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Kesner-Škreb, Marina; Medak Fell, Danijela

*Source / Izvornik:* **Newsletter : an occasional publication of the Institute of Public Finance, 2008, 10, 1 - 6**

**Journal article, Published version**

**Rad u časopisu, Objavljena verzija rada (izdavačev PDF)**

*Permanent link / Trajna poveznica:* <https://um.nsk.hr/um:nbn:hr:242:948864>

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*Download date / Datum preuzimanja:* **2024-06-29**



*Repository / Repozitorij:*

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# NEWSLETTER



No. 36

July 2008.

ISSN 1333-4417

Institute of Public Finance • HR-10000 Zagreb, Katančičeva 5, Croatia  
P. O. Box 320; Phone: (385 1) 4886 444; Fax: 4819 365; e-mail: office@ijf.hr; www.ijf.hr

**Marina Kesner-Škreb**  
**Danijela Medak Fell**

## **Value added tax in Croatia vs EU: Tax threshold, zero rate, building land taxation and exemptions<sup>1</sup>**

### **Introduction**

Value added tax is an important fiscal policy instrument of each country. It is for its importance for both national markets and the common European market that the European Commission seeks to harmonise VAT in EU Member States. The harmonisation of rules relies on the Directive<sup>2</sup> laying down the main determinants of a common European VAT system. In creating a common VAT system, care has been taken to maximise the efficiency of this type of tax, based on the recommendations of tax experts, and to design it as a simple and practical system with a single rate, a broadly defined tax base and a small number of exemptions. Besides a standard rate that may not go below 15%, one

<sup>1</sup> This paper is based on the studies made at the Institute of Public Finance by: Marijana Bađun, Marina Kesner-Škreb, Danijela Kuliš, Danijela Medak Fell, Ivica Urban and Goran Vukšić in co-operation with the employees of the Central Office of the Ministry of Finance's Tax Administration.

<sup>2</sup> The Council Directive 2006/112/EC on the common system of value added tax replaced the so-called Sixth Directive adopted in 1977, when the VAT harmonisation process was initiated in the EU.

The acceleration of Croatia's EU accession negotiations once again brought up the necessity to amend the Value Added Tax (VAT) Act that should be harmonised with the EU Council Directive on the common system of VAT. The most frequently mentioned changes relate to four areas: the determination of the VAT registration threshold, application of zero rates, taxation of building land and definition of exemptions. Here we will briefly discuss the relevant EU regulations, the Croatian legislation concerning these issues and the solutions applied in new EU Member States. Our aim is to explain the differences between the Croatian and the EU VAT system and to provide information on the solutions adopted by new Member States during their respective accession negotiations. It should be noted that the purpose of this paper is not to discuss the choice of potential solutions for Croatia, as it is going to result from its negotiations with the EU and it is therefore too early to speculate on this.

The Institute of Public Finance deals with economic research and analysis related to various forms of public finances such as the budget, taxation and customs duties. Its orientation is thus to the various economic, legal and institutional topics that are important for the sound long-term economic development of the Republic of Croatia. So that the public should be able to have a better insight into certain issues, the Institute of Public Finance is launching its Newsletter, in which it will from time to time publish informed and independent analysis of economic questions. The views expressed in the articles published in the Newsletter will reflect the opinions of the authors, which do not necessarily coincide with those of the Institute as institution. Full text of Newsletter is also available on Institute's Web site: <http://www.ijf.hr/newsletter>.

or two reduced rates are allowed for certain categories of goods and services, which may not be lower than 5%. However, the harmonisation process proved to be lengthy and complex, so that the “theoretically ideal” system is still burdened with numerous “transitional” provisions and special exemptions from common rules granted by the European Commission individually to Member States.

