of interest payments made to individuals. The *Code of Conduct* for business taxation represents a political commitment by Member States to tackle harmful tax measures. Member States are required not to introduce new harmful tax measures, and to roll-back existing ones.

The Community legislation in the field of **administrative co-operation and mutual assistance** between Member States' tax and customs authorities provides tools share information in order to circumvent tax evasion and tax avoidance. It allows gathering information about tax subjects, both automatically and on request.

The *acquis* in area of **operational capacity and computerisation** covers different areas of taxation. In the field of VAT, the *acquis* on the Value Added Tax Information Exchange System (VIES) provides for direct electronic interchange of data between national VAT administrations within the timeframe established in the relevant EU legislation. This allows national administrations to monitor and control intra-Community trade and detect possible irregularities. In addition, a specific IT system (VoeS) is required to establish the inter-connection for exchange of information among Member States related to the special scheme for e-Services provided by non-EU traders to EU citizens. Regarding excise duties, the EU *acquis* requires IT systems to allow Member States exchanging information on producers and traders of excisable products (SEED, MVS, EWSE and EMCS, the latter being under development). In the area of direct taxation Member States are required to put in place an automatic system for the exchange of information of savings income in the form of interest payments through an electronic standardised format.

II. COUNTRY ALIGNMENT AND IMPLEMENTATION CAPACITY

This part summarises the information provided by Croatia and the discussion at the screening meeting. Croatia accepted the *acquis* regarding Taxation and stated not to expect difficulties to implement the *acquis* by the time of accession. However, Croatia indicated it would request transitional periods in certain areas.

The General Tax Act (OG 127/00, 86/01 and 150/02) constitutes the foundation of the tax system in the Republic of Croatia. It governs tax relations between taxable persons, on the one hand, and tax authorities on the other. In addition, there are special tax laws relating to specific types of taxes, such as the Corporation Tax Act, the Income Tax Act, and the Value Added Tax Act. The General Tax Act covers public levies (taxes, customs duties, contributions, fees) and unless the law prescribes otherwise, the Act on General Administrative Proceedings is applied to the procedure used by the tax authorities in the implementation of tax legislation.

The total tax revenues, excluding social charges, account for approximately 25% of GDP. More than half of the tax revenues are received via VAT. Revenues generated by value added tax and excise duties flow into the central budget, whereas personal income and corporate taxes are distributed between national, county and local level based on a distribution percentage. Furthermore, Croatia applies taxes at county level, such as tax on inheritances, gifts, road motor vehicles, vessels, and amusement machines.

Local taxes are levied on, for example, holiday houses, uncultivated agriculturally cultivable land, unused entrepreneurial real estate, undeveloped building land, trade names and use of public land. Municipalities or cities can introduce the following taxes: surtax on income tax and consumption tax. Revenues derived from the Act on Real Estate Transfer Tax (OG 69/97, 26/00 and 153/02) are a joint source of income for central and local government.

As regards *institutional and administrative capacity*, the main bodies are the Croatian Tax Administration and the Customs Administration within the Ministry of Finance. They are responsible for the drafting of proposals for changes to tax policy and legislation, as well as implementation of tax legislation. The Tax Administration conducts offence proceedings of first instance. Both the Tax Administration and the Custom Administration are managed by Director Generals, who are at the same time Assistant Ministers of Finance. Croatia informed that the Tax Administration has 3926 employees of which 181 employees at the Central Office in Zagreb. There are 20 regional and 122 local offices. The tax audit is managed by the Tax Audit Division within the Central Office of the Tax Administration. The Customs Administration also has its Central Office in Zagreb and 12 regional Custom Houses. It has currently 3089 officers and employees and is responsible for the control of imports, exports or transit of goods, and for the excise duties.

A single *appeal* procedure applies to all types of taxes. It is governed by the General Tax Act and the General Administrative Procedure Act. In 2005, there were 9105 appeals of which 2582 were passed to the second instance body; of these 613 appeals were accepted and 1969 rejected. The Administrative Court dealt with 682 cases.

II.a. Indirect taxation

Croatia introduced a **Value Added Tax** system on 1 January 1998. This replaced a cumulative tax on turnover of goods or services. The legislation consists of the Act on VAT (OG 47/95 and subsequent amendments) and the Regulation on VAT (OG 60/96 and subsequent amendments). According to Croatia, its legislation is based on the EU Sixth Council Directive (77/388/EEC).

