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PwC Austrian Tax News*

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In this issue

Editorial

Friedrich Rödler

Dear Friends and Partners of PwC!

It is a great pleasure for me to present you the first issue of our English language Austrian Tax News. It shall give you a comprehensive overview of the recent developments in Austrian taxes.

Austria has experienced significant changes in tax law, in particular for corporations effective from 2005 onwards that offer a number of very beneficial tax planning opportunities. The most important changes are the reduction of the corporate income tax rate to 25 percent and a new system of group taxation providing the possibility to offset profits and losses within a group of affiliated companies in Austria and across the border. The acquisition of companies in Austria can be structured in a tax efficient way due to the possibility to deduct interest on the level of the acquisition vehicle. Under certain conditions amortization of goodwill is tax deductible also in the case of a share deal.

The new legal provisions will offer quite a number of interesting tax structuring opportunities: group structures, transfer pricing concepts, M&A transactions and financing models should be reconsidered from a different perspective. Austria also offers highly attractive tax incentives for R&D as well as for training of staff.

In this issue you will find a wide range of topics, such as EU law, group taxation, withholding tax aspects and tax treatment of expatriates. I am convinced that this newsletter will be helpful to you in your day-to-day business as an initial source of information. Obviously, articles in a newsletter can not be a comprehensive expertise on the topics covered and they do not intend to replace the detailed analysis of a specific problem to be solved. If you would like more information with regard to any of the topics dealt with in this newsletter please contact your regular PwC team or the authors of the respective article.

Yours sincerely,

Friedrich Rödler

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Harmonisation through EU law?

Violations of EU law strongly hinder international companies. An expert group at PwC assists companies in avoiding discrimination.

National regulations in tax law in Europe frequently entail poorer treatment of “foreigners” in cross-border transactions and investments. Such tax discrimination normally violates mandatory EU law. Increasingly, companies have been using existing appeal procedures in order to enforce equal legal treatment. Currently, the European Court of Justice (ECJ) is dealing with cross-border loss set-off, an issue that has not yet been settled from a European law perspective. Similar to the previous system of tax consolidation in Austria offsetting a subsidiary’s losses against the parent company’s profits is limited to domestic subsidiaries in Great Britain. The advocate-general at the ECJ recently saw tax discrimination of foreign subsidiaries in the Marks & Spencer case as a violation of the freedom of establishment. Should the ECJ follow the advocate-general‘s recommendations this would have far-reaching consequences for the taxation of companies in Europe. For companies operating in Austria this case would not have any direct consequences. Since 2005 group taxation provides scope for setting off losses of foreign subsidiaries against profits from the Austrian parent company.

Identifying and combating discrimination

For Austrian taxpayers, it is significant to what extent Austrian tax law violates prohibitions on discrimination in European law. As a result of various different judgments of the ECJ, adjustments were admittedly made in Austria to eliminate tax discrimination. Nonetheless, there are still numerous regulations in existence that could violate prohibitions on discrimination, such as differences in treatment of capital gains, withholding taxes or even in restrictions on investment incentives.

It is important specifically for international companies to be able to recognise tax discrimination abroad and take action against it. In order to identify such discrimination cases and subsequently to ensure better access to the basic freedoms guaranteed in European law, PwC in Europe has set up an “EU Direct Tax Group”. This network of specialists deals with violations of national tax law regulations against mandatory EU law in EU countries. In workshops with multinational companies and through country-specific studies it will be reviewed to what extent the concrete corporate tax situation features discriminatory tax regulations. This is the basis for being able to fight successfully against discrimination.

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Even group taxation has its tax pitfalls

Modern group taxation has replaced the former tax consolidation rules. But often prudence will still be advisable in the future. The new rules have their vagaries as well.

The cornerstone of the new group taxation rules is the offsetting of profits and losses of subsidiaries (group members) against the taxable income of the parent company (group principal). In the case of foreign subsidiaries the tax consolidation is limited to the offsetting of losses; at the time a foreign subsidiary turns profitable and can use a loss carry-forward in its home country, the parent company is subject to a recapture rule with regard to the subsidary’s losses applied against its taxable income. The same holds true if a foreign subsidiary leaves the taxgroup.

No write-off of investments

On the other hand, and to avoid double usage of losses, write-offs of investments and losses from the disposal of shares in domestic or foreign group members within a group are not tax deductible. It must be kept in mind that the write-off of investments in statutory accounts is not deductible for corporate income tax purposes. Nevertheless the write-off reduces the tax basis of the investment. This fact can frequently create adverse tax consequences. This is shown in the following example regarding a foreign investment.

