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Direct Taxes

Recent transfer pricing developments in the pharmaceutical industry

Drug Financing Contribution – Who bears the additional cost?

From 2004 pharmaceutical sales companies are subject to a Drug Financing Contribution (“Finanzierungs-Sicherungsbeitrag”) at a rate of currently 2% of the drug revenue. This is borne by the sales company and paid to the Austrian Social Security Institution. The burden is increased by Value Added Tax at a rate 20% of the Contribution. Recently, Roland Macho, an influential Senior Tax Auditor with the Austrian tax authorities, published an article in which he considered whether the captive distribution company or the producing company economically bears the contribution burden (i.e. whether the distribution company would be reimbursed by the producer). In his opinion, the decisive factor is the extent of functions and risks borne by the distribution company. In the case of a stripped risk distributor, a commissionaire or an agent, the producing entity should bear this burden. A fully fledged distribution company on the other hand would regularly have to incur at least part of the additional cost.

Although this statement does not, strictly speaking, represent the view of the tax authorities (as it is a private statement), our experience suggests that tax auditors will adhere to such a statement. The article suggests that the allocation of the Drug Financing Contribution is likely to be a point of discussion in many future tax audits. Groups taking a position clearly deviating from that described above should expect to meet opposition and should try to gather documentation supporting their position.

Increasing acceptance of the transactional net margin method (TNMM)

The other development worth mentioning concerns the choice of the “right” method to determine arm’s length transfer prices. Since the old State-regulated price mechanism was abolished in 1999, inter-company transfer prices are only governed by the arm’s length principle (no fixed mark-up). Tax authorities previously took the view that the resale minus method is generally the correct method and that transactional profit methods were only adopted as a ‘last resort’ in very exceptional cases. However, experience demonstrates that particularly in the pharmaceuticals industry, where there are few independent distribution companies with a functional character comparable to captive distributors, it is frequently very difficult to identify reliable comparatives. Furthermore, even if comparable transactions can be identified, the data required to establish an arm’s length price

based on the resale minus method (i.e. sales price and purchase price of the distributed goods in comparable transactions) is frequently not disclosed. TNMM provides significant advantages: firstly, net margins are usually more tolerant to functional differences than gross margins. Secondly, and most importantly, the data on comparable transactions required to establish an arm's length transfer price based on TNMM (i.e. profit and cost base or sale revenue) is published in well-known databases. It seams that the Austrian tax authorities have become aware of the practical difficulties in determining an adequate gross margin. In recent rulings of the Austrian Ministry of Finance and publications of senior representatives of the tax authorities, it is explicitly acknowledged that TNMM should be accepted if the difficulty of accessing the data needed to apply the traditional transaction methods (i.e. resale minus) can be demonstrated.

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Bulgaria and Romania to join EU on 1 January 2007

As of 1 January 2007, EU legislation will enter into force in Bulgaria and Romania. The EU Accession of both these countries will have an impact on a broad range of business, tax and legal issues. Austrian businesses will have to analyse their operations, identify potential risks and opportunities and prepare for the challenges arising as a result of Bulgaris and Romania's accession to the EU.

The shipment of goods from Austria to the new EU member countries is deemed an exempt intra-community supply of goods. The exemption is applied if the Austrian suppliers meet certain requirements; namely they have to obtain the Bulgarian or Romanian VAT identification number of the recipient. Additionally, the Austrian businesses have to complete the intra-Community supplies of goods into the Community Sales Listings and Intrastat. If a customer is not registered for VAT in Bulgaria or in Romania (e.g. a private individual), the supply is taxable in Austria (the place of departure of the transport of goods).

Furthermore, the Austrian businesses may need to register for VAT purposes in the new EU member countries, if they hold consignment stock or call off stock in Bulgaria or in Romania.

Otherwise, the shipment of goods from the new EU member states into Austria is deemed the intra-Community acquisition of goods and is subject to acquisition VAT in Austria.

