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Summary

Mergers and acquisitions of Croatian target companies may involve significant tax risks for domestic and foreign acquirers. Over the recent years, Croatian tax authorities have started to vigorously assess the economic substance of the envisaged M&As, often denying the acquirer different tax benefits, thus making the entire restructuring costlier. In doing so, Croatian tax authorities rely on a myriad of domestic anti-tax avoidance rules according to which M&A operations may be characterised as abusive. Accordingly, this paper offers a descriptive and systematic account on how Croatian anti-tax avoidance legislation may hinder M&A activity. Thereby, our aim is primarily to explore, both from a substantive and procedural point of view, the imagined boundary between legitimate and abusive tax planning.

Keywords: *mergers and acquisitions; tax planning; lawfully avoiding payment of taxes; tax neutrality; burden of proof; the general rule against tax evasion.*

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1. INTRODUCTION

It is well accepted in the business community that mergers and acquisitions (hereinafter: M&As) may offer significant tax benefits to the participating parties, but concurrently involve significant tax risks.[1] Thus, the structuring of the overall scheme of M&A, both in domestic and cross-border setting, necessarily calls for a healthy degree of tax planning, with the aim to mitigate pertinent tax hazards, e.g. related to the deduction of interest expenses, valuation of acquired assets, capital gains tax liability etc.[2]

Choosing the right "tax structure" of M&A transactions has become even a greater challenge recently as tax authorities worldwide started to scrutinize the transactions with ever more vigilance, putatively worried about potential tax abuse and ensuing losses of tax revenues in the post-structuring period.[3] While transfer pricing rules denote the most prominent legal instrument at the disposal of revenue bodies in challenging M&A transactions, in a number of countries significant role is also played by domestic anti-tax avoidance rules, such as a general anti-avoidance rule (hereinafter: GAAR).[4] Comparative experience shows that the application of domestic anti-abuse rules to M&A transactions boils down to the examination of commercial substance and rationale of the restructuring taken as a whole, as well as its individual steps.[5]

Insights from the Croatian M&A practice reveal that Croatian Tax Administration (hereinafter: CTA) may go to great lengths in fully or partially denying the right of the acquirer to utilize some valuable tax assets or other tax attributes of the target company. In doing so, CTA relies upon a hotchpotch of anti-avoidance rules that have been enshrined in domestic legislation over the past decade or so, particularly in the post-EU accession period.[6] As a result, not only does the tax terrain of M&As in Croatia become very risky from a substantive point of view, but also, from a procedural perspective, it may be very cumbersome for the taxpayer to demonstrate proper business purpose(s) underlying the restructuring and thus quash the presumption of abusive behaviour.

Against this backdrop, this paper explores how Croatian anti-tax avoidance legislation interacts with M&A activities involving Croatian target companies. In

1 See e.g. Endres, D., Spengel, C. D., (eds.), International Company Taxation and Tax Planning, Kluwer Law International, 2015, p. 489.

2 For a general overview see Blessing, P. H., Key Global Tax Concerns, in Blessing, P. H., (ed.), Tax Planning for International Mergers, Acquisitions, Joint Ventures and Restructurings, Kluwer Law International 2017, pp. 1-17.

3 See e.g. Cotrut, M., Ambagtsheer-Pakarinen, L., Business Restructurings: The Toolkit for Tackling Abusive International Tax Structures, in: Cotrut, M. (ed.), International Tax Structures in the BEPS Era: An Analysis of Anti-Abuse Measures, Online Books IBFD 2015, sec. 7.1.

4 See Kroppen, H., Silva, J. C., General Report, in IFA Cahiers Vol. 96a: Cross-border business restructuring, 2011, pp. 27-31.

5 See Cotrut, M., Ambagtsheer-Pakarinen, L., op. cit., sec. 7.3.

6 For a recent general overview of Croatian anti-tax avoidance legislation see Žunić Kovačević, N., Croatia, in Dourado, A. P., (ed.), Tax Avoidance Revisited in the EU BEPS Context, IBFD 2017.

doing so, particular attention is drawn to some selected issues that breed uncertainties and disputes, such as carry-forwards of transferring entity's tax losses. Our principal aim is to try to delimit when an M&A tax structure crosses the imaginary boundary between legitimate tax planning and tax abuse.

2. MERGERS AND ACQUISITIONS IN THE LIGHT OF CROATIAN ANTI-ABUSE LEGISLATION

On a raft of concerns regarding tax structuring of M&A transactions, a key issue is whether and under which conditions potentially valuable tax assets and other tax attributes of the target company (e.g. loss carry-forwards, excess tax credits, benefits approved by a tax ruling) survive the transaction, i.e. whether the acquirer may use these attributes in the post-acquisition period.[7] Typically, if an M&A transaction is carried on in the form of a "share deal", where the legal ownership of target's shares is transferred from the seller to the buyer, such tax attributes of the target are preserved and may be subsequently utilized by the buyer.[8] In other words, share transactions generally ensure tax neutrality, which is one of the key concepts in M&A tax planning.

2.1. Legal requirements for tax-neutral mergers and acquisitions

Under Croatian law, tax neutrality in the course of M&As has been assured by the provisions of Articles 19 and 20 of the Profits Tax Act (hereinafter: PTA).[9] Art. 19(1) PTA sets out that the key requirement for a tax-neutral merger or division is the so-called "continuity in taxation" (*kontinuitet u oporezivanju*). As per Art. 19(2) PTA, the continuity requirement is deemed to be satisfied if, during the transfer to the acquiring company, there are no changes in the assessment of assets and liabilities, i.e. if there is a roll-over of book values, for tax purposes, of the assets and liabilities involved.

