

# Arguments in Favor of a Double Taxation Treaty Between Croatia and the United States of America

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American Chamber of Commerce in Croatia *Američka gospodarska komora u Hrvatskoj*

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# Introduction

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Double taxation treaties (“tax treaties”) are international contracts entered into by states with the principal purpose to reduce or eliminate double taxation of income earned by residents of each country from sources within the other country.

Tax treaties are intended to prevent avoidance or evasion of taxes but their actual influence exceeds this purpose: they also help promote and foster closer economic cooperation by helping to eliminate possible barriers to trade and investment caused by overlapping taxing jurisdictions. These objectives are primarily achieved through an agreement to limit, in specified situations, the right to tax income derived from each country’s territory by residents of the other country. Reduced tax rates and exemptions vary among countries and specific items of income, in line with the terms of each negotiated tax treaty. The objective of preventing tax avoidance and evasion is generally accomplished by the agreement of countries that are parties to the tax treaty to exchange tax-related information.

The United States (US) has tax treaties in place with a number of foreign countries<sup>1</sup>. Such tax treaties are complex, take time to negotiate and are negotiated at the highest government level. In the US specifically, this obligation lies with the US Department of the Treasury. However, despite their complexity and the time consuming process of arriving at such a tax treaty, they represent almost a standard in US relations with amicable countries.

Despite a number of attempts to date to initiate the negotiating process for signing a tax treaty with the US coming from Croatia, no such treaty is currently in place. In this position paper AmCham wishes to present a number of arguments in favor of re-initializing the request for opening the negotiation procedure for putting a tax treaty between Croatia and the US in place.

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<sup>1</sup> For example, The Internal Revenue Service web-site lists a total of 66 countries with which the USA has tax treaties in place on March 16, 2018: [https://www.irs.gov/pub/irs-utl/Tax\\_Treaty\\_Table\\_3.pdf](https://www.irs.gov/pub/irs-utl/Tax_Treaty_Table_3.pdf).

# Arguments in Favor of a Double Taxation Treaty

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## *Fostering investments from Croatia to the US*

The current US administration is focusing both on increasing exports (which is facilitated by the current low value of the dollar, despite rising oil prices) as well as actively seeking to attract investments. A tax treaty would play a significant role in fostering investments from Croatia to the US in line with US policy, and would provide Croatian investors fairer access to the US market. A tax treaty would be the logical first step to attract investments from Croatia.

## *US standard in relations with amicable countries*

It could be said that a tax treaty represents a US standard in relations with “friendly”, partner countries. Taking into account the good political relations between Croatia and the US, the absence of a tax treaty is almost surprising.

## *Equal treatment of all EU members*

The European Union (EU) is an important trading partner for the US. Croatia is currently the only EU member state which has not signed a tax treaty with the US.

## *Transparency of doing business*

A tax treaty would ensure much greater transparency in doing business between Croatia and the US. The current absence of a tax treaty effectively forces companies (and individuals) to structure their investments in the US/Croatia through subsidiaries registered in other countries, which reduces transparency. A “positive and attractive tax environment” on both sides, in combination with a tax treaty, would act for the benefit of both countries.

## *Administrative and financial unburdening*

In addition to negatively influencing the level of transparency, the absence of a tax treaty, which fosters direct bilateral business relations and investments between two countries, places an additional administrative and financial burden on both Croatian and US companies which structure their investments in the US/Croatia through subsidiaries registered in other countries. Also, such structures are likely to become even more complicated and costly in the near future, in the light of new EU and global regulations which require companies to add “substance” to their operations, with the exact aim of discouraging companies to structure operations in a country simply for the purposes of doing business elsewhere.

### ***Efficient transfer of knowledge***

The absence of a tax treaty can also be argued to pose an important obstacle to efficient transfer of knowledge between Croatia and the US due to the costs of withholding taxes on the provision of certain services and royalties and the costs of the taxation of labor. Having a tax treaty in place would allow US companies to directly attract Croatian knowledge, and vice-versa. This is a crucial issue for SMEs and particularly for companies in the IT sector.

