DIVIDENDS PROVISIONS IN CROATIAN DOUBLE TAXATION AGREEMENTS

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Review article*
UDC 336.2(497.5)
JEL E62, H25

Abstract

This paper analyzes the provisions concerning dividends in the double taxation avoidance agreements concluded by the Republic of Croatia. Since the base for taxation is necessarily laid down in domestic law, Croatian legislation is examined as well. The author primarily discusses dividends provisions in four agreements signed with Germany, Austria, Switzerland and Slovenia, in addition to analyzing the differences from and similarities with the OECD Model Convention. Second, the paper briefly explains the methods for eliminating double taxation on income from dividends. Finally, it addresses the changes necessary for accession to the European Union.

Key words: dividends, taxation, double taxation, double taxation agreements, OECD Model Convention, Croatia

1 Introduction

Double taxation may appear in the international exchange of goods and services. This is when a resident of one state receives income from another state while both states have the right to tax the said income according to their own legislation. In order to prevent this, model conventions were created. The two most common are the UN and the OECD conventions (United Nations, 1997; OECD, 1997). The conventions clarify and standardize the fiscal situation of taxpayers in each member country[1] who are engaged in commercial, industrial, financial or any other activities in other member countries. These texts offer common solutions applicable by all member states to identical cases of double taxation.

* *Received:* October 4, 2006.
Accepted: February 12, 2007.

[1] Members of the OECD or UN.

Croatia has signed 39 double taxation agreements with other countries. These texts lay down rules for the taxation of income or capital crossing international frontiers. They define taxing rights between the respective two countries. The primary purpose of agreements is to eliminate or reduce international double taxation and to prevent tax evasion. When there are no agreements between the states, the taxpayers have to comply with domestic law, which only sometimes may regulate the limitation of double taxation.[2]

The OECD Model Convention (below: the Convention) and the agreements that follow it are organized in seven chapters. This paper will deal only with Chapter III, which contains the distributive rules regarding income taxes. More precisely, it will attempt to analyse the dividends provisions in agreements concluded by the Republic of Croatia. In Croatian legal system, international agreements or treaties are a part of the legislation that is hierarchically, in terms of legal power, above statutes but below the Constitution. Therefore, rules laid out in the agreements have priority over domestic laws. Nevertheless, this is not to say that domestic laws are of no importance. The tax base has always to be laid down in domestic law. Agreements mostly regulate only the way in which the competence to tax income and capital will be distributed between the parties; they do not grant the right to tax, which is in the purview of domestic legislation.

This paper will, first, discuss the dividends provisions in four agreements signed over the past fifteen years and attempt to find and analyze differences and similarities with the Convention. Second, it will briefly explain methods for the elimination of double taxation for income on dividends and again analyze the differences and similarities between the agreements and the Convention. Finally, it will address the changes necessary for accession to the European Union (below: EU).[3] The paper to some extent follows a much more thorough and detailed legal analysis on double taxation conventions made in one of the most important books in international tax law (Vogel [et al.], 1998).

2 The highlighted agreements

The agreements and their particular provisions that will be discussed in this paper are given in Table 1. Texts of the relevant provisions are listed in Annex I to this paper.

The agreement for the avoidance of double taxation with respect to taxes on income and on capital that was concluded by the former Socialist Federal Republic of Yugoslavia - SFRJ (hereinafter: ex-Yugoslavia) with Germany, still remains in force for Croatia although the drafting of the new agreement with Germany is under way.[4]

[2] E.g. the Croatian Income Tax Act and Profit Tax Act both provide for the elimination of double taxation by use of the method of imputation (NN 177/04). The Slovenian Corporate Income Tax Act provides for evasion of double taxation of income in its Article 55 by providing the method of tax credit under the condition that there is no DTC signed (Zakon o davku od dohodkov pravnih oseb, UL 17/05).

[3] Through enlargement of the EU, accession states are required to change their legal framework and align it according to guidelines of the EU. Croatia is one of the accession states and its DTCs will be amended according to the EU legal framework.

[4] Croatian agreements are published in Narodne Novine (hereinafter: NN) in the International Agreements section (abbreviation: MU).

Table 1 Some double taxation agreements

Agreements	Year of validity	Dividends Article
ex-Yugoslavia/Germany[5]	1989	11
Croatia/Switzerland[6]	2000	10
Croatia/Austria[7]	2002	10
Croatia/Slovenia[8]	2005	10

Croatia currently has 39 agreements in force. Some were taken over by succession from ex-Yugoslavia in 1991, while others were signed later. The one with Germany has been in force since 1989. The agreement with Switzerland has been in force since 2000, with Austria since 2002 while one of the most recent ones signed with Slovenia came into force in 2006. These agreements were selected according to the time they entered into force in order to cover the entire period of the independence of Croatia. In addition they are representative of similar documents signed with EU and non EU countries as well as those taken over from ex-Yugoslavia. Finally, these texts represent the evolution of Croatian foreign policy from its beginnings.

3 Dividends

OECD Model Convention Article 10 states that*:*

"1 Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.

2 However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed: (a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends; (b) 15 per cent of the gross amount of the dividends in all other cases.

The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of these limitations.

[5] Ugovor o izbjegavanju dvostrukog oporezivanja porezima na dohodak i na imovinu između SFR Jugoslavije i Savezne Republike Njemačke, NN-MU 53/91 (hereinafter: DTC with Germany) („Narodne Novine", abbreviation :„NN" is the Official Gazette of the Republic of Croatia where all legislative texts brought by the State are published. First digit indicates the ordinal number of the journal, second two digits after the slash sign indicates the year. „MU" is the official abbreviation for the International Agreements section).

[6] Ugovor između Republike Hrvatske i Švicarske Konfederacije o izbjegavanju dvostrukog oporezivanja porezima na dohodak i na imovinu, NN-MU 8/99 (hereinafter: DTC with Switzerland).

[7] Ugovor između Republike Hrvatske i Republike Austrije o izbjegavanju dvostrukog oporezivanja porezima na dohodak i na imovinu, NN-MU 3/01 (hereinafter: DTC with Austria).

[8] Ugovor između Republike Hrvatske i Republike Slovenije o izbjegavanju dvostrukog oporezivanja i sprječavanju izbjegavanja plaćanja poreza na dohodak i na imovinu, NN-MU 8/05 (hereinafter: DTC with Slovenia).

This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.

3 The term "dividends" as used in this Article means income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.

4 The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the dividends, being a resident of a Contracting State, carries on business in the other Contracting State of which the company paying the dividends is a resident through a permanent establishment situated therein and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.

5 Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company, except insofar as such dividends are paid to a resident of that other State or insofar as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment situated in that other State, nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State."

Hypothetical case

State R and State S have signed an agreement similar to the Convention.

Problem: What if Ms. MM has residence in State R and receives dividends in State S, where is she taxed?

The provision of the agreement concerning dividends (usually Article 10) applies to this question. According to paragraph 2 of that rule, Ms. MM must pay taxes in the maximum amount of 15% of the gross income on dividends in State S. In addition to paying taxes in State S, Ms. MM will also have to pay taxes on income from dividends in State R which has also the right to tax according to its domestic tax rate.

However, the two states will have to divide their competence to tax. According to this provision of the agreement, it is clear that a limited double taxation is allowed since Ms. MM must pay taxes on the same tax base in two different states but both parties have to limit their amount of tax. This is called "tax sharing" because two contractual parties have agreed to share their right to tax the same income.

It is clear how State S is limited because the maximum tax is clearly stated in the text of the agreement. What about State R? State R may apply its domestic tax rate. However, the agreement between State R and State S provides in its Article 23 for the application of a method for the elimination of double taxation. By applying the credit method, State R will have to credit the tax already paid in State S to the tax still due. The credit method is always automatically applied when income on dividends is taxed.[9] Therefore, it is obvious that there is only a formally limited double taxation and Ms. MM will not be taxed twice on the same income.

