

TAX EXEMPTION AND TAX RELIEF IN PROFIT TAX SYSTEM OF THE REPUBLIC OF CROATIA

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ABSTRACT

The importance of the analysis of tax exemption and profit tax system of the Republic of Croatia legislation derives from the fact that these have not been regulated by a single legislation i.e. Profit Tax Act and Profit Tax Ordinance but also other legal provisions presented in this paper. Extraordinary tax advantages in free trade areas, highland areas and areas of special state care and tax advantages for investment incentives have been analyzed.

In spite of the current need for retaining particular tax advantages for areas with low economic potential and other tax incentives for economic potentials stimulation as well as for reducing economic problems that our state has encountered, these incentives have been gradually reduced so that the legislation in these areas needs to be well laid out in order to avoid legal insecurity.

JEL classification: H20, K34

Key words: taxpayer, tax base, tax exemption, free trade areas, special state care, investment incentives

1. INTRODUCTION

Based on fiscal sovereignty a state affects economic power of its citizens. Natural persons are obliged to pay personal income tax whereas legal persons pay corporate profit tax. As well as taxation of income and corporate profit tax is familiar with more than a few exemptions.¹ Therefore, free trade areas, hill and mountain areas and areas of special state concern remain a sort of entrepreneurial oases until 2016. Entrepreneurs performing business activities in these areas enjoy the right of tax relief with an aim of achieving certain economic development stage and increasing employment rates. However, this system has changed in the course of the years and soon a cut in the system is expected since *acquis* and the practice of the EU do not recognise such relief system. Thus in the process of harmonization of our legislation with the *acquis* all forms of tax relief will change and all relief shall be categorized as state incentives the regulation of which shall be subject to strict EU norms.

2. Corporate Profit Tax Benefit in Free Areas

The project of founding free trade areas as economic subjects started in Croatia in 1996. A free trade area is part of the territory of the Republic of Croatia that is specially marked and enclosed and in which economic activities take place under special conditions.²³ A free trade area can be founded on the grounds of the awarded concession by the government of the Republic of Croatia. The government of the Republic of Croatia determines the free trade area founding concession rate. 50 % of the rate amounts to the budget and 50% to the district i.e. municipality.

There are numerous reasons for founding a free trade area and the most frequent are:

- investment incentive
- new technologies and equipment introduction
- business modernisation and improvement
- establishing contact among industries
- production launching

¹ Javne financije u Hrvatskoj (2000.), Institut za javne financije, Zagreb

² Free Trade Areas Act, Official Gazette No 44/1996, 78/1999, 92/2005, 85/2008

³ A free trade area can be founded in the area of harbour, airport, river port, along international roads and other areas meeting the requirements for its activity. It can consist of a number of separate parts if the conditions stipulated by the law are met. (Art. 3)

- to stimulate employment
- export of goods
- attracting foreign investments

The businesses that can be performed in free trade areas include goods production, finishing, storage of the whole sale goods, strategic activities of business support, founding technological development-innovation centers for rendering services, with exception of banking and other pecuniary businesses and services involving insurance and reinsurance of property and persons.

It should be emphasized that retail trade is not permitted in the area.

There are currently fifteen free trade areas in the Republic of Croatia two of which are not operating.

