

Recommendations for Reform of the Tax System with the Emphasis on the Unburdening of Labor

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

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Introduction

According to AmCham's *Survey of the Business Environment in Croatia*, the participants view labor taxation and tax burden as one of the main constraining factors for doing business in Croatia. Furthermore, the lack of adequate workforce issue has appeared for the first time in 2017 as one of the key issues. The survey was published on March 28, 2018, and was carried out on a sample of 140 management board members of domestic and international companies in Croatia.

Main limiting factors for doing business in the past five years:

- 1) Unstable regulatory framework
- 2) Long and complex administrative procedures
- 3) Taxation of labor

Main limiting factors for doing business in 2017:

- 1) Long and complex administrative procedures
- 2) Unstable regulatory framework
- 3) Taxation of labor
- 4) Lack of suitable work force

Biggest disadvantages of doing business in Croatia compared to CEE countries:

- 1) Slow administration
- 1) Tax burden
- 3) Lack of a long-term government strategy
- 3) Small market

The tax reform in 2017 included amendments to 15 acts. Some of the measures favored the improvement of the business environment. The threshold for entering the VAT system has increased from HRK 230,000 to HRK 300,000. In the case of income tax, the lowest rate of 12% has been abolished (though it remained in use for certain forms of income) and tax rates of 25% and 40% have been lowered to 24% and 36%. Reducing income tax has positively impacted the reduction of the tax burden on labor. The basic personal allowance increased from HRK 2,600 to HRK 3,800 and a single tax bracket of HRK 0–17,500 was introduced with a rate of 24%. Income tax is not paid on the cost of accommodation and food for seasonal fixed-term workers. The corporate tax rate of 20% has been lowered to 18%, and for sole proprietors and small businesses with annual revenues of less than HRK 3 million it has been lowered to 12%.

In 2018, Croatia will mark its fifth year of European Union membership. In the economic sense it is important to emphasize two related facts: the Croatian

active labor force is leaving the country in significant numbers to work in more competitive markets, while at the same time Croatia has seen economic growth accompanied by increased demand for labor. This has had a further effect on the mismatch between supply and demand on the labor market, making it necessary to provide a stimulating tax framework that would allow the retention of existing, but also attract new workers and additional investments.

In this position paper, the American Chamber of Commerce presents its recommendations for attracting investments and greater competitiveness of Croatian employers in attracting and retaining workers.

General Recommendations

Better legislation

Frequent changes and amendments to tax regulations is one of the key features of the Croatian tax system. Frequent, unpredictable, and non-standardized changes to the tax system, regardless of content, are not good for the economy. The announcements by the Ministry of Finance that there will be no tax changes in the current year if they had not been agreed on in the previous year, as well as the practice of planning tax regulations in the previous year, AmCham sees as a positive move, but it is important to keep this principle in the future.

Tax authorities as partners to the business community

AmCham members often report on their impression that tax inspectors are focused on looking for errors in order to penalize businesses. Inspectors and the Tax Administration should position themselves as advisors to the business community. If it is clear that an error was unintentional, it is sufficient and far more useful to issue a warning with a plan to rectify the error.

In a considerable number of cases, tax inspectors discover an error in the books and build a case to penalize companies, leaving them with the sole option of going through years of appeals and litigation. Such behavior by the tax authorities directly affects the business and investment environment in the country.

In accordance with the best practices of tax authorities in developed countries, when entrepreneurs voluntarily inform the tax authorities of previously miscalculated taxes or other procedural errors, the Croatian Tax Administration should take their initiative and openness into consideration, mitigate possible adverse consequences (additional liabilities and penalties), and cooperate with the entrepreneur on solving the problem.

It is important to stick to the principle of proportionality. Family run farms or small businesses often do not have a permanently employed accountant and it is not justifiable to have the same expectations and demands from them as from larger companies with accounting departments. Examples of practices show inconsistent conduct of tax officers, who often have requests that cannot be met within the set deadlines.

AmCham invites the Tax Administration to be more proactive in the area of preventive measures, instead of issuing additional tax liabilities and fines in cases of mere oversights (such as not submitting a blank VAT form).