The standard VAT rate is 22%. In addition, Croatia applies zero and 10 percent reduced rates. Under Croatian law a taxable person is defined as any business entity – a legal or natural person supplying goods or services. Public authorities are also considered taxable persons when engaged in an economic activity. As regards the taxable scope, the law applies to goods and services supplied -for consideration- by a taxable person in Croatia, as well as to imports. The taxable amount is deemed to be the consideration for goods or services domestically supplied or the customs value in case of imports. Consideration includes everything the recipient of goods or services is required to pay, excluding the amount of tax.

As a general rule, the place of taxable transactions is the location where the taxable person has established her/his business. For every supply of goods or services, taxable persons must issue an *invoice*, with a mandatory content.

Leasing or letting immovable property for housing purposes is exempt from VAT. The sale of real estate constructed before 1 January 1998 is not subject to VAT. Real estate constructed after this date and supplied by a taxable person is subject to VAT. Subject to taxation is not only the first supply of such an immovable property constructed after 1 January 1998, but every subsequent transaction by a taxable person that is entitled to tax deduction for the same immovable property. Land, whether improved or not, is not subject to VAT. Furthermore, a range of institutions and organizations is exempted from paying VAT on their supply of goods and/or services, provided that their activities are carried out in accordance with relevant laws and regulations. These include the activities of banks, savings or insurance institutions, gambling businesses, medical service persons or institutions, organizations for welfare and social security, public cultural institutions, independent artists and artistic organizations, schools or universities, religious communities and institutions, as well as the supply of gold carried out by the Croatian National Bank, payment instruments in domestic and foreign currency, cash receivables, securities and shares. Croatian business entities with annual revenues below HRK 85,000 are not considered to be taxable persons.

VAT on imports of goods is assessed and collected by the Customs Administration. Goods which are exempt from domestic VAT are not subject to VAT on imports either. Furthermore, the list of VAT exemptions on import includes: the temporary import of customs duty exempt goods and final import of humanitarian aid, the import of gold carried out by the Croatian National Bank, payment instruments in domestic and foreign currency, securities and shares, import of goods for personal use in personal passenger luggage to the value of HRK 300.00, the import of goods by post and other deliveries free of consideration received by a natural person to the value of HRK 300.00, the import of advertising material and samples, the import of used household goods and personal items while moving into the Republic of Croatia, the import of trademarks, patents, models and accompanying documentation relevant to the protection of copyrights and industrial property, the import of documents and data carriers, services linked to the import of goods when the value of such services is included in the taxable base of imports, transportation services supplied in Croatia by the Croatian Railways, goods in transit through the customs territory of the Republic of Croatia, including services of transport and other dispatch services, the re-import of unchanged goods carried out by the exporter, own work from scientists, artist and writers; goods inherited by Croatian and foreign residents; medals, rewards and gifts received under international relations; agricultural and stock farming products supplied in Croatia by nationals of the Republic of Croatia living in border areas from their farms located in another country; goods given in the form of donations to humanitarian organizations, medical, educational, cultural, scientific, religious and social institutions, amateur sports clubs, and bodies of state and local government. Goods imported by these entities, when financed with foreign donations, are also exempted.

Furthermore, the Act on the Rights of the Croatian Homeland War Veterans and Family Members allows for VAT free import of passenger cars by the families of the diseased, imprisoned or missing Croatian veterans. Disabled war veterans are allowed the same benefit equaling the percentage of the physical disability. Croatian veterans have the right to import orthopedic aids, spare parts and consumable materials used therein, as well as the equipment for business activity without paying VAT.

The Act on the Legal Status of Religious Institutions provides for exemptions of VAT on imports of goods from foreign religious institutions and legal and natural persons intended for religious practice.

Exempted from VAT are also the export of goods and processed goods, including transportation and dispatching services, the supply of goods (export) into free zones, free and customs warehouses, the supply of goods and services to diplomatic and consular missions under the condition of reciprocity, the supply of services to foreign undertakings involved in maritime, air or river transportation, the supply of goods and services to humanitarian organizations and other institutions and bodies of public government, financed with donations received from abroad. Croatia does not deem temporary export of goods as export for tax purposes.

Taxable persons without a registered business establishment or private residence in Croatia and participating at trade fairs only, without supplying goods or services, are entitled to tax refunds.

Croatia informed it is preparing to have its legislation in the field of VAT aligned by mid 2008. However, it indicated that certain elements may require more time to be implemented and that transitional periods may be requested.