Herein the acquirer encounters some risk stemming from the target's financial accounting practices in the pre-restructuring period. Namely, in case the acquiring company had opted for the use of the revaluation model in measuring the value of its on-balance-sheet assets[10], there is a possibility that transferring assets are not valued at their fair value at the date of the acquisition. The Croatian Tax Administration has addressed this issue in a non-binding tax ruling of 11 March 2011, faced with the factual situation of a partial division transaction, in which immovable property, deemed to constitute a separate branch of activity for tax purposes, has been transferred from one existing company to another in exchange for the shares of the latter; with regard to the question at stake, the CTA convincingly argued that the continuity requirement

7 See Blessing P. H., op. cit., pp. 5-6.
8 See ibid., p. 4. Compare also Endres, D., Spengel, C., op. cit., pp. 491-494.
9 Official Gazette of the Republic of Croatia, nos., 177/04, 90/05, 57/06, 146/08, 146/08, 80/10, 22/12, 148/13, 143/14, 50/16, 115/16.
10 Generally on the difference between the cost model and the revaluation model see Koek, M., Van den Berg, T., Special Items, in Bakker, A., Van den Berg T., Janssen, B., (eds.), Tax Accounting: Unravelling the Mystery of Income Taxes, IBFD 2015, sec. 9.6.1.2.

for a tax-neutral transaction is not fulfilled, since the value of the counter-payment for the transferred assets far exceeded their book value.[11] For our purpose it is particularly interesting to note that the CTA also used an anti-tax abuse thread of thinking in assessing the given set of facts, especially because the transferor and the transferee were associated persons.

In any case, important legislative developments in this area have arisen following Croatia's accession to the European Union (hereinafter: EU) on July 1st 2013. Most notably, on that very date the amendments to the PTA came into force, by virtue of which the provisions of the EU Merger Directive were transposed into Croatian domestic law.[12] In this regard it has to be noted first that the aims and legal consequences of the Merger Directive[13] are fully aligned with the general rules of the PTA on tax-neutrality as regards M&As, laid out above.[14] Second, the Croatian legislator has opted, presumably wittingly, to extend the scope of application of the domestic provisions transposing the Merger Directive covering purely domestic corporate reorganizations as well.[15] This becomes clear upon reading the relevant administrative regulations, specifically, the then Ordinance on Profits Tax (hereinafter: OPT)[16], explicitly laying down uniform procedural requirements for domestic and cross-border intra-EU M&As.[17] Moreover, such equal treatment has been confirmed in the CTA's non-binding tax ruling dated May 28th 2014.[18] Accordingly, it seems that administrative practice affirms the view that the relationship between Articles 19 and 20 PTA on the one hand, and the newly enacted Articles 20.a-20.r PTA corresponds to the one between general and special norms.

The portrayed benefits of tax neutrality in the M&A context may be obtained only upon completion of several procedural steps, as set out in Articles 41.g – 41.j OPT. First of all, the acquirer is obliged to notify the CTA of the planned transaction – i.e. merger, division, exchange of shares or transfer of assets – and enclose all relevant information, most importantly the financial statements of the target company and a detailed depiction of the commercial and financial reasons underlying the transaction.[19] On this basis, tax authorities have a deadline of 90 days to issue the administrative

11 See Croatian Tax Administration, opinion No. 410-01/10-01/2163, 11 March 2011.

12 See Articles 20.a – 20.r PTA.

13 Council Directive 2009/133/EC of 19 October 2009 on the common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of shares concerning companies of different Member States and to the transfer of the registered office of an SE or SCE between Member States, OJ L 310, 25.11.2009.

14 For a general overview of the objectives of the Merger Directive see e.g. Helminen, M., EU Tax Law – Direct Taxation 2017, Online Books IBFD 2017, sec. 3.3.1.2.; Hofstätter M., Hohenwarter-Mayr, D., The Merger Directive, in: Lang, M., et al., Introduction to the European Tax Law on Direct Taxation, Linde 2013, pp. 158-159.

15 On this possibility see Helminen, M., op. cit., sec. 3.3.2.1.

16 Official Gazette of the Republic of Croatia, nos. 95/2005, 133/2007, 156/2008, 146/2009, 123/2010, 137/2011, 61/2012, 146/2012, 160/2013, 12/2014, 157/2014, 137/2015, 115/2016, 1/2017, 2/2018.

17 See Article 41.j(1) of the OPT.

18 Croatian Tax Administration, opinion No. 410-01/14-01/1387, 28 May 2014.

19 See Article 41.h – 41.j OPT.

decision which either allows or denies the benefits of tax neutrality for the pertinent transaction.[20] In essence, this amounts to a process of prior administrative approval, wherein eligibility of the taxpayer to obtain relevant tax advantages is assessed by the tax authorities.

2.2. The Application of the anti-abuse rule stemming from the implementation of the Merger Directive

In transposing the requirements of the Merger Directive in its national legislation, Croatia opted to exercise the option envisaged in Article 15(1)(a) of the Directive[21] and adopt an explicit anti-tax abuse provision on the domestic legal plane. Accordingly, under Article 20.p PTA, the above-described tax benefits will be denied if it is evident that the principal objective, or one of the principal objectives, of the transaction at hand is tax evasion or tax avoidance. Moreover, Article 41(h)(6) OPT lays down that Croatian tax authorities will issue an administrative decision refusing to grant the advantages of tax neutrality if they determine the objective of tax avoidance/evasion underlying the transaction, especially if there are no valid business reasons for the transaction, such as reorganization or financial rationalization of the business in question. While the wording of the quoted provision suggests that the lack of a valid business or commercial motives amounts to only one example of tax avoidance – leading to the conclusion that the taxpayer might be engaged in abusive behaviour also in other circumstances – administrative practice suggests that revenue bodies use it as a presumption of tax avoidance, as explicitly provided in the Merger Directive itself.[22] Such an approach of the CTA is clearly affirmed in the previously-cited non-binding tax ruling.[23]

Even more important for the participants of M&As is the way tax authorities apply the said provisions in practice. Anecdotal evidence suggests that the CTA relies on the wording of Article 41(h)(6) to fully shift the burden of proof on the taxpayer, i.e. that it is up to the taxpayer to prove that tax avoidance or tax evasion is not the primary purpose behind the reorganization. Put differently, administrative practice shows that when deciding on the granting of the benefits envisaged by Articles 20.a-20.r PTA, the CTA starts from the presumption that the intended transaction is being conducted with tax avoidance as one of its main purposes, even if there is no evidentiary substratum whatsoever supporting this position. In the second step, the onus is on the taxpayer to rebut this presumption, by bringing forward evidence of valid commercial purpose(s) underlying the reorganization, including, *inter alia*, the calculation of its commercial