Separation of first- and second-level tax authorities

The Tax Administration, which is responsible for tax decisions, and the appellate body, i.e. the Independent Sector for Second-Instance Administrative Procedure, should be strictly separated not only formally, but in practice as well. Further progress must be made in the area of reaching higher levels of expertise and experience of second-instance body experts.

The current appellate body often only confirms tax decisions made at first instance. In these circumstances, appeals against first-instance decisions seem meaningless and often only prolong the process.

Specialization of administrative judges for finance (primarily tax) law is also necessary. As a rule, judges dealing with a very wide range of administrative disputes from different legal areas also decide on highly sophisticated financial and tax cases, and their judgments, as a rule, have significant financial consequences.

Obligation to pay arising only after the administrative dispute

According to the existing legislation, the order of activities and obligations is as follows:

- Tax audits are performed by the Tax Administration or (e.g. in the case of special taxes on motor vehicles) the Customs Administration;
- After an audit, a record is made followed by a tax decision, against which the legal entity may appeal before the Independent Sector for Second-Instance Administrative Procedure;
- If the second-instance body confirms the decision, the legal entity is entitled to initiate an administrative procedure before the Administrative Court, but this does not delay the collection of the tax liability determined by the decision.

The Tax Administration can thus cause damage difficult to repair to the legal entity in a very short period of time, e.g. cause it to become insolvent or bankrupt, while the legal entity depends on the agility of the Administrative Court where disputes usually last several years.

Introducing voluntary reporting of undisclosed tax liabilities

The General Tax Act and other tax regulations related to the determination, calculation, and reporting of certain types of taxes prescribe penalties for tax misdemeanors and calculation of default interest on late liability payments. According to the provisions of the General Tax Act, interest is charged starting from the due date of a particular tax liability, and the maturity of a particular type of tax

is determined by special laws. As a rule, a tax liability becomes due on the day the tax liability arises.

In the tax systems of some EU member states, "voluntary disclosure of undisclosed tax liability" has been introduced. Its purpose is to encourage taxpayers to voluntarily disclose undisclosed tax liabilities before the Tax Administration determines these undisclosed tax liabilities during a supervisory procedure within the statute of limitations deadlines. In return, the Tax Administration, depending on the amount of the undisclosed tax liability and the circumstances that led to the failure to disclose on time (with or without the intent to evade), reduces the penalty and interest rates in percentages depending on the circumstances that are specifically defined.

The introduction of the proposed measure would create a positive environment in relations between taxpayers and tax authorities and serve as an incentive for taxpayers to voluntarily approach the Tax Administration and disclose tax liabilities that were not disclosed on time, while at the same time being aware of the material consequences of such an act, which should be less than in the case when the Tax Administration determines the liability itself.

Issuing certificates by the Tax Administration on the absence of tax debts promptly and on the basis of the current situation

Issuing certificates on the status of tax debt is facilitated by the good functioning of the ePorezna system, which AmCham welcomes. However, despite this system, the accuracy of the data on the tax debt status depends on timely data entry, which is performed by the Tax Administration. It is important to continue to increase efficiency in this respect.

For the purpose of further facilitating the participation of entrepreneurs in public tenders for which they regularly need confirmation that they do not have tax debts, it is suggested that debts of up to a reasonable amount, e.g. of up to HRK 1,000, should also be treated as the absence of tax debt. This can easily be achieved in the system in a way that debts below this particular amount do not appear at all on the tax debt print-out, as if there is no tax debt at all.

Administrative measures for facilitating business operations of entrepreneurs and the Tax Administration

Entrepreneurs often complain about a high level of bureaucracy, i.e. a large number of administrative requirements they have to fulfill for their tax and related liabilities. Further relief is proposed based on the digitization and automation of the entire system (modernization of the Tax Administration IT system), which would

contribute to the increase of transparency, equal treatment, and simplifying processes, and would be more environmentally friendly (“paperless business”). A large number of forms does not contribute to easier business operations. In addition, forms should be simplified. For example, what presents a difficulty is a large number of codes used in “JOPPD” forms or a large amount of data in VAT returns (e.g. the UK VAT form contains 5 to 7 fields, while the Croatian one has more than 20), the “RPO” form (taxpayer registration) and the like.