A VAT system was introduced in Croatia on 1 January 1998, replacing the multi-stage turnover tax<sup>3</sup>. The basic system also largely followed theoretical recommendations, i.e. it was applied at a uniform rate of 22% to a broadly defined tax base. It included a small number of standard exemptions and no zero rates, except on exports, so that it was basically very similar to the system applied within the EU. However, the introduction of zero rates on domestic supplies of certain goods and services, a redefinition of exemptions and of the threshold for VAT registration, as well as a different approach to the building land taxation represented marked deviations from EU practice. It can be expected that these differences will have to be reconciled in accordance with the Directive.

## 1. VAT registration threshold

The tax legislations of individual countries explicitly provide under what conditions and in which cases taxable persons who are entrepreneurs are obliged to register for VAT. The inclusion in or removal from the system depends on the level of turnover realised in a certain taxable period (usually a year), the so-called VAT registration threshold. Entrepreneurs participating in the VAT system are obliged to charge VAT on all supplies of goods and services, but are also entitled to deduct the VAT declared on their input invoices for the purchased goods and services. Entrepreneurs who do not qualify for VAT registration due to their low turnovers, do not declare VAT on their delivery invoices, and are not allowed to deduct VAT paid on the purchases of goods and services.

The level of threshold for VAT registration influences tax revenues and compliance costs. A threshold that is too high may result in a loss of tax revenues for the government, because of the non-registration of a certain number of taxable persons for VAT. On the other hand, a threshold that is too low and, consequently, a relatively large number of small entrepreneurs participating in the VAT system, considerably burdens the tax admini-

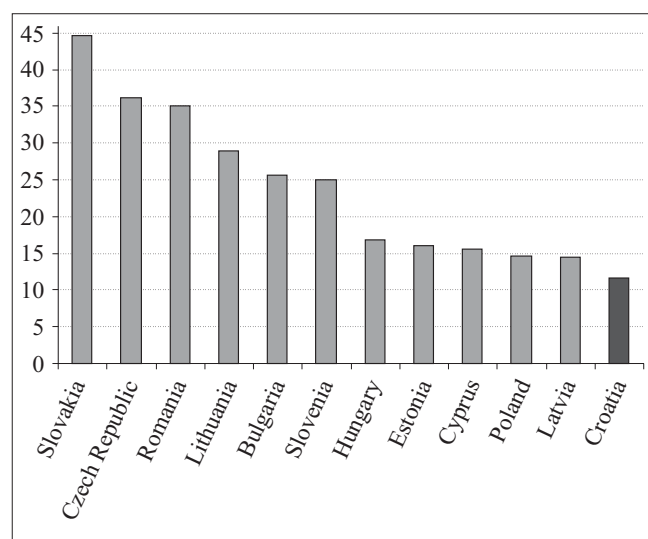
stration and increases compliance costs. The decision on the level of VAT threshold is usually based on the estimated impact of the level of threshold on compliance costs borne by both the tax administration and taxable persons, as well as on the number of taxable persons and the amount of collected tax revenues.

The EU Council Directive, in the part relating to exemptions for the supply of goods and services by small enterprises, lays down the minimum VAT registration threshold of EUR 5,000. However, Member States are allowed to determine higher thresholds subject to certain conditions.

In Croatia, taxable persons participate in the VAT system if their supplies of goods and services in the previous calendar year exceed the annual amount of HRK 85,000. Apart from the legal obligation to participate in the VAT system, entrepreneurs who have not exceeded the threshold may join the VAT system voluntarily, if they consider it more favourable for their business. However, in such case they must remain in the system for the following five years. At the time of its introduction in 1998, the VAT threshold was fixed at HRK 50,000.

After a year of application, i.e. on 1 January 1999, the threshold was raised to HRK 85,000 (the equivalent of about EUR 11.600), which is still in force.

Figure 1. VAT registration thresholds in new EU Member States in 2008 (in thousand EUR)



Source: IBFD Tax Surveys; available at: <http://online2.ibfd.org/eth>.