Practical example

The Austrian parent AG in 2005 acquires shares of the German subsidiary GmbH for 1,000 and admits the subsidiary GmbH into the group with effect as of 2006. In the years 2006 through 2009 the subsidiary GmbH incurs annual losses of 100 that are set off against the profits of the parent AG. Due to the loss situation, in 2009 the investment is written down by 700. In 2010 the investment is disposed of at its current book value of 300.

Recapture

Due to the formation of the group the write-off of the investment was not tax deductible. Current losses could initially be set off against Austian profits but were subject to recapture in the year when the subsidiary GmbH was disposed of. At the end of the day, the total loss on the (mis)investment could thus not be used for tax purposes. By contrast, without a formation of a tax group (with the corresponding option under section 10 of the Corporate Income Tax Act) the write-off of the investment could have been deducted over seven years (i.e. 100

per year). The subsequent disposal would not have changed anything. The remaining sevenths would continue to apply for the parent AG for the years 2011 to 2015.

Consider alternatives

It is precisely with foreign investments that one should always consider whether in the specific case admitting a subsidiary into the group or treating it as a qualifying investment outside of the group would entail greater advantages. Frequently, the structuring of the foreign investment as a permanent establishment or partnership in most cases could be more beneficial and the use of foreign tax losses can frequently be accomplished on more favourable terms than within the group.

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International holding privilege violates EU law

The Independent Fiscal Senate (Unabhängiger Finanzsenat, UFS) has recently held that the discriminatory treatment of foreign dividends by means of the international holding privilege violates EU law.

According to the current version of section 10 of the Corporate Income Tax Act dividends distributed by a foreign subsidiary are only tax-free, if the investment in the dividend-paying company has been held for the duration of at least one year. Previously, the minimum holding period was two years. In addition, the investment amount must represent at least ten percent (previously 25 percent directly) of the share capital. These restrictions do not apply to domestic dividends. The Independent Fiscal Senate had to rule on whether discriminatory treatment of foreign dividends constituted a violation of the basic freedoms of Community law.

Freedom of capital movement

The freedom of capital movement forbids all restrictions on capital movement between EU member states as well as EU member states and non-EU states. It covers cross-border transactions such as receiving dividends. The freedom of capital movement is a part of directly applicable primary Community law. The fiscal authorities are obligated to apply it directly and must not apply contradictory provisions of Austrian law. The court has found that discrimination of foreign dividends violated the freedom of capital movement as guaranteed by the EC Treaty.

Freedom of establishment

The freedom of establishment allows and guarantees business activities as well as the establishment and management of undertakings in other EU member states. It becomes applicable with the acquisition of shares in an undertaking domiciled in another member state if the investment achieves a scope that allows the investor to have a crucial influence on the undertaking's decision-making. In the court's view, section 10, paragraph 2 of the Corporate Income Tax Act violates the freedom of establishment. There are no grounds that would justify it.

The court's decision

In the opinion of the Independent Fiscal Senate the freedom of capital movement and establishment thus mandate equal treatment of domestic and foreign dividends. As for domestic dividend exemption from taxation can thus be claimed for dividends from foreign investments that do not meet the additional prerequisites (minimum investment amount, minimum holding period). This also applies to investments held via domestic investment funds.

Implication

An appeal filed by the tax office against the decision is pending. The Administrative Court thus will have the final say in the matter. In assessment cases still pending it could be considered to apply the opinion of the Independent Fiscal Senate. The disclosure of the argu-able legal view that income could be calculated contrary to the legislative wording of section 10 of the Corporate Income Tax Act is recommended. If the corporate income tax for the relevant year has already been assessed, other administrative procedures may be undertaken. Further implications on other provisions of the Austrian tax law are conceivable.

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Corporate Income Tax prepayments – Application for reduction

The core element of the second stage of the 2005 tax reform was undoubtedly the reduction of the corporate income tax rate.

