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# The history of double tax conventions in Croatia

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## Abstract

*After a short introduction, the authors briefly describe the national experience in handling the problems of international double taxation through double tax conventions. This chapter is divided according to stages in the history of double tax conventions identified. The authors analyse the goals of tax treaty policies in differentiated stages with a survey of the economic implications. Special focus is placed on inter-country influences and the impact on and of international institutions and organisations through an examination of the influence of bilateral tax treaties on model tax conventions and vice versa. The fifth chapter presents concluding observations.*

*Key words: double tax conventions, history, Croatia, model tax convention*

## 1 INTRODUCTION

Entrepreneurial cross-border operations often give rise to the incurrance of double taxation. Therefore, more than a century ago some governments resorted to signing bilateral conventions in an attempt to eliminate this obstacle for doing business abroad. In 1889, the first international conventions on avoiding of double taxation (double taxation convention(s), hereinafter: DTC, DTCs) were concluded “in what is now Germany, as treaties between certain component states of Prussia. The first bilateral DTA<sup>1</sup> was entered into by Prussia and Austria in 1899. A DTA was concluded between Hungary and Austria in 1909. However, few DTAs were entered into from then until the 1920s, when after World War I Germany embarked upon forming a number of DTAs with its neighbours. Also, at that time the League of Nations began investigating the problems of juridical double taxation, in response to an appeal by the 1920 Brussels International Financial Conference. In 1923 a Report on Double Taxation, prepared by an eminent group of fiscal economists at that time, was submitted to a League’s Economic and Financial Committee. That report formed the bases of the first draft model DTA, published in 1928” (Holmes, 2007:56). It is possible to define a few stages in the history of the first tax treaties: from the very beginning until World War I, treaties between World War I and World War II (treaties in the League of Nations days), and treaty practice from the establishment of the OECD until 1963.<sup>2</sup> After that, the modern period in the history of the tax treaties follows, marked by developments within the OECD.

This paper is based on the national report intended to provide an insight into the history of the Croatian DTA system at the conference “The History of Double Tax Conventions”, held from 3 to 5 July, 2008, in Rust, Austria. The aim of the paper is to present Croatia’s double tax treaty policy through the analysis of its changes from the foundation of the new state to the present time, with some remarks and observations considering that policy in the former Yugoslavia. The paper consists

<sup>1</sup>The quoted author uses the term “double taxation agreement”, abbreviated as “DTA”.

<sup>2</sup>See more in: Freiherr von Roenne (2011:17).

of five parts, the first and fifth being Introduction and Conclusion. The second part, entitled National experience, is the longest. It comprises three subparts. The first extensively explores the periods and goals of Croatian tax treaty policy, the second explains briefly the economic implications of the said policy, and the third deals with a double taxation specific, important for its juridical and economic consequences, issue – unilateral measures for the avoidance of double taxation. The third part examines influences that other countries have had on Croatia's double tax treaty policy, and the fourth part analyses, through three subparts, the impact on and of international institutions and organisations. That impact is visible through the influence of the model conventions, most notably of the OECD Model Convention.

The subject of double tax treaties, even when limited to only one country, is still very broad one. An analysis of Croatia's double tax treaties network alone would require a book; therefore, those topics exceed the limits of the task the authors defined for their research in this paper. We consider it a good starting point, a sort of introduction for a more extensive future research.

## 2 NATIONAL EXPERIENCE

### 2.1 PERIODS AND GOALS OF TAX TREATY POLICIES

Broadly speaking, one can make the following categorisation of DTCs and the history of DTCs in Croatia. In chronological sequence, the first category comprises those international treaties that were concluded by the former Yugoslavian Republic (hereinafter: the former SFRY)<sup>3</sup> and which remain in force in the Republic of Croatia on the basis of the state's succession. A second category of DTCs consists of a group of international treaties ratified or acceded to by the Republic of Croatia following its declaration of independence in 1991.

Taking the content of the DTCs into account, it is possible to differentiate between two developmental stages which in fact fully fit the division into the two periods, the DTCs concluded by the former SFRY and the DTCs concluded by Croatia after 1991. Here the essential difference is in the choice of method for the elimination of double taxation. In the majority of new agreements one finds the ordinary credit method, whereas in the old agreements concluded by the former SFRY the most used method is the exemption system with progression.<sup>4</sup> Stagnation is obvious in the early 1990s but this was due to the war and thus requires no specific analysis or treatment for the purposes of this report.

#### 2.1.1 Period until 1991

After gaining independence, the Republic of Croatia assumed their obligation to apply all international agreements concluded by the former SFRY provided that

<sup>3</sup> The acronym SFRY stands for: the Socialist Federative Republic of Yugoslavia, which was the official name of the country (in English).

<sup>4</sup> See more *infra* chapter 3.

they do not conflict with the fundamental principles of the new state system. On the basis that there are currently only four such DTCs which were in force in Croatia, including:

- The convention between The Republic of Finland and The Socialist Federal Republic of Yugoslavia for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital;
- The convention between the Kingdom of Norway and the Socialist Federal Republic of Yugoslavia for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital;
- The convention between the United Kingdom of Great Britain and Northern Ireland and the Socialist Federal Republic of Yugoslavia for the Avoidance of Double Taxation with Respect to Taxes on Income; and
- The convention between the Kingdom of Sweden and the Socialist Federal Republic of Yugoslavia for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital.<sup>5</sup>

As already pointed out, these old agreements, as a rule, employ the exemption system with progression, rather than the ordinary credit method – which will become the main feature of the DTCs of the next period.

### 2.1.2 Period from 1991 onwards

After Croatia gained its independence several years passed before the first DTC was concluded. The first DTCs that Croatia concluded as an independent state date back to 1995 and include three countries: Albania, Macedonia and Poland.<sup>6</sup>

These are:

- The agreement between the Republic of Croatia and the Republic of Poland for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital;
- The agreement between the Republic of Croatia and the Republic of Macedonia for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital; and
- The agreement between the Republic of Croatia and the Republic of Albania for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital.

They are all published in the Official Gazette of the Republic of Croatia “Narodne novine – Međunarodni ugovori” (hereinafter: NN MU, 13/95), and the former two have been in force since 1 January 1997, while the third has been in force since 1 January 1998.

<sup>5</sup> These agreements were published in the Official Gazette of the former Yugoslavian Republic (“Službeni list – međunarodni ugovori”) and the obligation to apply them is assumed by the Republic of Croatia as of 8 October 1991, the Official Gazette of the Republic of Croatia, where the international agreements are published – “Narodne novine – međunarodni ugovori”, hereinafter: NN MU, 53/91.

<sup>6</sup> There is no special reason that we can propound as a key factor for the conclusion of DTCs with these countries and not with some others.

