

TAX

A. CORPORATE INCOME TAX

CURRENT SITUATION

Taxation of corporations in Serbia is governed by the Law on Corporate Income Tax ("RS Official Gazette", No. 25/2001...84/2004; the "CIT Law"). The CIT Law is supplemented by a number of bylaws governing the implementation of the provisions of the CIT Law.

The changes to the CIT Law have been on the Government's agenda since 2006, to address the shortcomings of the current text of the CIT Law. The last draft proposal was submitted to the Serbian Parliament for adoption in January 2008 (the "Draft Proposal") but has been subsequently withdrawn. At the time of this report, the adoption of the Draft Proposal in its form dated January 2008 is questionable although the Draft Proposal is still published at the web-presentation of the Ministry of Finance.

POSITIVE DEVELOPMENTS

- Ministry of Finance has put forward Draft Proposal that addresses the majority of the existing problems of the taxation of corporate taxpayers.
- The most important changes to be introduced by the Draft Proposal include the abolishment of limitations on marketing and advertising expenses and reduction of general withholding tax rate from 20% to 15% (for non-treaty countries).
- The Draft Proposal provides for a possibility for tax payers to opt for a different tax year (other than calendar year).

REMAINING ISSUES

- Provisions governing taxation of permanent establishments are scarce and vague, and do not provide sufficient

guidance as to what constitutes a permanent establishment, methodology for establishing the profit subject to taxation, submission and payment of CIT in situations where no legal presence of foreign business in Serbia exists, etc;

- Provisions governing transfer-pricing are too vague and are rarely implemented in the practice. The lack of legislative guidance and any reliable practice in this area has caused significant uncertainties as to the way taxpayers should handle their related-party transactions:
- The absence of tax credit for tax paid by resident taxpayers abroad on types of income other than dividend leads to the double taxation of these types of income, as well as to distortion of neutrality of different types of income generated by Serbian corporate taxpayers abroad;
- No possibility, as per currently applicable legislation, for branches to utilize available tax incentives, especially tax credit for investment in fixed assets and tax credit for newly employed workers, which puts this legal form in a disadvantageous position comparing to tax position of "standard" legal entities;
- Neither the CIT Law, nor other relevant legislation provides a clear definition of the underdeveloped regions to which tax incentives for investment in these areas apply;
- The CIT Law does not contain a single provision to govern the taxation of investment funds. The result is the distortion of the tax neutrality of investment funds, as well as the neutrality of different forms of investment funds, in particular the closed-ended and open-ended funds;
- Current version of the CIT Law still prescribes as a penalty possibility for the tax authorities to introduce three to twelve months ban on business activities for taxpayers in case of preparation of tax return and tax balance sheet based on incorrect data which resulted in decrease of tax liability.

FIC RECOMMENDATIONS

- The Government of Serbia should proceed and re-forward the Draft Proposal to the Parliament for adoption;
- While the Draft Proposal addresses the majority of shortcomings of the present text of the CIT Law, some of its provisions introduce additional confusion in certain areas (such as, primarily, the taxation of permanent establishments). Certain issues have not been dealt with at all (the tax status of investment funds, the problem of tax credit for income generated by resident taxpayers abroad, transfer-pricing, etc.);
- Many of the existing problems in taxation of companies are related to the practical implementation of the provisions of the CIT Law. These problems should be dealt with in the bylaws of the Ministry of Finance and the Tax Authority, rather than by amendments to the CIT Law, which will introduce more flexibility in this area;
- Clarifications and consistency in approach of the Serbian tax authorities with respect to capital tax incentives such as 10-year tax holiday;
- Alignment of the tax balance sheet with current and proposed changes of CIT Law;
- Many of the existing problems are a result of the fact that the present text of the CIT Law was issued in 2001 (relying for the most part on the solutions of the previous law from 1994), drafted at the time when the business activity, in particular the presence of foreign business in Serbia was practically non-existent. For this reason, the existing solutions of the CIT Law are not fit to accommodate numerous changes which have been introduced in Serbian laws and business practice since 2001. Instead of providing partial and often inconsistent solutions through frequent amendments to an essentially outdated law, the Government should introduce a new and complete legislative text to provide a modern, clear and consistent system of taxation of companies in Serbia.

B. PERSONAL INCOME TAX

CURRENT SITUATION

Taxation of individuals is governed by the Personal Income Tax Law (the "PIT Law") from 2001, which was subject to two legislative adjustments in May and June 2009. In January, 2008, Ministry of finance has issued official draft proposal of the amendments to the PIT Law (the "Draft Proposal"). Due to two amendments to the PIT Law in 2009, where certain changes of the Draft Proposal have been adopted, it is realistic to expect that the Draft Proposal would require substantial adjustments before adoption in the Parliament of the Republic of Serbia.

POSITIVE DEVELOPMENTS

The Serbian Parliament has adopted changes to the Personal Income Tax Law introducing the temporary exemption of interest from euro deposits from Personal Income Tax until December 31st 2009. In addition, the said changes also introduced tax exemption for capital gains realized from sale of securities and stakes in legal entities from Personal Income Tax until December 31st 2009 as well as decrease of tax rate for income of entrepreneurs to 10% and simplification of rules for taxation of income from authorship agreements and similar rights.