Table 2 Example of dividends taxation in state of residence and state of source

State R- tax rate 40%		State S - tax rate 15%
Ms. MM – receives dividends		joint stock company – pays out dividends
dividend income = 100 tax due = 40 as per domestic rate		dividend income = 100 tax paid = 15
application of tax credit method:		
tax R	40	
tax S	– 15	
tax due	25	

Source: author

The principle of tax sharing introduced by the Convention represents a sort of compromise between the state of source and the state of residence.[10] The above is a simplified version of dividend taxation in state of residence and state of source. However, Ms. MM would probably have income other then dividends in her state of residence so the above table would never be like that in real life. That is to say, the tax paid on dividends in State S will be credited to the overall income tax due in State R but only in that part that relates to income from dividends. Therefore, only that fraction of income earned from dividends will serve as base for the application of the credit method, and the rest of the income will be taxed according to the domestic tax legislation of State R. In addition, if the tax paid on dividends in State S is greater than tax in State R, the tax due in State R will be 0 and the taxpayer cannot be credited with more, i.e. that surplus cannot be transferred to other items of income tax.

3.1 Commentary on Article 10 - Dividends

Chapter III of the Convention provides rules for regulating the taxation of income derived from certain assets and activities. These rules are divided into those regulating dividends, interest, royalties and immovable property. According to different "types of income", states may have the right to tax it or may have an obligation to exempt it from taxation. There is a certain pattern, if the rule provides that a particular income "shall be taxable only in..." "a state, then the other state must exempt it from taxation and leave the income to the other state for exclusive taxation. However, if the rule provides that the in-

[9] As opposed to the different, exemption method which may be agreed by the parties.

[10] Agreement states that the state of source is contractual party in which the income or capital subject to taxation arises, while the state of residence is the one in which the taxpayer is a resident.

come "may be taxed in..."[11] a state, then the other state also has the right to tax. The latter is the case with dividends. When both states have the right to tax the method for elimination of double taxation has to be applied as explained later under point IV.

The main feature suggested by the Convention concerning regulation of dividends is tax sharing between the state of residence and the state of source. This is because, usually, neither one of the contracting parties is willing to refrain from taxing – therefore, tax sharing is a compromise. To clarify, the state of source applies the agreed fixed reduced rate of taxation (e.g. the Convention Article 10 par. 2 a) 5%), while the state of residence always applies the credit method to avoid double taxation of dividends (Vogel [et al.], Article 23, parargaph 37). Nevertheless, this is only true for dividends and one should bear in mind that the exemption method is a separate method and may be used by the parties in all other provisions of an agreement.

As a general rule, provisions regulating taxation on income gained from assets, such as dividends, have priority over provisions regulating the taxation of business profits (Article 7 OECD MC). That is to say, should an uncertainty exist concerning the application of the provision on dividends or that on business profits, the first should prevail. However, when reading the dividends provision it may be noticed that one exception exists in paragraph 4, concerning permanent establishments - their income is determined pursuant to the rule on business profits.

Particularity of Croatia. Dividends are not taxable in Croatia as of 1st of January 2005 when the Income Tax Act (Zakon o porezu na dohodak, NN 177/04) and Profit Tax Act (Zakon o porezu na dobit, NN 177/04, 90/05 and 57/06) were amended. The bylaw to the Income Tax Act (Pravilnik o porezu na dohodak, NN 95/05, 96/06) reiterates that income from dividends is not taxable as of 1st January 2005. Although Croatia adopted the Profit Tax Act in 1993 (NN 109/93, 95/94, 106/96), dividends were excluded from the tax base, i.e. not taxable in Croatia until the amendment of the said Act in the year 2001 (Zakon o porezu na dohodak, NN 177/04). Due to new amendments of the same Act, dividends have once again not been taxable again in Croatia since 2005. The Constitution stipulates that any international agreement is in legal force above domestic laws. So one could say that if an agreement grants the right to tax, Croatia may use it. However, in the case of the agreements it is important to emphasize that a party can domestically apply these rules only within the framework given by laws and other legal acts. Therefore, dividends have not been taxable in Croatia since the beginning of 2005 even when an agreement provides for the right to tax. This situation does not affect the other party to an agreement; the provisions of the agreement with, e.g., Slovenia will be applicable to Croatian residents[12] who receive dividends from a Slovenian company and they may be taxed in that state according to the agreement in power but Slovenian residents need pay no taxes on income from dividends received in Croatia.

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[11] This is the difference between the more recent agreements and the oldest agreements concerned here. The agreement ex-Yugoslavia/Germany does not explicitly provide for taxation at the state of residence but implicitly this can be concluded from the experession "..may be taxed in ... Germany" meaning they will be taxed in Yugoslavia (ie. Croatia) as well.

[12] Term "Resident" is used for tax purposes only.

3.2 Common terms and rules used in the rule on dividends

There are two notions common to the rule on dividends: beneficial owner and the procedure of taxation.

3.2.1 Beneficial owner

The treaty benefits, i.e. tax relief, will be available only if the beneficial owner of such payments is resident in the other contracting state. The concept of the beneficial owner is introduced in these provisions in order to avoid the abuse of an agreement. In other words, if the recipient was not necessarily the beneficial owner, then he could be an agent representing a real owner in a third country who is not entitled to benefit from an agreement (Šola, 2001:68). Payment – as stipulated in Article 10 paragraph (2) of all agreements analyzed here, except the one with Germany – has to be performed by the beneficial owner or for the benefit of the beneficial owner which is a resident of the contracting state.

Rule: "The beneficial owner is he who is free to decide: (a) whether or not the capital or other assets should be used or made available for use by others, or (b) on how the yields thereof should be used, or (c) both" and he has to be a resident of the contracting state(Vogel [et al.], 1998: Preface to Articles 10 to 12, par. 9).

Obstacles that exclude beneficial ownership may be different but they are correspondingly easy to prove with legal entities and difficult with individuals.

Therefore, in Croatia – the foreign person who receives the dividends (who is also the resident of the other contracting state) must present the official form issued by the state of residence verifying the residence and sign a statement guaranteeing he or she is the beneficial owner of the dividends. The competent office of the state of his residence will issue such a document only to an individual who is a resident tax payer according to domestic legislation. Otherwise, the state of source may tax according to its domestic law, not the agreement provisions. Croatian authorities issue such an official form only to a natural or legal person who is also a resident tax payer pursuant to domestic tax legislation (Ministarstvo financija, 2000:2).

However, the agreement of ex-Yugoslavia and Germany[13] does not use the term "beneficial owner" as the Convention suggests. This agreement does not determine that the recipient of dividends has to be a "beneficial owner". Thus, it can be a third agent or anyone else, the only condition being that this person has to be a resident of Yugoslavia (today Croatia). Nevertheless, the term "beneficial ownership" is used in paragraph 3 which determines the exception of permanent establishments. Therefore, it may be concluded that the agreement of ex-Yugoslavia and Germany adopts the requirement of "beneficial ownership" for all dividends – only within the context of a permanent establishment where the income will be taxed according to the provision on business profits or independent personal services. Thus, all the risks of possible abuse – such as that an agent benefits from this provision - remain in existence for the parties of this agreement.

[13] The text of the provision may be found in Annex I to this paper

3.2.2 Taxation procedure

Taxes on dividends may be levied by withholding at source. It is actually retention of tax at source which is most often applied to the income of non residents, e.g. in Switzerland, the employer is obligated to retain taxes on a foreign employee's earnings and pay them to the tax authorities. In a similar manner, most countries provide for retention at source for taxes on dividends accruing to non-residents of that state.

Rule: The Convention foresees the following procedure for withholding tax on dividends: tax shall be paid according to the domestic tax rate in the state of residency (Article 10 par. 1) and tax shall be paid in the state of source at a reduced withholding rate (Article 10 par. 2).

If an agreement - (a) restricts the tax rate on dividends and other such items e.g. when tax is shared between the two contracting states, or (b) exempts such items altogether from the taxation of one party – the withholding procedure may be affected in two different manners. First, the debtor who owes the money may be authorized to retain a correspondingly lesser amount of tax. Second, the debtor may be obligated to withhold the tax at a normal rate under the domestic law but the excess will be later refunded to the person mentioned in the agreement (Staringer, 1994:571, par. 32). Therefore, when countries later, upon request, refund the correspondingly lesser amount of tax, they violate the reduced rate agreed upon in their agreement.