The Austrian businesses operating in Bulgaria and Romania will need to meet the compliance and VAT requirements of those jurisdictions. Consequently, documentary evidence will need to be obtained to use zero-rates and VAT exemptions. The Austrian businesses will also have to complete Community Sales Listings and Intrastat.

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"Undisclosed factoring" within the group

Factoring is commonly used as a tax structuring tool within group companies. Recently the Austrian Ministry of Finance issued a ruling summarizing its view on "undisclosed factoring".

"Undisclosed factoring" describes a situation where, after assigning the debts to a factor, the creditor continues to collect the payments from debtors. The debtors are not made aware of the involvement of a debt factor. The factor assumes only the bad debt risk.

The Austrian Ministry of Finance believes that where an Austrian company assigns its receivables to a foreign group company in order to transfer the bad debt risk to the foreign group company, there is a risk that this will be successfully challenged by the tax authorities. The risk is heightened where debt factoring does not lead to a reduction in bad debt expenses. The tax exposure is increased where factoring brings about an economically unjustifiable reduction in the operating profit of the Austrian company. This may occur where the Austrian company continues its debt collection

function and bad debt expenses do not reduce sufficiently to justify the high cost of factoring.

A further issue to consider is whether the use of an Austrian company to collect the receivables of an overseas factor constitutes an agent permanent establishment of the overseas entity.

According to the Ministry of Finance, there are strong arguments to support the existence of an agent permanent establishment, because the profit of the factor is heavily dependent on the collection agent's performance in keeping the bad debt expenses as low as possible. This means that if the foreign factor uses a dependent agent for the collection of debts instead of its own resources, this may constitute an agent permanent establishment.

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Silent partnership

Foreign multinationals investing in Austria may encounter a more exotic financing instrument frequently used in Austria, the silent partnership. This article outlines the legal nature and taxation of silent partnerships under Austrian law.

According to § 178 HGB (Austrian code of commercial law) a silent partner is a legal entity or private individual who invests in the business of another legal entity or private individual. It is an unpublished business relation that is not disclosed to third parties. It does not even require a formal (written) contract and only creates an internal legal obligation. The existence of silent partnerships will only be reflected in the notes to the financial statements where there has been a cash contribution or a contribution in kind. If the contribution is in the form of providing services to an enterprise, the tax authorities must be explicitly notified of the existence of the silent partnership in order for it to be recognised for tax purposes.

In Austria there are two different types of a silent partnership – the "typical" and the "atypical" silent partnership.

The essential characteristic of a typical silent partnership is a cash contribution or a contribution in kind to the business of an entrepreneur, as well as an investment in the form of providing a service to the business of the entrepreneur. Thus the silent partner contributes to the assets of the entrepreneur in return for participating in the profits and losses of the entrepreneur. The Austrian legislation limits the participation in losses to the amount of silent partner's contribution, but special arrangements can be made and the participation in losses can even be avoided. The silent partner's contribution is regarded as a debt instrument for tax purposes. His share in the profits of the entrepreneur is treated as a deductible interest expense.

The income from the participation of a typical silent partner is subject to 25% withholding tax if the entrepreneur runs a trading business. Additionally, the income is subject to income taxation at the marginal rate of the silent partner. Any payments of withholding tax may be credited against any income tax liability of the silent partner. Foreign investors are subject to non-resident taxation on their profits generated by the silent partnership, provided that 25% withholding tax falls due.

The atypical silent partner is entitled to participate in hidden reserves and goodwill. The atypical form of a silent partnership thus is regarded as a co-entrepreneurship for taxation purposes. The atypical silent partner directly participates in profits and losses of the business of the entrepreneur. He also is able to carry forward losses or offset losses carried forward against 75% of current profits. The atypical partnership is therefore frequently used where current losses of a business are to be transferred to investors who offset these losses against their income from other sources. There are, however, restrictions regarding the offset of publicly offered instruments which are aimed at securing tax savings from such loss utilisation. Such losses may only be offset against further profits of the business making the losses. Profits allocated to the atypical silent partner are not subject to 25% withholding tax. In most cases, the silent partnership interest constitutes a permanent establishment taxable in Austria.

