Tendencies in Croatian Tax Law regarding CFC Legislation[1]

Šime Jozipović[2]

1. Introduction

After a long and intense accession process, the Republic of Croatia recently became the twenty-eighth member state of the EU[3]. Following a wide-ranging reform process in all relevant areas, Croatia finally reached an acceptable level of harmonization with the *acquis communautaire.*[4] One of the key areas in the accession process was the area of international (primary inter-European) taxation. Many recent cases have revealed that even long-established member states sometimes have trouble harmonizing their tax law with the rules of European law. This especially applies to the complex structure of international tax law.[5] Despite the fact that Croatian tax law was heavily influenced by the German, Austrian and other EU tax systems, its international tax regulations, especially in the area of measures against tax avoidance, partially diverge from these systems. This is particularly apparent with regard to CFC legislation, which is in many European countries highly developed[6] and fiscally relevant, but in Croatia rather neglected.

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2 Šime Jozipović Mag. Iur., LLM ger. (LMU München) Researcher at the Max Planck Institute for Tax Law and Public Finance, contact: simejozipovic@hotmail.com

[3] Art. 3 Sub. 3. Treaty of accession of the Republic of Croatia to the European Union, Official Gazette of the Republic of Croatia - Narodne Novine (NN) 2/12. http://eur-lex.europa.eu/en/treaties/new-2-46.htm

[4] For information on the results of the EU accession negotiations with Croatia compiled by the Directorate General for Enlargement - European Commission from November 2011, see: http://ec.europa.eu/croatia/index_hr.htm

[5] For example, in the area analysed here: eCJ f. 12. 9. 2006, C-196/04, *Cadbury Schweppes.*

[6] See Wissenschaftlichen Beirat Steuern der Ernst & Young GmbH: Hinzurechnungsbesteuerung und gesonderte Feststellung von Besteuerungsgrundlagen IStR 2013, 549 fn. 5 refering to IBFD, European Tax Handbook, 2012.

Unlike German tax law,[7] Croatian tax law does not contain an international tax code, but rather regulates issues concerning international taxation in the general tax code and the respective special tax laws.[8] This is the result of a number of factors: the limited number of relevant international trading partners,[9] and a good network of DTT,[10] but it is also a consequence of limited experience with issues regarding international tax law.[11] The focus on DTT also led to a fragmentary regulation of controlled corporations. While controlled corporations with residence in Croatia are subject to regulations that limit some aspects of tax planning,[12] the Croatian CFC legislation exists in a limited spectrum as a result of the low corporate tax rate and some particularities of the Croatian tax system. The respective rules are implemented in different tax acts and further defined by internal regulations of the Ministry of Finance which lay down the fine line between illegal tax avoidance and legal planning methods. While this limited approach has the benefit of being more likely to be acceptable from an EU-law perspective,[13] its biggest disadvantage is its extremely limited area of impact.

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[7] German International Tax Code - Gesetz über die Besteuerung bei Auslandsbeziehungen (Außensteuergesetz) from 8. September 1972 (BGBl. I S. 1713), last time changed 26. June 2013 (BGBl. I S. 1809)

[8] For example Art. 56 f. Croatian Tax Code – Opći porezni zakon NN 147/08, 18/11, 78/12, 136/12, 73/13.

[9] See: *Dr. sc. Vlatka Bilas*: Croatian and EU Trade Connections – The Proceedings of Zagreb Faculty of Economics and Business, p. 72.

[10] Information about the application of Double Taxation Treaties (DTT), Primjena ugovora o izbjegavanju dvostrukog oporezivanja, published by the Croatian Ministry of Finance P 39 See:
http://www.porezna-uprava.hr/HR_publikacije/Prirucnici_brosure/DvostukoOporezivanje_2011.pdf

[11] Under the Yugoslav regime, private property and entrepreneurship were severely curtailed, so that many issues of international tax avoidance in the modern context did not arise. From 1991 to 1999 Croatia was internationally largely isolated and the tax system as a whole was not adequately functional due to the Yugoslav conflict and the issues arising from it in the ensuing period. In the last decade, significant developments in the field of international taxation have been made. However, a decade cannot be considered enough time to create an autonomous tax system in this field without resorting to foreign experience.

[12] See for example: Art. 31 d Sub. 3 regarding profit shifting methods within the EU and limiting the application of Art. 31 a - 31 d.