Croatia is trailing behind the new EU Member States in the level of VAT threshold. It should be noted, however, that a number of new EU Member States changed their levels of VAT threshold at the time of their accession

<sup>3</sup> Value Added Tax Act, OG Nos. 47/95, 106/96, 164/98, 54/00, 73/00 48/04, 82/04, 90/05 and 76/07.

to the EU. Thus, Romania lowered its threshold from EUR 57,000 to EUR 35,000; Czech Republic from CZK 3 million to CZK 2 million and further to CZK 1 million. Slovakia doubled its threshold, from SKK 750,000 to SKK 1,500,000, as well as Hungary – from HUF 2 million to HUF 4 million. Slovenia raised its threshold from EUR 20,000 to EUR 25,000. The levels of threshold remained unchanged in Bulgaria, Cyprus, Estonia, Lithuania, Latvia, Malta and Poland. However, as from 1 January 2008, Poland raised its VAT threshold from EUR 10,000 to EUR 14,700, and Hungary from EUR 15,700 to 16,900. Based on the experience of the new Member States, it can be concluded that Croatia should use the pre-accession period to reconsider its current VAT threshold and, should it be justified, change it prior to joining the EU.

## 2. Zero rate application

One of the areas in which the Croatian regulations considerably deviate from those of the EU is the application of zero rates. According to the provisions of the Directive, the application of the zero rate, i.e. the exemption from VAT with the right to deduct input tax, is only allowed for goods to be exported. Thus, exports are fully exempt from VAT which is only payable in the Member State of import, i.e. of consumption. However, there are some exceptions to this rule, so that some countries are allowed to apply zero rates on domestic deliveries as well. In such cases, the scope of application of the zero rate is broadly limited to the goods and services listed in Annex III to the Directive (see Box 1), to which the reduced rates may otherwise be applied.

*Box 1. Goods and services to which the reduced VAT rate referred to in Annex III to the Directive may be applied*

1. Foodstuffs
2. Water supply
3. Pharmaceutical products
4. Medical equipment for the disabled
5. Transport of passengers
6. Supply of books, newspapers and periodicals
7. Admission to cultural events and facilities
8. Reception of radio and television broadcasting services
9. Supply of services by artists
10. Construction and renovation of housing as part of a social policy

11. Supply of goods and services for agricultural production, excluding capital goods
12. Accommodation provided in hotels
13. Admission to sporting events
14. Use of sporting facilities
15. Supply of goods and services by welfare and social security organisations
16. Supply of services by undertakers and cremation services
17. Provision of medical and dental care
18. Supply of services connected with street cleaning, refuse collection and waste treatment.

In Croatia, the zero rate was initially applied only to exports. However, since end-1999 zero rates have been introduced in relation to domestic supplies of bread, milk, books, certain drugs and medical aids. Later on, the zero-rated category of products was expanded to include scientific journals and public showing of movies. It can be seen that all goods and services subject to a zero rate in Croatia belong to the category of goods and services specified in Annex III to the Directive, which may be subject to reduced rates, but not lower than 5%.

*Table 1. The zero VAT rate introduction dynamics in Croatia*

Date of application	Official Gazette	Goods
1 November 1999	OG 105/99	bread, milk, books, drugs specified on the CHII* List of Drugs, implants and orthopaedic aids
1 June 2000	OG 54/00	scientific journals
1 September 2000	OG 73/00	public showing of movies
1 January 2001	OG 73/00	organised tourist stays paid by bank transfers from abroad**

\* CHII - Croatian Health Insurance Institute

\*\* From 2006 tourist accommodation is taxed at the rate of 10%

In 2008, zero rates were applied in seven old Member States (Belgium, Denmark, Ireland, Finland, Sweden, Austria and UK) and in three new Member States (Cyprus, Malta and Poland).