Irrespective of the type of the silent partnership, the contribution of a silent partner into the business of a corporation is subject to 1% capital transfer tax.

In general, the silent partnership is a good opportunity to invest in a business of an entrepreneur/corporation without being registered in the commercial register. The atypical silent partnership offers tax benefits with regard to the optimal utilisation of tax losses.

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DTA Austria – Sweden

This article provides a brief description of the latest amendment to the Double Tax Treaty between Austria and Sweden.

Termination of tax-motivated immigration to Austria

In recent years, a noticeable number of Swedish individuals with shareholdings in Swedish companies immigrated to Austria. After becoming tax-resident in Austria by changing the centre of vital and economic interest from Sweden to Austria, the Swedish individuals sold their shares in the Swedish companies.

Sweden has not implemented domestic exit taxation: Swedish capital gains generated prior to emigration remain free of tax. In contrast, under the Austrian taxation concept, Austria exclusively taxes those capital gains, which are generated during Austrian tax residency. In line with the OECD Model Convention, the double tax agreement between Austria and Sweden allocated the entire taxation right in the above mentioned case solely to Austria. As a consequence, Sweden had no right to tax capital gains upon the sale of the shares due to the provisions of the tax treaty, while Austria did not tax "Swedish capital gains" in accordance with Austrian domestic tax law.

This tax advantage has been used extensively in the past. With reference to informal media sources, Sweden raised a complaint about this loss of domestic tax revenue, amounting to several hundred million euros.

A revised protocol, extending Article 8 of the double tax agreement, has now ended this tax-planning opportunity for Swedish individuals. Following the introduction of the new provision, Sweden now has the right to tax capital gains generated prior to the immigration to Austria. The new provision applies for the sale of shares on or after 1 January 2007. The amendment has no disadvantageous impact on the Austrian tax status. In fact, it represents a simplification for Austrians owning shares in an Austrian corporation, who intend to move to Sweden.

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Black funds – How to avoid lump-sum taxation

Last year's introduction of the reporting fund regime harmonised the taxation of certain foreign funds ("brighter than white funds" – ie those that report tax information on a daily basis to the Austrian National Bank with the taxation of domestic funds. Nevertheless, foreign funds which have no authorized tax agent in Austria continue to suffer an unfavourable lump-sum tax charge. Investors in so-called "black funds" are taxed, even if their fund units decrease in value.

In recent years, the range of funds available for private and institutional investors has increased enormously. Funds with new investment strategies and a special regional or sector focus have been launched. However, from a tax perspective, these newly-launched funds are not all recommended for Austrian investors. If the foreign fund has no authorized tax agent in Austria the investor will suffer an unfavourable lump-sum tax charge.

The tax base for black funds is the higher of 90% of the annual increase in value or 10% of the net asset value at year-end. Distributions paid by the black fund within the financial year can be deducted from this amount. So even if the net asset value of the units of a fund decreases e.g. from EUR 25 to EUR 20 the tax base for this unit is EUR 2. For an investor, who holds 1,000 units of this fund, the tax amounts to EUR 500 (1,000 units x EUR 2 x 25% tax rate) while his investment decreased in value by EUR 5,000.

Since the last amendment of the Investment Fund Act, investors are now allowed to provide a self-assessment of the amounts and composition of actual income of a black fund, in order to avoid the lump-sum taxation. In addition to the fact that the accurate calculation of the tax figures requires knowledge of investment fund taxation, experience demonstrates that it is very difficult for individual investors to obtain the required information from the fund administrator. PricewaterhouseCoopers therefore offers to support investors in black funds in calculating the correct figures. This service may be appropriate where the investment in black funds exceeds EUR 10,000.