It is also desirable to differently arrange the issuing of the Central Tax Administration Office’s opinion to the taxpayers, outside the system of binding opinions issued within a special procedure. An illustrative example is the question asked on August 6, to which the response was received at the end of the year. In comparison, in the UK, the same entrepreneur received a response within a few days. In addition, the list of topics for which a binding opinion can be required in the aforementioned special procedure should be substantially extended (the existing scope of topics is insufficient), and efforts for implementation that will enable the real and wide application of the binding opinion institute should be made.

It is important to implement measures aimed at improving the investment environment through a cheaper and simplified way of doing business.

Extending the period of tax loss carryforward

Existing regulations on the five-year loss carryforward do not encourage long-term investments, especially not investments in high-tech. It is necessary to extend the loss carryforward period in accordance with the best European and global practices. For example, Austria has a period of 7 years, while the US has 20 years. We believe that this period in Croatia should be extended from 5 to 10 years. A good example could be the solution implemented by Slovenia, where there is no time limit for the tax loss carryforward, but every year only 50% of the realized profit can be covered by the loss carryforward, and for 50% corporate tax needs to be paid.

Correction of tax liabilities due to uncollectible receivables

Legislative provisions provide Croatian taxpayers with the possibility of VAT liability correction in regard to uncollectible receivables, but the correction procedure is made difficult for taxpayers. Specifically, one of the conditions for correction is that the taxpayer who has supplied goods or provided a service has the recipient’s written statement that he has corrected the input tax deduction in his business records. In other words, no correction is possible without the customer’s cooperation.

For example, the UK tax system imposes an automatic and legal obligation on buyers to repay the input tax to the Tax Administration if they have not paid their suppliers within six months of delivery of goods or received services. AmCham believes that the Croatian Tax Administration should, by changing legal regulations, be involved in the process of collecting uncollectible claims and prescribe the deadline for taxpayers to make a correction of input tax deduction if they have not paid their suppliers on time. This would facilitate the process of correction for taxpayers who were unable to collect their receivables for the delivered goods and services, while at the same time having to pay VAT from their own funds because they did not collect their receivables from the buyer. The burden of correction would also be shifted from the taxpayer to the Tax Administration, which is considered to be a more appropriate and effective procedure.

Income tax - reducing the tax burden on labor contributions

Despite the changes in the taxation of labor from 2017 and 2018, income tax and social contributions still represent a relatively high burden, especially if we compare Croatia to other countries. AmCham's survey of the business environment, in which tax burden on labor was identified as one of the main limiting factors for doing business in Croatia, also confirms this.

There are a number of reasons that lead to high burden, one of which is the fact that the tax rate of 24% relates to a relatively narrow income (tax) bracket, so the higher tax rate of 36% already applies to income above HRK 17,500 per month.

Further reducing the burden on salaries is necessary to stimulate investment and employment. Widening the tax bracket that is taxed at a rate of 24% would have a positive impact on attracting investors and increase investment inflows from the perspective of the price of labor in Croatia. Based on the State Budget analysis, it is estimated that the annual revenue of the state budget from income tax (intended for local government units) amounts to approximately HRK 2 billion, while, in comparison, 1 percentage point of value added tax contributes about HRK 2.4 billion to the budget. Potential benefits from further burden reduction would be significantly higher than the consequent loss in revenue from income tax. At the same time, a possible VAT reduction by one or two percentage points does not mean much to consumers and would create a substantial budget deficit.

For most employers, employees are the biggest cost item. The tax burden on wages remains too high despite the tax reform. Net salaries, after all payables and contributions, remain relatively modest compared to the total cost for the employer.

Compared to competitive economies, highly paid employees are still "expensive", which is unstimulating for attracting investment and new employment in business activities that generate a greater added value. In addition, this practice discourages investors and global companies from opening regional centers in Croatia.

Examples of Bulgaria and Serbia demonstrate that the lower burden on wages with public dues can attract an increased level of investment and jobs without negative consequences for the state budget. In addition, impacts on the budget would be positive as a result of a positive psychological impact on consumption that would arise from removing the burden from wages.

The EY table below provides an overview of tax rates and contributions in Croatia and competing markets.