Croatia introduced **excise duties** in 1994. The legislation is laid down in a number of acts per product category, as well as in implementing regulations. Other relevant legislation includes the General Tax Code, the Customs Act, and the Offences Act. In 2002 the responsibility for excise duties was transferred from the Tax Administration to the Customs Administration, which is also an organisation within the Ministry of Finance. On 1 October 2003, the Service for Excise Duties was established as a new organization within the Customs Administration. Croatia has some production and storage environment where duties are suspended.

The tax liability incurs at the moment of dispatch or shipment, or for imports at the moment the customs debt arises. The excise duty is chargeable either at production, or at import. Taxpayers self-assess the amount and pay within 30 days after the date of delivery. In principle, for imports, the excise duty is assessed and collected within 30 days after the incurrance of the customs debt. In the case of tobacco products there are some differences. A tax payer can request a refund or apply for additional payment.

Excisable, imported goods (of foreign origin), stored in free zones, are not subject to excise duty. The tax debt arises at the moment of supply of the products from the free zones into the customs territory of the Republic of Croatia.

Croatia's legislation as regards *alcoholic beverages* is based on the Act on Excise Duty on Alcohol of 1994, lastly amended in 2001, the Wine Act of 2003, as well as implementing regulations. Subject to taxation are alcohol (ethyl alcohol obtained through fermentation) alcoholic beverages (containing more than 2% alcohol and sold in bottles or other suitable packaging and labelled as alcoholic beverages) and wines. Denatured alcohol (by prescribed

means, or imported from abroad as such) is exempt. On alcohol contained in wine Croatia applies a zero tax rate. Production for own consumption is liable to taxation at a quantity exceeding 20 litres of absolute alcohol per year. Products for exportation are exempted. The Ministry of Finances is responsible for labelling alcoholic beverages, with the exception of wines which are labelled by the Croatian Institute for Viticulture and Oenology. Import and export is subject to approval of the Customs Administration.

Croatia has a separate act for excise duty on beer (OG 51/1994), as amended in 2001, as well as related implementing legislation. Subject to taxation are all types of beer produced or imported to the customs territory of Croatia, irrespective of alcohol volume, type, ingredients and other features. Beer is defined as a refreshing drink obtained from water, malted barley, yeast, non-malted grains and from hops, irrespective of the concentrations of extract in the malt or in the concentration of alcohol in the beer. Non-alcoholic beer is defined as having an alcohol percentage below 0.5%, and is taxed at a lower rate. The taxable amount is based on the amount of hectolitres. Taxable persons are breweries, brewers for own consumption if they produce more than 1500 liters of beer annually per agricultural household, and importers. Payment of the tax is based on self-assessment due within 30 days after delivery in the case of production, or customs clearance in the case of imports. Exempt of taxation is the quantity of 0.5% of a loss that occurred in a warehouse or during transport. The tax authorities verify conformity of payment of excise duties with consumed raw materials, the quantity of beer and stocks; tax deductible technological loss; quantity of beer obtained after dilution of concentrated beer; and mandatory records.

Tobacco products' legislation is based on the Act on Excise Duty on Tobacco Products of 1994, lastly amended in 2004, the Tobacco Act of 1999, as well as related implementing regulations. Tobacco products include cigarettes, cigars, cigarillos, pipe and smoking tobacco, snuff, chewing tobacco and other tobacco products. Based on quality, organoleptic features, technical finish, packaging and labelling, they are classified into four groups with different tax rates: A – popular, B – standards, C- extra, and OTP – other tobacco products suitable for smoking. The tax liability incurs when the fiscal marks are taken over. The excise duties are exclusively specific. Tobacco products for export are tax exempt. Excise duties on unused or damaged fiscal marks can be refunded, but on lost fiscal marks the excise duty has to be paid. The Ministry of Agriculture, Forestry and Water Management is responsible for this tobacco classification, as well as monitoring the quality of tobacco products. The Ministry of Finance is responsible for issuing the excise duty stamps. Producers and importers must report intended changes in price to the Ministry of Finance 30 days in advance. The Ministry of Finance modernized its facilities to combat illegal sales of cigarettes. Croatia stated that these measures resulted in a higher receipt of excise duties.