The Convention provides for mutual agreement only concerning dividends. The parties regulate the manner in which they shall implement their limited taxing right by way of mutual agreement on the procedure of withholding at source. The agreements concerned here differ in stipulating this matter but, essentially this mutual agreement is only a way to determine the way in which the limited taxing rights of the state of source shall be applied. The manner of taxation depends, most often, on the domestic legislation. Therefore, in Croatia, the tax on dividends will not be paid since the domestic legislation does not provide for it. Pursuant to the principle of tax sharing the tax already paid in the other state will be credited to the tax due in state of residence as stipulated by the provision on methods for limitation of double taxation. However, if Croatia is the state of source then the tax credit is 0% and the tax payer must pay the full tax on dividends in his state of residence.

Croatia. Used to apply the system of withholding at source but not any more, since dividends are not taxable as of January 2005.

Germany. The practice of Germany in most of its agreements is to retain the full domestic tax rate at source and later refund at request – this system is called "retain and refund". In order to get the surplus refunded, the taxpayer must submit a special claim for it or, to avoid this, may apply for an exemption certificate (IBFD, 2005:177).

Slovenia. The agreement overrides the domestic law. The paying company withholds tax at 25% on dividends transferred abroad or dividends distributed to non-residents, unless otherwise provided for by an agreement. If corporate tax of 25% was previously imposed, there is no withholding tax on dividends distributed to a Slovenian resident who is a legal entity (Zakon o davku od dohodkov pravnih oseb, UL 17/05, Article 68).

Austria. The agreement with Croatia provides for the application of the domestic law of Austria in taxation of inter-company dividends (concept explained below under III, 1.3, b). Given that no minimum tax rate and no tax sharing are agreed, such dividends will be taxed at full domestic tax rate. Portfolio dividends will be taxed at 15% as agreed by the agreement.[14]

*Switzerland***.** The Swiss withholding tax rate is 35%, and Croatian resident shareholders are entitled to claim back the overpaid tax according to the agreement (Eckert, 2005). Thus, they will be entitled to claim back 4/7ths of the Swiss withholding tax leaving out 15% of the taxation levied.

3.3 Manner of taxation

The way in which taxation is conducted is divided between the two contracting states. The first two paragraphs of the dividends provision regulate that.

3.3.1 Manner of taxation - State of residence (paragraph 1)

In the Convention this provision confirms expressly that the state of residence is entitled to taxation of dividends received by its residents where: dividends are paid by a company that is a resident of a contracting state (source) to a resident of the other contracting state (residence).

This clarifies in which cases Article 10 is applicable, in other words, it is applicable only when two contracting states are concerned. If the company distributing benefits is a resident of any third state but the state of source, Article 10 does not apply (OECD, 1997, Article 10(1), par. 8).

Among the analysed agreements only the one with Germany does not contain an express confirmation of the above mentioned rule, but regulates where: dividends paid by a company resident in the Federal Republic of Germany (source) to a resident of Yugoslavia (residence) may be taxed in Germany[15] (source). However, the tax so charged may not exceed 15 per cent of the gross amount of the dividends.

Tax sharing is agreed but not as the Convention provides for. The usual rule is shrunk into one paragraph. There is no differentiation between direct and all other investments. Moreover, the rule refers only to a recipient in ex-Yugoslavia (as the state of residence) not *vice versa*. In other such agreements, countries are usually referred to as the “state of residency” or “state of source” because each contracting parties can be both. However, in the case of this agreement the situation is different and ex-Yugoslavia (today Croatia) may only be the state of residence and Germany may only be the state of source. The rate of taxation in Germany (the state of source) is set at 15% for all and any dividends, and whether the recipient is a company or an individual is completely disregarded. It can be concluded that while the Convention limits taxation in the state of source at 5% and 15%, this agreement with Germany does not benefit from such a provision. This is probably explicable by the nature of the political organization of ex-Yugoslavia. However, looking

[14] Dividends received by an individual who is the beneficial owner of shares with voting rights.

[15] Full text in Annex I.

from today's perspective, this agreement left a huge area uncovered. Dividends distributed from Croatia to Germany do not benefit from this document, there is no maximum limited tax rate for dividends arising in Croatia (domestic tax on dividends was 15% until 2005). Fortunately for German investors, even though this area is not regulated by agreement they benefit from overall non taxation of dividends in Croatia. Considering that Germany has the practice of exempting income from dividends received in other countries and dividends are presently not taxable in Croatia, German residents benefit from double non taxation of dividends.

3.3.2 Manner of taxation – State of source (paragraph 2)

Inter-company dividends. In practice there exists a distinction between inter-company dividends and all other dividends in the state of residence. According to Vogel [et al.] (1998, Article 10, par. 11), as states of residence, Germany and Switzerland typically provide for the exemption of taxation for inter-company dividends arising in a recipient's state of source (in Germany this principle is called Schachtelprivileg).

This paragraph regulates taxation by the state of source. The Convention provides for maximum rates of taxation and the parties may agree otherwise. In addition, for the dividends to be recognized as inter-company dividends according to the Convention, the beneficial owner has to: be a company (other than a partnership) that holds directly at least 25% of the capital of the company paying the dividends.

The Convention, version from 2003, makes a distinction between inter-company dividends (they may be called the associated company dividends as well - Article 10 (2) (a)) and all other dividends (Article 10 (2) (b)). If the beneficial owner holds a certain share (usually 25%) of ownership in the company that pays the dividends, a special reduced taxation rate is applied, overriding the general rule for all other dividends. The Convention provides for a maximum of 5% tax on inter-company dividends and a 15% tax rate on all other dividends.

It can be concluded thus, that direct investment is more favourably treated than other investments. However, this is only true when companies are investors. Individuals or partnerships do not enjoy the same advantage.

The phrase *other than a partnership* is relevant only if the domestic systems of the two contracting States allow partnerships to be considered as independent taxable entities (Vogel [et al.], 1998, Article 10 par. 74). However, that phrase is not used in the agreements of Croatia concerned here. This is obviously due to redundancy with domestic legal systems of the parties.

The second sentence foresees the mutual agreement by competent authorities of the contracting parties. This allows the tax authorities to choose the withholding method, which was described above.

Particularities of the analysed Croatian agreements:

The agreement with *Germany* (in its Article 11 on dividends) regulates only Croatian investments in Germany and not the opposite as well. Thus, German investments in Croatia are regulated only by the Croatian domestic law as if no agreement was signed. Such investments do not benefit from a limited taxation at source in Croatia, which would be expected. However, given that Croatia does not tax dividends at all - such dividends are not taxable either. In addition, the agreement does not differentiate between the inter-company dividends and all other dividends. Hence, such participations of Croatian companies are not taxed at a lower tax rate than portfolio investments. This agreement was signed in 1989, nevertheless, the Convention had incorporated the said principle as early as 1989, and thus the agreement with Germany could have contained it as well. In other words, the reasons for such wording should be sought in other motives the parties might have had. It could be this was the policy Germany had when negotiating. One of the reasons why this agreement did not contain the said differentiation is probably because in the ex-Yugoslavia, joint stock companies did not exist. There were various legal entities referred to as “companies” – organisations of associated labour, all of which belonged to the people, for there was no private ownership. This could be one of the reasons why such a provision was considered redundant given that an ex-Yugoslav “company” could not have fulfilled the condition of a company in a capitalist society. Obviously, all dividends are taxed at source (source being always Germany) at maximum tax rate of 15%.

The agreement with *Austria* is somewhat particular in regulating the taxation of inter-company dividends. Article 10, paragraph 2 b) provides for inter-company dividends being taxed *only* in the state of residence subject to the provision of Article 23, paragraph 1c) which stipulates that such dividends shall be exempt from taxation in Austria. The provisions read as follows:

Article 10, paragraph 2 b)	Article 23, paragraph 1 c)
If the beneficial owner is a company (other than a partnership) which holds directly at least 10 per cent of the capital of the company paying the dividends, such dividends shall, subject to the provisions of subparagraph c of paragraph 1 of Article 23, be taxable only in the Contracting State of which the beneficial owner of the dividends is a resident.	Dividends covered by subparagraph b) of paragraph 2 of Article 10 and paid by a company which is a resident of Croatia to a company which is a resident of Austria shall, subject to the relevant provisions of the domestic law of Austria but irrespective of any deviating minimum holding requirements of that law, be exempt from tax in Austria.

