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Serbia

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Overview of corporate tax work

Serbian corporate income tax law has been changed twice in the period January 2013 to May 2014. The majority of changes were of minor importance. The most significant amendment was deletion of the tax credit for investments in fixed assets. This change was made at the end of 2013, without thorough consideration of its effects. The business community reacted negatively to this change and one of the biggest companies in Serbia, NIS a.d., has already started lobbying to introduce a similar tax credit into the corporate tax system.

Another important improvement in the field of corporate income tax is the adoption of the Rulebook on transfer pricing which set out the obligation of tax debtors to prepare a report on transactions with transfer prices, with a list of requirements that such report must contain and a description of the documents which must accompany this report. It also enabled tax debtors who do not have a large number of transfer prices transactions to prepare a brief, instead of a full, report. This is the first act which defines in detail which documents, reports and data should be prepared by tax debtors in relation to transfer prices, so it represents a very important improvement in transfer pricing regulation.

Also adopted in addition to this Rulebook, were the Rules on Interest Rates Considered to Comply with the Arm's Length Principle. It would appear that the Ministry of Finance has chosen the worst approach when rendering these Rules – loans are classified only as short-term and long-term and according to the currency in which they were granted, and only one interest rate is specified for each of these loan types. First of all, the interest rate in any arm's length transaction is impacted by a number of circumstances: the loan amount; the loan term; the currency; the borrower's creditworthiness; the borrower's indebtedness before and after the loan is approved; the expected profitability of the borrower during the loan term; the collateral provided; and so forth. Of all the possible elements that impact the interest rate, the Ministry of Finance opted for only two − the loan term and currency, prescribing fixed interest rates for each. This will certainly cause some taxpayers to be additionally penalised. Namely, some of the taxpayers that take loans on the market at interest rates higher than those prescribed by these Rules will have to make corrections just because their interest on loans from related parties is higher than the specified interest, even though this interest is at the same time lower than the interest rate they usually take bank loans at. This definitely does not serve the purpose for which the transfer pricing rules were introduced in the first place.

Significant deals and highlights illustrating aspects of corporate tax

2013 and the beginning of 2014 was not a period during which a high number of deals were executed in Serbia. However, there were several interesting deals: (i) sale of portfolio from one bank to another, which transactions included the sale of, after the transfer of portfolio, a shell bank to a telecommunication company; (ii) sale of an insurance portfolio from one insurance company to another, which was the first insurance portfolio transfer from an operating insurer to another operating insurer; and by far the most valuable transaction in 2013; and (iii) sale of a cable TV and internet regional group of companies. One of the most important issues in the last mentioned transaction was the manner of performing the debt pushdown in the context of restrictive Serbian foreign transactions rules, which included consideration of the corporate tax effects of each of the debt pushdown scenarios. Apart from these transactions, all others were small transactions, without important corporate tax aspects.

Key developments affecting tax law and practice

For years, the rules on transfer prices have been the weakest part of the corporate income tax regime in the Republic of Serbia. Scarce and incomplete legal regulations, squeezed into only a few articles, which resulted in more questions than answers, have been causing headaches for everybody engaging in a commercial activity, and especially for foreign investors. The necessity for more adequate governance of this field was finally recognised last year by the Ministry of Finance and Economy and, by the end of 2012, amendments to the Law on Corporate Income Tax were adopted, which was the first positive step forward in more than 10 years.

The improvements achieved by these amendments may be divided in three groups. The first group includes defining in detail which company shall be deemed as related for the purpose of application of the rules on transfer prices. The second group includes defining in detail the manner of calculating the amount to be included in the tax basis, after the difference has been established between the price in the transaction with the related party and the arm's length price. The third group includes introduction of new methods for establishing the arm's length prices, in Serbian tax law previously unknown, as well as the rules for application thereof. The especially important novelty is the obligation to submit, together with the tax balance, the appropriate documentation. This obligation is regulated in more detail in the Rulebook on transfer prices, so tax debtors must submit: (i) analysis of the group of affiliates to which the taxpayer belongs; (ii) analysis of the activities; (iii) functional analysis; (iv) choice of the method for checking on the compliance of the transfer prices with the prices established under the arm's length principle; (v) conclusion; and (vi) attachments.