[13] With regard to European issues and actions of the member states: *Christian Möller:* Die Hinzurechnungsbesteuerung ausgewählter EU-Mitgliedstaaten – Reaktionen auf Cadbury Schweppes IStR 2010, 166.

This issue was largely ignored in the past, but has recently started to move to centre stage after the Ministry of Finance began a national campaign against tax evasion.[14] The current Croatian Minister of Finance defined the goals of the campaign as the creation of an environment ruled by the idea of a fair market position for all taxpayers, which can only be created by an objective and comprehensive taxation.[15] This goal cannot be achieved with the current legislation in the area of international law. As a result the Ministry of Finance has started work on a strategy to reform the Croatian international tax law and include regulations intended to prevent tax evasion, especially through controlled corporations in tax havens. The concluding reform could revolutionize the way of engaging with international tax issues in Croatia, but it could also give rise to legal uncertainty. Since the CFC legislation represents an important element of the reform and it has been almost completely excluded from theoretical and practical discussions, the analysis of its position within the broader context of the Croatian tax system is essential for the development of Croatian tax law as a whole.

As a result, this article outlines the existing limited regulations on controlled foreign companies in Croatia and the main issues that the Ministry of Finance needs to confront in the near future. Subsequently, for the first time in Croatian legal opinion, the article analyzes the reasons leading to this system of protection, thus covering Croatian constitutional provisions as well as economic and financial influences in this area. Based on this analysis, the article describes the distinctive features of Croatian tax legislation in this field, defines the previously unexplored interrelations of existing tax avoidance rules with regard to their influence on CFC legislation, and examines the prospects for the reform of this area.

[14] P 16 f Guidelines of the Ministry of Finance for Croatian fiscal policy for the period 2014-2016 available at: http://www.mfin.hr/hr/smjernice-ekonomske-i-fiskalne-politike

[15] See the interview with the Minister of Finance, Slavko Linić, dated 27.6.2013. http://dnevnik.hr/vijesti/hrvatska/linic-nema-presije-kritiziraju-me-oni-koji-bi-probleme-rijesili-neplacanjem-poreza---292428.html

2. The Croatian tax system

2.1. *The definition of controlled corporations*

The Croatian tax law defines controlled corporations as those over which another corporation can have a direct or indirect decisive influence, or over which another entity has "control", while the meaning of control in the field of tax law is legally defined.[16] As a result under the Croatian tax code control exists if the above-mentioned criteria are fulfilled or if there is a similar relationship between a natural person and a corporation, or if one of the following elements is present:[17]

1. the controlling corporation holds the majority of the shares of the controlled corporation or holds the majority of the voting rights;
2. the controlling corporation has the right to elect or appoint and/or revoke most members of the management board or the majority of executive directors or the supervisory board;
3. the controlling corporation has the right to exert or does in fact exert the major influence on the company;
4. the controlling corporation has the right to control the finance or business policy of the company based on the statute, a contract or any other legal act or agreement;
5. the controlling corporation has control over more than 50% of the voting rights based on a special agreement;
6. the controlling corporation has the power to direct the majority of votes on the meetings of the managing board of the corporation.

While these elements resemble the basic defining norms for controlled companies under some CFC regimes,[18] under Croatian law they serve mostly as a method for defining affiliated companies more exactly and for preventing tax fraud. As a result, they are more likely to be used as a measure for distancing the state from controlled corporations in Croatia when CFC rules of another state are applicable.

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[16] Art. 40. b Croatian Tax Code.
[17] Art. 40. c Croatian Tax Code.
[18] See for example Protzen AStG § 7 Steuerpflicht inländischer Gesellschafter, Außensteuergesetz Vol. 1 2009 Rn 191

2.2. *The treatment of income and profits under Croatian tax law*

The Croatian tax system contains some particular provisions on income and corporate taxation that strongly influence its regulations on international taxation. The CFC legislation in particular reflects the national standpoint towards dealing with certain kinds of income, primarily capital income, but other problematic income sources as well.[19] As a result, it is necessary to analyze the basic concepts of Croatian corporate and capital income taxation, in order to understand the measures the legislator integrated into Croatian law to ensure stable tax revenues and a just tax system in general. For this purpose, the following analysis contains the essential elements of the current tax system in Croatia, while simultaneously describing the historical developments that led to the present situation.