20 See Article 41.h(4) OPT.

21 Article 15(1)(a) Merger Directive reads as follows: „*A Member State may refuse to apply or withdraw the benefit of all or any part of the provisions of Articles 4 to 14 where it appears that one of the operations referred to in Article 1 (...) has as its principal objective or as one of its principal objectives tax evasion or tax avoidance; the fact that the operation is not carried out for valid commercial reasons such as the restructuring or rationalisation of the activities of the companies participating in the operation may constitute a presumption that the operation has tax evasion or tax avoidance as its principal objective or as one of its principal objectives.*"

22 See the second sentence in Article 15(1)(a) Merger Directive.

23 See Croatian Tax Administration, *supra* n. 18.

and financial benefits.[24] In the third and final step, the CTA assesses the economic substance and rationale of the reorganization and issues the authoritative decision on whether the legal requirements for a tax-neutral transaction have been fulfilled or not. In the latter case, the taxpayer can make use of the ordinary system of legal remedies in tax matters, including the right to an administrative review and, subsequently, the right to a judicial appeal.[25]

In some cases tax authorities have took an unusually stringent approach, denying the tax advantages on the basis of purely formal errors in the documentation submitted by the taxpayer, even though the tax avoidance motive of the reorganization has not been reasonably substantiated. Accordingly, some taxpayers have found it very cumbersome to quash the presumption of tax avoidance, even if making a plausible case why the transaction at hand makes sense from a business point of view and tax authorities failing to submit counterevidence. Absence of clear and detailed rules on the required standard of evidence makes matters even more troubling.

In our view, such practice potentially runs contrary to EU law, more specifically the principle of effectiveness, which sets limits on the procedural autonomy of EU Member States in cases where rights derived from EU law are at stake.[26] We base this argument on recent jurisprudence of the European Court of Justice (ECJ), in which the Court examined the compatibility with the primary EU law of the domestic provisions, by which the option prescribed in (now) Article 15(1) of the Merger Directive has been implemented.[27] First of all, it needs to be underlined that, under the EU principle of procedural effectiveness, Member States should refrain from actions that render virtually impossible or excessively difficult exercise of the rights derived from primary or secondary EU law, including the rights resulting from EU tax directives.[28] Secondly, a strand of ECJ's case law dealing with the substantive aspects of tax abuse in the context of the Merger Directive, confirms that Member States' tax authorities may not confine themselves to applying predetermined general criteria for assessing whether a tax abuse is taking place, but must subject each particular case to a general examination of that issue.[29] In other words, the implementation of the anti-abuse clause contained in Article 15(1)(a) Merger Directive should not take the form of general presumptions of tax abuse, without more detailed case-by-case inquiries.

Against this backdrop, in the *Euro Park Service* case, decided in March 2017, the ECJ addressed a more specific issue of the procedural rules applied in Member States in relation to granting pertinent tax advantages. The Court first affirmed the

24 See Article 41.h(2)(8) and 41(j)(2)(10) of the OPT.

25 Generally on the system of legal remedies in Croatian tax law see Žunić Kovačević, N., Upravnosudska kontrola u poreznim stvarima, Zbornik radova Pravnog fakulteta u Splitu, 53(1), 2016, pp. 279-295.

26 On the national procedural autonomy within the EU and the principles of effectiveness and equivalence see Terra B., Wattel, P., European Tax Law, Kluwer Law International 2012, pp. 120-130.

27 See in particular Judgment of 8 March 2017, *Euro Park Service*, EU:C:2016:806; Judgment of 18 October 2012, *Pelati*, EU:C:2012:639.

28 See e.g. Judgment of 9 February 1999, *Dilexport*, EU:C:1999:59, para. 25. Compare also Terra B., Wattel, P., *op. cit.*, p. 123 et seq.

29 See e.g. Judgment of 10 November 2011, *Foggia*, EU:C:2011:718, para. 37.

right of Member States to set up procedural schemes for approval or refusal of Merger Directive benefits.[30] However, in observance with the principle of effectiveness and, more specifically, the requirement of legal certainty, the ECJ found that relevant procedural rules "*(...) should be sufficiently precise, clear and foreseeable to enable taxpayers to know precisely their rights in order to ensure that they are able to benefit from tax advantages under the directive and to rely on them, if necessary, before the national courts*."[31] In the particular set of facts, the Court established that the pre-approval procedure envisaged in French domestic law failed to meet these standards, due to the apparent lack of detailed procedural rules and the level of discretion exercised by the tax authorities in delivering their decisions.[32] For the purposes of the present paper it is even more important how the Court addressed what is essentially the burden of proof issue: "*(...) However, in so far as the legislation at issue in the main proceedings, in order to grant the benefit of the deferral of the taxation of the capital gains under Directive 90/434, systematically and unconditionally requires the taxpayer to show that the operation concerned is justified on economic grounds and does not have as its principal objective, or as one of its principal objectives, tax evasion or tax avoidance, without the tax authority being required to provide even prima facie evidence that there are no valid commercial reasons or evidence of tax evasion or tax avoidance, that legislation introduces a general presumption of tax evasion or tax avoidance.*"[33] Put another way, the ECJ apparently shares the view that national revenue bodies, in the course of procedures related to tax-neutral reorganizations, should initially present at least some degree of evidence that the abstract notion of tax avoidance has materialized with regard to the individual situation. Failing to respect this essentially amounts to creating the general presumption of tax avoidance, which is prohibited under EU law. Accordingly, in our view, the ECJ's decision in *Euro Park Services* has to be read as demanding concrete substantiation of the tax authority's claim that tax avoidance is indeed at work, lest the full burden of proof be borne by the taxpayer.[34]

Taking another look at Croatian rules and administrative practices against the backdrop of the above findings, it is reasonable to conclude that taxpayers involved in M&A transactions in Croatia may find it excessively difficult to exercise the rights

30 *Euro Park Service*, *op. cit.*, para. 36. Compare in that regard the ECJ's reasoning in *Pelati*, *op. cit.*, paras. 21-37.