Subsequently, procedures were initiated to conclude new DTCs and 33 such agreements were in force in Croatia by 2008. Almost 20 DTCs have been concluded since that period, because today we have 57 DTCs in force. Throughout 1996 agreements with Romania, Russian Federation and Slovakia were concluded. Agreements with Greece, South Africa, Hungary and Ukraine were concluded in 1997, while only one agreement was entered into in 1998, the one with Bulgaria. From the end of 1990s onwards the preponderant part of the agreements had been concluded. Thus, in 1999 DTCs were concluded with the Czech Republic, Canada, Malta, Switzerland and Turkey. The same number of agreements was concluded in 2001 with Austria, China, Latvia, Lithuania and Netherlands. A fruitful year in 2003 brought about agreements with Belgium, Estonia, Ireland, Yugoslavia, Malaysia and Mauritius. In 2004 agreements were entered into with Belarus, Chile and France and in 2005 with San Marino and Slovenia. This brief timeline shows that the most efficient period for the conclusion of DTCs was the end of the 1990s and early 2000s. This is not at all surprising bearing in mind that the country was at war for the first half of 1990s and the immediate post-war period was primarily devoted to the recovery of Croatia's social and political life.

As mentioned before, the first "new" DTCs were concluded in 1995. The procedure of concluding international agreements then was prescribed by the Conclusion and Implementation of International Agreements Act in force as of 1991 (NN MU 53/91 and 93/91). The 1996 Conclusion and Implementation of International Agreements Act (hereinafter: the International Agreements Act – NN MU 28/96), which replaced the 1991 Act and is still in force today, brought no changes in the procedure that is briefly described below.

Competences for the conclusion of international agreements in Croatia depend on the nature and contents of the international agreement and are divided among the Croatian Parliament, the President of the Republic of Croatia and the Government of the Republic of Croatia. International agreements that call for the enactment or amendment of domestic law, international agreements of a military and political nature, and international agreements that financially oblige the Republic of Croatia are subject to ratification by the Croatian Parliament.

International agreements concluded and ratified in accordance with the Constitution and made public, and which are in force, are part of the internal legal order of the Republic of Croatia and are above the law in terms of legal effects. That is the case with DTCs, meaning that no other entity in Croatia, private or official, is a necessary participant in the procedure for negotiation and concluding DTCs. Basic rules that lay down the framework for concluding DTCs are the previously mentioned International Agreements Act along with other relevant sources of international law. This Act provides for several stages for the conclusion of DTCs. Article 7 vests the right to commence the procedure for concluding international treaties in the President of the Republic of Croatia as well as the Croatian

Government. In fact, this is the role assumed by the Ministry of Finance. In order to continue with a decision this procedure must contain a draft agreement, a list of members of delegation, a proposal on the authorised members of delegation and so on. The negotiation process is prescribed in Articles 8-14. In the negotiation itself the Republic of Croatia is represented by the delegation determined by the President of the Republic or the Government. The appointed delegation must follow the basic negotiating positions for conducting the negotiations. An authorised member of the delegation may sign a treaty which must thereafter be consistent with the formed negotiating positions. The process of treaty ratification is prescribed in Articles 15-24. The signed treaty has to be submitted for ratification within a 15-day period, and the process of treaty ratification is instituted by the Government by way of a Ministry of Foreign Affairs initiative. The Parliament ratifies the treaties. The process of ratification is laid down in Articles 25-26. The other stages of the procedure – entry into force, publication in the Official Gazette as well as registering, archiving, executing, implementing, amending and terminating the treaty – are also prescribed by same Act.

### 2.1.3 Croatian model double tax convention

All DTCs concluded by the Republic of Croatia are based on the Croatian Draft Agreement on the Avoidance of Double Taxation (hereinafter: the Croatian MC). This Draft is in compliance with the model agreement provided by the OECD (2003 – hereinafter: the OECD MC). The majority of concluded agreements cover taxes on income and on capital – all taxes imposed on total income, on total capital, or on elements of income or of capital, including taxes on capital appreciation and taxes on gains from the alienation of movable or immovable property, as well as taxes on the total amounts of wages or salaries paid by enterprises. Croatia never concluded a DTC that covers inheritance and gift taxation. The majority of agreements in force in Croatia cover the field of income and property as compared with those agreements which only cover income.

The Croatian MC is not publicly available.<sup>7</sup> All the Croatian DTCs that have been concluded to date are based on this model; it serves as the Croatian starting position in negotiations and as informal guidelines for the employees of the Ministry of Finance when negotiating new tax treaties. Since it is not publicly available, there has been no public discussion regarding its contents.<sup>8</sup> It should be noted, nevertheless, that the absence of a public discussion is not due to its concealed

<sup>7</sup> The authors were able to examine it only after they had formally requested it and upon the Ministry of Finance's approval.

<sup>8</sup> There is a (less public) discussion regarding the conclusion of DTCs. This discussion relates to the selection of countries with which a certain DTC will be concluded and the way in which the negotiation process is expedited but not the content of the DTC. For instance, such a discussion was held in the Croatian Parliament before the DTC with Slovenia was concluded. Unfortunately, this form of discussion does not include real public debate. In the case of DTCs there is no debate to include the state bodies applying the laws (and the DTCs), non-governmental organisations, interest groups and individual taxpayers. This, in fact, means that all these stakeholders have the right to express their opinions and present proposals but they cannot exercise their rights, although they should be interested in involving themselves in the preparation of drafts of statutes and of DTCs that concern the interests they represent and protect.

contents, but rather to a general lack of interest in international double taxation issues. This lack of interest is notable not only in general public, which may be understandable, but also in the circles of tax law practitioners and scholars. Had there been any general or expert interest in double taxation issues, the contents of the Croatian MC would have certainly come to the fore. Considering the present state of affairs, the only discussion concerning the Croatian MC is the one confined to a narrow circle of experts of the Ministry of Finance, consequently lacking potentially valuable independent inputs.

The Croatian MC has existed since the mid-1990s.<sup>9</sup> In the past decade, the national MC was revised several times and there are now several versions of it.<sup>10</sup> Regarding Croatia's DTC policy, it is not possible to isolate specific factors which brought about changes in it. Indeed, the changes themselves have had no meaningful impact. Certainly, international relations, trade and political situations always influence all aspects of international negotiations. Besides, Croatia's preparations for EU membership set demands on Croatian policy to have it brought in line with that of the EU. This having been said, in the field of DTCs no special requirements are discernible.

#### **2.1.4 Comparison of the tax treaty policies in the former SFRY and Croatia**

DTC policy is understood as an instrument for achieving economic goals. By concluding DTCs, a country attempts to integrate itself more easily into the international exchange of goods, services and capital as well as to improve its economic position. Although the former Yugoslavia was a socialist country, economic considerations largely influenced and determined the country's DTC policy. This policy was founded upon the concepts of the OECD Model (OECD, 2003). Furthermore, it was recognised that DTCs between Western and socialist countries were of great importance as instruments of economic cooperation (Debatin, 1985:132). The former Yugoslavia wanted to avoid the problem of double taxation by concluding DTCs with countries interested in improving mutual economic relations. By adopting the 1990 Constitution, Croatia changed its political system to a democratic parliamentary republic. This change coincided with the early stages of preparation for the status of candidate country and membership in the European Union, the Union being its most important trading partner. Certainly, these circumstances brought about changes in the country's DTCs policy and one of the factors was the change in the method for avoidance of international double taxation which is included in the new treaties. These "new" treaties that Croatia concluded as an independent state abandon the exemption method and provide for the credit method (i.e. the ordinary credit method) in the variety of ordinary credit.

<sup>9</sup> Unofficial data from the Ministry of Finance.

<sup>10</sup> The first version dates back to 1995. The last changes were a result of the new versions of the national MC – February 2000, October 2000, and July 2001.