In the Republic of Croatia corporate tax covers the taxation of limited companies and in some cases other types of companies or even natural persons if they fulfill specific requirements.[20] However, for present purposes, the analysis of the taxation of limited companies is central, while other special situations can be considered as theoretical cases. The Croatian corporate tax rate is 20% of the net profit of the company.[21] Although there are some regulations on the limitation of factors that decrease the tax base,[22] the Croatian corporate tax system can be considered fairly favourable to the taxpayer. These elements taken together result in a relatively low contribution by corporate tax to fiscal revenues: approximately 7% of the total.[23] The Croatian tax system does not place strong emphasis on the direct taxation of companies. This can be considered a result of the historical development of corporate taxation in

[19] The definition of "problematic" income sources is an extremely complex issue that every country has to adapt to the particularities of the national situation. See for example the specific income sources thematized in the US model, further described in: Andreas Demleitner Hinzurechnungsbesteuerung nach US-amerikanischem Recht IStR 2012, 461 f.

[20] Art 2 f. Croatian Corporate Tax Act – Zakon o porezu na dobit NN 177/04, 90/05, 57/06, 146/08, 80/10, 22/12.

[21] Art. 28 Croatian Corporate Tax Act.

[22] See for example *Kuzman Vujević*: Amortizacija s troškovnog, poreznog i računovodstvenog aspekta "Pomorstvo" 19. (2005), str. 159-169 ; *Vjekoslav Bratić & Ivica Urban*: Porezni izdaci u Hrvatskoj Financial Theory and Practice 30 (2) P. 129-194 (2006.)

[23] Annual fiscal report of the Croatian Ministry of Finance available at p1: http://www.mfin.hr/hr/drzavni-proracun-2012-godina

Croatia.[24] Although the former socialist system strictly limited the economic freedom of private companies, Croatian law is in theory based on an approach that supports and stimulates investment.[25]

The ideal of support and stimulation for investors was also the basis for a recent tax reform that created the option of tax deferral for reinvested profits. Basically, all net profits of a company that are normally taxed at a rate of 20% are tax-exempt if the company reinvests the profits in its business. In practice this rule creates a legal means for companies to avoid taxes without the need for a complex CFC structure. While this structure aims to stimulate companies to reinvest their profits, it also tends to deter the investment of new capital, because of the insecurity of investors about the future dividend payment policy of the company.[26] To prevent tax fraud, the legislator limited the option of reinvesting profits through rules that partially reflect standard CFC rules, and through specific formal requirements that allow better control over the whole process. This option represents a milestone in Croatian tax legislation and an enormous resource for future legal developments in this field.

The taxation of dividends is also a result of the recent reforms. While it was long a matter of debate whether the taxation of dividends represents an unconstitutional (economic) double taxation under Croatian tax law,[27] the introduction of a dividend tax was intended as a fiscal counterweight to changes in the corporate tax system. Dividends are taxed at a rate of 12% for all dividend income.[28] Limited companies are in general exempt from dividend tax as this would otherwise result in double taxation.[29] The

[24] See: *Božidar Jelčić ,Predrag Bejaković*: Razvoj i perspektive oporezivanja u Hrvatskoj, 2011. P 171.

[25] Art. 48 f. Constitution of the Republic of Croatia – Ustav Republike Hrvatske NN 56/90, 135/97, 8/98, 113/00, 124/00, 28/01, 41/01, 55/01, 76/10, 85/10.

[26] On this issue see for example: *Rieckers in Spindler/Stilz*, Aktiengesetz 2. Auflage 2010 AktG § 135 Ausübung des Stimmrechts durch Kreditinstitute und geschäftsmäßig Handelnde Rn. 52; *Pinkernell*: Das Steueroasen-Dilemma der amerikanischen IT-Konzerne IStR 2013, 180

[27] *Helena Blažević*: Ekonomsko dvostruko oporezivanje u Hrvatskoj Economic Review , 53 (3-4) 362-390 (2002) P 363 f.

[28] Art. 51. Sub. 4 Income Tax Act - Zakon o porezu na dohodak NN 177/04, 73/08, 80/10 , 114/11, 22/12, 144/12

[29] Art. 6 Sub. 1 Nr. 1 Croatian Corporate Tax Act.

exemption does not apply to dividends that are paid to foreign limited companies, for which there is a withholding tax of 12%.[30] This rule excludes companies within the EU if they fulfill the necessary requirements.[31] Dividend income is a result of the payouts by the company to the shareholder and, even though it affects another tax subject, it is in a direct relationship with the treatment of company profits (reinvestment or payout). As a result, even though dividend taxation represents a fiscal measure aimed at alleviating the negative effects on fiscal revenues due to tax deferral for reinvested profits, from an economic standpoint it may be considered a further distortion of the tax burden, in favour of the shareholders of companies that reinvest their profits in relation to the shareholders of companies that pay their profits out and therefore have to bear the entire tax burden on their own.