31 *Euro Park Service*, *op. cit.*, para. 40.

32 *Ibid.*, paras. 40-46.

33 *Ibid.*, para. 56.

34 Compare also the experience with the abuse of Merger Directive benefits in Denmark, as accounted by Bolander J., Graff Nielsen, J., Denmark, in Meussen G., (ed.), The Burden of Proof in Tax Law, IBFD 2013, pp. 97-98. As put by the authors: "*(...) Hence, the taxpayer has to present the relevant considerations in connection with the operation to the tax administration while the administration – in accordance with the inquisitorial procedure principle – may ask questions of the taxpayer who is required to answer these questions to the best of his ability. The consequence is that a presupposition of tax avoidance eo ipso requires a secure evidentiary foundation, and that the taxpayer and the tax administration in effect share the burden of proof – each pulling on different ends of the rope so to speak – to establish whether tax avoidance or tax evasion is the primary purpose of a given reorganization*."

provided for in the Merger Directive. The most problematic aspect is that Croatian tax authorities ostensibly share the view that the evidentiary onus *de facto* lies completely with the taxpayer; it is fully up to the taxpayer, upon initiating the pertinent procedure, to prove that the transaction at hand makes commercial and economic sense and to debunk the presumption of tax avoidance.[35] While it is important to reiterate that taxpayers wanting to make use of the Merger Directive benefits are bound to encounter some evidentiary requirements, particularly related to a more or less detailed description of the planned reorganization, ECJ's case law suggests that tax authorities should refrain from relying on blanket statements that tax avoidance is the aim underlying the transaction, without either providing any counter-evidence, or making a reasonable effort to clarify open issues in a two-way communication with the taxpayer(s).

Furthermore, one also needs to take into account the general rules of Croatian tax law on the burden of proof in tax matters, enacted in the General Tax Act (hereinafter: GTA).[36] In accordance with Article 88 GTA, tax authorities bear the burden of proof in relation to all facts that establish tax liability or lead to the increase in tax burden, while the taxpayer bears the burden of proof in relation to the facts pertaining to a minimization of tax or tax exemptions. Since the potential existence of tax avoidance motive is a fact that results in higher tax liability in cases of corporate reorganizations, it should be up to the tax authority to submit proper evidence thereto. In addition, one should take note of the principle of good faith, which has been enshrined in Croatian tax law ever since 2000, providing that the parties in the tax relationship should act conscientiously and fairly in accordance with the law.[37] While this principle demands stronger co-operation, even partnership-like relations, between taxpayers and tax authorities, administrative practice in the area dealt with in this paper certainly does not fit the bill.[38]

2.3. Relevance of other anti-abuse rules and principles

The rule contained in Article 20.p PTA is known in the tax doctrine as a targeted anti-avoidance rule (TAAR), i.e. a rule aimed at curbing a specific tax avoidance technique, in this case a solely-tax-motivated business restructuring operation.[39] But the question arises as to whether tax authorities may also challenge the transaction(s)

35 See the previously-cited non-binding tax ruling, Croatian Tax Administration, *supra* n. 18.

36 Official Gazette of the Republic of Croatia, no. 115/2016.

37 For the current version of the codification of the principle of good faith, see Article 9 of the GTA.

38 Generally on the features of tax relationship in Croatia see Gadžo,S., Tax Procedure Law in Transition: Croatian Experience, in: Milosavljević, B., et al. (eds), Law and Transition: Collection of Papers, University of Belgrade, Faculty of Law, 2017, pp. 177-189.

39 For a general description of TAARs (or SAARs, as they are also known in the academic literature), see e.g. Čičin-Šain, N., Analyse comparée des dispositifs de lutte contre l'évasion fiscale en droit fiscal croate et français Le cas de l'impôt sur les sociétés, L.G.D.J 2017, pp. 89-92.; Gadžo S., Klemenčić, I., Time to stop avoiding the tax avoidance issue in Croatia? A proposal based on recent developments in the European Union, Financial theory and practice 38(3), 2014, pp. 282.

at hand on the basis of other anti-tax avoidance rules enshrined under the Croatian legislation. In this regard, comparative experiences tell us that revenue bodies sometimes do not shy away from relying on anti-avoidance rules or judicial doctrines of more general application in denying the tax benefits for envisaged M&As.[40]

While it is beyond the scope of the present paper to give full details of the Croatian anti-avoidance legislative framework[41], some recent developments in this area are particularly worth exploring, especially the introduction of a new GAAR by virtue of 2016 amendments to the PTA.[42] As set out in the newly adopted Article 5.a of the PTA – curiously drafted on the basis of Article 2(1) of the EU Parent-Subsidiary Directive[43] – taxpayers shall not be granted any benefits envisaged in corporate tax legislation in case they make use of an arrangement or a series of arrangements which are classified as *non-genuine*. The article defines "non-genuine arrangements" as any business transaction, scheme, action, operation, understanding, promise or event, comprising of one or more than one steps or parts, which has been put into place for the main purpose or one of the main purposes of obtaining a tax advantage, having regard to all relevant facts and circumstances.[44] In addition, it is made clear that such arrangements may be considered non-genuine only to the extent that they are not put into place for valid commercial reasons which reflect economic reality, i.e. if they are put into place for the purposes of tax evasion or fraud.[45]

Further instructions on the application of the new GAAR are found in the OPT. Accordingly, it is clarified that in the assessment of the arrangement's genuineness, it is important to establish whether the arrangement, regardless of any subjective intention of the taxpayer, defeats the object, spirit and the purpose of the pertinent tax provision.[46] Moreover, some typical examples of non-genuine arrangements are provided, including the so-called U-turn transactions and transactions that entail a mismatch between tax benefits and associated business risks.[47]

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40 See Kroppen, H., Silva, J. C., op. cit., pp. 27-31; Cotrut, M., Ambagtsheer-Pakarinen, L., op. cit., sec. 7.3.1.