The provision of Article 10 lowers the direct holding rate to 10% and provides that inter-company dividends will be taxed according to Austrian domestic law *only*. Thus, there is no tax sharing foreseen for taxation of inter-company dividends. However, if the two provisions are analyzed more closely it may be concluded that inter-company dividends distributed by a Croatian company will not be taxed in Croatia or in Austria either because Article 23 provides for exemption. In turn, inter-company dividends distributed by an Austrian company to an owner residing in Croatia will not be taxed in Austria because such dividends may be taxed in the state of residence only, but they will not be taxed in Croatia either because domestic legislation does not foresee taxation of dividends. Therefore, beneficial owners of inter-company dividends will benefit from double non taxation.

The agreement with *Slovenia* does not differentiate between inter-company dividends and portfolio dividends as it does not differentiate between companies and individuals (legaland natural persons), using rather a flat tax rate of a maximum 5% of the gross amount of the dividends in the state of source. Thus, all investments are treated equally and none are favored over the others, or rather, the Convention recommended maximum 15% tax rate for portfolio dividends is lowered to the same maximum tax rate as recommended for the inter company dividends. This text is similar to the agreement with Germany in that it does not differiate between inter-company and portfolio dividends. However, one significant difference is that the limited tax rate is lowered to 5% whereas in the agreement with Germany it is 15% for all. This lowers the tax burden for Croatian investors in Slovenia because in the end they only pay the 5% in Slovenia. Slovenian investors in Croatia do not benefit from this lowered tax rate because when Slovenia applies the credit method to the repatriated dividends, the tax rate will be augmented to Slovenian domestic tax rate.

Table 3 Taxation of inter-company dividends

Agreement	Amount of direct holding required	Limited tax rate (%)		Dividends Article in the agreement
		Individuals	Companies	
ex-Yugoslavia /Germany	independent of the direct holding	15	15	11 (1)
Croatia / Switzerland	25% possible for companies only	15	5	10 (2)
Croatia / Austria	10% possible for companies only	15	0 (exempt)	10 (2)
Croatia / Slovenia	independent of the direct holding	5	5	10 (2)

Source: author

3.4 Definition of dividends

The agreements do not define dividends clearly and definitely. As stipulated in the Convention Commentary, it is impossible to define dividends fully and exhaustively due to great differences between the domestic laws of the countries. Consequently, the definition merely mentions examples to be found in the majority of the member countries' laws (OECD, 1997, Article 10 (3) par. 23).

Payments regarded as dividends may include not only distributions of profits decided by annual general meetings of the shareholders, but also other benefits in money or money's worth, as long as the state of paying company's residence taxes such benefits as dividends (ibid, Article 10 (3) par. 28).

The text defining dividends refers to the domestic law of the state of source. Hence, domestic law of the contracting party applies and leaves no scope for any different agreement application by the other party – the state of residence.

Rule: The Convention defines dividends as: (1) income from shares, jouissance shares or jouissance rights, mining shares, founders' shares; (2) from other rights, not being debt-claims, participating in profits; (3) as well as income from other corporate rights, to the extent that such income is subjected to the same taxation treatment as income from shares by the laws of the state of which the company making the distribution is a resident.

Although the definition is separated in three parts for easier analysis, these parts are not independent – it is a single rule. Each part of the definition refers to the previous one and narrows it down e.g. income specified in the first part shall not be considered as dividends if it is derived from debt claims or only income from corporate rights can be considered as dividends even the one derived from debt claims (Vogel [et al.], 1998, Article 10 par. 185).

The first two parts of the definition shall be interpreted only by reference to the treaty itself. The third part of the definition shall be interpreted with reference to the domestic law of the state of source (ibid, Article 10 par. 186). Thus, the law of the State of source shall become "treaty law" regarding this matter. Therefore, if an entity is qualified as a company by one contracting state but not by the other, the law of the State of effective place of management shall prevail (OECD, 1997, Article 10 (3) par. 27).

Ad 1) The Convention and most treaties mentioned here include jouissance shares or jouissance rights, mining shares, founders' shares in their dividends definition. Bons de jouissance are a type of equity security known as profit sharing certificates that confer no voting rights and have no par value. However, the Croatia/Switzerland agreement fails to mention them even though such rights are quite common in Switzerland and are granted by companies and may carry all such property rights as shareholders may expect for voting or other control rights (Vogel [et al.], 1998, Article 10 par. 193).

These jouissance shares or jouissance rights are hybrids and the payments based on them are usually subject to the provision of interest, unless the treaty clearly defines them as dividends (IBFD, 2005:175). Obviously, in this case income from juissance rights was not intended to be considered as dividends by the contractual parties of the said agreement. Thus, the scope of the definition of dividends is narrowed and such rights are subject to the provision of interest.

Mining and founders' shares are mentioned in all agreements treated here except for the Croatia/Switzerland agreement. These concern shares in mining companies. The lack of these usual examples in some agreements may show an attempt by the authors to eliminate any barriers to qualification of the dividends. Using only the term shares may mean that the authors wanted to leave the interpretation of this term completely free, not binding it by any additional examples. The only thing that limits this quite wide notion of shares is the remaining two parts of the definition.

Ad 2) This phrase *from other rights, not being debt-claims, participating in profits* is mentioned in all agreements treated here. It refers only to participatory rights the title to which is documented by securities. This phrase limits the first part of the definition in that it clearly excludes debt-claims (even if this limit is not expressly stipulated in domestic law of a party).

Ad 3) This last part of the definition is also included in all agreements analysed here and elevates the domestic law of the state of source to the level of treaty law. Thus, any decision made by the state of source qualifying an item of income as a dividend has a binding effect on the recipient's state of residence as well.

Nevertheless, the state of source may not determine dividends negatively, meaning, it may not determine what items of income do not constitute dividends. However, if the state of source fails to qualify certain income as dividends, such income may still be treated as dividend in the state of residence (Vogel [et al.], 1998, Article 10 par. 220).

The agreement with Germany in its third part of definition fails to mention the restriction that the items of income subjected to the same taxation treatment as income from shares must arise from "corporate rights". This shows an attempt to remove treaty barriers to reclassification of dividends.

Table 4 Defining the dividends

	The term dividends means:			
Agreements countries	income from shares, jouissance shares or jouissance rights, mining shares, founders' shares	from other rights, not being debt-claims, participating in profits	as well as income from other corporate rights, to the extent that such income is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.	additions
Croatia / Switzerland	income from shares	as Convention	as Convention	–
Croatia / Austria	as Convention	as Convention	as Convention	–
Ex Yugoslavia / Germany	as Convention	as Convention	as the Convention but not mentioning income from corporate rights	income derived by a sleeping partner form his participation as such, distributions on investment trust certificates
Croatia/ Slovenia	mining rights are omitted	as the Convention	as the Convention	–

Source: author

Particularity of agreement with Germany - sleeping partner and distributions on investment trust certificates – in the agreement with Germany there is an addition to the definition:" *... income derived by a sleeping partner from his participation as such and distributions on certificates of an investment trust."* According to domestic law of Germany, interest paid on the loan or sleeping partner's profit share are treated as dividends (ibid, Article 10 par. 200). Under the system established by the Convention, income derived by a sleeping partner falls under the scope of interest within the meaning of Article 11 on interest. However, the agreement with Germany expressly includes "…income derived by a sleeping partner…" in its definition of dividends. Therefore, the differentiation between interest and dividends is clear – in this agreement income derived by a sleeping partner falls under the scope of dividends.

Regarding the distributions on investment trust certificates - "Income accruing to German open-end investment funds is deemed to pass through them and is therefore attributed to the holders of the certificates issued by the funds." Distributions by German investment funds come under the mentioned dividend definition only to the extent "…that they arise from receipts, which in turn would be considered dividends if obtained directly – i.e. without the fund's intervention – by the holder of the certificate" (ibid, Article 10 par. 209).

3.5 Permanent establishment

The exception of permanent establishments proviso. Article 10 (4) of the Convention provides for an exception in the general rule of taxation of dividends. This is when a company forms a permanent establishment[16] maintained by an enterprise in the state of source or a fixed base from which an individual performs his personal services (e.g. a branch or an office). In that way, the state of source may tax only the net amount of the business profits or income and not the gross amount of the dividends. In other words, this means that only in this exceptional case are dividends not taxed according to the lower rate provided by the agreement. They are taxed as business profits (or as independent personal services; however, this stipulation was erased from the 2003 Convention). Since the provision regulating business profits does not provide for a special reduced rate, this means that such income *is* taxed – according to the rates of domestic legislation of the state of source.