Oil derivatives legislation is based on the Act on Excise Tax on Oil Derivates (55/2000) as amended in 2006 (OG 57/2006). Other related laws are the Public Roads Act (2004), the Act on State Grants for Agriculture, Fishery and Forestry, the Act on Oil and Oil Derivatives Market, as well as implementing regulations. Subject to taxation are (un)leaded motor gasoline, diesel fuel, Eurodiesel diesel fuel with blue dye (or Blue Diesel), heating oil, jet fuel and aviation gasoline, liquefied petroleum gas, and all types of petroleum. The loss of oil derivatives incurred at the producer's and at the tax payers wholesale storehouses, are also subject to taxation, with the exception of loss caused by *force majeure*. The amount of excise duty for Blue Diesel, heating oil (light, medium and heavy), and jet fuel and aviation gasoline is zero. The excise duty on motor gasoline and diesel fuel includes a fee for financing the construction and maintenance of public roads. On 24 May 2006 amendments to the Law on Excise Tax on Oil Products (57/2006) came into force. As a result excise duty rates can be adjusted by Government directly through implementing legislation. From 1 January 2006 leaded petrol is no longer allowed to enter the Croatian market, but some

supplies remain. Croatia defines the tax base as 1 litre of oil derivative at 15 degrees Celsius, or 1 kilogram of oil derivative. The tax liability is incurred at the moment of delivery from the producers'/wholesalers' warehouse, at the moment when the customs debt arises, or when loss is determined. Exported products and deliveries to taxpayers' warehouses are exempted from duties. Oil derivatives are not exempt from excise duty in free zones. However, a taxable person may store oil derivatives in his own wholesale storehouse free from excise duty if reported to the competent authorities on forehand. Croatia marks heating oil red. Motor fuel for agricultural machinery at commercial farms, and for fishing vessels and machinery used in aquaculture, are marked blue.

As regards *other excise duties* a law on excises of coffee (NN 87/2005) came into force on 1 September 2005. To combat illegal trade of coffee a labelling system has been introduced. Passenger cars, motorcycles, vessels and aircrafts are subject to excise duties. In addition, a special sales tax is applied to these goods when domestically sold as second-hand. Furthermore, luxury products, such as jewelry, watches, furs and reptiles wear, as well as footwear, fireworks and arms, are liable to excise duties at 30% of the tax base. Excise duties on luxury goods are to be paid within 10 days after the end of the calendar month. Excise duties are also levied on non alcoholic beverages.

Croatia informed it is preparing to have its legislation in the field of excise duties aligned towards the end of 2008. However, it indicated that certain elements may require more time possibly resulting in requests for transitional periods.

Both the Customs Act and the General Tax Code provide for appeal procedures.

II.b. Direct Taxation

Croatia stated that the non-discrimination principle is applied between residents and non-residents as regards personal income tax. Its Personal Income Tax Act (OG 177/04) states that residents (defined as any individual having domicile or habitual residence in Croatia) are liable to income tax based on their income earned in Croatia and abroad. Croatia uses a worldwide income principle or unlimited tax liability. The credit method is used for income tax paid abroad. Non-residents are liable to personal income tax based on their taxable income in the Republic of Croatia (source of income principle or limited tax liability). The taxable amount of income for both residents and non-residents is the total amount of income reduced by personal allowances. However, non-residents are not granted the increase of personal allowances for dependent members of their intermediate families, housing and medical care, or expenses for tax deductible insurance premiums paid.

As regards to profit tax, the Profit Tax Act (OG 177/04, 90/05 and 57/06) is the main piece of legislation. The tax rate is fixed at 20% for all types of businesses, including investment funds other than open investment funds. The tax base is calculated on the basis of the Accounting Act (2005) and International Accounting Standards. Income of an individual becomes liable to profit tax if the total turn-over is larger than 2 million HKR; if the income (profits) exceeds 400.000 HKR; if the assets value higher than 2 million HKR; or if the individual employs more than 15 persons.

Croatia has concluded 40 double taxation agreements, including with all EU Members States, except for Portugal and the Republic of Cyprus. The OECD model is used. The agreements provide, for example, for reduced for withholding tax rates on interest and royalties, application of the transfer pricing rule, and a method for avoiding double taxation.

The Croatian Profit Tax Act ensures that no tax is levied at the time of a transaction covered by the Merger Directive. The Croatian legislation provides for deferral of taxation in purely domestic situations for mergers, acquisitions, or divisions resulting in a split-up and split-off. In these cases the book value is rolled over without changes in valuation of assets and liabilities. Croatia intends to have its legislation aligned by the end of 2008, by extending the transactions to cross-border situations, though achieving implementation may take longer.