Of course, during the negotiations with new EU accession candidates, the Commission was disinclined to approve new exemptions or deviations from the defined rules. Of 12 new EU Member States, only Cyprus, Malta and Poland, during their accession processes, succeeded in maintaining the right to apply zero rates. This ri-

ght exclusively relates to the goods and services listed in Annex III and their duration is strictly limited pursuant to the temporary provisions of the Directive. Thus, Cyprus was entitled to apply zero rates to the supplies of particular foodstuffs and beverages, as well as to the supplies of pharmaceutical products, drugs and vaccines until 31 December 2007. Malta may apply zero rates on foodstuffs and pharmaceuticals until 1 January 2010, whereas Poland was allowed to apply zero rates to certain books and specialised periodicals until 31 December 2007. Interestingly enough, both Cyprus and Poland succeeded in maintaining the right to postpone the abolition of zero rates until 31 December 2009 and 31 December 2010 respectively.

Table 2. VAT rates in new EU Member States and in Croatia, 2008 (%)

Member State	Standard VAT rate	Reduced rate	Zero rate
Bulgaria	20	7	no
Cyprus	15	5 and 8	yes
Czech Republic	19	9	no
Estonia	18	5	no
Hungary	20	5	no
Latvia	18	5	no
Lithuania	18	5 and 9	no
Malta	18	5	yes
Poland	22	7	yes
Romania	19	9	no
Slovenia	20	8.5	no
Slovakia	19	10	no
Croatia	22	10	yes

Source: IBFD, *European Tax Surveys*, available at: <http://online2.ibfd.org/eth>

Based on these countries' experiences, the following conclusions can be drawn: the EU rules concerning zero rates are very rigid; there is a tendency towards a complete abolishment of zero rates within the EU; and the room for granting exemptions is very limited, both in terms of products covered and the duration of derogations. Croatia should reconsider the importance of the zero rate by category of products to which it is applied and, possibly, apply for a temporary postponement of the zero rate abolishment for principal categories of products.

### 3. Building land taxation

In the EU, VAT is generally charged on the sale of building land, whereas non-building land is VAT-exempt.

Specifically, according to the Directive, the tax is charged on the supply of undeveloped land (the land not built upon), where the supplier is subject to VAT. However, non-building land is exempt from taxation. Moreover, only new buildings, including the land on which they stand, are subject to VAT, while the supply of old buildings (and the land pertaining to them) is exempt from VAT. The EU allows the right to opt for the taxation<sup>4</sup> of exempt supplies, i.e. old buildings and non-building land.

Under the Croatian VAT system, the supply of land is generally exempt from taxation. VAT is only charged on new buildings (those constructed after 1 January 1998) supplied by taxable persons. However, VAT is not charged on the supply of the land pertaining to such buildings, which is rather subject to real estate transaction tax. Moreover, the latter is also charged on the supply of 'old' buildings, i.e. those built and supplied until 31 December 1997, as well as on any type of land (building and non-building land).

Within its EU accession process, Croatia will most probably introduce some changes in the real property taxation. This will primarily include the application of VAT to any type of building land, i.e. undeveloped land (land not built upon) or the land pertaining to a new building, which is currently subject to real property transaction tax. Instead of the currently applied real property transaction tax at a rate of 5%, this land should be subject to VAT at a rate of 22%. Imposing VAT on building land will produce some economic effects, notably regarding the costs to taxable persons in construction and, indirectly, regarding real property prices. It is worth noting that the costs of the purchase of building land borne by a building enterprise depend on the VAT status of the person selling the land to the enterprise. Specifically, it is crucial that a VAT-registered building enterprise qualifies for the deduction of input tax on building land purchased from a VAT-registered seller, because the costs to be borne by the enterprise are then lower. However, if it purchases the land from a natural or legal person not subject to VAT, the costs to be borne by such enterprise remain unchanged because the supply of such land is still subject to real property transaction tax which is not deductible like input tax. It follows that, due to a change in building land taxation, the cost of purchasing building land to a building enterprise can either remain the same or be higher.