The range of application. A permanent establishment is defined in Article 5 of the Convention.

Rule of exception is given in provisions concerning dividends (typically paragraph 4) and it provides that if: (1) a resident of one contracting State receives from sources in the other contracting State; (2) dividends of which he is the beneficial owner; (3)and at the same time carries on a business there through a permanent establishment, (4) or performs independent personal services there from a fixed base, (5) and where such dividends pertain to the permanent establishment or fixed base, the taxation of such items of income shall be governed by the provision on business profits (Article 7 of the Convention) or that concerning independent personal services (Article 14). The article stipulating taxation of independent personal services is erased from the Convention (version January 2003) due to redundancy. Thus, taxation of such items are only be governed by the provision on business profits.

Ad 1, 2) The relationship must always be between the two contracting states, any third states being excluded from this rule. Only assets arising between the parties of the agreement are concerned.

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[16] Each agreement provides for a definition of „permanent establishment" (usually in Article 5).

Ad 3, 4) Conduct of business may be direct or indirect (e.g. through a partner).

Ad 5) The dividend, interest or royalty must be directly or effectively connected to the right or property (e.g. investment of the beneficial owner) (Vogel [et al.], 1998, Preface to Arts 10 to 12 par. 24, 25).

Croatian agreements with Germany, Switzerland and Austria provide for the said exception but they still contain the wording of Article 14 on independent personal services which was deleted from the Convention (version January 2003). However, this does not change much in the application of these documents because the provision on business profits governs the taxation of such items of income in the end. This means that business profits are taxed according to domestic legislation of the state where the permanent establishment is situated. The business profits of the permanent establishment are established by way of direct or indirect tax method as stipulated in Article 7 of the Convention. The direct method means taxation on the part of the business profits of the permanent establishment only (applied in Croatia – Zakon o porezu na dobit, NN 177/04, 90/05, 57/06, Article 15). By way of the indirect method (if customary in the state which is entitled to tax, e.g. Germany) the profits are determined to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, and thus only the profits pertaining to one designated permanent establishment are taxed (Zdravec, 2000:105).

3.6 Extra-territorial taxation

Together with the exception of the permanent establishment, this is the second exception concerning the provision regulating dividends. This paragraph deals only with dividends paid by a company which is a resident of a contracting state to a resident of the other contracting state. Certain states tax also distributions by non-resident companies for profits arising in their territory. Pursuant to Article 7 of the Convention, they may well do so, but the shareholders of such companies should not be taxed as well at any rate (OECD, 1997, Article 10 (5) par. 33).

This paragraph is not present in the agreement with Germany. All other agreements are in line with the Convention. The Convention prohibits the "extra-territorial" taxation of distributed dividends and gives priority to the residence/permanent establishment principle. Thus, a state cannot tax profits of a non-resident company even if the profits were derived from its territory.

This paragraph provides only for taxation at source, thus, it does not regulate taxation at residence (ibid, Article 10 (5) par. 37).

Range of application. Only the state of residence of the company may tax the profits. However, the state of source may tax any profits if: (a) the dividends accrue to a resident of the state of source of the profit, or (b) the shareholder is not a resident of that state of source – the holding in respect of which the dividends are paid is effectively connected with a permanent establishment or a fixed base situated in the state of source (Vogel [et al.], 1998, Article 10 par. 252).

Rule. Where (a) company which is a resident of a contracting state (b) derives profits or income from the other contracting state (state of non-residence), that other state may not impose any tax on the dividends paid by the company, except insofar (c) as such dividends are paid to a resident of the state of non-residence or (d) as the shareholding in respect of which the dividends are paid is effectively connected with a permanent establishment or a fixed base situated in the state of non-residence. Furthermore, the state of non-residence may not subject the company which is a resident of the other contracting state (e) to a tax on undistributed profits, even if the dividends paid or the undistributed profits (f) consist wholly or partly of profits or income which the company derived from the state of non-residence (ibid, Article 10 par. 255).

More simply stated - the state of source may not tax dividends paid by a non-resident except if (a) the recipient is the resident of the state of source or (b) there is an effective connection to a permanent establishment or a fixed base situated in the state of source.

The ban on extra territorial taxation applies only if the company is not also a resident of the other contracting state from which it derives income or profits. The place of residence shall be determined by application of the definition of residence stipulated in agreement (in particular, its Article 4), and not domestic law (ibid, Article 10 par. 257).

The rule's basic purpose is to draw the line between the taxing powers of the two contracting states in regard to their residents (ibid, Article 10 par. 258). With exception of the permanent establishment this provision allows for taxation of dividends only if the recipient is a resident of the state imposing the tax. Taxation is not allowed if the recipient is a resident of the other state or of a third state (ibid, Article 10 par. 259). However, Article 10 (1) to (4) is inapplicable if the state of source of the dividends and the state of the recipient's residence are the same. In that case, Article 21, entitled "other income", is applicable. This means that if the effect of the ban is not applied under Article 10 (5) it will be applied through the application of the provision regulating other income (OECD, 1997, Article 10 (5) par. 35). The same situation arises if the recipient is a resident of the third state and that state has an agreement with the state where the dividends are cashed in (ibid).

4 Methods for elimination of double taxation

When applying the principle of tax sharing, the parties have to agree on a certain method of splitting this right in advance. Chapter V of the Convention provides for a choice between the exemption method and the credit method as two equally valid but separate solutions. Neither of them is the one and only method, and very often in agreements each prevailing one is supplemented by elements of the other. In other words, although the two methods are as different as black and white, in practice they are often mixed to gray. There is one exception to this freedom of choice and that is, that even when a state chooses the exemption method, the Convention always[17] applies the method of tax credit on taxation of dividends. This is in order to respect one of the basic principles of the model convention – the principle of tax sharing. However, contractual parties are free to give up their right to tax and apply the exemption method on dividends as well as it will be seen in the agreement with Germany. The Convention suggested two methods in Articles 23A and B

[17] In practice, this rule is sometimes changed and exemption mathod is applied for dividends.

but paragraphs 23A(2) and 23B(1) both refer to the credit method in the taxation of dividends. Therefore, the credit method will be explained more thoroughly although the exemption method is no less important a solution for all other provisions.

In the case of dividends where treaties restrict taxation by the state of source, those distributive rules take precedence over and are supplemented by the method of elimination of double taxation. The reason why the distributive rules in the dividends article take precedence is because that provision is *lex specialis* and therefore has priority.

4.1 Exemption Method

The exemption method (sometimes referred to as the territorial method) exempts from taxation that part of the income that has been acquired in the other country. It is considered that the state of source has a "better" right to tax because that income has been acquired on its territory. The amount of income to be exempted from taxation in the state of residency is equal to the amount of income which would be taxable according to domestic regulation if there was no agreement. In other words, the "income" is calculated according to the domestic rules and definitions of each country. Therefore, it is obvious that the rules establishing a tax base in the state of residency can differ from the same rules in the state of source.

There are two subcategories of this method: (a) Method of full exemption – income already taxed in the state of source is completely exempted from taxation in the state of residence; (b) Method of exemption with progression – income already taxed in the state of source is exempted from taxation in the state of residence, but it will be added into the calculation to determine the level of tax to be levied on the rest of the income (Prislan Šušterčić, 2000; (Vogel [et al.], 1998, Article 23 par. 123). This method is recommended in the Convention.

4.2 Credit (or Imputation) Method

The state of residency allows for credit of the income tax already paid in the state of source. The tax credited will be the amount of domestic tax that the state of residency imposes for that income. The possibility of a different calculation of the tax base between the two countries exists here. No more can be credited than what is foreseen by the domestic tax rate in the state of residency. This means that if income tax paid in the state of source was 10% and in the state of residence it is 15%, then 10% will be credited but 5% still has to be paid to the state of residency. If the tax rate is higher in the state of source, then tax due in the state of residency is calculated at 0%.

The table below shows two different situations (A and B) to simplify the given explanation.