Croatia does not levy withholding taxes on interest and royalty payments made between resident companies. A withholding tax of 15% is applied on interest and royalty payments to non-residents. This withholding tax may be reduced to 0%, 5%, or 10%, depending on the respective Double Taxation Agreement. No source taxation is provided in the agreements with France, Malta, Hungary and the Netherlands. Interest from government and corporation bonds and interest paid to foreign banks is exempt. Croatia informed that it defines royalties in line with the OECD Model Convention. Where interest and royalty payments are received by a resident Croatian company, double taxation is avoided by the credit method. Croatia plans to have its Profit Tax Act amended by the end of 2008. However, it believes more time could be needed to reach full alignment.

In the area of the Parent-Subsidiary Directive, profits are only subject to taxation at the level of a subsidiary. No withholding tax is levied on dividend distributions to domestic or foreign parent companies. At the level of the parent company, double taxation is avoided by exempting the received dividends.

Dividends are tax exempt, both from foreign or domestic sources. They are regulated by the provisions of the Companies Act (111/93, 34/99, 118/03). Croatia provided a definition of dividend by referring to double taxation agreements. Dividend is defined as the distribution of profits to the shareholders by companies limited by shares, limited partnerships with share capital, limited liability companies or other joint stock companies.

The Personal Income Act does not apply any withholding tax on interest on *savings* earned by non-resident nor residents individuals. Croatia informed its legislation has no legal restrictions for providing exchanges of information with EU Member States on interest payments. By the date of accession Croatia expects to have its legislation fully aligned, as well as the exchange of information requirement applied.

Croatia does not apply any capital duties, or any similar taxes on the raising of capital.

Croatia indicated not to introduce any harmful tax measures and to adopt the principles of the *Code of Conduct* as a whole. Croatia has not delegated any discretionary powers to local tax authorities on changing tax rates. Imposing, abolishing, and introducing exemptions require legislation. Croatia stated its legislation does not include a legal base to allow for creating individually negotiated tax holidays at company level.

Croatia applied fiscal state aid (see also screening report on Competition), in the form of reduced liability on income and corporate tax, that is mainly related to the free zones, the organised industrial zones and the technology development zones, as well as economically deprived areas. Croatia informed that in 2005 and 2006 the regime of relief, exemptions and incentives regulated by Profit Tax Act was changed in order to align it with the EC fiscal state aid rules. In 2005 the first step relieves and exemptions were deleted from the Profit Tax Act and transferred under jurisdiction of the ministries responsible for areas of special government concern, hills and mountains areas and the territory of the city of Vukovar. The second step towards alignment was made in May 2006 by way of deleting the exemptions and incentives for research & development, employment and training from the Profit Tax

Act. Croatia allows for accelerated depreciation in the area of research & development to reduce the tax base. The responsibility for preparing further adjustments to the mentioned areas was transferred on to the Ministry of Science, Education and Sport and the Ministry of Economy, Labour and Entrepreneurship.

II.c. Administrative co-operation and mutual assistance

Croatia informed it does not have legislation regarding the *acquis* on administrative cooperation and mutual assistance. Nevertheless, it does not expect any difficulties with the acceptance and implementation of the *acquis* in this area.

Croatia indicated that *combating fraud* is coordinated at the Central Office of the Tax Administration, but that activities are also carried out by regional offices. In addition, Croatia introduced a Financial Police organisation that became operational at the beginning of 2006. It is an administrative organisation, employing 95 people, that falls under the responsibility of the Ministry of Finance. It is managed by a Director, who is equally Assistant Minister. He also runs the Central Office in Zagreb. The Director is appointed and removed from office by the Government, upon a proposal by the Minister of Finance. There are regional financial police stations in Zagreb, Split, Zadar, Rijeka and Osijek. The Financial Police Act (OG 78/99) lays down audit responsibilities for all budgetary revenues, with a special focus on excise duties in close cooperation with the Customs Administration. However, as its administrative capacity is under development, the customs administration has remained active for the moment. Coordination between the two organisations is regular.

Since 2001 Croatia is a member of the Intra-European Organization of Tax Administrations (IOTA). Using IOTA communication channels, Croatia requests and provides information with its members. Since 2004 Croatia has initiated bilateral cooperation with several Member States (Austria, France, the Netherlands and Slovenia). The most intensive cooperation has been established with the Netherlands throughout the MATRA pre-accession program for the "Risk Analysis" project. As regards administrative cooperation in the field of direct taxation, Croatia applies 40 double taxation agreements. These agreements are based on the OECD Model Tax Convention on Income and Capital. The treaties provides for exchange of information on direct taxation; on request, automatically and spontaneously. In practice the exchange of information is mostly on request. Also, a mutual agreement procedure is included to resolve any questions on interpretation and/or application.