Table 1. Free Trade Areas in Croatia

Free Trade Area	CITY	LAND AREA (m ²)	FREE LOTS m2	NUMBER OF AREA USERS	EMPLOYEES NUMBER
KRAPINSKO - ZAGORSKA FREE TRADE AREA	Krapina	70.000	30.000	14	123
FREE TRADE AREA OSIJEK	Osijek	270.000	80.000	4	630
FREE TRADE AREA KUKULJANOVO	Kukuljanovo	28.000	1.000.000	5	73
FREE TRADE AREA OF THE RIJEKA HARBOUR	Rijeka	1.635.000	570.870	9	1.332
FREE TRADE AREA ZAGREB	Zagreb	79.860	0	125	225
FREE TRADE AREA OBROVAC*	Obrovac				
FREE TRADE AREA OF THE SPLIT HARBOUR	Split	259.900	100.000	23	45
FREE TRADE AREA OF THE PULA HARBOUR	Pula	73.000	0	19	588
FREE TRADE AREA SPLITSKO - DALMATINSKA	Split				
FREE TRADE AREA OF THE PLOČE HARBOUR	Ploče	2.145.892	1.548.700	3	1.064
FREE TRADE AREA BUJE*	Buje				
FREE TRADE AREA ĐURO ĐAKOVIĆ-SL. SLAVONSKI BROD	Slavonski Brod	262.493	63.100	27	1.114
FREE TRADE AREA VARAŽDIN	Varaždin	600.000	0	1	200
THE DANUBE FREE TRADE AREA OF VUKOVAR	Vukovar	21.080	13.432	20	123
FREE TRADE AREA RIBNIK	Ribnik	32.000	10.000	7	17

* the area is not operating

Source: <http://zone.mingorp.hr/slobodne/podaciozonamai.htm>

However, due to changes of the law, free areas are no longer so attractive for investors which resulted in decrease in the proceeds of concessionaires and brought into question the area furnishing and equipment debt servicing. Numerous prospective investors have desisted among which there are American investors ready to invest \$ 100 Million in the bio-ethanol production. The realisation of concession of the free trade area has become too complicated and bureaucratized and has resulted in increasing costs for some investors; since announced investments failed the concessionary income decreased.

One of the main conditions for Croatian accession to the European Union is to abolish customs free businesses in accordance with the standards of the EU. Starting on 1 January 2009 the clients of free trade areas should pay the full amount of benefit tax instead of a half and additionally VAT after Croatian accession to the EU. Free trade area as such shall cease to exist and becomes an economic area.

This is exactly what happened in the Free trade area Osijek. This area lost almost 15 of its clients⁴ until 2010 and they moved to the area of special state concern where benefits are still valid. Besides, in June 2010 the ten-year contract expires with the biggest client of the area Benetton-Croatia⁵.

Amendments of the Law on Free Trade Areas, 2008 regulate relief for the area users until 2008 and in particular for the users that have performed or shall perform activities in the area after the Law of 2008 enters into force.

The area users (at the same time corporate profit taxpayers) have had twofold relief. The first is the lower tax rate -10% or corporate profit tax exemption for the time of 5 years if they invest more than a million HRK⁶ in infrastructure area

⁴ There are about 30 of them in the area but few of them are involved in production.

⁵ Benetton will remain in the area but has already announced its exit from the free customs operating system

⁶ The Corporate Profit Tax Ordinance (NN 95/05, 133/07) considers that the area user constructs or takes part in the construction of infrastructure area objects in terms of the provision of Art. 24 section 2 of the Law if he invests in spacial, infrastructure, utility, energetic, security and other objects necessary for area users activities. These could be buildings that serve for business, administration, supervision and security and also power facilities, halls, hangars, storehouses, objects with the purpose of environmental protection. Objects can be defined as both equipment and facilities necessary for object functioning as is the case with signalling security, communication, power and other facilities and equipment. These objects include also infrastructure objects such as roads, access roads, entrances, railroads with facilities and equipment, then coast, breakwater, facilities and plants and other objects with the purpose of putting in, anchoring and protection of ships, loading and

objects construction. In the transitional period stipulated rights for the users of free trade areas paying profit 10% depending on the regional map of the Republic of Croatia and in particular for those users who invested in the area and by the amended law gained the status of the bearer of investment incentives.