Croatia's economy has undergone a profound transformation since the country gained its independence. The achievements were accelerated by the transformation and opening of Croatia to global markets through the WTO<sup>11</sup> and the CEFTA memberships, cooperation with the Southeast European neighbours and, especially, the signing of the Stabilisation and Association Agreement with the EU. Croatia has gone a long way in liberalising its trade, having signed more than 35 free trade agreements.<sup>12</sup> The economic success formula of the EU accession countries has shown that there was a need for a much more intensive adoption of the progressive (market-based) institutions and policies. Applying this conclusion to the circumstances in Croatia it may be said that there was and still is room for further liberalisation of trade and changes in the economy. The economically significant period of Croatian development started at the end of the 1990s when the majority of agreements that are part of the "economic field" were signed.<sup>13</sup> Before that, at the time when the first DTCs were concluded (in 1995) it became apparent that Croatia's economy was a post-socialist one. The country was faced with various problems related to the creation of an appropriate policy for the development and growth of its economy. The gradual increase in competitiveness on the world market and export growth was signs of success in the process of restructuring. The problems related to the fact that it was a post-war period and at the same time a period of the systemic transformation as the transition from the former socialist centrally planned system to the open market economy. This means that the systemic transformation is not only a complex pragmatic, but also an evolutionary process.<sup>14</sup>

There are no trade-specific provisions in the DTCs that apply to Croatia. Although the Croatian policy on the conclusion of DTCs is largely in line with the basic principles laid down in the OECD Model Double Taxation Convention, there are several special objectives that Croatia strives to meet when concluding tax conventions. Croatia is a country with a small domestic market but a relatively large foreign market. As a consequence, a relatively large number of entrepreneurs operate primarily on an international basis. The country has built an open economy and its policy on DTCs reflects this situation, especially when it comes to its relationship with the EU. Croatia's DTC policy is in line with the goal of removing obstacles to the international flows of goods and capital.<sup>15</sup> In compliance with the

<sup>11</sup> Croatia became a WTO member (No. 140) on 30 November 2000.

<sup>12</sup> Free Trade Agreement between the EFTA states and Croatia was signed in Vaduz, Liechtenstein, on 21 June 2001.

<sup>13</sup> The Free Trade Agreement (hereinafter: the FTA) with the EU-27 – in force as of 1 January 2002 (in force in the 10 new EU member states since 2004 and in Romania and Bulgaria since 2007), the FTA with the EFTA states (in force as of 2002), the FTA with the CEFTA states 2006 – Croatia, Albania, Bosnia and Herzegovina, Montenegro, Kosovo, Macedonia, Moldova and Serbia – in force as of 2007, and the FTA with Turkey in force as of 2003.

<sup>14</sup> "(...) since it is not only the political, the economic, the legal, and the social order which have to be accounted for by transformation policy, but also historical legacies as well as informal institutions such as norms, conventions, and ethical rules which inevitably lead to path dependence of societal development (...)" see, Ahrens (2006).

<sup>15</sup> Such a policy did not result in expected, inter alia, foreign investments, but the goal of removing obstacles to the flows of goods and capital was accomplished. Thus, it is possible to conclude that this policy was to

principles of residence country taxation, the Croatian Profit Tax Act provides, to some extent, capital import neutrality.<sup>16</sup>

While the economic background serves as a somewhat important impulse for concluding new agreements, it has not produced a change in the policy. Trade and economic relations with neighbouring countries and the EU certainly influenced the conclusion of new international treaties in general. In that respect, the DTCs were concluded primarily with countries which are important trade partners of Croatia or its neighbours.

Although the initiative was primarily in the hands of the Ministry of Finance, there are some signs of the influence of several other groups in initiating the conclusion process of certain DTCs. The main influence on negotiations of the DTCs or even an initiative to commence those negotiations comes primarily from the Government<sup>17</sup> or the President of Republic. It seems, however, important to mention certain attempts from the strongest trade association – namely the Croatian Chamber of Economy. Likewise, some “pressure” coupled with concrete demands came from personally interested tax payers.<sup>18</sup>

The predominant influence on Croatian DTC policy was, and still is, executed by the Ministry of Finance. Since the DTCs are highly specialized legal documents, requiring a profound knowledge of both domestic and international tax law, it rarely (if ever) gets in the politicians’ area of interest; therefore it is left to the Ministry’s experts. For example, there was only once a discussion in the Croatian Parliament on a DTC, that with Slovenia (the discussion tackled the issue of cross-border workers’ taxation). Business conditions were not the issue, except as a general observation that international double taxation is an obstacle to doing business and that, as such, it should be prevented through DTCs. The situation has not changed over the years; there is no sign that the problem of double taxation has come to the attention of the business community, at least in the sense of its readiness to act, i.e. to propose and advocate solutions that would enhance its position in cross-border business activities. Clear indicators of such a state are the contents of the Croatian periodicals dealing, in principle, with the technical aspects of practical issues of interest for the business community (e.g. managerial finance in

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some extent successful.

<sup>16</sup> See *Zakon o porezu na dobit* (NN 177/04, 90/05, 57/26) came into force on 1 June 2006, applicable since 1 January 2007, Article 30 regarding crediting foreign tax. Article 30 reads: “(1) If a taxpayer has derived an income or profit abroad (directly or through its permanent establishment) and paid the profit tax or a tax of the same kind, the tax paid abroad may be credited against the domestic tax up to the amount of the profit tax which would be payable on such profit or revenue in Croatia. (2) The amount of the profit tax referred to in Paragraph (1) of this Article shall be assessed by applying a crediting rate to the profit or revenue derived abroad. The crediting rate shall be determined as the ratio between the total tax liability before the additional reductions in the tax base and the total profit solely derived in Croatia. (3) For the purpose of crediting the foreign tax paid abroad, referred to in Paragraph (1) of this Article, the taxpayer shall provide the Tax Administration with the evidence of the tax payment abroad.”

<sup>17</sup> Special influence comes from Ministry of Foreign Affairs and European Integrations.

<sup>18</sup> Taxpayers applied “pressure” and demanded the conclusion of the DTC with Slovenia. These taxpayers were personally interested in this matter.

general, all aspects of accounting, taxes, social contributions, auditing).<sup>19</sup> While there were some articles in those periodicals dealing with certain international double taxation issues, it should be noted that those articles were written by the employees of the Ministry of Finance, rather than by, for example, interested businessmen, managers or lawyers working in the private sector. This reveals that the most relevant, and quite often the only relevant, entity deciding on double taxation policy was, at all times, the tax administration. This is especially noticeable from the lack of proof of influence exercised by any specific economic-political interest, i.e. of any pressure group intent on accomplishing some sort of specific goal. Accordingly, there is no evidence that changing business conditions play any role when Croatia is concluding a new DTC. One possible explanation could be that Croatia is a predominantly import-oriented country, not only the import of goods and services, but also the import of capital. This means that there are relatively few Croatian entrepreneurs engaged in business over the border, and hence exposed to double taxation. If the opposite were the case, the pressure from that part of the business community would presumably be much stronger. Furthermore, that pressure would, predictably, bear fruit since there is no known conflicting interest that would hinder such development. It could be further assumed that Croatian residents who encounter certain problems while doing business in foreign countries are satisfied with the unilateral measures available in those countries, and with the Croatian procedures resulting in the recognition of foreign taxes. On the other hand, there is no sign of the activity of foreign entrepreneurs carrying out business in Croatia, intended to amend the provisions of the Croatian DTCs. Their influence could be expected through the Croatian Chamber of Economy, the meeting point of the Croatian Government and domestic and foreign businesses, but such influence has not been exerted so far.<sup>20</sup>

Croatia is focused on concluding new DTCs rather than amending the existing ones. This could be explained by at least two factors. First, Croatia is a relatively new European country; as such, it has only started to build its network of international conventions, DTCs included. The main goal still is to establish the country's position in international relations, so the problems of DTC application, as rather legally sophisticated documents of no general interest and understanding, have not yet come to the fore. Second, and tightly allied with the previous factor, is the aforementioned lack of input from the private sector (individuals and legal entities) indicating problems caused by international double taxation. The absence of any reports on the problems or cases in which they arise, whether in periodicals or in official Ministry's releases and opinions, is a clear sign of this trend.