II.d. Operational capacity and computerisation

The Tax Administration has recently developed an IT strategy, including preparations for EU-compatible IT systems. As regards VAT, Croatia is modernizing its computer infrastructure to prepare interconnectivity and interoperability with the EU IT systems, allowing electronic exchange of VAT information with EU Member States. Croatia is working towards completion of these preparations by end of 2008.

Concerning excise duties, the Excise Movement Control System (EMCS), including a register of certified excise duty warehouse keepers and registered traders, is planned in line with the *acquis*. The IT support applications for excise duties will become part of the IT system of the Customs Administration. Croatia is preparing physical interoperability and interconnectivity with the EU. A gateway (Common Communication Network / Common System Interface) will be installed at the Customs premises.

The IT maintenance is mainly outsourced to private companies.

III. ASSESSMENT OF THE DEGREE OF ALIGNMENT AND IMPLEMENTING CAPACITY

The overall structure of tax legislation is similar to the EU standards and has reached a satisfactory level of alignment at this stage of negotiations. However, significant efforts are needed to accelerate gradual alignment to close remaining gaps and ensure application and enforcement of the *acquis*.

As regards *institutional and administrative capacity*, the Croatian Tax Administration needs to have the systems, procedures and personnel to implement and enforce the *acquis* in this chapter so that continuation of a homogeneous and harmonised approach in the EU will be ensured. The Croatian Tax Administration must continue to guarantee that tax revenues are accurately collected, accounted, disbursed, reported and audited. This requires development of policies, systems, procedures, technologies and instruments compatible with the EU requirements and standards. Preparations to strengthen the administrative capacity are well under way. The functioning of the newly established Financial Police requires close monitoring. In addition, the management and control of the high number of free zones in Croatia requires attention.

III.a. Indirect Taxation

Croatia's **Value Added Tax** system follows the main structure of the legislation of the EU. However, there are a large number of discrepancies. As regards the taxable scope, VAT legislation needs to also include Croatia's free zones in the fiscal territory. On taxing final use and consumption within the free zone Croatia uses a structure that deviates from the EU. The EU exempts goods temporarily stored in the free zone but taxes final use and consumption in such zone. Concerning taxable transactions, samples and gifts of small value for business purposes should not be considered as supplies for consideration and, in the field of supplies for private use, some terminology has also to be harmonised.

The threshold for the registration of taxable persons is more than double the level defined in the *acquis*. Although Croatia's legislation does not include the concept of a taxable person 'acting as such', acts carried out in its capacity as a private person are not taxed. Public authorities are considered taxable persons when engaged in an economic activity.

Croatia's list of imports exemptions is partly in line with the *acquis*. Some exemptions are not, however, covered under Croatian law, such as the import of fish caught at sea or imports of goods by charity organisations, health, educational, cultural, scientific, religious and social institutions, sports clubs and government and local self-government bodies, financed from pecuniary donations received from abroad. On the other hand, Croatian law exempts some groups, which the *acquis* does not. For example, the families of diseased, imprisoned or missing Croatian veterans are exempt from paying VAT on certain products, such as passenger cars.

In the field of place of taxable transactions Croatia's legislation on the supply of immovable property is not in line with the *acquis*. The place of taxation regarding supplies of goods on board ships, aircrafts or trains, supplies and handling of gas and electricity, telecommunications, radio and TV broadcasting services and e-services have to be harmonised with the *acquis*.

For imports of goods the taxable amount is yet to be defined as taxable amount including all expenses incurred up to the first place of destination in the country and the taxable amount for services supplied for non-business purposes is to be defined as the cost of services.

Croatia introduced a uniform reduced VAT rate of 10% for the tourism sector (NN 90/2005). This eliminated an element of discrimination (previously a rate of 0% for foreign tourists applied compared to 22% for domestic tourists), but the 10% rate is not in line with the *acquis*. Significant steps are required as concerns the elimination of zero VAT rates on food, drugs, books, etc. In July 2005, Croatia prolonged the period for VAT refund from 15 to 30 days. Significant steps are required to introduce VAT refund also to non-established traders.

Croatia applies a considerably wide range of exemptions that will need to be brought into line with the *acquis*. Moreover, Croatia does not apply special schemes for travel agencies, second-hand goods, works of art, collector's items and antiques, investment gold and electronically supplied services to end customers by taxable persons not established within the Community, as required under the *acquis*.