Overview of tax systems in 2018	Croatia	Bulgaria	Czech Republic	Romania	Serbia	Slovakia
Corporate tax rate (in general)	12% - for generated revenue of up to HRK 3,000,000.00 18% - for generated revenue of HRK 3,000,000.01 or greater	10%	19%	16%	15%	21%
VAT rate (in general)	25%	20%	21%	19%	20%	20%
Income tax rates (wages)	24%, 36% + surtax up to 18% (the highest rate is applied to annual taxable income above HRK 210,000.00, or EUR 28,000.00 in 2018)	10%	20.1% - 23.35% depending on income level	10%	10% (+10% for annual income from EUR 20,097.00 to EUR 40,194.00, or +15% for incomes above EUR 40,194.00)	19% (25% if annual income exceeds EUR 35,268.06)
Contributions on wages	Employee: 20% (partially limited) Employer: 17.2% (unlimited)	Employee: 13.78% (limited) Employer: 18.92% to 19.62% (limited)	Employee: 11% (partially limited) Employer: 34% (partially limited)	Employee: 35% (unlimited) Employer: 2.25% (unlimited)	Employee: 19.9% (limited) Employer: 17.9% (limited)	Employee: 13.4% (partially limited) Employer: 35.2% (partially limited)

Source: EY, Comparative analysis 2018

The table shows that Croatia is not competitive when it comes to the tax burden on labor, particularly in the area of higher incomes. This is one of the reasons why a large number of propulsive sectors in Croatia are experiencing problems with a lack of qualified workers, a fact especially evident in, for example, the ICT industry and tourism.

Reducing the tax burden on labor would contribute to the opening up of regional centers of international companies in Croatia, since due to the reduction of the public imposts burden on wages it would be more affordable for entrepreneurs to pay the best managers. This would enable Croatia to establish its position as a regional business center, where its membership in the EU and its geographical position would be of help, and expensive employment is a hindrance.

Reducing the tax burden on some employee income

Share plans

One of the further possible and desirable changes or additions to the system of income taxation, which could have a significant effect on Croatia's attractiveness as a location for foreign direct investment, is also a reduction of the burden of allocating shares to employees. Namely, in recent years, Employee Share Plans have been introduced in many international companies and have become "best practice" for rewarding and retaining employees worldwide while the global trend is to include a wider circle of employees in such programs. The purpose of such plans is to promote productivity of employees, retain key employees of the company, and link the interest of employees with the interest of the company to increase growth by involving employees in the success of the company.

The advantage of an Employee Share Plan for the employee is that the tax treatment of such income in most tax jurisdictions is usually more beneficial than the tax treatment of employment income. Croatia is an exception in this regard as well because the currently valid regulations do not foresee the possibility of a more favorable tax treatment of the above-mentioned income for employees that are below the level of board members. The effective income tax rate and contributions for compulsory social insurance on income based on participation in Employee Share Plans in Croatia is currently significantly higher than of those in comparable neighboring countries.

The effective income tax rate and contributions for compulsory social insurance¹ on income from share plans	
Croatia	93.17%
Slovakia	35.05%
Hungary	30.34%
Slovenia	25.00%
Czech Republic	22.00%
Romania	16.00%
Poland	14.37%

¹ The American Chamber of Commerce in Croatia (2017), *Employee Share Plans – Taxation in Croatia*, the data is taken from the research conducted by KPMG Croatia for the purposes of the document

In order for Croatia to follow European trends, it is necessary to amend the regulations of the Income Tax Act and related implementing legislation to allow that the income received based on an employee's participation in an Employees Share Plan is treated, for example, in the same way as the private investment income that the employee would realize in the open public market (e.g. dividend income and capital gain taxation), i.e. as the gross income from capital taxable at the income tax rate of 12% plus a corresponding surtax (the effective tax rate for an employee who is a tax resident of Zagreb would be 14.16%). Since this is a capital income, it would be exempt from social security contributions.

AmCham proposes that certain payments to workers or to the benefit of workers are not considered taxable benefit in kind.

Allowances for workers' health

- ***Allowance for workers' meals***

AmCham proposes to introduce the possibility of payment of a non-taxable reasonable daily allowance for workers' meals (per working day), e.g. HRK 30–35. This amount should not be subject to contributions for compulsory social insurance. This would encourage employers to relatively cheaply provide their workers the additional benefit of easier financing their meal in a working day. Also, for low income activities, such a measure would also play an important role in reducing social disparities, i.e. the prevention of poverty.