41 For more details see e.g. Žunić Kovačević, N., et al., Croatia in M. Lang et al. (eds.), GAARs - A Key Element of Tax Systems in the Post- BEPS World, IBFD 2016, pp. 205-218.; Gadžo, S., Klemenčić, I., op. cit., pp. 290-293.; Rogić Lugarić, T., Promišljanja o općem pravilu za sprječavanje zakonitog izbjegavanja porezne obveze in Arbutina, H., Rogić Lugarić T., (eds.), Spomenica prof. dr. sc. Juri Šimoviću, Pravni fakultet Sveučilišta u Zagrebu, 2017, pp. 237-239.

42 A detailed account of this legislative development is given in Čičin-Šain, N., Opće pravilo za sprječavanje izbjegavanja poreza uvedeno u sustav poreza na dobitak, Pravo i porezi, 10 (2016), pp. 12-17.

43 Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, OJ L 345, 29.12.2011, with subsequent amendments. For criticism of such approach of Croatian legislator in implementing the 2015 amendments to the Parent-Subsidiary Directive see Čičin-Šain, N., op. cit., p. 13.

44 Article 5.a(1) and 5.a(2) of the PTA.

45 Article 5.a(3) of the PTA.

46 Article 11.c(2) of the OCT.

47 Article 11.c(2) of the OCT. The examples are essentially copy-pasted from an earlier attempt of the EU institutions to introduce a uniform GAAR in the internal market. See *Commission Recommendation on aggressive tax planning*, C (2012) 8806 final, OJ L 338, 12.12.2012.

Although the necessity for a comprehensive reform of the Croatian anti-tax avoidance framework has been articulated in academic literature[48], the newly introduced GAAR inevitably breeds uncertainty. The lack of case law hitherto makes it even harder to speculate how the tax authorities will interpret contentious elements of the GAAR, such as "arrangements", "valid commercial reasons", "economic reality", etc.[49] For the purposes of the present paper, it is, however, vital to explore possible ramifications of the newly-introduced GAAR on M&A transactions involving Croatian target companies.

Three points deserve special attention. First, regarding the legal compatibility between the GAAR and the TAAR found in Article 20.p PTA, a question may arise whether tax planning structures that passed the CTA's scrutiny under the special rule may still be assessed, potentially resulting in the denial of pertinent tax benefits, by virtue of the GAAR.[50] If one strictly applies the *lex specialis* doctrine, the answer would be in the negative, i.e. the application of the GAAR would be precluded. Such inference seems rather convincing if one takes into account the legal nature of the Croatian GAAR, which is essentially a copycat of the GAAR laid down in the Parent-Subsidiary Directive. If one acknowledges that the latter is not a "principles-based GAAR" akin to its counterparts found in some domestic tax systems (e.g. that of the United Kingdom), but rather a rule having a narrower and more specific remit[51], we share the view that the CTA should abstain from applying the GAAR to business restructuring transactions previously tested under Article 20.p of the PTA. Second, and more important for practical purposes, if one compares the wording of these rules, the room for possible conflict between the two is ostensibly very limited. Namely, as already mentioned above (section 2.2), the taxpayer may escape the application of the TAAR if he demonstrates valid business reasons for the business restructuring operation. Very similarly, under the newly-adopted GAAR, taxpayer's arrangements are considered non-genuine only to the extent that they are not put into place for *valid commercial reasons* reflecting economic reality.[52] One may even go a step

48 See e.g. Prebble, R., Does Croatia Need a General Anti-Avoidance Rule? Recommended Changes to Croatia's Current Legislative Framework, Financial theory and practice, 29(3), 2005, pp. 211-227; Gadžo, S., Klemenčić, I., op. cit., pp. 290-297; Čičin-Šain, N., op. cit., pp. Rogić Lugarić, T., op. cit., pp. 237-239.

49 For a critical overview of these elements found in the GAAR enshrined in Parent-Subsidiary Directive see e.g. Weber, D., The New Common Minimum Anti-Abuse Rule in the EU Parent-Subsidiary Directive: Background, Impact, Applicability, Purpose and Effect, Intertax 44(2), 2016, pp. 98–129.

50 Generally on the relationship between GAARs and TAARs see Krever, R., General Report: GAARs in Lang, M., et al. (eds.), GAARs - A Key Element of Tax Systems in the Post- BEPS World, IBFD 2016, pp. 13-14.; Rosenblatt, P., Tron, M. E., General Report, in: IFA Cahiers Vol. 103a: Seeking anti-avoidance measures of general nature and scope - GAAR and other rules, 2018, pp. 23-24.

51 See Tavares, R., Bogenschneider, B., The New De Minimis Anti-Abuse Rule in the Parent-Subsidiary Directive: Validating EU Tax Competition and Corporate Tax Avoidance?, Intertax 43(8/9), 2015, pp. 488-489.

52 For a detailed analysis of this "artificiality test" or "substance test" of the GAAR enshrined in Parent-Subsidiary Directive see Weber, D., op. cit., pp. 113-115.

further and embrace the introduction of the GAAR as a step towards clarifying the ambiguities in application of the pertinent TAAR. This line of argument resonates well with a standard role played by GAARs in comparative tax systems, namely that of drawing the legislative boundary between legitimate tax planning and unacceptable tax avoidance.[53] Third, and related to the previous point, the "substance test" or the objective prong of the new GAAR should not be all that unfamiliar to Croatian tax practitioners, since the principle of "economic approach" – or, using the comparative tax jargon, "substance-over-form" principle – has been one of the keystones of Croatian tax law for almost two decades now.[54] This principle sets out the approach of interpretation of tax laws, giving legal basis to the CTA to disregard taxpayers' structures that are deemed abusive and impose the tax directly on the underlying commercial reality. The jurisprudence of the Croatian administrative courts regarding substance-over-form principle confirms that taxpayers may not rely solely on the classification of their actions under civil or commercial law in order to obtain tax benefits envisaged in relevant tax laws.[55] Conversely, the points of departure for classifying facts for tax-law purposes are various elements associated with economic substance, including commercial rationale of the transaction, actual behaviour of the parties, existence and usage of tangible assets etc.