<sup>19</sup> Those are, e.g. *Financije i porezi, Računovodstvo i financije, Računovodstvo, revizija i financije*.

<sup>20</sup> Based on the statement of an employee of the Croatian Chamber of Economy, in a short conversation with the author (Hrvoje Arbutina) on 15 May 2008.

## 2.2 BACKGROUND: ECONOMIC IMPLICATIONS

The structure of the administrative division of Croatia is as follows. The territory of the Republic of Croatia is divided into the following administrative units: municipalities, towns and counties. Municipalities and towns are units of local self-government which carry out the affairs of local jurisdiction by which the needs of citizens are directly fulfilled, and in particular the affairs related to the organisation of localities and housing, area and urban planning, public utilities, child care, social welfare, primary health services, education and elementary schools, culture, physical education and sports, customer protection, protection and improvement of the environment, fire protection and civil defence. Counties are units of regional self-government which carry out affairs of regional significance, and in particular affairs related to education, the health service, area and urban planning, economic development, traffic and traffic infrastructure and the development of the educational network, health, social and cultural institutions. The capital city of Zagreb is attributed the status of a county.

Although local and regional governmental units have limited powers of taxation, the authority to stipulate all the basic features of all the taxes belongs to the Parliament. Local governments are entitled to determine taxes but within the limits of the acts passed by the Parliament. The Financing of Units of Local and Regional Self-Government Act states that local and regional governments are entitled to set taxes within the limits of the acts in force and lists all types of local and regional taxes, stipulating all elements of each tax (tax subject, taxable object, tax base, tax rate or other measure, exemptions and allowances). Consequently, it may be said that the state has exclusive jurisdiction to legislate on taxation issues. According to the Constitution of the Republic of Croatia, the international treaties signed, ratified, publicised and entered into in force are part of the internal legal order of the Republic of Croatia and produce legal effects that supersede those of Croatian statutes.<sup>21</sup> Bearing in mind the different solutions that each legal system adopts, it is important to emphasise this supra-statutory legal force guaranteed for ratified treaties (Rodin, 2002). That is also the case with the DTCs. As outlined and described above, the procedure shows that the authorities responsible for the mutual agreement procedure are similar but not identical to the DTC negotiators, since DTC negotiators include members from the Ministry of Finance.<sup>22</sup>

It is to be concluded that within the scheme of multilevel systems (state level, counties, municipalities and towns) which exists in Croatia the limitations envisaged in the respective DTCs apply to all levels, which is consistent with the OECD Model.

<sup>21</sup> The Constitution of the Republic of Croatia provides: Published treaties, the ratification of which has been accepted by the Parliament and which bind Croatia, are part of the legal system; if the treaty is different from statute, it is the treaty that must be applied (NN MU 41/01 and 55/01).

<sup>22</sup> See *supra* chapter 2.2.

Previous experience then provides no evidence of any coordination between the authorities responsible for negotiating and concluding international treaties in general, on the one hand, and DTC negotiators, on the other. The same conclusion is applicable in respect of the coordination between local tax offices and DTC negotiators, although local tax offices apply DTCs, thus being in the optimal position to indicate practical problems or possible disadvantages of the DTCs.

### 2.3 UNILATERAL MEASURES FOR AVOIDANCE OF DOUBLE TAXATION

Croatia prescribed unilateral measures in its tax system, enabling the avoidance of international double taxation even when a DTC has not been concluded. In fact, in the case of Croatia, one could hardly talk of measures (in plural), since there is an absolute prevalence of one measure – the ordinary credit method. It is included as a method for the avoidance of double taxation, both in the Income Tax Act (NN 177/04) (regulating the taxation of individuals) and in the Profit Tax Act (NN 177/04, 90/05, 57/06) (mostly regulating the taxation of legal entities, but also some categories of individual entrepreneurs).

Croatia's DTCs follow the credit method as it is formulated in Article 23B of the OECD MC, i.e. the ordinary credit method. Thus, they are in accordance with unilateral measures regulated by Croatian legislation. However, the possibility of applying the exemption with progression for income and capital exclusively taxable in the other contracting state has been included in the treaty with Switzerland.<sup>23</sup>

Since there are unilateral measures in the Croatian tax system, aiming at solving the double taxation issue, there is the question of the need for the DTCs. This need has, in fact, not been the object of research in Croatian tax literature, in either scientific or practice-oriented periodicals; rather, it can be said to have been taken for granted in Croatian expert tax writings. Explanations are to be looked for elsewhere, e.g. in the international expert tax literature. As already mentioned, subsequent to gaining independence, Croatia started to build own network of international conventions as an additional, and important, symbol of its recognition as an equal member of the international community; DTCs just suit the purpose of achieving this affirmation. Further, their conclusion represents a continuance of the practice begun in the former Yugoslavia, which concluded 22 DTCs in all. Croatia also considers this practice to be useful and beneficial for its own purposes. In the absence of reliable data, other and, from an expert point of view, perhaps more important reasons that a number of DTCs have actually been concluded by Croatia have to be derived from the literature. These reasons are embedded in the general functioning of the country's tax system: combating fiscal evasion and exchange of information on tax systems with the other contracting state

<sup>23</sup> Article 23 Paragraph 1c of the Agreement between Government of the Republic of Croatia and the Government of the Republic of Macedonia for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital (NN MU 13/95).

(country's point of view), and the application of the Non-Discrimination Article (taxpayer's point of view) (Baker, 1994:12). Furthermore, the DTCs are probably generally seen as a means of promoting investments from one country to another, and for removing "fiscal blocks to the movement of individuals between countries" (ibid:13) As for the former Yugoslavia, some views were expressed by a then high-ranking official of the former Yugoslavian Federal Ministry of Finance.<sup>24</sup> He explicitly stated that the purpose of DTCs was the complete protection of the taxpayer against double taxation while at the same time ensuring the following:

- preventing discrimination among taxpayers on an international basis;
- assuring legal and fiscal security of taxpayers;
- stimulating investment of foreign capital; and
- improving economic, scientific, cultural and recreational cooperation among the revenue bodies of the countries that have concluded a treaty (Arsić, 1985:142).