There are several subcategories to the credit method: (a) Method of full credit – the state of residence takes into account the whole amount of tax already paid on the income; (b) Method of ordinary credit - the state of residence takes into account the amount of tax levied in the state of source, but only to the amount which equals the tax that state itself would levy on the income. This method is used in the Convention (OECD, 1997, Article 23 A(2) par. 47 and Article 23 B(1) par. 57); (c) Method of fictitious credit – there are two subcategories: *Tax matching credit* - as explained below under IV, 1.2, b); and *Tax sparing credit* – as explained below under IV, 1.2, b).

Table 5 Total amount of tax due in different cases[a]

A All income arising in state of residency	Total tax due 35,000			
B Income arising in: state of residency 80,000 and state of source 20,000	Total tax due if tax rate in state of source:		Amount of tax given up by state of residence	
	case 1 4,000	case 2 8,000	case 1 4,000	case 2 8,000
No Contract	39,000	43,000	0	0
Full exemption	28,000	32,000	11,000	11,000
Exemption with progression	32,000	36,000	7,000	7,000
Full credit	35,000	35,000	4,000	8,000
Ordinary credit	35,000	36,000	4,000	7,000

[a] In Table 5 a revenue of 100,000 is taken for example where 80,000 is derived in the state of residency and 20,000 in the state of source. Supposing that the state of residency taxes the revenue of 100,000 at the rate of 35% and the revenue of 80,000 at the rate of 30%. Assuming also that in the state of source the rate is either 20% (case 1) or 40% (case 2). In which case the tax due is 4,000 (case 1) or 8,000 (case 2).

Source: OECD (2001, Article 23 par. 18, 28)

The credit method treats all income equally, whether made domestically or abroad. The state of residence applies its domestic tax rate to its resident's entire income (leaving out only that part which was taxed by the other state). Tax incentives given by the state of source are thus nullified by the state of residence. The state of residence disadvantages its own companies in terms of international competitiveness. While juridical double taxation is successfully avoided, economic double taxation is often not since income could be taxed first at the level of subsidiary and second at the level of parent company (ibid, Article 23 A(2), par. 50). There are, however, certain provisions that are often agreed upon in the agreements to reduce the negative economic effect of the credit method:

a) Inter-company dividend exemption or indirect credit

- *Inter-company dividend exemption.* The first part of this rule is found in Article 10 (2) a) of the Convention and in most agreements where the taxation of dividends distributed within the company is reduced to 5% in the state of source. As for the state of residence, it exempts from taxation income derived from dividends distributed by subsidiaries located in other states. Thus, the entire tax burden that remains in the end is the reduced tax rate in the state of source. Agreements normally require for a minimum holding when inter-company dividend exemption applies. This is also provided for in the Parent-Subsidiary Directive explained below under V. Only the agreement with Austria provides for the inter-company dividend exemption but without conditioning a minimum holding. The agreement with Germany provides for exemption of dividends but does not regulate inter-company dividends at all.

- *Indirect credit.* If the method of indirect credit is used, the resident state of the parent company permits a credit for the tax paid by its subsidiary in another state. By allowing for the tax paid by the subsidiary to be credited against the income of the parent company, the state of residence allows credit to a different taxpayer. This method must be clearly distinguished from the credit (or imputation) system explained above. They differ in that the "ordinary" credit method allows credit for tax paid by the resident tax payer while the indirect credit method allows credit for tax paid by a different taxpayer. This latter rule is also used in the Parent-Subsidiary Directive explained below under V.

b) Non-nullification concessions: Tax sparing credit or tax matching credit

- *Tax sparing credit.* This is a form of double tax relief both from the state of source and the state of residence. More precisely, if the state of source gives an incentive (e.g. a subsidy) to the taxpayer it thus lowers its tax rate. In order for this tax incentive to be spared in the state of residence, that state will fictively credit the tax rate that the tax payer would have paid in the state of source had the incentive not been given to him. In other words, the state of residence takes into account the amount of tax it should have been paid on the income in the state of source. Therefore, the effect of the tax sparing credit is that the tax incentive is transferred to the state of residence.
- *Tax matching credit.* The state of residence takes into account a larger amount of tax than the sum that has been paid or should have been paid on the income in the state of source. The state of source does not reduce its own tax rate, thus it is not a subsidy (Vogel [et al.], 1998, Article 23 par. 195).

4.3 Comparison of the methods for elimination of double taxation

Although it seems the two methods have too many subcategories to understand them clearly, the Convention has limited the choice to only two (OECD, 1997, Article 23 par. 29) – the method of ordinary credit and the exemption method with progression.

Member countries are free to choose between those two. The exemption method creates equal competitive conditions for all investors in the state of source. On the other hand, the credit method assimilates all investments of capital regardless of whether they are realized in the state of residency or abroad. Possible problems foreign investors might face are that all tax reliefs given by the foreign state are reversed if their state of residency applies the method of credit. However, one agreement may foresee both methods. Namely, the agreement with Germany foresees the application of exemption with progression for German residents who invest in Croatia. Since dividends are not taxable in Croatia they benefit from double non taxation (except for a progressively higher tax rate on other income). On the other hand, the same agreement foresees the application of the credit method for Croatian residents investing in Germany, who thus pay the limited tax at source in Germany, which should be credited to the tax due in Croatia, but since dividends are not taxable in Croatia, German tax is all they pay.

In conclusion, if the credit method is applied, state of residence may tax that part of the income which the state of source did not. Even if the tax payer is exempt from taxation in the state of source, the state of residence may, nevertheless collect the income tax for the overall income acquired in both states. When the credit method is applied, the income tax rate is always higher. On the other hand, if both states apply the exemption method, the tax payer might benefit from double non taxation. However, as already stated, when income from dividends is taxed, the credit method is always applied.

Losses. When the credit method is applied then all income whether acquired at home or abroad (world income) is computed to form the tax base. Therefore, all losses whether incurred at home or abroad are also taken into account and can be offset against profit made. However, if the exemption method is applied, then income derived abroad is excluded from the tax base in the state of residence. The result of that method is that such income is excluded in the calculation from any carry back or carry forward of losses incurred in state of residence (Vogel [et al.], 1998, Article 23 par. 68a). Likewise, losses incurred abroad cannot be set off against profits at home.

According to the Croatian Profit Tax Act (NN 177/04, 90/05 and 57/06 Article 17), companies can carry forward their losses for five years and offset them against any class of income. The tax base for residents is computed by taking into consideration all income acquired at home and abroad (ibid, Article 5). Given that the credit method is applied to the taxation of dividends, all losses incurred abroad may be set off against profits from any class of income at home. When private individuals are concerned, legislation is somewhat different providing that losses may be carried forward for five years but they can be set off only against same classes of income (Zakon o porezu na dohodak, NN 177/04, Article 35 par. 2, 3). The tax base for residents is calculated according to their worldwide income and the tax credit method is applied (ibid, Article 6 par. 1; Article 37 par. 4).

Some countries allow for excess foreign tax credits to be carried forward for future years and/or to offset excess foreign tax credits against other foreign-source income. Croatia does not recognize such transactions in its legislation. Therefore, this will not be elaborated further but rather more emphasis will be given to carrying forward or offsetting of losses.

4.4 Application of methods for the elimination of double taxation

Obviously, Croatia's treaty practice has been different in recent years or, rather, different to the practice ex-Yugoslavia had in negotiating its agreements (later succeeded by Croatia). The main method for the elimination of double taxation in the agreement of ex-Yugoslavia with Germany from 1989 was exemption with progression except for dividends (interest and royalties) to which ordinary credit applied. On the other hand, Croatia has a policy of negotiating the method of ordinary credit for all items of income and capital in its agreements.

Exemption of dividends. Although the Convention strictly applies the method of tax credit to thetaxation of dividends, in practice, the agreements with Germany and Austria (for inter-company dividends) provide for the exemption method. Nearly all German agreements allow for inter-company dividend exemption (Vogel [et al.], 1998, Article 23 par. 99). Austria does differentiate between portfolio and inter-company dividends, applying the credit method to the first and the exemption method to the latter. The inter-company dividend exemption in agreements with Austria might be the consequence of the trend introduced by the Parent-Subsidiary Directive of the EU as mentioned under V. Nevertheless, Austria is still under no obligation to apply that Directive towards a non-member country such as Croatia. It should be mentioned that Germany also agreed to tax sparing credit in almost all of its agreements with developing countries, but the agreement with ex-Yugoslavia does not provide for that because dividends from Croatia are exempted from taxation in Germany altogether (ibid, Article 23 par. 193).