Accordingly, if we imagine a business restructuring in the form of company division, where certain valuable assets are carved-out and transferred to a newly formed entity, both the TAAR of Article 20.p CTA and the newly-adopted GAAR would call for an assessment of whether the transaction as a whole, and its individual steps, make commercial sense. Relatedly, in order to get the benefits of tax neutral restructuring, the taxpayer should be able to demonstrate that the spin-off entity is able to have commercial life of its own, e.g. that it has adequate premises, employees, operating assets, separate business activities and is able to bear significant risks.[56] If this is not the case, then it is safe to conclude that the transaction lacks valid business rationale and amounts to a "non-genuine arrangement". In more practical terms, this testing of economic substance will usually boil down to an analysis of the relevant documentation.[57] This makes the above analysis of the *onus probandi* issue even more vexing.

3. THE LIMITATIONS ON CARRY-FORWARDS OF TRANSFERRING ENTITY'S TAX LOSSES

As already explained in the present paper (section 2), an M&A transaction carried through a "share deal" offers, as a general rule, the benefit of preserving the target company's tax attributes and enables their subsequent utilization at the hand of

53 See Gadžo, S., Klemenčić, I., op. cit., pp. 282-283 and the sources referred to therein.
54 Generally on this, Žunić Kovačević, N., et al., op. cit., pp. 206-207. The principle is enshrined in Article 11 of the current version of the GTA.
55 See e.g. Decision of the Administrative Court in Rijeka, Case No. 6 UsI-792/13-9, 18 July 2014.
56 Compare also Kroppen, H., Silva, J. C., op. cit., pp. 30.
57 See also Cotrut, M., Ambagtsheer-Pakarinen, L., op. cit., sec. 7.3.2.

the acquirer. In the M&A environment special attention in this regard is paid to the preservation and usage of tax losses incurred by the target company, i.e. rules on loss carryovers. Within the due diligence process it is vital to examine the possibility that some tax losses of the target may be lost due to rules prohibiting tax loss trafficking, enshrined in the domestic law of a number of countries.[58] Such anti-tax loss trafficking provisions may be branded as another species of TAARs.[59]

Against this backdrop, it has to be noted first, that Croatian corporate tax law allows only for loss carry-forwards, not carry-backs.[60] Loss carry-forward is limited for the period of five years, i.e. five future taxable periods, and earlier losses are to be offset before the later ones.[61] Domestic anti-loss trafficking rules employ both an "activity test" or "economic identity test" and an "ownership test".[62]

More precisely, under Article 17(5) of the PTA, the right to use earlier tax losses of the target company (legal predecessor) ceases for the acquirer (legal successor) in two specific cases: 1) where, within the period of two years after the transaction, business activity of the target is significantly changed;[63] 2) if the target company did not perform any business activities within two years preceding the transaction. In addition to this business activity test, Article 17(7) of the PTA sets out an ownership test, prescribing that tax losses may not be carry-forwarded in case of a significant change in the ownership of the target company, i.e. when more than 50% of target's equity change owner(s) in relation to the beginning of the tax year.[64] However, in the described cases there is also an "escape rule": under Art. 17(8) of the PTA, the legal successor of the target may still utilize target's losses if the change of business activity, or the change of ownership, had the aim to preserve employment or the aim of business recovery.[65] The elements of this escape rule are further clarified in the OPT.[66] Importantly, the concept of "business recovery" (*sanacija poslovanja*) is deemed to include all procedures aimed at increasing revenue through the revival and continuation of business activities, along with job preservation.[67]

Regarding the application of the ownership, there has been some ambiguity in tax practice, particularly concerning cases where the economic identity of the target remains unchanged after the share transaction, i.e. where only ownership of the company is significantly changed. In its public ruling the CTA offered a pro-taxpayer

58 Generally on loss trafficking and the rules aimed at curbing it, see Endres, D., Spengel, C. D., op. cit., pp. 99-100.
59 On the discussion on the role of TAARs and GAARs see section 2.3. above.
60 This is provided in Article 17(2) PTA. For a concise comparative overview of loss carryovers see e.g. Endres, D., Spengel, C. D., op. cit., p. 98; Avi Yonah, R., Sartori, N., Marian, O., Global Perspectives on Income Taxation Law, Oxford University Press, 2011, pp. 84-85.
61 Art. 17(4) of the PTA.
62 Generally on these typical criteria used in anti-loss trafficking rules see Endres, D., Spengel, C. D., op. cit., p. 99.
63 What constitutes a „significant change of activity" is clarified in Article 38(5) OPT, by reference to the National Classification of Activities (NKD 2007).
64 Art. 17(7) of the PTA.
65 Art. 17(8) of the PTA.
66 Article 38, paras. 6-9 of the OPT.
67 Article 38(8) of the OPT.

interpretation of the relevant statutory provision, making clear that loss-carry-forwards will be denied only if the change in ownership is accompanied with the change in economic identity of the target.[68]

4. PROCEDURAL INSTRUMENTS FOR ENHANCING TAX CERTAINTY IN BUSINESS RESTRUCTURING TRANSACTIONS

Within the maze of anti-tax avoidance rules relevant for M&As involving Croatian target companies – explored in previous sections of this paper – tax risks abound for prospective investors. Particularly disconcerting is the increasing number of cases in which tax authorities deny the sought-after tax benefits by qualifying a transaction as abusive, often on arbitrary grounds and without offering reasonable evidentiary substantiation for such findings.[69] These concerns only add to the plethora of issues related to the overall tax environment in Croatia. Namely, recent studies using data collected from business representatives and tax advisors display that key problems include, *inter alia*, the following: (i) frequent changes and complexity of tax legislation, which is sometimes even applied retrospectively; (ii) tax authorities' prejudicial view of the taxpayers as tax evaders; (iii) excessive length of tax dispute procedures; (iv) unwillingness of the tax authorities to truly co-operate with taxpayers; (v) practice of non-uniform application of tax legislation by different organizational units within the CTA; (vi) legal framework and practice of tax audit procedures (vii) unsatisfactory statutory provisions on advance tax rulings, resulting in their underuse in practice.[70] All of these factors contribute to the conclusion that legal uncertainty is a pervasive feature of the Croatian tax system.[71] This should be particularly worrying for policymakers, since there is ample evidence that tax uncertainty, particularly regarding corporate income tax and value added tax (VAT), has serious impact on investment and location decisions.[72]