He also pointed out some other purposes of Yugoslav DTCs, such as tax treatment of dividends, particularly relevant for the purpose of attracting direct foreign investments (which was one of the officially proclaimed goals of the former SFRY economic policy). There were two problems: first, there were no dividends in the legal system of the former Yugoslavian Republic, so the returns the foreign investors realised through their investment in the former SFRY had to be characterised differently. Second, and more important, when a country in which a foreign investor was resident was taxing those returns, it only recognised the tax that was effectively paid in the former SFRY. This system overrode the effect of tax incentives that the former SFRY had envisaged at the time. This is a well known problem in international taxation, soluble by tax sparing credit; the former Yugoslavian Republic obviously (and quite understandably, bearing in mind her economic interest) wanted the tax sparing credit proviso to be built into her DTCs with developed countries.

Looking at the period in which Croatia has existed as an independent country, i.e. the past 22 years, there have been no changes in the relationship between unilateral measures and the DTCs. In other words, Croatia harmonised the "ordinary credit method approach", stipulated by Income Tax Act and Profit Tax Act as unilateral method, with the same approach present in its DTCs. However, given that some of the DTCs concluded by the former SFRY are still in force in Croatia<sup>25</sup>, they also need to be taken into consideration. Different to Croatian practice, DTCs of the former SFRY sometimes provided for exemption through the progression method as the *lex generalis* when it came to avoidance of double taxation

<sup>24</sup> We assume the views Mr. Arsić expressed in the quoted paper to be official ones (or at least the ones very close to official) since he, as the author of the paper is (1) mentioned as the official of the Federal Ministry of Finance, and (2) did not, in any way, mention that the views expressed in the paper are his, and not necessarily the ones of the Ministry of Finance.

<sup>25</sup> Those are DTCs with Norway, Sweden and the UK.

of income and of capital; the credit method, as the *lex specialis*, was provided for passive income (mostly dividends, but sometimes royalties and interest too). For instance, the DTC entered into between the SFRY and Norway,<sup>26</sup> still in force as part of the Croatian DTC network, envisages (Article 23, Paragraph 1c) exemption with progression as the method for the avoidance of double taxation to be applied by Yugoslavia at that time (now Croatia). The then Yugoslavia (and now Croatia) apply the credit method when taxing income from dividends and royalties (Articles 10 and 12) of Yugoslav (i.e. Croatian) residents derived in Norway. This means that, by way of the former Yugoslavian DTCs, there is the exemption with progression method in Croatian DTCs network. The tax sparing proviso is included in Article 23, Paragraph 2c of the DTC with Norway, and it only applies to situations where residents of Norway derive profit in respect of their participation in a joint venture with the Croatian (formerly Yugoslav) enterprise. The time limit for the application of this provision has been set at ten years, with the possibility of extension upon the agreement of the tax authorities of the contracting states.

The DTCs with Sweden<sup>27</sup> and the United Kingdom follow a similar pattern (Article 22 in both DTCs): Croatia (formerly Yugoslavia) applies the exemption with progression, except for dividends (the DTC with Sweden), interest and royalties (the DTC with the UK), for which the credit method was prescribed, while Sweden and the United Kingdom respectively opted for the credit method as a general rule.

There are exceptions to the described approach. For instance, Article 22 of the DTC between the SFRY and Finland,<sup>28</sup> in force in Croatia, provides that the credit method is to be used by both contracting states. The tax sparing credit proviso has been included in this DTC too (Article 22, Paragraph 4a), with a temporal clause (five years, with the possibility of extension upon the agreement of the contracting states tax authorities, Article 22, Paragraph 4b).

When comparing unilateral measures and DTC provisions, the main differences are: (1) the prevalence of the exemption with the progression method in the treaties concluded by the former SFRY and now in force in the Republic of Croatia on the basis of succession, and (2) the presence of the tax sparing credit proviso in the majority of those treaties. However, that proviso cannot be found in the DTCs which Croatia concluded as an independent state. It seems that the time for applying the tax sparing credit has expired, at least where European countries are concerned. This is the consequence of the broader trend of abandonment of the tax sparing credit. However, the existence of the tax sparing credit in the DTCs which are in force in Croatia on the basis of succession is worth noting.

<sup>26</sup> Published in Službeni list, MU 9/85, 53/91.

<sup>27</sup> Published in Službeni list, MU 7/81, 53/91.

<sup>28</sup> Published in Službeni list, MU 8/87, 53/91.

### 3 INTER-COUNTRY INFLUENCE

The negotiators on behalf of the former Yugoslavian Republic had a stronger, if not much stronger, negotiating position than their Croatian counterparts nowadays. Croatian negotiators are obviously not in a position to demand any substantial deviation of the OECD MC, while the negotiators of the former SFRY were able to achieve certain goals that had a significant economic impact on the former SFRY. This, of course, includes the tax sparing credit proviso which is incorporated into a number of the former Yugoslavian DTCs. This change in the negotiating position may be understood as a consequence of the decline of the state-planned socialism in Central and Eastern European countries (as well as the so-called self-governing socialism, in the case of Yugoslavia). The disappearance of the regime (the foundation of which constituted a firm and strong alliance between countries bound by the same political and economic system, notwithstanding, of course, the desirability and even necessity of changes) weakened, at the same time, the negotiating position of those countries on the international stage. Although formally not part of COMECON, and by many material accounts actually different to COMECON countries, the former SFRY benefited from the general state of affairs in the sense that it enjoyed similar treatment to those countries when it was negotiating the DTCs.<sup>29</sup>

During the transition to a market-oriented economy, when negotiating its DTCs, Croatia complied with the OECD MC. Since the OECD MC clearly represents the interests of developed countries, the conclusion can easily be that Croatia today generally complies with their conceptions. This is especially true since there is no specific interest (e.g. business, social or fiscal) articulated in the form of the Croatian negotiating position which would be firmly established or even non-negotiable.

Croatian DTCs are not all the same. It is sufficient to look at the table overview of these DTCs to establish this as a fact.<sup>30</sup> This overview contains, among other data, the rates on passive income, included in Croatian DTCs. It is obvious that there are different rates, fixed in different DTCs (e.g. 0, 5, 10 and 15 per cent for dividends), different percentages of shares in a company's share of capital required for the affiliation privilege to become applicable. In the course of the research, we were not able to establish the existence of a pattern for negotiating such provisions; neither geographical location nor the contracting states' degree of development provided an answer. Additionally, neither the time of publishing or entry into force of each individual DTC nor the information acquired from the Ministry of Finance can confirm any pattern.<sup>31</sup> Considering that Croatia follows the OECD

<sup>29</sup> However, this treatment was not as beneficial as the treatment which some other socialist and developing countries enjoyed; for more details, see: Debatin (1985:132).

<sup>30</sup> Available at: [[http://www.porezna-uprava.hr/hr\\_propisi/\\_layouts/in2.vuk.sp.propisi.intranet/propisi.aspx#id=gru598](http://www.porezna-uprava.hr/hr_propisi/_layouts/in2.vuk.sp.propisi.intranet/propisi.aspx#id=gru598)].

<sup>31</sup> Based on a short interview the author (Hrvoje Arbutina) had with an official of the Ministry of Finance, on 27 May 2008.