<sup>4</sup> The Directive grants the Member States a right of option for taxation in respect of the supply of old buildings and non-building land. Thus, it provides that Member States may grant taxable persons the right to charge either VAT or real property transaction tax on these transactions.

Generally, all the new Member States apply standard VAT rates<sup>5</sup> to land and new real property, with the exemption of building land for which optional taxation is allowed. However, given the flexibility of the Directive, individual Member States provide different definitions of relevant terms, like ‘first occupation of a dwelling’, ‘non-building’, ‘building land’ etc. It can be expected that, after joining the EU, Croatia will have to do the same, i.e. impose VAT on building land.

#### 4. The definition of exemption

Another area that will require significant adjustments with the EU *acquis* is the exemption from VAT without the right to deduct input tax in domestic transactions.

The main difference between the EU’s and Croatian VAT systems lies in the principles on which the definition of the right to exemption is based. The EU system relies on the so-called functional principle, whereas the Croatian one is based on the so-called institutional principle. In other words, the Directive specifies the *activities* that are exempt from VAT, irrespective of which institution or company carries them out, whereas Croatia follows the opposite approach: the Act lays down the exempt types of *institutions* with regard to any activity they may carry out. This implies that, according to the current Act, e.g. banks are exempt from VAT with regard to the whole scope of their activities, but are not entitled to deduct input tax for purchased goods and services. When the Directive becomes applicable, banks will be exempt from VAT, not for the whole scope of their activities, but only for their banking transactions specified in the Directive. For all other activities not set forth in the Directive, banks will have to be VAT-registered and charge VAT on their supplies, but will be entitled to a (proportional) deduction of input tax on purchased goods and services. Expectations are that there will be little room for negotiations in harmonising these regulations and that Croatia will have to adopt the functional principle.

The Directive lists a number of activities that may be exempt from VAT, irrespective of which entity carries them out. They comprise activities in the public inter-

est and other exemptions. *The activities in the public interest* include public postal services, the provision of hospital and medical care, social welfare and social security services, protection and education of children and young persons, school and university education, the supply of services by non-profit making (political, trade union, religious, philanthropic, etc.) organisations, certain services linked to sport and cultural services, and services provided by public radio and television<sup>6</sup>. *Other exemptions* include a great number of various transactions, e.g. insurance and reinsurance transactions, the letting of immovable property, granting and negotiation of credit, negotiation of credit guarantees, trading in and management of securities, and transactions concerning money, deposit and current accounts, as well as other means of payment<sup>7</sup>.

The following institutions are VAT-exempt in Croatia: banks, savings banks, savings and loan co-operatives, insurance and reinsurance companies, private medical practices, health care, social welfare, educational, religious and cultural institutions, and betting shops. Also exempt is the letting of housing space<sup>8</sup>. The stated institutions are currently exempt from VAT, but they are not entitled to deduct the input tax paid on their purchases. The harmonisation with the EU regulations will result in exempting the institutions and companies referred to in Article 11 of the current VAT Act according to the so-called functional principle. This means that they will continue to be VAT-exempt without the right to deduct input tax, but only for certain types of goods and services as specified in the Directive. They will be obliged to charge VAT on their other supplies, but will also be entitled to deduct the tax paid on inputs used in the production of such goods and services. Naturally, the change in regulations will also affect some legal entities which carry out the stated activities and have not been exempt before.

To sum up, in its way towards the implementation of the functional principle, Croatia should analyse in detail and define all the differences between the two systems and take the necessary actions in order to make the transition to the new system as smooth as possible for both the tax administration and taxable persons.

<sup>5</sup> An overview of standard rates is given in Table 2.

<sup>6</sup> For more details, see Article 132 of the Directive.

<sup>7</sup> The list of activities is not complete. For more details, see Articles 135-137 of the Directive.

<sup>8</sup> For more details, see Article 11, Paragraph 1 of the VAT Act.

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