The corporate income tax rate fell from 34 to 25 percent. Due to a lack of adjustment in the provisions for the automatic calculation of prepayments, these are generally too high for 2005 and must be adjusted by means of individual applications for reduction. After the tax rate decrease as of 1 January 2005 it is currently assumed by many companies that the reduction will automatically be taken into account by fiscal authorities for ongoing tax prepayments. In that case, the tax relief would have immediate cash effects. However, under the current legal situation, prepayments for 2005 and subsequent years will not be reduced automatically. Moreover, an application for reduction in corporate income tax may only be granted if the 2005 expected taxable income will be fully disclosed and evidenced on the basis of concrete and detailed estimations. Such a forecast could involve considerable time and effort on the part of the company. Tax payers should claim a reduction of the 2005 prepayments as soon as possible in order to maximise the cash flow advantage resulting from the reduction of the corporate tax rate.

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Withholding tax on foreign investment funds

If a foreign fund complies with certain reporting regulations, the 2004 Tax Amendment Act allows the deduction of withholding tax on deemed distributed income of foreign investment funds.

Based on the new law the advantage of complete final taxation (which was in the past only possible for domestic funds) is now also possible for income from foreign funds received by private investors after 30 June 2005 provided that the foreign fund complies with certain reporting regulations. Furthermore, if fund certificates of such reporting funds are purchased/sold, the investor will receive a 25 percent tax credit/deduction on the reported net interest income only; no lump sum taxation (0.8 percent per month) or taxation on basis of the deemed distributed income (DDI) for the full financial year of the fund is applicable anymore. Finally, no safeguard tax will be deducted. If the foreign fund does not follow the new reporting regime, the old procedures remain applicable. Until now it has been required to include DDI from foreign investment funds in the investor's income tax return (taxed at 25 percent flat rate). Additionally, in case that the investor did not disclose the funds with the tax office, safeguard tax was levied as prepayment of the investor's income tax.

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Indirect Taxes

Cross-border leasing of cars: legislation not in line with EU law

The Independent Fiscal Senate (Unabhängiger Finanzsenat, UFS) of Linz has decided that the new legislation on the taxation of the deemed self-supply for cross-border leasing of cars violates EU law. Companies may use beneficial cost abroad.

In 1995, Austria implemented a rule to avoid that Austrian businesses lease their cars abroad in order to obtain a VAT deduction on car leasing. Businesses which lease their cars abroad and recover the input VAT incurred in the other country should account for Austrian VAT under the self-supply rules. The ECJ ruled on 11 September 2003 ("Cookies World") that the self-supply rules were contrary to Community law. On 29 March 2003 the self-supply rules on cross-border leasing of cars were reintroduced for a limited period of time up to 31 December 2005 (recently extended to 31 December 2008) after consultations of the EU VAT Committee. On 1 March 2005 the Independent Fiscal Senate decided upon direct application of Community law that the reintroduced legislation on the deemed self-supply is again not compliant with EU law. The tax authorities have already appealed against this decision, but it is expected that the Administrative Court and/or the ECJ will confirm the decision of the Independent Fiscal Senate. Thus, businesses might take the opportunity to reduce VAT cost in case of cross-border leasing of cars. Due to a proposal to amend the Sixth EU VAT Directive in the field of B2B services, however, the cross-border leasing of cars might become taxable for Austrian businesses in Austria as of 2006. In this case Austrian VAT incurred on cross-border leasing of cars would not be recoverable at all as in the case of domestic leasing of cars.

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Equal status for foreign pensions

EU law has also changed the qualification of foreign pensions or income from foreign pension funds.

Austria recently implemented Directive 2003/41/EC of the European Parliament and of the Council of 3 July 2003 on the activities and supervision of institutions for occupational retirement provision and changed sections 25 and 26 of the Austrian Income Tax Act. Accordingly, income from employment now also includes income and benefits from foreign pension funds. Whereas up to now only 25 percent of such income was taxed, if there was no statutory obligation to pay contributions, from 2005 onwards, the portion of the pension payments attributable to employer's contributions will be fully taxed.

25 percent for the employee's portion

The portion of the pension payments attributable to the employee's contribution is basically assessed at 25 percent. However, if the contributions can be considered deductible from income earned abroad, the benefits are fully taxable in Austria. Contributions which are paid by the employer for his employees to foreign institutions are no longer included under section 26 of the Income Tax Act, i.e. like con-tributions to domestic pension funds these benefits are not deemed to be income from employment anymore. This also applies to the transfer of benefit commitments or to the vestment to a foreign institution.

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Income of managing directors: less is more

Reduction of corporate income tax opens up new income prospects for a managing director (or another person working for a company) who holds a substantial share in the company.