Croatia should also align its invoice requirements to the *acquis*.

In the field of **excise duties** Croatia has reached a limited level of alignment. The system of excise duties requires substantial changes regarding for example product coverage, excise duty chargeability, moment of chargeability, accompanying administrative documents, supplies for personal needs, losses and shortages, rates and duty suspensions, refunds, exemptions, etc. Croatia should adapt its duty suspension system (with registered warehouses, authorised warehouse keepers, registered and non-registered traders, guarantees, etc), identify its excise products by means of Combined Nomenclature codes and align the taxable amounts.

On taxing final use and consumption within the free zone Croatia uses a structure that deviates from the EU. The latter exempts goods temporarily stored in the free zone but taxes final use and consumption in such zone.

The *acquis* permits the use of excise duty stamps for fiscal purposes, provided that these are also made available to warehouse-keepers in other Member States and that they do not give rise to trade barriers or extra border formalities and that the general provisions of Directive 92/12/EEC are respected, in particular as regards the moment at which the excise duty becomes chargeable. In accordance with Article 6 of this Directive, this is the moment at which the products are released for consumption, even if the products carry tax markings.

Croatia taxes all *alcoholic beverages* with an alcohol content of more than 2%, whereas the EU legislation taxes products with alcoholic content starting from 1.2%.

As regards beer, Croatia uses hectolitres as the tax base to levy excise duties on beer, whereas the EU uses the strength of the beer (percent of alcohol per hectolitre beer) or the Plato degree as a base. In addition, Croatia allows a special duty for beer produced for own consumption and taxes beer with a strength of not more than 0.5% which is not foreseen under the *acquis*.

On *wine*, the taxable products should be identified by means of the Combined Nomenclature codes as in the EU legislation.

Croatia should introduce the concept of intermediate products in its legislation, based on the *acquis* provisions. On *alcohol products*, the definitions on such products should be aligned to the *acquis* and they should be identified by means of Combined Nomenclature codes. In addition the rates and reduced rates should be harmonised with the *acquis*. The concept of small distilleries, which can benefit from reduced duties, is to be legally fixed. Finally, a number of exemptions will have to be aligned with the EU legislation.

On *tobacco products*, Croatia does not apply an ad valorem duty on cigarettes, nor is the excise duty calculated on the basis of the Most Popular Price Category. Moreover, the taxation structure on tobacco products, including the tax base and the definitions, as well as the minimum rates, must be brought in line with the *acquis*.

Furthermore, exemptions on denatured or reprocessed manufactured tobacco and some other provisions, for example the different treatment of importers and manufacturers with regard to tax liability and the advance approval of price changes, have to be harmonised.

In Croatia, the tax liability incurs when stamps are taken over. However, in the EU the liability incurs at the moment of release for consumption.

As regards *energy products*, alignment is at an early stage. Further harmonisation is needed in defining the products and the scope of taxation, in particular taking into account the purpose definitions provided for in Directives 92/12 and 2003/96. The products should be identified by means of Combined Nomenclature codes. Croatia uses a marking system (blue and red) for oil derivatives at a lower rate. This mixing of two systems is not in line with the *acquis*. The level of taxation of the different products has to be harmonised. As Croatia applies duty rates which are significantly below the minimum levels required in the *acquis* the minimum tax rates have to be adjusted. A number of exemptions (e.g. environmental friendly use, energy intensive business, and biomass), refunds provisions and guarantees for domestic deliveries need to be harmonised.

Croatia keeps a record of taxable persons, but not yet conform Directive 2003/96. Croatia needs to adjust its list of obligatory and non-obligatory exemptions to the *acquis*.

Croatia levies excise duties on coffee and on luxury products, which the *acquis* does not prescribe. However, neither does the *acquis* prevent levying these excise duties provided that this does not give rise to barriers in the free circulation of products within the EU or to systematic border controls.

III.b. Direct Taxation

As regards personal income tax, the application of the non-discriminatory principle inscribed in the *acquis* needs to be monitored closely.

