Council of the European Union

Brussels, 2 June 2022
(OR. en)

9295/22
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LIMITE

FISC 114
ECOFIN 452

REPORT

From:	General Secretariat of the Council
To:	Permanent Representatives Committee
Subject:	Code of Conduct Group (Business Taxation) - Report to the Council = Approval

Croatia's newly introduced tax incentive for investment projects in the manufacturing industry (HR019) – Agreed Description

1. Relevant legal framework

The new tax incentive for investment projects in the manufacturing industry has been introduced by adjusting the Act on Investment Promotion (OJ, No. 32/20). The amendments were adopted by the Croatian Parliament in March 2020 and took effect as from 20 March 2020.

The measure is analytically laid down in the Regulation on Investment Promotion (OJ, No. 146/20) as amended. The relevant Regulation entered into force on 5 January 2021.

2. Purpose of the measure

The aim of the measure is to grant support for investment projects, to modernize the production and processing activities, which will increase productivity.

3. Design of the measure

3.1.Beneficiaries

Based on Article 6 of the Investment Promotion Act, a beneficiary is "an entrepreneur in the manufacturing sector - a natural person (craftsman) who is a taxpayer of profit tax or a company - registered in the territory of the Republic of Croatia, who uses the aid".

Hence all Croatian companies subject to Corporate Income Tax can benefit from the measure. The measure is as well available to individuals, or Croatia-located PEs of foreign companies.

3.2.Territorial scope

The measure is only available to companies established in Croatia making investments and having fixed assets there.

The regional investment aid can be granted only in assisted areas of the Republic of Croatia or NUTS II regions for investment in tangible and intangible assets that represent eligible investment costs.

Both tangible and intangible assets which represent eligible cost of investment must be linked to the investment project and assisted area in which the project could be realized and should not be relocated to other areas. They may only be used in the business unit receiving state aid.

3.3.Eligible investments

The newly introduced tax incentive may be realized only for high-tech investment projects in the manufacturing industry in order to modernize business processes, develop automation, robotization and digitalisation of production and manufacturing processes.

The term high technology, i.e. technology classified as a technologically more advanced generation of technology in relation to long-term assets that are being modernised, means investment in tangible and intangible assets in industries, sectors and production-processing activities based on knowledge, which have a relatively fast technological progress and increase in productivity of production and processing activities and the potential for rapid growth in the volume of production and processing.

Modernization is understood as a profound change in the production and processing activities, which involves the entry of long-term assets (equipment/machines) into the ownership of the beneficiaries of investment support. Both high-tech tangible assets and intangible assets qualify for the tax incentive[1].

The assets should be new or not have been used before.

Trademarks and patents may be eligible costs for the investment. However, for an investment to be considered eligible, the following conditions must be met:

- The intangible asset must be used exclusively in the business unit receiving support,
- The intangible asset must be subject to amortisation,
- The intangible asset must be purchased from third parties under market conditions, excluding buyer-related parties,
- The intangible asset must be included in the balance sheet of the beneficiary and should remain associated with the project for which the aid has been granted for at least five years or three years in the case of micro, small and medium-sized undertakings.

The tax advantage is only available for investments in the manufacturing industry. It concerns the activities listed in Appendix I, Fields C - Processing Industry of the Decision on the National Classification of Economic Activities 2007. – NCEA 2007 (OG 58/2007).[2] Some activities are explicitly excluded.[3]

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[1] The tangible assets can be categorised as a more technologically advanced generation of long-term high-tech assets relative to long-term assets being modernised such as specialised robots, robotic systems and robotic stations, automation and production process self-management equipment and machines, automated production management systems, and machinery/equipment for the digitisation of production and manufacturing processes.
The long-term fixed intangible assets can be categorised as a more technologically advanced generation of long-term high-tech intangible assets relative to long-term assets being modernised, such as the latest generation of automated management software for manufacturing processes in the production and manufacturing industry, software in the function of digitisation of production and manufacturing processes, software for the development of self-managing systems, logic controllers and automated lines of production processes and software for machine learning, artificial intelligence development and system visualisation.