The total amount of the non-taxation of reinvested profit and the reduced tax base when profits are not paid out results in a huge gap between companies that reinvest their profits and companies that do not. This issue has been extensively discussed internationally in relation to "0%" corporate tax rates in tax havens and the advantages of long-term investment in such countries.[32] Consequently, the current Croatian tax system can be considered as investment-friendly to an extent that is rarely seen in a country with an overall fiscal pressure that is standard for European countries. Such radical changes in the tax system of a country are likely to lead to loopholes in the system and increase the total amount of tax evasion. This applies especially for measures that directly result in tax benefits. The situation becomes even more complicated when it is observed in an international environment with cross-border (re-)investment and limitations on the control mechanisms of the state. As a result, in the following discussion the protection methods implemented in the new

[30] Art. 31. Sub. 7. Croatian Corporate Tax Act.
[31] Art. 31.e Sub. 1. Croatian Corporate Tax Act.
[32] See for example the effects on profits of long-term investments through low tax countries in *Alexander Rust*: CFC Legislation and EC Law INTERTAX, Vol. 36, I. 11 P 493.

regulation and their connection with controlled foreign corporations will be analyzed.

2.3. *Tax exemption (deferral) for reinvested profits*

Tax deferral for reinvested profits is one of the key elements of the new Croatian corporate taxation regime.[33] While the Corporate Tax Act does not contain an explicit norm that defines the beneficial treatment of reinvested profits as tax deferral but as tax exemption, it has the same effect as tax deferral. The taxpayer is exempted from all taxes on profits that are reinvested, but in the case of a distribution of profits in any way affecting the nominal worth of the reinvested profit, the previously exempted profit becomes taxable. The deferral effect is further regulated in the corporate tax regulation.[34] However, it has to be considered rather as the result of the domestic workings of Croatian tax law and therefore a norm deriving from constitutional norms and the basic provisions of the tax system, which legitimizes this regulation severely limiting the position of the taxpayer.

The procedure for claiming an exemption on reinvested capital is strictly regulated. First, the taxable profit within the period has to be used to increase the company's nominal capital.[35] This increase has to be registered in the court registry, in accordance with special regulations.[36] Based on this registration, the company can then submit a request for exemption in its tax returns or in the six months after their submission.[37] The tax returns have to include a statement about the use of the profits including the reinvested profits,[38] as well as an overview of the capital

[33] The new regulation was the central element of the recent tax reform and broadly discussed. About the importance and impact of the reinvestment regulation see the interview with the Minister of Finance Slavko Linić dated 5.9.2013 in Business.hr http: http://www.business.hr/ekonomija-7/linic-gospodarstvenici-su-reinvestirali-oko-milijardu-kuna-dobiti-sto-se-negativno-odrazilo-na-proracun

[34] Pravilnik o porezu na dobit NN 95/05, 133/07, 156/08, 146/09, 123/10, 137/11, 61/12 i 146/12.

[35] Art. 6. Sub. 1 Nr. 5 , Sub. 5. Income Tax Act, Art 12 a Sub. 1 Nr. 1 Corporate Tax Regulation.

[36] Art 12 a Sub. 1 Nr. 2 Corporate Tax Regulation.

[37] Art. 12 a Sub. 2 Corporate Tax Regulation.

[38] On the detailed procedure see the position of the Ministry of Finance on the reinvestment procedure: Mišljenje porezne uprave - Porezna olakšica za reinvestiranu dobit Nr.:410-01/12-01/2897

reserves of the company.[39] A request that fulfills all the elements of the predetermined procedure has to be accepted regardless of what the reinvested profit has been used for, except in two specific cases:

1. If the profit to be reinvested is made within the banking and finance sector, it cannot be exempted regardless of the purpose of the reinvestment.[40] This regulation takes into consideration the special position of banking and finance as a sector *sui generis*: based on the special factual and legal situation, profits in this sector are much more likely to be transferred and effective control becomes nearly impossible. In addition, financial institutions are prepared for long-term investment as part of their business strategy. To include this sector in the profit reinvestment regulation would make Croatia an ideal tax haven as the destination for the creation of controlled corporations, and Croatia would be confronted with an enormous long-term tax shortfall. These considerations, especially the fiscal effects of such a rule and the failure to obtain positive effects for the Croatian economy, resulted in the exclusion of this sector. The norm therefore applies directly to the origin of the profit and not to the purpose of the reinvestment of the profit. Such an approach shows that the legislator does not generally perceive investments in this sector as problematic but rather sees the need to tax them as they emerge.
2. The exemption will not apply to cases in which the increase of the nominal capital has taken place with the aim of avoiding taxes or engaging in tax fraud.[41] While the term "tax avoidance" is not further defined in the law, it has to be interpreted in relation to the purpose of the rules on tax deferral for reinvested profits and based on the inner logic of the corporate tax system. As a result, the term "tax avoidance" cannot be characterized as just any activity that is motivated by reducing the tax burden, because the legislator adopted

[39] Art. 12 a Sub. 4 Corporate Tax Regulation.
[40] Art 6. Sub. 6. Income Tax Act.
[41] Art 6. Sub. 7. Income Tax Act.

this measure intentionally to stimulate companies to reinvest profits. However, this term cannot be limited to illegal tax avoidance by means of forbidden methods because this is already covered by the term "tax fraud". Hence, the term "tax avoidance" in the context of the regulations on reinvested profit has to be interpreted as activities aimed at the reduction of the tax burden through the advantages ensuing from the regulations on tax deferral for reinvested profits that are not intended to produce a reinvestment effect but just tax relief.

One element that all the regulations have in common is that they do not limit the essential freedom of businesses to allocate their reinvested profit for any purpose connected with their business. This includes the creation of new enterprises, the formation of a controlled corporation or the acquisition of company shares, as long as this does not take place in contravention of the above-mentioned limitations. As a result, the effects and limitations have to be put in the context of an internationally active company. The regulations do not directly exclude the application of the exemption on international investments. Nor would such limitations be easy to justify within the rules of national constitutional law and EU law. As a result it should be borne in mind that the above-mentioned limitations have a universal application, but in current circumstances their prime focus will be on international cases, especially cases regarding CFCs. Such an application of general rules, even though it represents an exception in the area of CFC legislation, is not unique to Croatia.[42] However the specifications of the system as a whole require different provisions from those usually implemented in national law.

One interesting question in this regard is the position of other (EU member) states towards this model. A tax system that has a developed CFC regime usually adopts an approach that taxes generated profits as they emerge, taxing them at the national tax level after the deduction of the already

[42] See for example *Möller* Die Hinzurechnungsbesteuerung ausgewählter EU-Mitgliedstaaten – Reaktionen auf Cadbury Schweppes IStR 2010 P 167f.

taxed amount at the level of the controlled company. However, since reinvested profits are not taxed at all, a controlled corporation in Croatia would pay no taxes, though the obligation to pay 20% on any profits later paid out would remain. As a result, if the parent company is taxed without the reduction that would apply if the subsidiary were taxed at a 20% rate in Croatia at the time when the subsidiary is finally taxed in Croatia, then a clear case of double taxation would arise. However, if the parent company is taxed at a reduced rate, the deferral effect would be largely intact. Due to the continuing right of Croatia to tax this amount and the general inclusion of foreign taxes in the calculation of tax duty for the controlling company, from a theoretical standpoint it would be logical not to tax the disputed amount. However, because of the far-reaching practical consequences and the uncertainties about the development of CFC legislation in the EU, a clear answer cannot be given at this point. The answer to this question will most likely be found in the bilateral agreements between Croatia and other states, especially their DTT, and the standpoint of the concerned state towards CFC-legislation. However, the exclusion of profits from the finance sector as well as tax evasion and tax fraud has to be recognized as a sign of goodwill on the part of the Croatian legislator, showing an intention not to undermine other tax systems.