Croatia needs to transpose Directive 2003/48/EC (Savings Directive) and be prepared to exchange information on interest payments to individuals with all the Member States and with the 9 dependent and associated territories that have requested reciprocity. During the transitional period of the Savings Directive, Croatia will have to grant full credit for the withholding tax levied on interest payments made to its residents in Austria, Belgium and Luxembourg (as well as in 6 of the above mentioned dependent territories and in the 5 non-EU European countries having agreed equivalent measures with the Community - Switzerland, Liechtenstein, Andorra, Monaco and San Marino-). In this context, Croatia will also have to:

- Examine if the Annex to the Savings Directive has to be completed as far as Croatian entities are concerned;
- Conclude bilateral agreements for the same measures as those of the Directive with the 10 dependent or associated territories (those mentioned above plus the Cayman islands), in accordance with the models agreed by Member States meeting within the EU Council to this purpose;

- Confirm to Switzerland, Liechtenstein, Andorra, and San Marino the political commitments taken by Member States within the Memorandums of Understanding joined to the Community agreements on taxation on savings with these non-EU European countries;
- Apply the provisions of Article 15 of the agreement on taxation of savings between the Community and Switzerland as far as dividends, interest and royalties payments between associated companies are concerned; and
- Communicate its competent authorities for the application of the Agreements with Switzerland, Liechtenstein, Monaco, Andorra and San Marino.

As regards corporation tax, Croatia's level of alignment is limited.

Croatia's alignment on the Parent Subsidiary Directive is well advanced. No withholding tax is levied for dividend distributions by Croatian companies to Croatian or foreign parent companies. Croatia's tax structure ensures that there is no double taxation by unconditionally applying the exemption method for dividends received from both domestic and foreign sources. This is in line with the Parent-Subsidiary Directive.

The alignment on the Merger Directive has reached a satisfactory level. The Croatian Profit Tax Act ensures that no tax is levied at the time of execution of the transactions covered by the Merger Directive for domestic operations. The Croatian legislation provides for deferral of taxation, as does the *acquis*. However, the Croatian rules only apply to domestic situations and therefore need to be extended to cross-border transitions with Member States as provided by the *acquis*.

Upon accession at the latest, Croatia should have transposed the Interest and Royalties Directive and have eliminated its withholding taxes on interest and royalties payments. As regards taxation on the raising of capital by companies, Croatia has no capital duty and therefore fully complies with the *acquis* in this area.

As regards the *Code of Conduct*, Croatia's indication not to introduce new harmful tax measures will need to be monitored. Preparations for the adoption of the Code of Conduct require a further in-depth analysis on potentially existing harmful measures in Croatia. However, the reduced tax liability for business activities in economically deprived areas and free zones needs to be brought in line with the *acquis*.

With regard to deferral of losses, the Croatian tax legislation is in line with the *acquis* as far as deferring tax liability from the time of transaction, takeover, or the moment of a loss incurred. However, special tax rules that apply to domestic situations need to be applied in the same way for cross-border transactions with Member States.

III.c. Administrative co-operation and mutual assistance

Croatia has started applying mutual assistance for the recovery of taxes with a number of Member States through bilateral cooperation. Administrative cooperation in the fight against fraud in the field of direct taxation is established through bilateral treaties. This provides a degree of preparedness for alignment. Croatia does not have any legislation regarding the *acquis* on mutual assistance and administration.

III.d. Operational capacity and computerisation

Croatia has sufficient awareness of the necessities to prepare interconnectivity and interoperability with the physical tax infrastructure of EU Member States, through parallel planning of related legislation requires attention. Croatia is preparing for EU-compatible IT systems, but it needs to further develop its systems in order to allow the exchange of computerised data between the EU and the Tax (and Customs, with regard to excise duties) administration upon accession.

As regards *computerisation* in the field of VAT, Croatia is preparing for the development of the IT systems allowing interoperability and interconnectivity with the EU systems. Croatia should also ensure that the exchange of the information among Member States related to the special scheme for e-Services provided by non-EU traders to EU citizens, is in place and inter-connected with EU systems

Regarding excise duties, Croatia is preparing to have an infrastructure that allows physical interoperability and interconnectivity with the EU systems. This should allow Member States to exchange information on producers and traders of excisable products (SEED, MVS, EWSE). The use of a Common Communication Network (both Common Communication Network mail and Common System Interface mail) will need to be integrated in the infrastructure of the Tax and Customs Administrations. In developing the Excise Movement Control System (EMCS) a timely alignment of the *acquis* (Directive 92/12) on the suspension movement needs to be taken into account.

In the area of direct taxation, Croatia needs to prepare an IT system allowing the exchange of information on income received by non-residents on savings products.

Croatia will also need to prepare for exchange of all other forms in the taxation domain. For example, the Croatian taxation information needs to be integrated in the Tax Inventory available on the "Europa" website.