The area users performing business activities in the area until the day when this Law entered into force shall pay tax on profit depending on territorial unit for statistics of the level II in which the area is situated and in accordance with the NKPJ-Nacionalna klasifikacija prostornih jedinica za statistiku (National classification of territorial units for statistics)⁷ in the following way:

- a) The area users in the territorial unit for statistics of level II–North-Eastern Croatia (HR 01) shall pay profit tax
 - 50% of the stipulated tax rate for the period from 2008 until 2010
 - 75% of the stipulated tax rate for the period from 2011 until 2013
 - stipulated tax rate starting from 2014

- b) The area users in the territorial units for statistics of level II–Central and Eastern (Pannonian) Croatia (HR 02) shall pay profit tax
 - 50% of the stipulated tax rate for the period from 2008 until 2013
 - 75% of the stipulated tax rate for the period from 2014 until 2016
 - stipulated tax rate starting from 2017

The area users of the City of Vukovar performing business activities in free area as this Law entered into force shall pay profit tax:

- 0% of the stipulated tax rate for the period from 2008 until 2010
- 25% of the stipulated tax rate for the period from 2011 until 2013
- 75% of the stipulated tax rate for the period from 2014 until 2016
- valid tax rate starting from 2017

reloading of goods, operational areas, objects, facilities, plants, fittings and equipment used for starting, taking off and stay of aircrafts, aircraft and goods reception and equipment, as well as utilities including water supply system, sewage, sanitation and gas pipeline etc. Exemption and relief for operating in the area is established for the profit share realized in the area if the tax payer does not operate exclusively in the area.

⁷ Amidžić Peročević, K. (2010.) Porezne olakšice u porezu na dobit za poduzetnike koji posluju u slobodnim zonama, Računovodstvo i financije 2/2010

It should be also noted that both goods deliveries in the area and deliveries within the area have been exempted from VAT payment, which ceases the moment Croatia becomes a full member of the EU.

3. CORPORATE PROFIT TAX BENEFIT IN HILL AND MOUNTAIN AREAS

Special benefits in hill and mountain areas⁸ have been included in the Law on Hill and Mountain Areas⁹. In line with this Law the corporate profit taxpayers involved in agriculture and fishery in hill and mountain areas pay corporate profit tax of 75% of the stipulated tax rate if they employ more than five employees permanently¹⁰ where more than 50% of the employees have residence or are domiciled in the hill and mountain area or the area of special state concern. This benefit ceases the moment Croatia becomes a full member of the European Union.

The Law provides for special relief in the period from 2008 to 2010 for the corporate profit taxpayers involved in performing business activities other than agriculture and fishing in hill and mountain area and employ more than five employees permanently where more than 50% of the employees have residence or are domiciled in the hill and mountain area or the area of special state concern pay corporate profit tax of 75% of the stipulated tax rate. Since the year 2010 has already begun, it leaves us nothing else but to see whether the legislator shall remain consistent.

4. CORPORATE PROFIT TAX BENEFIT IN AREAS OF SPECIAL STATE CONCERN

The Republic of Croatia has established the Areas of Special State Concern¹¹ in order to eliminate the war consequences, enable faster return of the population liv-

⁸ The status of hill and mountain areas have the following local self-government units:

- cities/towns: Buzet, Čabar, Delnice, Imotski, Lepoglava, Ogulin, Orahovica, Senj, Sinj, Trilj, Vrbosko i Vrgorac,
- municipalities: Bistra, Budinščina, Cerovlje, Čavle, Dicmo, Đurmanec, Fužine, Gračišće, Jelenje, Jesenje, Kalnik, Kaptol, Karlobag, Klana, Klis, Lobar, Lokve, Lovreć, Lupoglav, Ljubešćica, Matulji, Motovun, Mrkopalj, Muć, Novi Golubovec, Podbablje, Primorski Dolac, Radoboj, Ravna Gora, Skrad, Stubičke Toplice, Šestanovac and Vinodol municipality

⁹ Law on Hill and Mountain Areas, Official Gazette No. 12/02, 32/02, 117/03, 42/05, 90/05

¹⁰ The taxpayer in section 2 of this Article is considered to have employed an employee permanently if the employee has spent at least nine months of the fiscal period at the work of the taxpayer and has had residence and domicile in the hill and mountain area or the area of special state concern (Art. 7c).