REMAINING ISSUES

- Higher thresholds for payment of annual income tax for foreign nationals lead to discrimination of Serbian taxpayers without any plausible justification;
- Double taxation of income received from abroad by Serbian tax residents in situation when such income is recharged to Serbian companies;
- The tax treatment of compensation of business expenses to natural persons (both employees, and persons engaged under service contracts) has not been dealt with adequately in the PIT Law. These expenses are routinely taxed as if they represent a personal expense of persons to whom they were compensated. In that sense, the PIT Law should make a clear distinction between compensation of business expenses, which do not

represent income of natural persons, and cannot be subject to taxation, and compensation of personal expenses, which should be taxed;

- Specific problem are compensations of expenses for business travel abroad, which are not regulated neither in terms of procedure in which such expenses need to be documented by Serbian companies, nor in terms of thresholds which are "exempt" from the obligation to pay tax. In the absence of relevant bylaws to regulate this matter, Serbian tax authorities continue to apply the Decree on the Compensation of Expenses and Severance Pays to Employees in State Bodies. Not only that this practice has no ground in the applicable laws, but is also completely inappropriate, as the Decree imposes limitations on travel expenses which may be appropriate when it comes to civil servants, but are absolutely out of place in the business environment.

FIC RECOMMENDATIONS

- Clear rules with respect to taxation of foreign-source income received by Serbian tax residents with an aim to exclude double taxation. In addition, the application of the cedular system of taxation of personal income remains the central problem of the Serbian system of taxation of individuals. This system was abandoned as unclear and unjust by many advanced tax jurisdictions, and Serbian government should replace it with the synthetic system as well;

C. VALUE ADDED TAX

CURRENT SITUATION

The Value Added Tax is governed by the Law on Value Added Tax from 2004 (the "VAT Law"). In 2007, VAT Law was amended by the Law on Changes and Amendments to the VAT Law which introduced significant changes in the existing VAT System

POSITIVE DEVELOPMENTS

The amendments to the VAT Law introduced in 2007 have refined and clarified many of the legislative provisions which have been proven to be controversial in the practice. Examples of these include clarification with respect of issuance of

invoices for services with unlimited duration, prescribing the taxable base for contributions in kind, VAT refund to foreign companies, etc.

REMAINING ISSUES

- Due to the abolishment of VAT refund, and the absence of the possibility for the VAT registration of foreign taxpayers in Serbia without legal presence, foreign companies now do not have any means to recover the VAT paid in Serbia. The 18% VAT paid to their Serbian suppliers is an additional cost for any company with direct operations in Serbia. Not only does this solution distort the neutrality of VAT, but it also discriminates foreign companies against Serbian taxpayers. On the other hand, this exposes Serbian companies to the risk of being denied the right to refund in foreign countries on the grounds on lack of reciprocity (e.g. Germany, Hungary);

- Rules relevant for the implementation of the VAT Law are scattered over numerous bylaws, instead of being summarized in one act;
- While Serbian Tax Authority has adapted itself very quickly to the VAT system and become quite proficient in the application of VAT Law, due to lack of clear legislative guidance many of the provisions of the VAT Law are still subject of considerable controversy in practice (e.g. application of “reverse charge” mechanism).

FIC RECOMMENDATIONS

- Tax Authority should issue comprehensive guidelines for the application of provisions of VAT Law to address various issues which have repeatedly been source of problems in the practice;
- Provisions of the VAT Law dealing with the position of foreign entities within Serbian VAT system should be revisited and amended so as allow foreign business, without legal presence in Serbia, to register for VAT purposes in Serbia.

D. THE LAW ON TAX PROCEDURE AND TAX ADMINISTRATION

CURRENT SITUATION

The Law on Tax Procedure and Tax Administration (“RS Official Gazette”, No. 80/02...61/07; the “TPTA”) regulates the general issues related to the organization of the Tax Authority and the administrative procedure before the Tax Authority. The general administrative and procedural rules of the TPTA apply to all forms of tax applicable in Serbia, unless specific tax law contains special provisions to govern a specific issue, and, in that sense, the relationship between TPTA and tax laws is that of the *lex generalis* to *lex specialis*. The TPTA was last amended in March 2009.

POSITIVE DEVELOPMENTS

The latest changes predominately dealt with clarifying the jurisdiction and organization of the tax administration itself.

REMAINING ISSUES

- Even with recent changes to the Law, there are still considerable discretionary powers given to the tax inspectors especially in the area of tax penalties. In addition, the uncertainties with respect to the statute of limitation period (i.e. 3 or 5 years) still remain unaddressed;
- Furthermore, the period for which adjusted tax returns is limited only to previous 12 months although the statute of limitation period is much longer. In this way, taxpayers do not have legal possibility to adjust (without penalties) mistakes discovered by themselves that refer to periods prior to the 12-months timeframe;
- Finally, the “threshold” for existence of potential tax criminal act (in case of an intention) is just RSD 150,000. Such fixed monetary amount does not take into consideration the relative size of the taxpayer in question or the relative value of identified non-compliance with its overall tax payments throughout a calendar year.

FIC RECOMMENDATIONS

- Tightening of the deadlines for the issuance of decisions of the Tax Authority;
- Increase of period for submission of adjusted tax returns from the current 12 months to 3/5 years (within the entire statute of limitation period)
- Clarification of the relationship of the penal provisions of the TPTA and those prescribed by the individual tax laws;
- Linking the “threshold” for existence of potential tax criminal act to the actual business indicators of the company (e.g. as a % of total tax liabilities, turnover, etc.)
- Relevant Serbian authorities should consider introduction of the “binding opinions” in the Serbian tax system whereby such rules would be bindings for the requestor of such an opinion (similarly to the “binding opinion” approach already applied by the customs authorities and tax authorities of neighbouring countries such as Bosnia/ Republic of Srpska), as this would introduce a greater level of certainty for Serbian taxpayers, especially in the areas which have proven to be controversial in the practice, and provide additional source of guidelines as to the practical implementation of Serbian tax laws.