The Rulebook further specifies what each of the analyses should include, as well as the reasons for application of the appropriate method, and the conclusion whether the prices in the transactions with the related parties should be adjusted. It also provides for the methods used for determining the arm's length transaction prices, as well as for the rule that, when defining such prices, the method to be used shall be the one most appropriate for the circumstances of the case, with the possibility to use a combination of several methods when so required. The Rulebook also establishes further rules for choosing the method, providing that the choice shall be based upon the analysis of the facts, with the following to be taken into consideration: (i) nature of the transactions being the subject of the analysis; (ii) availability and reliability of the data for the analysis; (iii) the extent of comparability between the transactions carried out at the transfer prices and the transactions carried out with or between the non-related parties (when these transactions are used for checking compliance of the transfer prices of the taxpayer with the arm's length prices); (iv) appropriateness of use of the financial data of the non-related parties for the analysis of the compliance of the transfer prices for certain types of transactions the taxpayer carries out with the related parties; and (v) nature and reliability of the assumptions.

Although in general the adoption of this Rulebook is positive, the time of its rendering, by the middle of the business year, should be negatively assessed. Only in July 2013 did taxpayers learn of the rules subject to which they will have to establish the differences, if any, between the prices for the transactions with their related parties and the arm's length prices, during the whole year 2013, and to prepare the documentation specified by the Rules. It is very important to avoid such cases. Although some might say it is not a big deal, since taxpayers had known that they would be obliged to provide the documentation, and anyway had to choose a model and support with documents the justifiability thereof, such positions cannot be accepted for the simple reason that it is the duty of the Government to, before start of the "race", set clear rules to be followed, and not to announce the rules halfway.

Attractions for holding companies

The Republic of Serbia is not known as a good jurisdiction for holding companies. The main reason for this does not lie with the tax system, but in the rules that regulate payments abroad and conducting business with foreign entities and foreign currency, which are especially rigid with respect to the possibility of financing operations abroad from Serbia by loans. Additionally, the Republic of Serbia does not have special corporate tax rules applicable only to holding companies. These companies have the same obligations as all other taxpayers of corporate tax and the only benefit that can be identified is the tax treatment of dividends received by the resident mother company from the resident daughter company, which are not included in the tax base of the resident mother company. But this rule applies to all dividends received by Serbian resident companies from other Serbian resident companies, and not only to holding companies.

The remaining part of this section, divided into parts 'Dividends', 'Tax consolidation' and 'Capital gains and losses', gives an overview of rules that affect the holding companies.

<u>Dividends</u>

The dividend received by the resident taxpayer from another resident taxpayer is not included in the tax base. The same applies for the liquidation and bankruptcy surplus, which from 1 January 2013 has the same tax treatment as the dividend (before that it had the same treatment as the capital gain).

The rules regarding the profits and dividends made from abroad are as follows:

1. If the resident taxpayer acquires profit by conducting business operations in another country, for which operations the taxes have been paid in that country, it will be entitled to a tax credit in the amount of tax paid in that foreign country. However, such tax credit may not exceed the amount of tax which would be calculated on profit made abroad by applying the provisions of the Serbian corporate income tax law.
2. A parent company − resident of the Republic of Serbia − which holds at least 10% of the shares in the non-resident company for at least one year prior to the submission of the tax balance in which it uses this tax credit, can reduce the determined amount of the company income tax:
   (a) for the amount of tax which has been paid by its non-resident company in a foreign country, for the profits from which the dividends have been paid, which are included in the income of the parent company; as well as
   (b) for the amount of withholding tax which has been paid by the non-resident company

in a foreign country, on the basis of dividends paid to the parent company.

When the parent company calculates its taxable basis and intends to use this tax credit, the income from dividends from the non-resident company must be included in the income of the resident parent company, in the amount increased for the paid company income tax and the withholding tax on dividends.

Then, the tax credit can be used for reduction of the parent company's determined tax in the amount of the tax paid in a foreign country. However, the amount of tax credit cannot be higher than the amount which would be paid by the application of the 15% tax rate on the income from dividends received from the non-resident company, increased for the tax which the non-resident company has paid in the foreign country on the profits from which the dividends have been distributed. The unused part of the tax credit may be transferred in the future years, but no longer than five years.