2.4. *The constitutional foundation of the tax system*

Based on the experiences of many older constitutions and constitution-like legal acts, the framers of the Croatian Constitution recognized the importance of tax law as an area of government that can seriously restrain basic human rights. As a result, the essential principles of tax law that form the Croatian tax system are laid down in the Constitution. This means that the equal treatment of taxpayers and taxation based on economic strength[43] are vital elements that strongly influenced the Croatian tax system from its initial stages. In addition to the special norms on taxation, like other constitutions, the Croatian Constitution contains norms that are

[43] Art. 51. Constitution of the Republic of Croatia.

not primarily directed towards taxation, but still strongly shape national tax law. One of the key factors in the context of international tax law and CFC legislation in particular is Article 49 Sub. 5, that provides that any investor is free to withdraw their capital and profits from the country. While this rule represents part of the Croatian response to the anti-free enterprise norms of the previous regime and was intended to reduce uncertainty for investors with regard to potential nationalizations or other assaults on their capital, it has become a significant factor for law-making in Croatia.

If these constitutional norms are taken together in the field of international taxation, they create a basic structure defining the limits and duties of the state to provide a capital-friendly but equality-based tax system. While the effect of the constitutional norms on taxation and the norms protecting capital cannot be analyzed in this article, their influence on CFC legislation can be understood from their historical development balancing opposing imperatives within the broader logic of constitutionality. Within this framework, the line between tax duty and capital freedom in Croatian law has to be considered from an inclusive perspective. Freedom of capital was never conceived as an absolute right, but as a result of the overall development of a free democratic society.[44] Freedom of capital therefore reflects the state's interest in the creation of economic growth and social welfare. Consequently, the state's rights in matters of taxation and the abstract right of taxpayers to equal taxation, giving rise to the duty of the state to enforce equal taxation, have to be considered primarily applicable to the freedom of capital, as taxation is based on constitutional tax principles without affecting the essence of the freedom of capital or limiting it to an unnecessary extent.

Applying these considerations to international tax rules reveals a certain logic in the treatment of international tax planning and capital relocation through the establishment of CFCs. The legislator is entitled to tax the profits of companies as they are generated. However, after taxpayers fulfill

[44] About the social development and the equity protection *Arsen Bačić*: Komentar Ustava Republike Hrvatske, 2002. P 145 f.

their obligations, profits can be freely moved without further interference by the state. This basic rule cannot solve the issues emerging out of the complex problems of CFC because the international aspects result in a contradiction between the elements of the basic rule. As a result, the constitutional principles have to be analyzed in the context of the Croatian tax system and its international interactions in specific CFC cases.

3. CFC legislation in Croatia as a consequence of the tax system

Based on the tax system outlined above, the Croatian CFC rules diverge strongly from other European systems. CFC regulation is usually adopted to limit artificial tax deferral through low-tax offshore vehicles. In Croatia the situation is particular since the regulations on reinvested profits shift the focus of CFC regulation. While CFC rules generally attempt to prevent the stacking of profits in a company, the Croatian law allows and even stimulates such behaviour. As a result, the central issues for Croatian CFC regulation can be divided into two areas: the regulations to prevent profits generated in Croatia by Croatian companies being relocated to CFCs, and the regulations concerning profits generated by CFCs.

3.1. *The regulation concerning profit generated in Croatia being relocated to controlled foreign corporations*

The Croatian tax system allows the reinvestment of generated profit without taxing the respective tax subject based on the profit. While this is a positive innovation that could contribute to the recovery of Croatia's economy on a national scale, within the area of international tax law it gives rise to a series of questions: first of all, the general application of this rule on international cases has to be considered. Even though this measure was implemented because of its effects as state support for the industry, the legislator did not attempt to limit tax deferral to cases of national investment. This has to be considered mainly as reflecting an awareness of

the standpoint of the CJEU on such limitations.[45] As a result, reinvestment in the form of the incorporation and capitalization of a CFC has to be considered legal. The possibility to generate profit and, instead of paying tax on it, having the option to relocate it at will creates an enormous potential for tax evasion. This was also considered by the Croatian legislator, who as a result implemented a general anti-abuse rule that in combination with the preventive control of investments should grant sufficient protection against tax evasion and tax fraud.