[2] Activities such as: production of food products, beverage production, production of tobacco products, textile production, production of clothing, production of leather and related products, processing of wood and wood and cork products, except furniture; production of straw and knitting materials, production of paper and paper products, print and multiply recorded records, production of coke and refined petroleum products, manufacture of chemicals and chemical products, production of basic pharmaceutical products and pharmaceutical preparations, manufacture of rubber and plastic products, production of other non-metallic mineral products, metal production, production of finished metal products, other than machinery and equipment, manufacture of computers and electronic and optical products, production of electrical equipment, manufacture of machinery and appliances, manufacture of motor vehicles, trailers and semi-trailers, production of

3.4. Tax advantage

The advantage consists of a reduction in the tax rate by 50, 75 or 100%, depending on the invested amount (50% for investments between EUR 500,000 and 1 Mio; 75% for investments between EUR 1 and 3 Mio and 100% for investments exceeding EUR 3 Mio).

The beneficiary may use the tax incentive after the expiration of the first year from the beginning of the investment project, provided that he has realized the minimum amount of investment prescribed by law. The tax advantage together with other types of aid for the same eligible costs must not exceed the amount of the maximum aid intensity prescribed by the Regional Aid Map, but not longer than a period of up to 10 years from the start of the investment project.

3.5. Amount of the tax advantage

The tax advantage is limited to a maximum amount (which acts as a ceiling). This maximum amount depends on the maximum aid intensity, which is the gross aid equivalent expressed in percentage of eligible costs before deduction of tax or other charges. This amount has to be limited by a percentage based on the regional aid map. For Croatia, for the period 2014 – 2021, the percentage amounts to 25%, increased by 10% for medium companies and by 20% for small companies.

Example:

A large company makes an investment – which fulfils all the conditions – of EUR 4,000,000 and can hence benefit from the reduction of the tax rate by 100%. Taking into account the maximum percentages of the regional aid map, the tax advantage should be limited to 25% of the invested amount or EUR 1,000,000.

If the company realizes a profit of EUR 1,000,000 in the first eligible year, the tax advantage amounts to EUR 180,000[4] of corporate income tax which does not have to be paid due to the tax reduction of the tax rate by 100%.

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other means of transport, furniture production, other manufacturing industry and repair and installation of machines and equipment.

[3] Article 6, paragraph 2 of the Promotion Investment Act. It concern a.o. aid directly related to export, aid to undertakings in difficulty, aid to the fisheries, aquaculture and primary agriculture production sectors, steel sector, coal sector, artificial fibre sector, transport sector, energy production, development of broadband networks, research infrastructures and the shipbuilding sector.

[4] Based on the Croatian statutory corporate income tax rate of 18%.

As the maximum value of the benefit is limited to EUR 1,000,000, the company has the possibility to benefit fully from the tax exemption for a period of 5 years if the same amount of profit is realized every year, until the maximum value is exhausted: EUR 180.000 x 5 = EUR 900,000. In the sixth year, the benefit has to be limited to EUR 100.000.

As of 1 January 2022, a new regional aid map is in place. As a consequence, the maximum aid intensity has been increased and amounts now to:

- 50% for large 60% for medium and 70% for small entrepreneurs for the regions Pannonian Croatia and Northern Croatia;
- 40% for large, 50% for medium and 60% for small entrepreneurs for the region Adriatic Croatia; and
- 35% for large, 45% for medium and 55% for small entrepreneurs for the city of Zagreb.

As the tax benefit is a reduction of the corporate income tax rate, the tax benefit is applied to all the profits realized by the company and not only the profits related to the investment. As a consequence, not only production income can benefit from the measure, but also income from other activities or passive income such as royalties or interest.

The tax benefit is only effective when the company has a taxable income.