3. The resident which acquires profits from a foreign country via interest, authors' fees, rents for the lease of movable and immovable property as well as via dividends for which it cannot use the tax credit explained above, and for which the withholding tax has been paid in a foreign country, may reduce the determined corporate income tax in the Republic of Serbia for the amount of the withholding tax paid in that foreign country.

   If the resident exercises its right for this tax credit, profits from interest, authorship fees, rents for the lease of movable and immovable property and dividends, which are made in a foreign country, and on the basis of which the tax credit is exercised, are included in the income of the resident in the amount increased for the paid withholding tax. This tax credit may be used to decrease the calculated tax in the amount of taxes paid in a foreign country, but no higher than the amount calculated by applying the 15% tax rate on the tax base that is equal to 40% of the profits on which the withholding tax has been paid in a foreign country, and which were included in the resident income.

<u>Tax consolidation</u>

A parent company, and its subsidiaries in which the parent company controls directly or indirectly at least 75% shares, are considered as connected legal entities and they are entitled to request tax consolidation on condition that all connected legal entities are Serbian residents.

If the tax consolidation is granted, every member of the connected legal entities group is obliged to submit its tax return and its tax balances, while the parent company is obliged to submit the consolidated tax balances for the group of connected legal entities as well. In the consolidated tax balances, the losses of one or more connected legal entities are compensated on account of the profits made by other connected legal entities in the same tax period.

The taxable profits made by a member of a connected legal entities group, which is shown in the consolidated tax balances, cannot be reduced for the losses from that group member's tax balances of previous years, or tax periods before the consolidation.

Each entity in the group pays part of the tax calculated on the consolidated balance, in proportion to the taxable income from their individual tax balances.

Once approved, tax consolidation must be applied for a minimum duration of five years or tax periods.

If the conditions for the consolidation change before the expiry of the five-year period, or one legal entity, several connected legal entities or all connected legal entities in the group later opt for individual taxation before the five-year period expires, all connected legal entities are obliged to appropriately pay the difference between the tax they have paid using the consolidation and the tax they would have paid if the consolidation was not applied.

Capital gains and losses

A capital gain is any income earned by a taxpayer by selling or transferring the real estate, the industrial property rights, the interests in the capital of legal entities and shares and other securities (with the exception of bonds issued in conformity with the regulations dealing with settlement of commitments of the Republic of Serbia) and investment units bought up by open investment funds.

While the selling price is the price received against the sale, or the market price in case of the sale to a related entity in the sense of the transfer pricing rules, the rules regarding the determination of the acquisition price are more complex. Namely, the general principle is that the acquisition price used in the determination of capital gains is the price at which a taxpayer has acquired the assets, less the depreciation. The acquisition shall be corrected to the estimated or fair value established in accordance with the IAS and/or IFRS and the adopted accounting policies, if the change to fair value has been declared wholly as revenue of the period in which it was made. If the price at which the assets were acquired has not been declared in the taxpayer's books or in accordance with the provisions of the law, the acquisition price to be used is the market price on the date of acquisition, as determined by the competent tax office.

- In the case of sale of real estate under construction, the acquisition price includes the construction costs declared until the date of sale in accordance with IAS and/or IFRS and the regulations dealing with accounting and auditing.
- In the case of real estate acquired on the basis of the founder's share or by increasing the founder's share, the acquisition price shall be the market price of that real estate on the date of issue of the founder's share.
- In the case of securities which are traded on the regulated market, according to the law dealing with the securities and other financial instruments market, the acquisition price shall be the price the taxpayer can prove as actually paid at the acquisition, but if the taxpayer has no proof to that effect, the lowest price fetched on the regulated market in the year preceding the sale of such securities (or in the trading period, if trading lasted less than a year).
- In the case of securities which are not traded on the regulated market, the acquisition price of securities shall be the price the taxpayer can prove to be the one actually paid, and if the taxpayer has no such proof, their nominal value.
- In the case of securities acquired on the basis of the founder's share or by increasing the founder's share, the acquisition price shall be the market price valid on the regulated market on the share issuing date or, if such price was not fixed, the nominal value of securities on the share issuing date.