¹¹ Special State Concern Areas Law, Art. 2, Official Gazette No. 86/08

ing in this area before the Homeland war and encourage demographic renewal and economic development so that all areas develop equally. The area of special state concern can be divided into three groups: the first and the second group comprise the areas according to conditions emerging on the basis of occupation state and consequences of Great–Serbian aggression on Croatia whereas the criteria of the third group are economic development, structural issues, demographic and special criteria.

As for tax relief twofold criteria are applied on corporate profit tax in special state concern areas.

According to the first, taxpayers performing business activities in agriculture and fishery in the area of special state concern and employing herein more than five employees permanently, where more than 50% of the employees have residence or are domiciled in the area of special state concern for at least nine months pay corporate profit tax in the following way by the time of Croatia's entry into the European Union:

1. exempted from paying corporate profit tax in the area of the first group,
2. pay 25% of the stipulated tax rate (i.e. 5%) in the area of the second group,
3. pay 75% of the stipulated tax rate (i.e. 15%) in the area of the third group.¹²

According to the second criterion, taxpayers performing business activities in the area of special state concern other than agriculture and fishery, employing more than five employees permanently, where more than 50% of the employees have residence or are domiciled in the area of special state concern pay corporate profit tax as follows:

1. profit taxpayer performing business activities in the areas of the first group of areas of special state concern¹³

¹² Special State Concern Areas Law, Art. 23, Official Gazette No. 86/08

¹³ The first group of areas of special state concern comprises areas of cities and municipalities along the state border occupied in the Homeland war and city/municipal center is not more than 15 km in the straight line distant from the state border and has not more than 5000 inhabitants according to the census of 1991 as well as other then occupied areas of cities, municipalities and settlements of Croatian Danube region. This would include the following cities and municipalities: Antunovac, Beli Manastir, Bilje, Bogdanovci, Borovo, Cetingrad, Civljane, Čeminac, Darda, Donji Kukuzari, Donji Lapac, Draž, Dubrovačko primorje, Dragalić, Dvor, Erdut, Ernestinovo, Gvozd, Hrvatska Dubica, Hrvatska Kostajnica, Ilok, Jagodnjak, Jasenovac, Kijevo, Kneževi Vinogradi, Lovas, Majur, Markušica, Negoslavci, Nijemci, Nuštar, Petlovac, Plitvička Jezera, Popovac, Rakovica, Slunj, Stara

- exempted from paying corporate profit tax for the period from 2008 to 2010
 - pays 25% of the stipulated tax for the period from 2011 to 2013
 - pays 75% of the stipulated tax for the period from 2014 to 2016
 - pays the amount of the stipulated tax rate starting from 2017
2. Profit taxpayer performing business activities in the area of the second group of special state concern areas¹⁴:
- pays 25% of the stipulated tax for the period from 2008 to 2010
 - pays 75% of the stipulated tax for the period from 2011 to 2013
 - pays the amount of the stipulated tax rate starting from 2014
3. Corporate profit taxpayer performing business activities in the area of the third group of special state concern areas¹⁵:

Gradiška, Stari Jankovci, Šodolovci, Tompojevci, Topusko, Tordinci, Tovarnik, Trpinja, Vojnić, Vrljika, Vukovar i Župa dubrovačka as well as the settlements in the cities: Osijek-settlement: Klisa, Nemetin, Sarvaš, Tenja; Vinkovci – settlement: Mirkovci.