3.6.<u>Procedural aspects</u>

An enterprise intending to acquire the status of a beneficiary of the measures must file an application for the use of incentives, using the prescribed forms, with the Ministry of Economy and Sustainable Development before the beginning of the investment.

If the conditions prescribed by law are fulfilled, the company will then receive a certificate from the competent Ministry stating that the company is a 'beneficiary of investment support' and is entitled to make use the tax benefit (reduction of the tax rate). After the end of the first year following completion of the investment and provided that the certificate has been obtained, the company can benefit from the tax benefit.

The aid beneficiary is obliged to submit annual reports.

3.7. *Conditions*

3.7.1. Productivity growth

In order to be able to benefit from the tax measure, the productivity per employee should have increased by 10%. To determine the productivity growth per employee, the following formula is used:

$$PGE = \frac{\left(\frac{TI\,n+4}{average\ number\ of\ employees\ n+4}\right) - \left(\frac{TI\,n-1}{average\ number\ of\ employees\ n-1}\right)}{\frac{TI\ \ n-1}{average\ number\ of\ employees\ n-1}}\ x\ 100$$

$$=>\ 10$$

PGE = Productivity Growth per Employee

TI = Total Income

n = year beginning investment

n+4 = year after the expiration of the three-year period of realization of the investment project

n-1 = year preceding the year of the beginning of the investment

A comparison is made between 1) the level of productivity per employee in the year preceding the year in which the investment is made and 2) the level of productivity per employee in the year after the three-year implementation period of the investment project.

The comparison must show an increase of at least 10% per employee. The company loses the tax advantage for the whole period if this condition has not been met. As a consequence, the company has to reimburse the received tax advantage, as increased by the basic reference rate, which is determined and published by reference to State Aid rules, increased by 100 basis points.

3.7.2. Employment

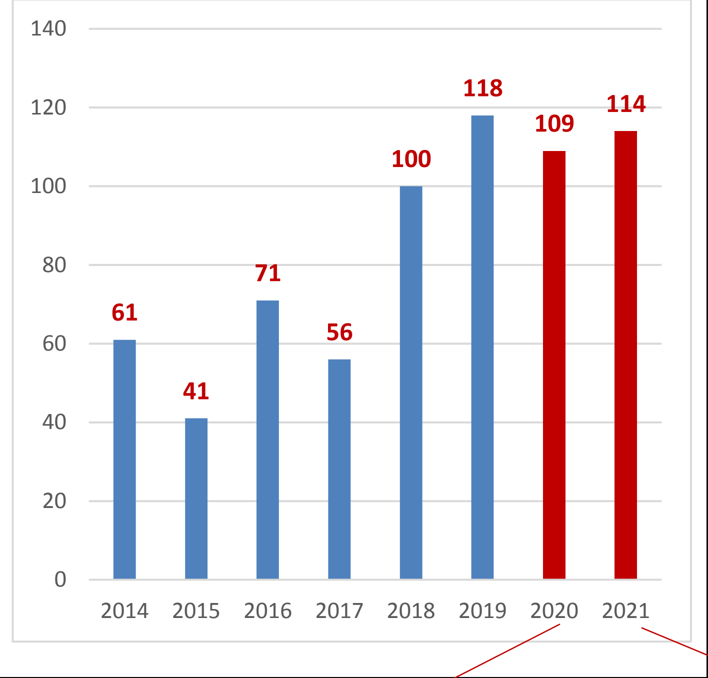
The level of employment should be maintained (or increased). The level of employment is the average number of employees in the twelve months prior to starting to invest into the modernisation of business processes. It should be maintained during the entire period can benefit from the tax benefit, i.e. 10 years.

The level employment for each year is tested by virtue of the annual reports that the beneficiaries have to file.

4. Impact of the measure

The new measure is one of the tax incentives included in the Act on Investment Promotion. In 2020 and 2021, respectively 109 and 114 certificates have been issued, certifying the status of investment aid beneficiaries under the Investment Promotion Act.