- ***Allowance for sports activities***

Due to a high number of sick days, obesity of a part of the population, healthcare costs and damages to the economy and the state in general that have arisen from this, AmCham proposes the introduction of the possibility of non-taxable financing of employees' sports activities, with an aim to improve their general health (e.g. monthly or annual gym and city pool membership, sports fields time slots, etc.).

- ***Supplementary health insurance***

In 2017, the Croatian Health Insurance Fund (HZZO) recorded an average of 4,244,232 compulsory insured persons. On December 31, 2017 the number of insured persons paying for supplementary health insurance amounted to 1,650,442, which is only 38.9% of the total number of compulsory insured persons.²

² Croatian Health Insurance Fund (2018), *Report on the Operations of the Croatian Health Insurance Fund for 2017*, Zagreb

AmCham proposes enabling a non-taxable payment of supplementary health insurance by employers for employees. This would contribute to a better healthcare system and financing of health services. The introduction of non-taxable payment of supplementary health insurance by employers for employees would increase the number of payments and increase the share of employees with supplementary health insurance.

The introduction of non-taxable supplementary health insurance would be financially neutral for the state budget. The Ministry of Finance is currently remediating a shortage in the health care system. Increasing health care revenue due to a higher number of insured people, as a consequence of non-taxable supplementary health insurance for employees, would result in lower payments from the Ministry of Finance to the health care system.

- ***Organization of team building activities***

Work requires a certain psycho-physical effort of every employee. At the same time, individual workers are most often part of an organizational unit or a team with whom they solve and complete tasks.

In line with the trends of developed economies, Croatian employers increasingly organize team building activities. Joint activities of coworkers lead to a better team spirit, sense of belonging to a collective and contribute to better mutual trust, understanding and respect, resulting in significantly better individual and collective business results.

Currently, this type of activities are subject to taxation, which is a significant cost to employers who often decide not to organize recreational activities for employees or to reduce the scope and quality of planned activities in order to reduce costs. Organization of team building is a standard in the contemporary organization management and human potential management. Taxing recreational activities for employees makes it difficult to keep up to date with the most contemporary business trends for employers in Croatia.

AmCham believes that non-taxation of team building activities, more specifically the clear regulation of the tax treatment of team building activities, would have multiple positive effects on the psychophysical benefit of employees, but also on better productivity of individuals, companies and ultimately the Croatian economy.

Allowance for accommodation and food for temporarily posted workers

It is necessary to equalize the rights of all taxpayers in a similar/same category. The recent amendments to the income tax regulations allowed the non-taxable

allowance for accommodation and food for tourism workers, thus boosting the mobility of the workforce and assisting tourism workers who temporarily moved from their place of residence because of work in covering the cost of accommodation and other expenses that are related to that change.

However, there is no reason to have this option available only in tourism. For example, the company Mirna, a member of the Podravka Group, has a sardine factory in Rovinj and the need to send a certain number of workers to work in that factory. Paying for accommodation and food for these temporarily posted workers is subject to taxes and contributions, which increases the cost of their work and therefore reduces business competitiveness. AmCham therefore proposes that the aforementioned legal provisions on seasonal workers related to the tourism sector apply to all industries.

Use of taxi services during a business trip

If a worker uses taxi services or some other mean of transportation for transportation from the airport to the destination of business trip, these expenses are not considered to be transportation in the destination of the business trip and are recognized as transportation cost of the business trip. It is considered as transportation to the destination of the business trip, not within the destination of the business trip, so the cost can be compensated to the employee without paying income taxes and contributions.

In case where expenses for the taxi services are related to the transportation within the destination of the business trip, mentioned expenses should be paid from the amount of the daily allowance. However, if expenses are reimbursed to the employee, they should be taxed as salary in kind.

In principle workers are trying to maximize use of their time during a business trip. In case where there are multiple meetings and business activities organized in a single day taxi services are usually used to avoid slowdown and unnecessary prolongation of stay. Use of taxi services for business purposes is a business expenditure and should not be covered from a worker's daily allowance.

AmCham considers that the use of taxi services during a business trip should be treated as the cost of the trip, without being treated as salary in kind, meaning that the daily allowance should only be used to cover the cost of drinks and meals during a business trip.

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