Table 6 The methods for the elimination of double taxation used

Agreements	Article of the agreement	Method of elimination of double taxation used	
		Croatia	Other contracting party
ex-Yugoslavia / Germany	24	Croatia applies method of exemption with progression. For dividends (interest and royalties) it applies the method of ordinary credit.	In Germany the method is not specifically determined – methods of tax exemption with progression, full credit and ordinary credit are used but the criterion of the state of source is respected. Income from all dividends paid in ex-Yugoslavia is exempted from taxation in Germany.
Croatia / Switzerland	23	Croatia generally applies method of ordinary credit but if any item of capital or income is exempt according to distributive rules of the agreement, then it applies method of exemption with progression.	In Switzerland the method of tax credit or the method of tax exemption with progression. Subject- to- tax clause is included.
Croatia / Austria	23		Austria applies the method of usual tax credit for portfolio dividends received in Croatia. However, for inter-company dividends received in Croatia, Austria applies the method of full exemption.
Croatia / Slovenia	23		Same as stated for Croatia.

Subject-to-tax clause. According to OECD (1997, Article 23 A(1) par. 35), Switzerland applies this clause while stating that it will apply the exemption or credit method only if the tax has effectively been paid on the income in the other state. However, Swiss authorities do not consider the term “effectively paid” to mean that taxes have effectively been paid in the state of source in any case. To illustrate, if the state of source allows gain realized upon sale of the shares in one company to be compensated against the loss incurred on the disposal of the shares in another, income would be viewed as effectively taxed. However, the situation would be different if an income or taxpayer were entirely exempt from taxation in the source state. By applying this clause, Switzerland combats double non taxation of income and abuse of agreements such as treaty shopping (Danon and Salomé, 2000:385, 386). This is the only example of subject-to-tax clause in the agreements concerned.

5 Future of the analyzed agreements within the European Union

In July 1990 the following measures concerning taxation of companies in the EU were adopted: the Parent –Subsidiary Directive, the Merger Directive, and the Arbitration Convention.

Only the Parent-Subsidiary Directive is of interest for this paper. The Commission Directive on the common system of taxation applicable to parent companies and subsidiaries of different Member States has two objectives: (1) it requires the member states to exempt from withholding tax in the source state distributions of a subsidiary to its parent company resident in another member state; and (2) at the same time, the state of residence of the parent company is obliged to exempt or credit this distribution.

Additional conditions exist – both parent company and its subsidiary should have a legal form that is regulated in the Directive. Furthermore, according to Article 3 of the Directive the minimum required holding is now 15%[18] of the issued shares or voting rights of the subsidiary. The minimum holding period is two years. The European Court of Justice (1996) ruled in the *Denkavit* case that although the tax advantage may be denied if the minimum holding period is not respected, the granting of the advantage may not be subject to that condition at the time of the profit distribution.

The Directive is treaty-compatible, for it states in Article 7 (2) that provisions of the agreements stand at the same level as the Directive and that they are applicable cumulatively. Thus, the provision that is more favorable for a particular taxpayer is the one applicable.

In line with Article 4 of the Directive, the parent company should not be taxed on the profits distributed by its subsidiary if they are both resident in a member state. The Directive provides for the indirect credit method or inter-company dividend exemption to be applied. Methods of indirect credit and inter-company dividend exemption were already explained under IV, 1.2.

According to Directive 2003/123/EC, adopted by the European Council on 22 December 2003, the Parent-Subsidiary Directive is amended. The directive now applies to more types of entities. The shareholding requirement mentioned above is reduced from 25 to 20% as of 1 January 2005 and it will continue to reduce in phases. Accordingly, from 1 January 2007 it will be 15% and from 1 January 2009 it will be 10%. Regarding the application of the credit method, in addition to tax paid by immediate subsidiaries, all tax paid by other connected subsidiaries will be deducted. The application of the Parent-Sub-

[18] Reduced from 25% to 20% as of 1st January 2005 and it will continue to reduce in phases. Accordingly, from 1st January 2007, 15% and from 1st January 2009, 10%

sidiary Directive will be extended to profit distributions received by permanent establishments situated in other member states if profits are distributed by subsidiaries in a member state. A permanent establishment is defined as a fixed place of business situated in an EU member state through which the business of a company of another EU member state is wholly or partly carried on, in so far as the profits of that place of business are subject to tax in the EU member state in which it is situated by virtue of the relevant tax treaty or, in absence thereof, by virtue of national law. This Directive had to be implemented in member states by 31 December 2004, accordingly, all later member states such as Croatia will have to implement it as well.

Concerning the agreements treated in this paper, the above would not be applicable to them yet. However, this might change very soon as Croatia is bound to become an EU member. The agreement with Switzerland would remain unaffected as that country is not within the EU. Slovenia became a member of the EU in 2004 and its agreements succeeded or concluded with EU member states are now influenced by the Parent-Subsidiary Directive (and the Directive 2003/123/EC). The Slovenian new Tax Procedure Act (UL 25/05) (in its Article 3) and the new Corporate Income Tax Act (UL 17/05) (in its Article 69) foresee the implication of the Parent Subsidiary Directive. Croatia will have to make those changes as well and adjust its present legislative system (shortly described in Table 7 below) to the legislative system of the EU.

Table 7 Domestic tax regulation in Croatia

Item of taxation	Croatia
taxation of companies	companies are mostly subject to tax levied only by the state. Their income is subject to profit tax. Natural persons are subject to income tax and may only under certain circumstances be subject to profit tax.
type of tax system	this is a classical system of taxation. Profits are taxed at hands of the company.
	dividends were taxable from 2001 to 2005 but have not been taxed since 2006.
taxable income	resident companies are taxed on their worldwide income
exempt income	dividends
losses	losses may be carried forward for 5 years
withholding tax	no withholding tax for dividends
elimination of double taxation	by way of ordinary credit method
dividends	no taxation

Source: Zakon o porezu na dobit, (NN 177/04, 90/05, 57/06); Zakon o porezu na dohodak, (NN 177/04).

When inter-company dividends are concerned, the member states of the EU usually include a lower rate of ownership participation (lower than the usual 25%[19]). Most often, they limit this participation to 10% whereas such inter-company dividends are not taxed

[19] This has been lowered to 20% by Council Directive 2003/123/EC. It will further be lowered in phases down to 10%.

at all (0% rate). The reason for such a beneficial tax treatment is that the company in the state of source is taxed on corporate income. Therefore, a high tax on dividends would actually be a second tax on the same income (when paid to the mother company).

Finally, dividend taxation of individuals is still not completely compatible with the requirements of the internal EU market. Guidance has been given by a Communication from the Commission of 19 December 2003. Member states should treat domestic, inbound and outbound dividends in the same way in order to protect cross border investments and capital markets of the EU (Dividend taxation of individuals). In the case *Verkooijen*, 6 June 2000, the European Court of Justice (1998) decided that different tax treatment of domestic and inbound dividends was incompatible with the EC Treaty. More precisely, inbound dividends cannot be taxed at a higher rate than the domestic ones. It can be concluded that if the member states do not comply with the above mentioned Communication and the case law, they will probably be obligated to do so in the near future. This stands true for the candidate countries such as Croatia as well.

6 Conclusion

The agreement with Switzerland is closest to the provisions suggested by the Convention while the agreement with Germany is furthest from it. This should be expected since ex-Yugoslavia could not have been an equal partner in an agreement with a capitalist country such as Germany. The ex-Yugoslavia domestic legal system did not regulate shares or dividends. Given that a country's domestic legal system provides the basis for the application of an agreement, ex-Yugoslavia was somewhat disabled from the start. One of the basic principles of tax sharing is only agreed for investments in Germany, whereas for foreign investments in Croatia it is not. However, given the present situation where Croatia does not tax dividends and the fact that Germany applies exemption with progression to its residents as the method for elimination of double taxation - German investors in Croatia benefit from double non taxation (except for progressively higher tax rate in Germany). Therefore, Croatia should see an increase in German investments at present. During this period while Croatia does not tax dividends, the present agreement is favorable to foreign investments.