Against this backdrop, it may be somewhat comforting that in recent years Croatian tax procedure law underwent significant modernization, with the introduction of new, compliance-oriented instruments.[73] In addition, this was coupled with other institutional and regulatory developments important especially for big businesses, such as the formation of a special Large Taxpayers Unit within the CTA, introduction

68 See Croatian Tax Administration, opinion No. 410-01/10-01/1624, 16 August 2010. This clarification has been subsequently included in Article 38(4) of the OPT.

69 On the problem of burden of proof in this context see section 2.2 of this paper.

70 See Stojić H., *et al.*, White Book 2017, Foreign Investors Council 2017, 39-44; Gadžo, S., op. cit., pp. 182-183, and the sources referred to therein.

71 Quite interestingly, one recent survey, conducted among tax professionals operating in 28 European countries, shows that only France and Italy fare worse than Croatia in terms of tax uncertainty. See Deloitte (2015), European tax survey 2015: Transparency, simplification and collaboration, https://www2.deloitte.com/global/en/pages/tax/articles/european-tax-survey.html (accessed 12 November 2018).

72 See IMF & OECD (2017), OECD/IMF Report on Tax Certainty, http://www.oecd.org/tax/tax-policy/tax-certainty-report-oecd-imf-report-g20-finance-ministers-march-2017.pdf (accessed 12 November 2018), pp. 25-32.

73 For an overview see e.g. Gadžo, S., op. cit., pp. 184-188.

of "tax settlements" within tax audit procedures etc. Accordingly, *de lege lata* there are some instruments prospective investors may rely upon in order to mitigate the risk of overstepping the boundary of legitimate tax planning within the M&A context.

Most notably, as of 2015 Croatian taxpayers may obtain an advance ruling regarding the planned transaction, as set out by Article 10 of the GTA.[74] While the objective scope of the advance ruling scheme is, as it stands today, severely limited, assessment of the corporate tax base related to corporate restructurings is explicitly mentioned as one of the questions taxpayers may seek clarification on from the CTA.[75] Accordingly, taxpayers may obtain beforehand the opinion of the tax authorities' whether the benefits of tax neutrality would apply to the planned transaction – e.g. also with regard to loss carry-forwards – thus increasing the level of legal certainty.

An even stronger level of tax certainty is guaranteed where Croatian target companies have, prior to the planned business restructuring transaction, been engaged in the recently introduced horizontal monitoring scheme, regulated in Article 70 of the current version of the GTA. Within this scheme, the taxpayer obliges to be fully transparent on his activities and tax risks, while complying with all duties prescribed by tax legislation in a timely manner. Conversely, tax authorities need to adjust the extent of using their supervisory discretion to the quality of the taxpayer's internal control and auditing processes. Moreover, they are obliged to interact with the taxpayer quickly and transparently, so to avoid any potential disputes.[76]

Taking a brief look *de lege ferenda*, Croatian M&A landscape would undeniably benefit from further improvements on the procedural plane. Since it seems that the resolution of tax disputes is the Achilles heel of the entire tax system, possible answers lie in: (i) the creation of a more robust compliance programmes[77]; (ii) introduction of an additional tier of dispute resolution, in the form of quasi-judicial, independent panels or committee, which may issue (non-binding) opinions on the application of pertinent tax-law provisions, including GAARs and other anti-tax avoidance rules[78]; (iii) usage of (mandatory) arbitration, especially in the cross-border context[79]. Against the background of recent developments in Croatian anti-tax avoidance framework, even some more modest steps, such as timely and more systematic publication of tax

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74 For general information on advance ruling system in Croatia see Žunić Kovačević, N., Prethodna obvezujuća porezna mišljenja – novi institut hrvatskog poreznog postupka, Zbornik Pravnog fakulteta Sveučilišta u Rijeci, 37(1), 2016, pp. 267-289.

75 See Article 10(2)(3). Even more notably, within the recently proposed amendments to the GTA, the objective scope of the scheme will be severely broadened.

76 See Gadžo, S., op. cit., pp. 187-188 and the sources referred to therein.

77 See e.g. IMF & OECD (2017), op. cit., pp. 50-52.

78 For some comparative experiences with this instrument see e.g. Rosenblatt, P., Tron, M. E., op. cit., p. 38;

79 See, e.g. IMF & OECD (2017), op. cit., pp. 49-50, 57; Del Campo, C., General report in IFA Cahiers de Droit Fiscal Vol. 101a: Dispute resolution procedures in international tax matters, 2016, pp. 59-62. For an analysis of alternative dispute resolution instruments in the context of Croatian tax law see Rogić Lugarić, T., Čičin-Šain, N., Alternativno rješavanje sporova u poreznom pravu: utopija ili rješenje?, Zbornik Pravnog fakulteta u Zagrebu 64(3), 2014, pp. 347-375; Žunić Kovačević, N., Upravnosudska kontrola u poreznim stvarima, op. cit., pp. 288-295.

authorities' positions and guidance on specific issues, may go a far way in abating legal uncertainty for taxpayers.