¹⁴ The second group of state concern area comprises cities, municipalities and settlements that had been under occupation during the Homeland war are not included in the first group. Accordingly, these are municipalities and cities of Barilović, Benkovac, Biskupija, Brestovac, Čačinci, Drniš, Đulovac, Ervenik, Glina, Gornji Bogičevci, Gospić, Gračac, Grubišno Polje, Hrvace, Jasenice, Josipdol, Kistanje, Knin, Konavle, Krnjak, Lasinja, Lipik, Lišane Ostrovičke, Lovinac, Mikleuš, Novigrad, Novska, Obrovac, Okučani, Otočac, Pakrac, Petrinja, Plaški, Polača, Poličnik, Posedarje, Promina, Ružić, Saborsko, Sirač, Skradin, Stankovci, Ston, Sunja, Škabrnja, Tounj, Udbina, Velika, Velika Pisanica, Veliki Grđevac, Voćin, Vrhovine i Zemunik Donji. This group also includes settlements in the cities : Daruvar – settlement : Markovac, Vrbovac; Dubrovnik – settlements : Bosanka, Brsečine, Dubravica, Donje Obuljeno, Čajkovića, Čajkovići, Gornje Obuljeno, Gromača, Kliševo, Knežica, Komolac, Ljubač, Mokošica, Mravinjac, Mrčevo, Nova Mokošica, Orašac, Osojnik, Petrovo selo, Prijevoj, Pobrežje, Rožat, Šumet, Tršteno, Zaton; Karlovac – settlements : Banska Selnica, Banski Moravci, Blatnica Pokupska, Brezova Glava, Brežani, Brođani, Cerovac Vukmanički, Donja Trebinja, Donji Sjeniĉak, Gornja Trebinja, Gornji Sjeniĉak, Ivanković Sela, Ivošević Selo, Kablar, Kamensko, Karlovac – parts of Gornje Mekušje, Sajevec i Turanj, Klipino Brdo, Kljaiĉ Brdo, Knez Gorica, Lipje, Manjerovići, Okić, Popović Brdo, Ribari, Skakavac, Slunjska Selnica, Slunjski Moravci, Tušilović, Udbina, Utinja, Vukmanić; Sisak – settlements: Blinjski Kut, Klobučak, Letovanci, Madžari, Staro Selo; Slatina – settlements : Golenić, Ivanbrijeg, Lukavac; Virovitica settlements : Jasenaš; Vodice - settlements : Čista Mala, Čista Velika, Grabovci; Zadar – settlements : Babindub, Crno.

¹⁵ By the Government Decision on confirming the status of the appurtenance of municipalities of the third group to the area of special state concern (Official Gazette No 138/02) the status of appurtenance to the third group of areas of special state concern is given to the following municipalities: a) on the grounds of economic underdevelopment: Babina Greda, Bebrina, Cestica, Cista Provo, Dekanovec, Donja Voća, Drenovci, Gornja Rijeka, Gradina, Gundinci, Gunja, Klakar, Levanjska

- pays 75% of the stipulated tax for the period from 2008 to 2010
- pays 85% of the stipulated tax for the period from 2011 to 2013
- pays the amount of the stipulated tax rate starting from 2014¹⁶

5. TAX BENEFIT BY WAY OF INVESTMENT INCENTIVE

As a special benefit we point out the one by way of investment incentive in economic activities in the area of the Republic of Croatia and creating additional jobs related to these investments. Tax benefit is a reduced tax obligation and sometimes even exemption of corporate profit tax payment depending on investment amount and number of employees, which we shall deal with further on.

If the corporate profit taxpayer invests up to 1.5 million Euro in HRK equivalent value the corporate profit tax rate is reduced by 50% for the period of 10 years starting from the investment year on condition that within 3 years after gaining the status of incentive bearer i.e. investment commencement at least 10 new jobs related to the investment are created.

If a taxpayer invests 1.5 to 4 million Euros in HRK equivalent value the corporate profit tax rate is reduced by 65% of the stipulated tax rate for the period of 10 years starting with the investment commencement on condition that 30 new jobs related to the investment are created within three years after gaining the status of incentive bearer i.e. investment commencement.

If a taxpayer invests 4 to 8 million Euros in HRK equivalent value the corporate profit tax rate is reduced by 85% of the stipulated tax rate for the period of 10 years starting with the investment commencement, on condition that 50 new jobs related to the investment are created within three years after gaining the status of incentive bearer i.e. investment commencement.