The tax treatment of managing directors of a company is a challenging issue. The reason: According to the Administrative Court's established case law, the managing director who holds a substantial share in the company represents a special type of taxpayer. He is classified as self-employed in certain respects but his salary is subject to contributions to the family allowance fund and to municipal tax in the same way as salaries paid to staff.

Can contributions to the family allowance fund and municipal tax be avoided?

According to the latest decision of the Administrative Court on this subject, there is only one criterion which decides on whether the contribution and the municipal tax become due: this is the integration of the managing director into the company's operational organism. The other criteria which used to be of equal importance (i.e. entrepreneurial risk, ongoing remuneration) are only relevant, if the operational integration does not allow an unambiguous classification. Full-time managing directors normally meet the integration criterion. The chances to avoid the contributions to the family allowance fund and the municipal tax by means of special compensation schemes are limited with the new case law at hand.

Given the corporate income tax rate of 25 percent which has been applicable since the beginning of 2005, a significant reduction of the salary and payment of these amounts by way of profit distribution might be an interesting alternative. The taxation at the rate of 25 percent for corporate income tax and 25 percent for withholding tax on dividends results in a tax burden of only 43.75 percent. With a salary of more than EUR 25,000 this alternative is more attractive tax-wise than normal income tax plus about eight percent of payroll related costs. Whether tax issues can arise in case of a significant reduction of the managing director's compensation cannot be fully excluded, given the background of the Austrian administrative practice. It is possible that inappropriate low salaries for the managing directors can be adjusted back to an appropriate level for tax purposes. If significantly reduced salaries are not accepted, the amounts paid as salaries could be treated as profit distributions only. When choosing an attractive tax arrangement, other issues such as social security should be taken into account.

Beneficial contributions to the Commercial Social Security system

From a social security point of view, an externally recruited managing director as well as a managing director who holds a substantial share in the company can either be deemed to be an employee or an "old" or "new" self-employed person. Any employed managing director with an interest of up to 25 percent is subject to mandatory coverage under the General Social Security Act. The self-employed persons are subject to the Commercial Social Security scheme. A comparison of the contributions for 2005 indicated that the maximum amount under the General Social Security Act is EUR 19,667.34 while it is EUR 12,332.70 under the Commercial Social Security Act. The maximum Commercial Social Security contribution is thus below the maximum General Social Security contribution by EUR 7,334.64. On the other hand, 20 percent of the medical costs incurred by a person falling under the Commercial Social Security scheme must be borne by the person himself.

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Austrian Tax Facts & Figures

Taxation of corporations

Corporate income tax rate (Basis – adjusted statutory accounts)	25%	Non-deductible expenses (examples)	
Dividend withholding tax	25%	Long-term accruals	20%
Witholding tax on licences/royalties	20%	Business meals	50%
Interest	0%	Excessive car expenses for luxury cars	
Significant allowances		Tax loss carry forwards	
Research & Development (R&D) (Alternatively premiums in cash: 8%)	up to 35%	Losses may be carried forward for an indefinite period of time	
Learning & Education (L&E) (Alternatively premiums in cash: 6%)	up to 35%	Usage of tax losses: 75% of taxable income	

International participation exemption for holding companies		Group taxation: Consolidation of tax losses with taxable profits	
Conditions: Investments >10%, 1 year holding		Conditions: Qualifying participations > 50%	
Dividends	0%	Group agreement and agreement on allocation of cost	
Capital gains	0%		
Thin capitalization rules	None	Losses of foreign participations may be offset against profits of group leader	
CFC rules	None		

Double taxation agreements with 68 countries – mainly exemption method

Taxation of individuals

Individual income tax rate = Progressive rate		Social security on monthly earnings up to EUR 3,630	
below 10,000	0%	Employer's share	up to 21.9%
from 10,000 to 25,000	23.0%	Employee's share	up to 18.0%
from 25,000 to 51,000	33.5%	Payroll related taxes	approx. 8.0%
over 51,000	50.0%	Income cap for social security contributions / Social security totalisation agreements with various states	
after deducting personal expenses (limited)			

Value added tax
in line with the 6th EU directive

Standard rate	20%
Reduced rate (Food, rent, public transportation etc.)	10%
VAT refund for foreign enterprises – available up to June 30 of the following year.	

Other taxes

Real estate transfer tax	3.5%
Capital tax	1.0%
Stamp duties - Loan agreements	0.8%
Rent agreements	1.0%

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We encourage feedback on the newsletter and the content. Equally, we welcome any of your thoughts on topics that you would like to see addressed in future issues.

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