When taxation of inter-company dividends is concerned, the agreement with Austria does not provide for tax sharing and it does not provide for a limited tax rate. Thus, such direct participations of companies are taxed at the domestic tax rate of each contracting state.

The agreement with Slovenia does not differentiate at all between inter-company and portfolio dividends, just like the agreement of ex-Yugoslavia. . Thus, the most recent and the oldest of the agreements analyzed here seem to have identical provisions in that sense. Does this mean that Croatia is going backwards in its policy when differentiation between the two types of dividends is concerned? Well, rather then saying that policy is retrograding, it would be closer to the truth to say that Croatia has no policy regarding the differentiation of the two types of dividends. These four agreements reflect Croatian negotiating policy since it declared independence and no distinctive pattern could be found as to why sometimes the said differentiation was included in the agreement and why in other times it was not. There is no relevant period which could be singled out as the period of one or the other policy. There is also no certain group or type of countries which could be singled out as the one on which Croatian modeled its policy. Therefore, the only safe conclusion that can be drawn from this is that there was/is no policy when negotiating differentiation of inter-company and portfolio dividends. The one important step forward in the agreement with Slovenia is that the maximum tax rate for taxation in the state of source is 5%, thus the recommended Convention rate for inter-company dividends and lower than the recommended 15% for portfolio dividends. The Convention sets the maximum tax rate but the states are allowed to lower it. In this case, the lower tax rate on portfolio dividends is an incentive for Croatian investors in Slovenia, but the opposite cannot be claimed for Slovenian investors in Croatia because the credit method applied in Slovenia siphons off the limited tax rate incentive. The agreement with Slovenia shows that Croatia has, however, a new policy since its independence of negotiating the maximum 5% rate for taxation in the state of source. This same pattern was followed in almost all agreements which did not make a distinction between the two types of dividends.

An evolution or rather a change in Croatian policy can be seen from the selection of the methods for the avoidance of double taxation. In 1989 it was the exemption method, but in all later agreements analyzed here Croatia chose the credit method. Dividends were taxable in Croatia from 2001 to 2005 and during that period it would have been logical to give arguments pro and contra each of the methods. However, given that dividends are not taxable in Croatia at present, there is no legal foundation for the application of either one of the methods (exemption could be applied because it simply exempts from taxation, but the credit method absolutely not). Therefore, any further discussion as to whether the change from the exemption to the credit method is positive or not is superfluous. In a way, it may be concluded that even though Croatia has chosen the credit method recently still dividends are "exempted" (as in not taxed) from taxation when the state of residence is Croatia.

EU membership is bound to bring many changes some of which will affect the elaborated agreements, e.g. the agreements restrict source state tax to a specific rate for inter-company dividends, but this will now be overlapped for inter-company dividends by the EU Parent-Subsidiary Directive and those states will have to exempt such participations of parent companies. The Directive stands at the same level as the agreements signed between the member countries. Thus, the provision that is more favorable to a particular taxpayer.

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Anex I

Comparison of the provision on dividends in the analyzed double taxation agreements

Dividends provision by paragraphs	Agreement between the Federal Republic of Germany and the Socialist Federal Republic of Yugoslavia for the avoidance of double taxation with respect to taxes on income and on capital (NN - MU 12/88) Art. 11	Agreement between the Swiss Confederation and the Republic of Croatia for the avoidance of double taxation with respect to taxes on income and on capital (NN - MU 8/99) Art. 10	Agreement between the Republic of Austria and the Republic of Croatia for the avoidance of double taxation with respect to taxes on income and on capital (NN - MU 3/01) Art. 10	Agreement between the Republic of Croatia and the Republic of Slovenia for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital (NN – MU 8/05) Art.10
Par. 1 Tax sharing	(1) Dividends paid by a company which is a resident of the Federal Republic of Germany to a resident of Yugoslavia may be taxed in the Federal Republic of Germany. However the tax so charged shall not exceed 15 per cent of the gross amount of the dividends.	1. Dividends paid by a company which is a resident of a contracting state to a resident of the other contracting state may be taxed in that other state.	(1) Dividends paid by a company which is a resident of a contracting state to a resident of the other contracting state may be taxed in that other state.	(1) Dividends paid by a company which is a resident of a contracting state to a resident of the other contracting state may be taxed in that other state.
Par. 2 Limited taxation	This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.	2. However, such dividends may also be taxed in the contracting state of which the company paying the dividends is a resident and according to the laws of that state, but if the recipient is the beneficial owner of the dividends the tax so charged shall not exceed: a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends; b) 15 per cent of the gross amount of the dividends in all other cases. The competent authorities of the contracting states shall by mutual agreement settle the mode of application of these limitations. This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.	(2) a) However, such dividends may also be taxed in the contracting state of which the company paying the dividends is a resident and according to the laws of that state, but if the recipient is the beneficial owner of the dividends the tax so charged shall not exceed 15 per cent of the gross amount of the dividends. b) If the beneficial owner is a company (other than a partnership) which holds directly at least 10 per cent of the capital of the company paying the dividends, such dividends shall, subject to the provisions of subparagraph c of paragraph 1 of Article 23, be taxable only in the contracting state of which the beneficial owner of the dividends is a resident. This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.	(2) However, such dividends may also be taxed in the contracting state of which the company paying the dividends is a resident and according to the laws of that state, but if the beneficial owner of the dividends is a resident of the other contracting state, the tax so charged shall not exceed 5 per cent of the gross amount of the dividends. The competent authorities of the contracting states shall by mutual agreement settle the mode of application of this limitation. This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.

Par. 3 Definition	(2) The term “dividends” as used in this Article means a) dividends on shares including income from shares, “jouissance” shares or “jouissance” rights, mining shares, founders’ shares or other rights, not being debt-claims, participating in profits, and b) other income which is subjected to the same taxation treatment as income from shares by the laws of the Federal Republic of Germany of which the company making the distribution is a resident, and income derived by a sleeping partner from his participation as such and distributions on certificates of an investment trust.	3. The term “dividends” as used in this Article means income from shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the state of which the company making the distribution is a resident.	(3) The term “dividends” as used in this Article means income from shares, “jouissance” shares or “jouissance” rights, mining shares, founders’ shares or other rights, not being debt claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the state of which the company making the distribution is a resident.	(3) The term “dividends” as used in this Article means income from shares, mining shares, founders’ shares or other rights, not being debt claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the state of which the company making the distribution is a resident.
par 4 Exception of permanent establishment	(3) The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the dividends, being a resident of Yugoslavia, carries on business in the Federal Republic of Germany through a permanent establishment situated therein, or performs in the Federal Republic of Germany independent personal services from a fixed base situated therein, and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of Article 7 or Article 15, as the case may be, shall apply.	4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the dividends, being a resident of a contracting state, carries on business in the other contracting state of which the company paying the dividends is a resident, through a permanent establishment situated therein, or performs in that other state independent personal services from a fixed base situated therein, and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of Article 7 or Article 14, as the case may be, shall apply.	(4) The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the dividends, being a resident of a contracting state, carries on business in the other contracting state of which the company paying the dividends is a resident, through a permanent establishment situated therein, or performs in that other state independent personal services from a fixed base situated therein, and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of Article 7 or Article 14, as the case may be, shall apply.	(4) The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the dividends, being a resident of a contracting state, carries on business in the other contracting state of which the company paying the dividends is a resident through a permanent establishment situated therein and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.

par 5 Arms length principle		5. Where a company which is a resident of a contracting state derives profits or income from the other contracting state, that other state may not impose any tax on the dividends paid by the company, except insofar as such dividends are paid to a resident of that other state or insofar as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment or a fixed base situated in that other state, nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other state.	(5) Where a company which is a resident of a contracting state derives profits or income from the other contracting state, that other state may not impose any tax on the dividends paid by the company, except insofar as such dividends are paid to a resident of that other state or insofar as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment or a fixed base situated in that other state, nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other state.	(5) Where a company which is a resident of a contracting state derives profits or income from the other contracting state, that other state may not impose any tax on the dividends paid by the company, except insofar as such dividends are paid to a resident of that other state or insofar as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment situated in that other state, nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other state.