MC scheme, and lacking an explanation from the authoritative source, only a hypothesis could be put forward that those differences are the product of the influences which the other contracting party to these bilateral agreements exercised over Croatia during negotiations. However, this is probably true only in cases where those states have considerable experience in negotiating DTCs (e.g. Austria, Belgium, France, the United Kingdom). When it comes to less experienced partners (which are themselves new countries, or countries in transition, e.g. Bosnia and Herzegovina, Macedonia, Albania, Belarus, etc.), this explanation is not convincing. In those cases, recent experiences were drawn upon, together with the new knowledge which younger employees of the Ministry of Finance acquired at numerous expert seminars organised by the OECD, the EU, and the ministries of finance of developed countries.<sup>32</sup>

As for the former Yugoslavian DTCs, it is now virtually impossible to positively establish their background and negotiating environment, since no sources are available in Croatia, whether documents or persons. However, a certain pattern can be established that was in many ways similar, if not the same, for the former socialist countries. One of the features characteristic of this pattern was the prevalence of exemption with progression as the method for avoidance of double taxation. This was not only due to continental legal inheritance, in which the exemption method is generally and historically inherent; it was also in accordance with the socialist (governmentally supervised) structure of enterprises in the former SFRY – that is to say, since taxation of those entities could not have been compared with taxes imposed on Western enterprises, the credit method was often not applicable (Debatin, 1985:124).

The inclusion of the tax sparing credit proviso is another feature of the former Yugoslavian DTCs concluded with developed countries. A tax sparing credit is the means of attracting direct foreign investments by way of DTCs.<sup>33</sup>

Both these features could be construed as a consequence of certain influences which the former Yugoslavia did not itself designed, but willingly applied. This is especially true, of course, when it came to the application of the tax sparing credit.

<sup>32</sup> One of the authors (Hrvoje Arbutina) learned of these seminars while contacting some of the said employees in the course of the postgraduate study “Fiscal System and Fiscal Policy”, organized at the Faculty of Law, University in Zagreb, which began in 1995. All of the postgraduate students evaluated the knowledge acquired on the seminars as high and very usable in practice.

<sup>33</sup> “Term used to denote a special form of double taxation relief in tax treaties with developing countries. Where a country grants tax incentives to encourage foreign investment (e.g. tax holiday in respect of the profits of a company carrying on a pioneer industry) and that company is a resident of another country with which a tax treaty has been concluded, the other country may give the company “tax sparing” relief. This is achieved by the other country giving a credit against its own tax for the tax which the company would have paid if the tax had not been “spared” (i.e. given up) under the provisions of the tax holiday rules. The purpose of tax sparing relief is to prevent the loss of a double taxation credit from negating the incentive offered by the tax holiday, etc. provided for in the country which is seeking to encourage foreign investment” (IBFD, 1996:304). Tax sparing credit proviso is included in former Yugoslav DTCs with Finland (Art 22, Par 4), Norway (Art 23, Par 2), Sweden (Art 22, Par 3) and United Kingdom (Art 22, Par 1 and 3), still in use in the Republic of Croatia.

## 4 IMPACT ON AND OF INTERNATIONAL INSTITUTIONS AND ORGANISATIONS

### 4.1 MODEL TAX CONVENTIONS

The product of the systematic, international approach to the international double taxation problem (after World War I, within the League of Nations) was the first Model Double Taxation Convention, developed by the group of tax experts from various countries<sup>34</sup> Their work has been continued after World War II, under auspices of the OECD, and resulted in a new Model Convention (OECD Model Tax Convention on Income and on Capital). This is soft law, a document presented to the countries of the world as something to start with when negotiating their bilateral or multilateral treaties. Although every country has its own model, the OECD's, being a legal text of high quality, is so influential that hardly any country avoids it completely. Every article of the Model is accompanied with a commentary, explaining meanings and goals of the provisions.

A tax treaty is an international treaty that distributes taxing rights between contracting parties. A treaty based on the OECD Model will therefore confer its taxing rights distributions in its own text, and, as for the OECD Model, developing countries objected that it prefers interests of the developed countries over theirs when stipulating those distributions, giving developed countries considerably more taxing rights in the case of, e.g. dividend, interest and royalties taxation. Consequently, a new model was developed, this time under auspices of the United Nations; hence the name – United Nations Model Double Taxation Convention between Developed and Developing Countries. Although leaning heavily on the OECD Model, it changed some of its provisions so that they corresponded more with interests of the developing countries.

### 4.2 INFLUENCE OF BILATERAL TAX TREATIES ON MODEL TAX CONVENTIONS

International tax law, including the law of the DTCs, had already been highly developed by the time Croatia acquired her independence. Accordingly, Croatia's DTCs did not affect the model tax conventions. Furthermore, even considerably older, former Yugoslavian, DTCs did not influence these model conventions. Both countries entered into DTC negotiations at a time when a number of established solutions in existing model conventions had already existed.

### 4.3 INFLUENCE OF MODEL TAX CONVENTIONS ON BILATERAL TAX TREATIES

Croatia's DTC policy is, to a great extent, influenced by the OECD MC. It was the key legal document that served as starting point in tax treaty negotiations following the formation of the Republic of Croatia. The former Yugoslavian treaties, too, in general followed the OECD MC, quite likely under the influence of the co-contracting states. Those treaties, as a matter of course, deviated to a certain

<sup>34</sup> Those were: Bruins (The Netherlands), Einaudi (Italy), Seligman (USA) and Stamp (UK).

extent from the OECD MC due to the specific (self-governing, socialist) socio-economic system present in the former SFRY.

Generally, there are two widespread, internationally acknowledged, model conventions for negotiating DTCs – the above mentioned OECD MC, and the United Nations Model Double Taxation Convention between Developed and Developing Countries<sup>35</sup> (hereinafter: UN MC). The OECD MC is the earlier one, and it, along with the Commentaries accompanying every one of its articles, provided itself a pattern for the UN MC. While the OECD MC represents the interests of developed countries, the UN MC is more adjusted to the interests of developing countries. DTCs are, by definition, international agreements that distribute taxing rights between contracting parties. According to the UN MC, it means that, in DTCs with developed countries, developing countries have more taxing rights. It is, e.g. emphasized in the cases of the so-called passive income – dividends, interest and royalties (Articles 10, 11 and 12 of both MCs), where the UN MC stipulates the dominant taxing position for developing countries, contrary to the OECD MC, assigning the prevailing taxing position to developed states.<sup>36</sup>

The standard Croatian MC is today deeply rooted in the OECD MC. However, the Croatian MC does not follow the OECD MC to the letter. Some solutions in the Croatian MC are more in line with the UN MC, so the influence of the latter MC should also be taken into consideration. Those solutions enable the Croatian negotiators to pursue more flexibility as well as some key policy goals during the negotiations. The aforementioned influences should not be overrated. For example, despite being a developing and transitional country, Croatia in Article 5, Paragraph 3 (Permanent Establishment, a building site or construction or installation project) of its MC, opts for the twelve-month period as the one that constitutes a permanent establishment, rather than the six-month period suggested in the UN MC. This is, however, due to the specific position that the Croatian building enterprises are in, when compared to the Croatian enterprises generally. Although it has been previously mentioned that the Croatian economy is import-oriented, this is not the case in the building and construction sector. In a comparison between foreign construction companies working in Croatia and Croatian building enterprises engaged in activities abroad, the balance is heavily weighted in favour of the latter. Thus, the twelve-month period for constituting a permanent establishment is presently more in line with Croatian economic interests. It is also worth noting that Croatian legislation unilaterally provides for a six-month period in which a building site or installation project of a non-resident entrepreneur can constitute a permanent establishment.<sup>37</sup> There are some additional provisions in which the

<sup>35</sup> Available at: [<http://unpan1.un.org/intradoc/groups/public/documents/un/unpan002084.pdf>].