The acquisition price of a share in the equity of legal entities and industrial property rights shall be the price the taxpayer can prove to be the one actually paid. The acquisition price of a share in the equity of legal entities and industrial property rights, acquired on the basis of the founder's share or by increasing the founder's share, is the market price valid on the share issuing date. The acquisition price of an investment unit is the net value of the open fund assets per investment unit on the date of payment plus the purchase fee, if the managing company charges one, in conformity with the law dealing with investment funds.

Any capital gain shall be included in taxable profit in the amount set in the way specified above. Any capital loss incurred in the sale of a proprietary right may be offset with the capital gain made in the sale of another proprietary right in the same year. If a capital loss is declared even after the offsetting, it is permissible for it to be offset with future capital gains in the next five years.

Industry sector focus

Being straightforward, the Serbian corporate income tax does not give special treatment to any industry sector. Usage of tax incentives is open generally to any business activity, so pointing out some of the incentives as particularly interesting to some sectors is related to the fact that some sectors assume big investments, and not that incentives are legally available for only some of the sectors. For example, a 10-year tax holiday is available, under certain conditions, to taxpayers who invest more than a billion dinars in the fixed assets of a company, which uses those fixed assets for conducting business activity, and which in the period of investment employs an additional 100 employees. This incentive is formally available to companies conducting any business activity, but practically can be exercised only by some industry sectors.

Energy is a sector that has great potential, but it also has big problems. On one side, Gazprom and state gas company Srbijagas started activities to build the South Stream gas pipeline at the end of 2012, and the Republic of Serbia adopted in January 2013 the Law on South Stream, as part of the preparations for the construction of the part of the South Stream pipeline that will go through the territory of the Republic of Serbia. It is expected that this project will employ many Serbian companies in construction, but the differences between the EU and the Russian Federation related to this project have caused delays in its realisation. Also, several deals that include small hydro plants, wind parks and biomass plants are either on hold or in the very initial phase, making this a sector that has a lot of potential if new investors can be galvanised. On the other hand, the biggest producer of electricity, Elektroprivreda Srbije (EPS) is in big financial problems, and the state as its owner must find a way to resolve these problems, as they have the negative effect on the whole sector. Unfortunately, the Serbian tax system does not provide enough incentives for the use of green energy, and changes in this respect would be highly desirable.

The IT sector, and especially the part that produces software, was in focus at the beginning of the year, when the Ministry of Finance announced that it was working on a programme of incentives for this sector. After this work was finished, and IT companies had the chance to give their comments, the Government adopted at the beginning of March 2013 a Strategy of development and support for the IT industry, which should have an impact on corporate income tax law and the taxation of IT companies. The Strategy envisages further amendments to corporate income tax law, announcing a new incentive – a tax credit for investment in research and development. This tax credit would be available to all companies under the same conditions that currently exist for investments in fixed assets (which is a different incentive from the 10-year tax holiday discussed above). It also envisages amendments to the social security contributions law, which should introduce a special way of calculating social contributions for employees who work in software companies, lowering the burden on their net salaries by 35.5%. Unfortunately, none of these amendments have actually been adopted up to now.

The year ahead

After the elections held in March 2014, the new Government started amendments to the tax on salaries, providing tax relief for companies hiring new employees. On the other hand, it is currently silent on its intentions with respect to corporate taxation. It is virtually unknown what will be the actions of the Government in this respect and whether we should expect other amendments in this field. The parties which comprise the Government have a 4/5 majority in Parliament, so it is expected that they will remain in office for a full term, which also means that amendments to corporate income tax should be expected, but at this point of time it is hard to assess when this will happen and in which direction the amendments will go.

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Nikola is a Partner and his practice is mainly Tax and M&A law. He advises clients on diverse tax law issues and represents them in the tax procedure and administrative tax disputes concerning VAT, corporate income tax, individuals' income taxes, property taxes, etc. Nikola acts as a tax consultant to a number of domestic and international companies and individuals and he is a member of the Serbian Fiscal Association and the International Fiscal Association. He has published several articles for domestic and foreign media, including: "Taxation of Cloud services in Serbia" (The Lawyer, March 2014) Guide to Doing Business in Serbia (tax part, publisher: Lex Mundi, October 2011), and "Death as a taxable event and its international ramifications" (publisher: International Fiscal Association Cahiers, Volume 95b, 2011). Nikola has also participated in a number of M&A transactions involving both the state and the private investors.

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