Figure: 1. Annual number of issued Certificates on the status of beneficiaries



From Figure: 1. It can be seen that the annual average number of issued Certificates of status of investment aid beneficiaries under the Investment Promotion Act is 83,75, which in relation to the total number of registered companies in the Republic of Croatia (217,352) represents a share of 0.038%.

We can also note that the number of issued Certificates on the status of beneficiaries of investment aid has decreased in the last two years, ie in the period of the COVID-19 pandemic decreases (compared to 2019 when we record the largest number of issued Certificates on the status of beneficiaries of investment aid) for 7.6% in 2020, or 3.4% in 2021, compared to 2019.

Figure: 2. Share of FDI's in total Certificates 2020

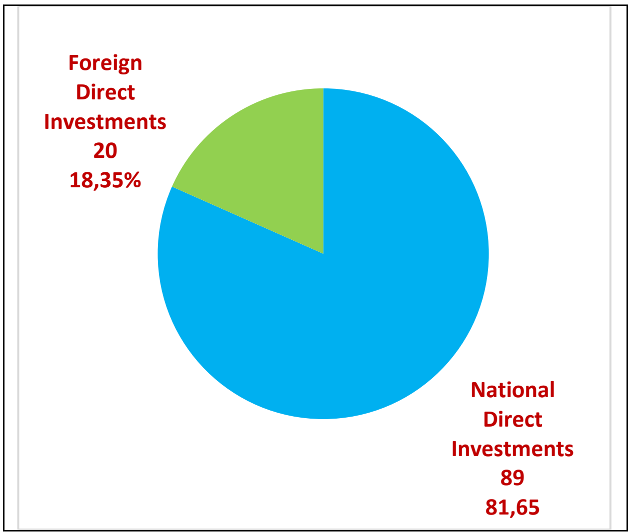
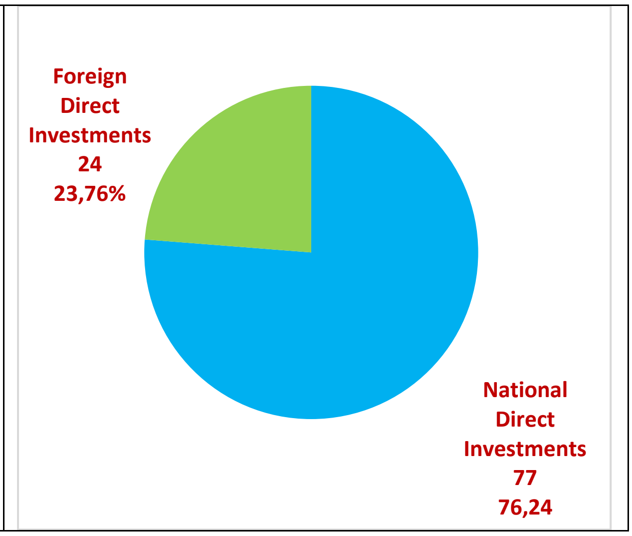


Figure: 3. Share of FDI's in total Certificates 2021



Moreover, out of the 109 and 114 certificates, only one certificate in 2020 related to the new measure. None were issued in 2021.

The company received the status of beneficiary for the modernization of business processes for the project in the amount of material investments of 21,530,470.00 HRK (EUR 2,855,500).

The investment resulted in a 50% reduction of the tax rate in 2021, which amounts to a tax benefit of HRK 1,463,083.25 (EUR 194,043), representing 6,79% of eligible cost of the investments. Based on current figures it can be assumed that the company will be able to benefit from the measure for 4 years from the beginning of the investment project.

It can be seen that the company with beneficiary status for the modernization during the observed period (2019-2020) of the Total income generated, almost 100% (99,55%-99,81%) is generated through operating income (production income), and not through other activities or passive income such as royalties or interest.

5. Follow-up

The COCG agreed with the description of HR019 measure.