### ***Fostering trade and investment ties***

Croatian companies which establish subsidiaries in the US are subject to US Federal and State corporate income tax and then the payment of dividends to the Croatian company is subject to withholding tax at a rate of 30%. Given that the Croatian corporate income tax rate is 12% or 18% the cumulative US tax rate is highly discouraging for Croatian companies doing business in the US. This issue especially strongly affects large companies, which are forced to do business in the US through distributors or through subsidiaries in other countries. This negatively affects the scope of business and investments that might be brought to the US.

### ***Treatment of individuals***

The absence of a tax treaty significantly affects US citizens working in Croatia and vice-versa. The issue is twofold: both the possibility of the individuals being double taxed/taxed at a higher rate and the requirement to fulfill various administrative requirements – such as the obligation of completing and filing tax documentation in both countries.

The absence of a tax treaty also significantly affects US citizens retiring and receiving pensions in Croatia and vice-versa.

Finally, US citizens having at their disposal an apartment or a house in Croatia and/or spending a fairly large amount of time per annum in Croatia are exposed to a possibility that Croatia could treat them as its tax residents, which complicates their tax situation even if they do not have any Croatian sourced income, whereas they are at the same time taxed in the US based on their US citizenship. This, too, would be rather easily resolved if there was a tax treaty in place.

# Sample Calculation to Simulate the Impact of a Double Taxation Treaty

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Set out below is a sample calculation to simulate the impact of a double taxation treaty, with the following assumptions:

- The Croatian company is owned 100% by a US company;
- The Croatian company pays Croatian corporate profits tax at the rate of 18%;
- For illustrative and simplicity purposes we have ignored parafiscal and other taxes that may apply;
- The Croatian company makes three payments during the year to its US parent:
  - Interest and royalties
    - in the absence of a double taxation treaty interest and royalty payments are subject to 15% Croatian withholding tax (WHT) which must be withheld by the Croatian subsidiary and only the after tax (net) amount may be paid to the US parent;
  - Dividends
    - in the absence of a double taxation treaty dividend payments are subject to 12% Croatian withholding tax which must be withheld by the Croatian subsidiary and only the after tax (net) amount may be paid to the US parent.

In all three cases, in the best case scenario, a Croatia – USA double taxation treaty would eliminate WHT on the interest, royalty and dividend payments such that the full amount may be paid to the US parent: this is a significant cash flow advantage for the US parent.

**Table 1:** Sample impact of a Croatia - USA Double Taxation Treaty (DTT) on an example of a Croatian subsidiary of a US company (source: KPMG Croatia)

<b>Croatian limited liability company</b>	<b>No DTT</b>	<b>DTT</b>
	<b>USD '000</b>	<b>USD '000</b>
<b>Revenue</b>	1.000,00	1.000,00
<b>Various costs</b>	-500,00	-500,00
<b>Interest to US parent</b>	-85,00	-100,00
<b>Croatian WHT on interest to US parent at 15%</b>	-15,00	0,00
<b>Royalty to US parent</b>	-85,00	-100,00
<b>Croatian WHT on royalty to US parent at 15%</b>	-15,00	0,00
<b>Net profit before tax</b>	300,00	300,00
<b>Croatian corporate profit tax</b>	-54,00	-54,00
<b>Net profit after tax</b>	246,00	246,00
<b>Dividend to US parent</b>	-216,48	-246,00
<b>Croatian WHT on dividend to US parent at 12%</b>	-29,52	0,00
<b>Net cash</b>	0,00	0,00
<b>Croatian corporate profits tax paid</b>	-54,00	-54,00
<b>Croatian WHT paid</b>	<b>-59,52</b>	<b>0,00</b>
<b>Total Croatian taxes paid</b>	<b>-113,52</b>	<b>-54,00</b>

## Recommendation

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In order to follow global and EU best practice in economic and political relations, and to eliminate administrative and taxation impediments in bilateral trade relations between Croatia and the US we propose that a double tax treaty be negotiated between Croatia and the US.

## Conclusion

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The application of the provided recommendation would result in the overall administrative and tax burden on bilateral investment and trade decreasing, which would ensure that Croatia and US would both become more favourable countries for investments.

Also, the entering into of a tax treaty would ensure that Croatian businesses, citizens and investors are not disadvantaged in the US and vice versa vis-à-vis third country businesses, citizens and investors.

By applying the recommendation Croatia and the US will increase transparency and reduce administrative and financial burdens on both Croatian and US companies and citizens.

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