5. CONCLUDING REMARKS

Drawing the line between legitimate tax planning and illegitimate tax avoidance is one of the Gordian knots in tax law theory and practice. This paper has tried to offer a descriptive and systematic account of anti-tax avoidance rules that may be used the Croatian tax authorities in order to deny the tax benefits of a business restructuring operation. What emerges from the analysis is that prospective investors should, more than ever before, structure all the steps of an M&A transaction in a way that reflects the underlying economic substance and makes commercial sense. Failing to do so may trigger the scrutiny of tax authorities, on the basis of either targeted anti-avoidance rules (TAARs) or the general anti-avoidance rule (GAAR). We have underlined how in this context a special set of problems arises from a procedural perspective. Most notably, practical application of the rules on burden of proof result in great difficulties for the taxpayer to demonstrate proper business purpose(s) underlying the restructuring and thus quash the presumption of abusive behaviour. The resulting uncertainties are bound to increase in light of newly adopted rules, such as the GAAR that is based on the ambiguous interpretation of the "genuineness" or "artificiality" of taxpayers' arrangements.

Based on the above, it comes as no surprise that the answer to the main research question seems rather inconclusive. It is, however, safe to assume that M&A transactions the conduct of which may be substantiated with detailed due diligence analyses and that offer clear, tangible benefits to the participants will remain on the safe side of the CTA's inquiry. The role of documentary requirements in this regard cannot be overstated. Furthermore, as discussed above, taxpayers may rely on some procedural instruments to mitigate future tax risks in the M&A environment. While advance tax rulings appear to be particularly useful for this purpose *de lege lata*, future modernization of dispute resolution framework would serve a great deal in enhancing legal certainty for prospective investors. As to this last point, some optimism is in order, considering how in recent years the Croatian policymakers have responded relatively quickly to relevant developments at the global and EU level.

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Sažetak

POREZNI RIZICI SPAJANJA I PREUZIMANJA TRGOVAČKIH DRUŠTAVA U HRVATSKOJ: GDJE JE GRANICA IZMEĐU LEGITIMNOG POSLOVNOG RESTRUKTURIRANJA I AGRESIVNOG POREZNOG PLANIRANJA?

Transakcije spajanja i preuzimanja često su izvor raznovrsnih poreznih rizika. U recentnoj praksi hrvatskih poreznih tijela sve su češći slučajevi odbijanja poreznih pogodnosti za navedene transakcije, temeljem različitih protuevazijskih pravila ugrađenih u domaće zakonodavstvo. Riječju, analizom gospodarske biti planiranog restrukturiranja porezna tijela izvode zaključak kako je posrijedi (zakonito) izbjegavanje plaćanja poreza. Cilj je rada, u svjetlu važećeg protuevazijskog pravnog okvira, ocrtati granicu između dopuštenog i legitimnog poreznog planiranja s jedne strane te porezne evazije s druge. U tom smislu posebno će se upozoriti i na relevantne postupovno-pravne aspekte, poput pravila o teretu dokazivanja.

Ključne riječi: *spajanja i preuzimanja; porezno planiranje; zakonito izbjegavanje plaćanja poreza; porezna neutralnost; teret dokazivanja; opće pravilo protiv izbjegavanja poreza.*

Zusammenfasssung

STEUERBEZOGENE RISIKEN DER FUSIONEN UND ÜBERNAHMEN IN KROATIEN: ABGRENZUNG ZWISCHEN LEGITIMER UNTERNEHMENSUMSTRUKTURIERUNG UND AGGRESSIVER STEUERPLANUNG

Durch Fusionen und Übernahmen der kroatischen Zielunternehmen können bedeutende Steuerrisiken für heimische und fremde kontrollierende Unternehmen entstehen. In den letzten Jahren haben kroatische Steuerbehörden begonnen, den

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wirtschaftlichen Gehalt vorgesehener Fusionen und Übernahmen zu bewerten. Dabei werden dem kontrollierenden Unternehmen oft die Steuervorteile verwehrt, was den ganzen Umstrukturierungsprozess teurer macht. Die kroatischen Steuerbehörden stützen sich dabei auf unzählige Regeln der Bekämpfung von Steuervermeidung, gemäß welchen die M&A-Transaktionen als missbräuchlich bezeichnet werden können. Demgemäß wird in diesem Beitrag beschreibend und systematisch erklärt, wie die kroatische Gesetzgebung zur Bekämpfung von Steuervermeidung die Fusions- und Übernahmeaktivitäten hindern kann. Dabei ist es das Ziel dieses Beitrags sowohl aus der Perspektive des materiellen Rechts als auch des Verfahrensrechts zu untersuchen, wo die imaginäre Grenze zwischen der legitimen und missbräuchlichen Steuerplanung liegt.

Schlüsselwörter: *Fusionen und Übernahmen; Steuerplanung; gesetzlich Steuerzahlungen vermeiden; Steuerneutralität; Beweislast; die allgemeine Regel gegen Steuerhinterziehung.*

Riassunto

I RISCHI FISCALI DI FUSIONE E RILEVAMENTO DELLE SOCIETÀ COMMERCIALI IN CROAZIA: DOV'È IL CONFINE TRA LA RISTRUTTURAZIONE LEGITTIMA ED UNA PIANIFICAZIONE FISCALE AGGRESSIVA?

Le operazioni volte alla fusione ed al rilevamento sovente sono fonte di vari rischi fiscali. Nella recente prassi degli enti fiscali croati sono sempre più frequenti i casi di rigetto di agevolazioni fiscali per dette operazioni, in ragione di differenti regole antievasione radicate nella legislazione domestica. In sostanza, mediate l'analisi del contenuto economico della ristrutturazione pianificata gli enti fiscali giungono alla conclusione come si tratti di una (legale) elusione del pagamento del fisco. Lo scopo del lavoro, alla luce del vigente quadro normativo anti-evasione, è quello di delineare il confine tra la pianificazione fiscale ammessa e legittima da una parte e l'evasione fiscale dall'altra. In tale senso, in particolare se ne sottolineeranno gli aspetti procedurali, quali le regole sull'onere probatorio.

Parole chiave: *fusioni e rilevamenti; pianificazione fiscale; elusione del pagamento del fisco; neutralità fiscale; onere probatorio; regola generale contro l'evasione fiscale.*