<sup>36</sup> When it comes to investments, developed countries are the countries from which the investors (and capital) come (i.e. they are the states of residence of the investors). Developing countries are the states from which the investment income originates (the states of source).

<sup>37</sup> See *Opći porezni zakon* (General Tax Law) (NN 127/00, 86/01, 150/02), Article 40 Paragraph 1 al. 7; *Zakon o porezu na dobit*, Article 4 Paragraph 2 Item 7.

Croatian MC differs from the OECD MC. Some of these provisions have been changed over time. It has to be said, as a general remark, that both versions of the Croatian MC, analysed below, envisage the fixed base, which has been removed from the OECD MC.

The mentioned differences and alterations are:

*Article 8 (Shipping, Inland and Waterways Transport and Air Transport).* That Article is in Croatian MC titled “Shipping, Inland and Waterways Transport Road and Air Transport” (emphasis added). According to the title, Paragraph 1 *in principio* reads “Profits from the operation of ships, aircraft or road transport vehicles...” (emphasis added), i.e. road transport vehicles have been added, which are not specifically mentioned either in Article 8 of the OECD MC or in the UN MC. This was already the object of criticism as a solution not following Croatian economic interests,<sup>38</sup> namely that the “inclusion of road transport into Article 8 represents the intention of countries in which the management of a great deal of international road transport enterprises is located, e.g. Turkey and Poland. The consequence is that the source country, even if the permanent establishment of the transport enterprise is located in that country, loses the right to tax. It can hardly be said that Croatia dominates the European road cargo transport market. Road transport should, therefore, be deleted from Article 8” (ibid).

*Article 10 (Dividends).* Paragraph 2, of the OECD MC provides for 5 and 15 per cent withholding tax rates in the source state for the beneficial owner, while the Croatian MC does not specify the percentage amounts.

*Article 11 (Interest).* Paragraph 2 has been omitted in the Croatian MC 2000. That MC provided for the exclusive right to tax the interest in the state of residency of the recipient of the interest, thereby denying the possibility for that interest to be taxed in the state of the payer and omitting at the same time the provision favourable for the beneficial owner of the said interest as the resident of the contracting state. It was a specific solution, not present in either of the MCs. The present Croatian MC, however, is in line with the UN MC.

*Article 12 (Royalties).* Paragraph 1 of the Croatian MC 2000 omitted beneficial ownership, i.e. it failed to provide beneficial ownership, together with residence, as a condition for taxation in the state of residence, and gave the exclusive right to tax to the state of residence. This provision is thus a mixture of the solutions that exist both in the OECD MC and the UN MC. Article 12, Paragraph 4 of the Croatian MC is identical to Article 12, Paragraph 5 of the UN MC, i.e. to the “permanent establishment (and fixed base) proviso”, authorising the state of the permanent establishment (and fixed base) to tax royalties if they are borne by the perma-

<sup>38</sup> Engelschalk, *Stručno mišljenje uz reformu obrasca za ugovor o izbjegavanju dvostrukog oporezivanja Republike Hrvatske* (Expert Opinion on the Reform of the Model Convention for the Avoidance of the Double Taxation of the Republic of Croatia), non-published, made available to the authors by the Ministry of Finance.

ment establishment or fixed base; in that case, they are deemed to arise in the state where the permanent establishment or fixed base are situated. Article 12, Paragraph 1 of the current Croatian MC endows the contracting state with the right to tax the resident who is beneficial owner of the royalties (in accordance with the OECD MC), but not exclusively; it also authorises the source state to tax dividends (in accordance with the UN MC). The rest of Article 12 follows the UN MC.

*Article 13 (Capital Gains).* Paragraph 4 (the gains derived from the alienation of shares in a company the value of which consists principally of immovable property in the source state), as it reads in the OECD MC, does not (and did not) exist in the Croatian MCs. This, however, is probably not the result of the pursuit of some specific tax treaty policy goal, but rather due to the fact that the Croatian MC in use now is dated July 2001 and therefore based on the version of Article 13 of the OECD MC at the time when that article did not itself contain Paragraph 4 as found in today's version. Notwithstanding the Croatian MC, however, some Croatian treaties concluded after the year 2002 contain Paragraph 4 as drafted in the OECD MC: the treaties with Bosnia and Herzegovina (entered into force on 1 January 2006), Chile (entered into force on 1 January 2005), Germany (entered into force on 1 January 2007), Ireland (entered into force on 1 January 2004), Jordan (entered into force on 1 January 2007), Moldova (entered into force on 1 January 2007), Spain (entered into force on 1 January 2007), and Yugoslavia<sup>39</sup> (entered into force on 1 January 2005). Paragraph 3 of the Croatian MC also refers to road vehicles in addition to ships and aircraft.<sup>40</sup>

*Article 14 (Independent Personal Services).* Although that Article was removed from the OECD MC in 2002, it is still present in the Croatian MC, as well as in the most recent Croatian tax treaties, which demonstrates the bearing of the UN MC. This is the case with the treaty with Austria (entered into force on 1 January 2002), Belarus (entered into force on 1 January 2005), Belgium (entered into force on 1 January 2005), Bosnia and Herzegovina (entered into force on 1 January 2006), Chile (entered into force on 1 January 2005), China (entered into force on 1 January 2002), Estonia (entered into force on 1 January 2005), France (entered into force on 1 January 2006), Germany (entered into force on 1 January 2007), Ireland (entered into force on 1 January 2004), Jordan (entered into force on 1 January 2007), Korea (entered into force on 1 January 2006), Latvia (entered into force on 1 January 2002), Lithuania (entered into force on 1 January 2002), Malaysia (entered into force on 1 January 2005), Mauritius (entered into force on 1 January 2004), the Netherlands (entered into force on 1 January 2002), San Marino (entered into force on 1 January 2006) and Yugoslavia (entered into force on 1 January 2005).

<sup>39</sup> Yugoslavia does not exist anymore, since it dissolved into two independent states – Serbia and Montenegro. However, the treaty concluded with Yugoslavia is still in use with both new countries.

<sup>40</sup> See *supra* the commentary on Article 8 of the Croatian MC.

Only a few new Croatian treaties follow the OECD MC and omit Article 14 altogether; these are the treaty with Moldova (entered into force on 1 January 2007), Slovenia (entered into force on 1 January 2006) and Spain (entered into force on 1 January 2007).<sup>41</sup>

*Article 15.* That Article of the Croatian MC is still entitled “Dependent Personal Services” in accordance with the UN MC and different from the OECD MC’s title “Income from Employment”. Paragraph 4 of that Article exists neither in the OECD MC nor in the UN MC. That paragraph regulates the treatment of the social security contributions, stating that:

“when [those contributions] are paid to a social security scheme in the other contracting state, they shall, in determining the individual’s taxable income, in the first mentioned state be treated in the same way and subjected to the same conditions and scope as contributions paid to social security scheme that are recognized as such for tax purposes in the first mentioned state, provided that:

- the individual was not a resident of that state immediately before he began to exercise employment in that state, and the contributions to the social security scheme for such individual were already paid in the other state, and
- the competent authorities of the first mentioned state have established that the institutions to which contributions for social security scheme are paid in general correspond to the institutions that are in that state acknowledged as such for tax purposes.”