Varoš, Oprisavci, Podgorač, Podravska Moslavina, Podturen, Pojezerje, Proložac, Punitovci, Satnica Đakovačka, Semeljci, Sikirevci, Slavonski Šamac, Sopje, Trnava, Velika Kapanica, Vođinci, Vrbanja, Vrbje, Zrinski Topolovac; 2) by the criterion of structural difficulties: Cernik, Galovac, Kula Norinska, Lečevica, Lokvičići, Oriovac, Otok (Splitsko-dalmatinska county), Otok (Vukovarsko-srijemska county), Pakoštane, Runovići, Starigrad, Suhopolje, Vladislavci, Zagvozd, Zažablje; 3) on the basis of demographic criterion: Bednja, Berek, Bosiljevo, Brinje, Brod Moravice, Crnac, Čadavica, Čaglin, Generalski Stol, Grožnjan, Ivanska, Kraljevec na Sutli, Lanišće, Netretić, Oprtalj, Perušić, Pisarovina, Pokupsko, Prgomet, Ribnik, Unešić, Zagorska Sela, Žumberak.

¹⁶ Special State Concern Areas Law, Art. 24, Official Gazette No. 86/08

If a taxpayer invests more than 8 million Euros in HRK equivalent value the corporate profit tax rate is reduced by 100% of the stipulated tax rate (he is completely exempted from tax obligation) for the period of 10 years starting with the investment commencement on condition that 75 new jobs related to the investment are created within three years after gaining the status of incentive bearer i.e. investment commencement.

Tax benefit total that the bearer of incentives can use in the course of the period of tax benefit utilisation is determined in an absolute total as a balance a) of the corporate profit tax total received by application of the Corporate Profit Tax Act and b) amount calculated by application of the Investment Promotion Law taking into consideration the maximum allowed amount of total incentives referred to in Art. 2 subsection 8 of the Law¹⁷ (Art. 4, section 5).

If the incentive bearer violates the condition determining creation of new jobs regulated by preceding provisions, i.e. reduces the number of new jobs determined by preceding provisions his right to tax benefit ceases for the complete period the benefit is allowed with obligation of refunding the means realized by utilising allowed benefit increased for the amount of legal default interest (Art. 4 section 6).

Minimum period of validity of the status of incentive bearer i.e. preservation of the subject investment and creating new jobs related to this investment is 5 years but not shorter than the incentive measures utilisation period (Art. 4 section 7).

6. CONCLUSION

The major issue is the fact that legal matter is diffused and hard to be collected in one place. It has been included in numerous laws amending the Corporate Profit Tax Act¹⁸ overlapping in many areas. However, many issues have remained incomplete. When it comes to the Free Trade Areas Law neither the procedure can be

¹⁷ Investment Promotion Law Art. 2 subsection 8 stipulates maximum support as gross equivalent of up to 50% of justified investment costs, increased by 10 gross percentage points in cases of investment incentive of middle entrepreneurs, i.e. increased by gross 20 percentage points in cases of incentive of small entrepreneurs and in accordance with the map of regional state support and this is the upper limit of total cumulative support i.e. the sum of justified incentive measures referred to in Art. 4, 6, 7, 8, 11 and 12 of the Law including the support from other sources. Maximum support intensity must not exceed the upper limit of the allowed intensity established by the map of regional state supports.

¹⁸ Corporate Profit Tax Act, Official Gazette No. 177/04, 90/05, 57/06

found in any of the instruments nor has it been defined who controls the application of the Law unlike for the support used by entrepreneurs performing business activities in areas of special state concern as well as in hill and mountain areas. We can suppose that this control shall be exercised by the Ministry of Economy, Labour and Entrepreneurship since area users receive their zone entrepreneurial status confirmation by the very Ministry.

Nevertheless, it should be noted that by the time of Croatian entry into the European Union there will be little space for further changes thus the current way of doing business and benefits will completely change. There will be a period of transition that in certain places has already come into force and in which tax benefits will have gradually be reduced and finally abolished by 2016. Performing business activities in free zones, hill and mountain areas, in areas of special state concern will equal to performing business activities in any other area of the Republic of Croatia; according to current regulations by the time Croatia enters the European Union the zones will be special customs areas only in reference to the third non-member states of the EU.

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