An investment by means of incorporation, capitalization or the acquisition of shares of a CFC in general represents a valid reinvestment as long as it is within the range of normal economic activity.[46] However, such investment is governed by the regulations on tax avoidance and tax fraud. This regulation, which applies to national and international cases, can seriously limit the actions of a company that intends to invest in a foreign country through a subsidiary. The reinvestment rule applies only after the tax authorities have granted the tax rebate on reinvested profits. As a result, the taxpayer has to make the investment and afterwards apply for the tax rebate. Especially in international cases this will become problematic and generate legal uncertainty, because the rule states that the tax authorities can refuse to grant a tax rebate if there is a possibility that the approval of the tax rebate could lead to tax evasion. In this case the taxpayer has the right to prove that the investment is based on economic interests regarding normal activity and does not solely aim to achieve beneficial taxation. The Croatian regulation in this field has to be considered as relatively strict because it is based on the power to refuse to grant a tax rebate solely on the grounds of possible tax evasion. Considering the enormous potential for tax evasion arising from the reinvestment regulation, this provision is

[45] See: *Christian Ranacher, Markus Frischhut*: Handbuch Anwendung des EU-Rechts: mit Judikatur (EuGH, VfGH, VwGH, OGH) ; [Strukturprinzipien, Unionsbürgerschaft, Grundfreiheiten, doppelte Bindung, indirekter Vollzug, Rechtsschutz, Staatshaftung] P 187 f.

[46] Since the banking and finance sector is excluded from the possibility of reinvesting profits, and the reinvestment has to be within the regulat economic activity of a company, reinvestments that have the sole purpouse of acquiring financial capital can never be considered an adequate investment within the reinvestment regulation. However, the strategic acquisition of shares of business partners or competitors can be considered a reinvestment if they serve a purpose aimed at the improvement of the company as a whole.

necessary to protect Croatia's tax revenues. However, it is questionable why the decision has to be taken after the investment has already been made. An earlier review of each case would result in greater legal certainty and be much more within the principle of good faith in the area of tax procedures.

If this issue is placed in the context of constitutional tax principles, the relation between taxation principles and capital freedom does not represent a problem in the specific case, because the part of the after-tax capital is absolutely free, while the tax regulation applies only to the amount that is usually subject to tax.[47] This also leads to the avoidance of issues in the field of international law that in normal CFC cases appear as the delineation between two sovereign tax systems.[48] On the other hand, it is necessary to consider whether this regulation represents a violation of the principle of equality of taxpayers. International cases will much more likely be considered within the boundaries of the exception and therefore companies with international subsidiaries will be in a better position than other companies. However, this situation represents less an issue of legislation and more a question of the practical application of the rule. If the tax authorities base their decisions on objective factors rather than the simple fact that the subsidiary is located in another country, this will clearly be within the parameters laid down by the tax principles of the Constitution. Therefore, a "blacklist approach" to this issue would not be considered constitutional, while a case-by-case approach would. However, no definition of investments that would be considered within the exception has been provided by the tax authorities till now. It is likely that the tax authorities will choose a combination of an unofficial blacklist and a subsequent in-depth analysis of comparable cases. Such an approach must be defined as both immature and hazardous and therefore it is to be hoped that the future practice of this rule will provide the necessary certainty for taxpayers.

[47]The Croatian freedom of capital has to be distinguished from the EU basic freedom of capital because the Croatian freedom of capital refers to (net) profits and invested capital. As a result, the Croatian freedom of capital cannot be measured by the standards of the EU law and CJEU rulings.

[48] On this issue see: *Kluge:* Internationales Steuerrecht, 2000. P 412.

3.2. *Regulations concerning the profits generated by a CFC*

In addition to the question of untaxed profits being shifted, the classical situation to which CFC legislation usually applies has to be considered. Croatian law allows companies to defer taxes, and as a result the question of CFC legislation in this regard might seem irrelevant, but if the focus is moved from the deferring effect of the regulation towards the potential tax shortfall resulting from measures executed by the controlled corporations outside the area of influence of the Croatian tax authorities,[49] the question becomes highly relevant. As well as the negative effects of tax deferral, the main concern of the states that have some kind of CFC legislation is the absence of control over the actions of the CFC and the threat of revenue shortfalls through the illegal actions of the company. With regard to Croatia, this opens an unusual discussion.

While other legislators would just tax the controlling corporation before it receives the transfer of funds from the controlled company, Croatian law has no intention of taxing reinvested profits or dividend payments between companies, since the Croatian tax system and the constitutional norms prohibit such an approach. The freedom of capital laid down by the Constitution forbids intrusion into the capital transfers of companies as long as their fair taxation in Croatia is not endangered. If it is taken into the equation that the Croatian tax system does not tax dividend profits at the level of national corporations, but only at the level of the income of natural persons or foreigners if they do not fulfill certain requirements, this leads to some important conclusions:

1. If the corporation in Croatia is just an intermediate holding company with shareholders within the EU that fulfill these requirements, there is no basis for taxation in Croatia at all at a corporate or dividend tax level. As a result, further protection mechanisms would not be consistent with the tax system *per se*.