This paragraph also regulates what is covered by the term “social security scheme” in Croatia and in the other contracting state for the purposes of Article 15. From the wording of the provision, it could be construed that it is aimed at preventing avoidance of social contributions payments, and that it is based on reciprocity. The present Croatian MC does not contain such a provision, and its Article 15 is in line with the OECD MC.

*Article 18 (Pensions).* In the present Croatian MC, it is fully in line with the OECD MC. The Croatian MC 2000, however, contained three paragraphs. The first paragraph closely followed the provision of the OECD MC. The second paragraph (allocating the right to tax payments received by the resident of the contracting state to the state under whose public social security scheme the payments were received) was in accordance with Article 18, Paragraphs 2 and 3 respectively (alternatives A and B of Article 18) of the UN MC. The third paragraph contained a definition of the term “rent”.

<sup>41</sup> Interestingly, the version of the Croatian MC, dated October 2000, did not contain the Independent Personal Services article; it was removed from the MC, although at that time it was still present in the OECD MC. However, that article was (again) included in the present Croatian MC.

*Article 22 (Capital).* Article 22 of the Croatian MC differs from the OECD MC in that it, in Paragraph 3 (the road transport vehicles alongside ships, aircraft and boats), contains the items of capital taxable in the contracting state in which the place of effective management of the enterprise is situated.<sup>42</sup>

*Article 23.* The present version of Article 23 (Avoidance of Double Taxation) is completely in line with Article 23B of the OECD MC. Furthermore, all Croatian treaties (except for those concluded by the former SFRY) contain the credit method for the avoidance of double taxation.<sup>43</sup> It is all the more surprising that the Croatian MC 2000 contained the exemption method as a general rule in Paragraph 1a, and the credit method, as a *lex specialis*, in Paragraph 1b, for dividends not included under (a), remuneration derived in respect of employment exercised aboard a ship, aircraft or road transport vehicle<sup>44</sup> operated in international traffic, or aboard a boat engaged in inland waterways transportation, director's fees, and the income of artists and sportsmen. Paragraph 2 provides for the non-application of Paragraph 1a "if the other contracting state exempts income or capital of the Croatia's resident, or applies the provisions of Paragraph 2 of Article 10 and 11 to such income".

*Article 27 of the OECD MC (Assistance in the Collection of Taxes).* Neither it is included in the Croatian MC, nor is it found in the treaties that Croatia has concluded thus far. When asked, the officials of the Ministry of Finance could not explain the non-inclusion of Article 27 by any systemic policy goal. Rather, it appears that: (1) no immediate pressure or interest exists, which would lead to inclusion of that article of the OECD MC in the Croatian MC, and (2) no general long-term policy (e.g., international administrative cooperation) dictates such an inclusion either.

However, since Croatia, due to its accession to the EU, had to include *acquis communautaire* in its legal system, the Croatian General Tax Act has been significantly amended. EU Directives 77/799 EEC and 2008/55 EC, regulating administrative cooperation in the field of direct taxation, are now part of the General Tax Act, providing the legal basis for assistance in the collection of direct taxes at least with the EU Member States.

## 5 CONCLUSION

Croatian DTC policy could (and should) be analysed with the reference to two periods of time: (1) the period since Croatia declared independence, and, (2) the period when Croatia was a part of the former Yugoslavia when a certain number of treaties was concluded, some of which are still in force in Croatia today.

<sup>42</sup> See *supra* the commentary on Article 8 of the Croatian MC.

<sup>43</sup> However, see *supra* for the exemption in the treaty with Switzerland.

<sup>44</sup> For the road transport vehicles, see *supra* the commentary on Article 8 of the Croatian MC.

1) As for the first mentioned time period (although it chronologically comes later), one may say that there were no significant changes in the Croatian double tax treaty policy during the whole period from independence until the present. There are at least two reasons for such consistency: first, the time period is too short for any substantial changes to have occurred; and second, and by far more important, there was no driving force to initiate even the formation of a well-grounded and elaborated double tax treaty policy, let alone to change it over the years. On the other hand, it was never doubted that Croatia needed a double tax treaty network; as explained above, concluding these treaties was another opportunity to confirm the international relevance and independent status of the new country, and every such opportunity has been readily seized.

In the absence of deliberate efforts to articulate a tax treaty policy founded on distinct interests and aimed at achieving certain clearly defined goals, the main role in the tax treaty negotiations was played (and is still being played) by administrative experts, i.e. the officials of the Ministry of Finance. Pressured, from the one side, by the imperative to build the Croatian double tax treaty network, and faced, from the other, with a lack of policy direction, they resort to a reliable source – the OECD MC (although the UN MC and its influence, must, by no means, be neglected).<sup>45</sup>

2) The former SFRY's tax treaties, although some of them are still applicable in Croatia, were the product of a different socio-economic system, and, consequently, of a different legal culture. As far as the former Yugoslavia is concerned, it was firmly grounded (1) in the system of so-called self-governing socialism, and (2) in the position of the former Yugoslavia as a developing country. Both these characteristics were expressed in the provisions of the treaties. Therefore, they were, more or less, the product of a defined interest and policy, stemming ultimately from an ideological point of view, which is evident in their terminology; e.g. they use terms typical for the then socio-economic order ("organization of associated labour", "income of organization of associated labour"). On the other hand, that system did not know of dividends as a form of corporate or individual income. Regarding the system from which they originated, it could be concluded that those treaties, while applicable through some legal interpretational effort, were terminologically not completely suited for the market-oriented system.

Thus, the main incentive for the changes in the double tax treaty policy in the case of Croatia turned out to be the major historical switch from a planned to a market-oriented economy, accompanied with the appearance of the Republic of Croatia as a new subject in the international arena, and not the subtle changes in the other-

<sup>45</sup> Information acquired during a short interview the author (Hrvoje Arbutina) had with the official of the Ministry of Finance, on 27 May 2008.



wise well-established double tax treaty policy that developed over a longer period of time.

When, in the context of the DTC policy, comparing the situation of the former Yugoslavia with that of the Republic of Croatia, one thing is evident – the difference in the number of the DTCs. While former Yugoslavia, during its forty-five years history, concluded 22 such conventions, Croatia, in twenty years of its existence, concluded fifty DTCs. The former SFRY was evidently very cautious when concluding them. This should be ascribed to general suspicion regarding foreign investments taking place in the country. Those conventions are widely perceived as a vehicle to induce such investments, through eliminating tax obstacles. While Croatia is by no means a primary target for foreign investments in today's world, those suspicions are certainly not part of the prevalent ideology anymore, so the new country feels free to build an extensive network of DTCs. They have not so far proved efficient in attracting foreign capital, however, so one can conclude that, while not harmful, they are, generally, rather neutral legal instruments, only waiting for the chance to be substantially helpful.

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