[49] This was also a prime consideration for the implementation of the first CFC rules in the USA. See Revenue Act from 1962, P.L. 87-834, 87th Cong. 2d. Sess. (Oct 16, 1962). See on the development of the regulation: *Dilworth*: Tax Reform: International Tax Issues and Some Proposals, International Tax Journal 2009, p. 12 f.

2. The need to protect potential tax revenues is mostly limited to the dividend taxation of natural persons, and the general exemption of corporations from dividend taxation cannot be solved by means of CFC rules, since such a solution would lead towards an unconstitutional disparity of treatment of taxpayers.

Therefore, the Croatian legislator has adequately regulated the protection by means of anti-tax evasion rules, such as transfer pricing rules and debt capital rules. However, the CFC legislation is still relevant to a certain extent, based on the anti-avoidance rules within the Corporate Tax Act and the Tax Code. As a result, even though the CFC legislation does not directly result in taxation of the controlling company, it could in some cases result in the taxation of the shareholders. This could be the case when the creation of a CFC is aimed solely at tax evasion, and then the anti-avoidance rule of the reinvestment regulations, in interrelation with the regulations on controlled corporations and based on the constitutional values of equal taxation, would provide the basis for the non-acceptance of the construction and directly tax the Croatian shareholders. However, in practice, the new rules have been in existence for nearly a year and it is doubtful that the tax authorities, except in extreme cases, will go so far as to tax the shareholders directly, especially because of the lack of experience and case law in this area. Therefore, a CFC rule covering the particular cases in which the Croatian tax system is in danger has to be considered a better and more realistic solution.

4. Conclusion

Croatian tax law diverges in terms of international tax law from most European and international tax systems to a significant extent. This is particularly noticeable in the area of international corporate taxation, where Croatia tries to create a corporation-friendly tax system that nevertheless does not risk being perceived as a low-tax system or centre for ventures aimed at tax evasion. Within this structure, the regulations on reinvested

profits are an essential element of the economic strategy of the state. In addition to the economic effects of such a regulation, the fiscal effects of this regulation in combination with its interaction with other provisions of Croatian tax law create a tax system that to a considerable extent makes CFC legislation in its classic form redundant. Within this analysis of the Croatian tax system, however, it should be clear that, while the regulation solves some problems that are the object of CFC legislation, it also gives rise to new problems that have to be solved on a similar level to classical CFC legislation.

As part of the constitutional analysis, two key elements were detected that define the state's reasons to act and its limitations in relation to applicable methods. The first key element was the sum of the constitutional tax principles based on equality and economic power. By means of an examination in the historical and comparative contexts, clear boundaries and directives regarding the international taxation of CFCs were detected. The second element, the freedom of capital, conversely highlighted a broader freedom in this field. Both principles were harmonized through a teleological analysis of capital freedom, which had to comply with the fiscal rights of the state. From these conclusions the current legislation in Croatia was critically analyzed and defects of the current system were pointed out.

The current Croatian legislation contains few norms that could be considered part of CFC legislation. However, the reinvestment regulation makes the Croatian tax system particularly noteworthy as a destination for CFCs and the rules limiting the tax exemption are, through their impact on CFC cases, highly relevant for Croatian controlling and controlled companies. Considering the possible solutions, the question arises as to whether the legislator should have implemented less stringent protection mechanisms that could have the same effect. In addition to these regulations, the taxation of foreign profits in the light of tax fraud represents the second important issue under Croatian tax law. This issue has still not been analyzed in-depth by the tax authorities and continues to generate legal uncertainty. While the taxation of foreign profits of controlled

companies at shareholder level in Croatia is based on a range of rules, their interaction still has not been examined in practice and it is doubtful whether it can be under the current circumstances. As a result, the Croatian legislation in this field has to be clarified, so that a fair and transparent position of the tax authorities on these matters can be guaranteed. Consequently, the current state of affairs needs to be reviewed and clearer rules have to be implemented, in addition to the promotion of the protection mechanisms against international tax evasion. This will become especially relevant when considered in the context of the reactions of other CFC regimes to the Croatian deferral method, which basically gives rise to exactly the opposite effect of what most CFC rules try to achieve.