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Important changes to the VAT Guidelines

The paper on the amendments to the VAT Guidelines proposed by the Ministry of Finance addresses not only the issue of export evidence, but also the provision and remittance of vouchers. Furthermore, the paper confirms the extension of the input VAT deduction for faxed invoices.

Freight forwarder certificate as evidence of export

When goods are dispatched from Austria to a non EC-Member State, the supplier of the goods has to provide export evidence by means of shipping documents (e.g. freight bill, consignment note etc.) in order to apply the tax exemption.

Further to the above-mentioned documents, export evidence can be provided in the form of a certificate issued by a freight forwarder who is resident in one of the EC-Member States. The draft amendments to the VAT Guidelines state that, from January 2007, the certificate has to include the following information:

1. Name and address of the freight forwarder and the supplier,
2. Date of issue and date of passing the goods to the freight forwarder,
3. Quantity and description of the goods supplied,
4. Place and date of export,
5. Name and address of the recipient and destination in the non EC-Member State,
6. Signature of and confirmation by the issuer that the information on the certificate can be substantiated by business documents used in the EC-Member States.

The reaction of both professional organisations and businesses to these stringent requirements for freight forwarder certificates has been rather negative. Such institutions and businesses propose that freight forwarder certificates should contain only that information needed to provide evidence of a cross border dispatch. Furthermore, they argue that it should be possible to submit freight forwarder certificates electronically. It has yet to be seen whether the Austrian Ministry of Finance will reflect these suggestions in the final version of the amendments to the VAT Guidelines.

Input VAT deduction for faxed invoices may be claimed until the end of 2007

The Austrian Ministry of Finance stated in its guidelines of 13 July 2005 that invoices transmitted by e-mail or fax are considered to be electronic invoices. Such invoices will only be accepted as valid VAT invoices (and the recipient will therefore only be entitled to reclaim the input VAT) if the invoices are either:

- provided with an advanced electronic signature (AES) or
- transmitted by means of electronic data interchange (EDI).

The possibility to deduct input VAT from faxed invoices without AES or EDI was expected to end on 31 December 2005. However, in November 2005, the Austrian Ministry of Finance extended the possibility to recover input VAT from such faxed invoices until the end of 2006, as many businesses were facing problems in reorganizing their electronic invoicing. In view of the fact that businesses continue to struggle with these issues, the Austrian Ministry of Finance has announced a further 12 month extension of the limit, i.e. until the end of 2007. This regulation has been included in the amendments to the VAT Guidelines.

Thus, it will be possible to reclaim the input VAT on faxed invoices until the end of 2007.

Reduction of taxable basis for the provision of vouchers

Vouchers issued in the course of an advertising campaign which enable the end customers to purchase goods or services at a discount (as stated on the face of the voucher), may lead to a reduction of the taxable basis. This treatment is consistent with decisions of the European Court of Justice (ECJ) and has already been applied by the Austrian tax authorities.

Vouchers are guaranteed rights for discount or remuneration, e.g. coupons which are issued by a taxable person to stimulate its sales and which entitle the recipient to purchase the goods or services at a discount (as stated on the face of the voucher). The end customer can either directly "pay" with the voucher or get the voucher exchanged by the issuer for cash.

The issuer of the voucher can reduce the taxable basis under the following conditions:

1. The issuer has carried out a domestic supply subject to Austrian VAT,
2. The issuer has exchanged for cash the face value of a voucher to an end customer,
3. The supply of goods or services provided to the end customer who uses the voucher is subject to Austrian VAT,
4. The issuer can demonstrate that the above-mentioned requirements have been fulfilled.

The issuer of the voucher has to retain the following evidence:

- an invoice of the taxable supply of goods or services and
- a document proving the exchange

for cash of the nominal value of the voucher or
- other verifiable documents which prove that the requirements for the reduction of the taxable basis have been fulfilled.

At the earliest, the issuer of the voucher is allowed to reduce the tax base in the taxation period in which the voucher was actually remunerated.

In cases where the issuer of the voucher does not pursue a concrete advertising strategy, i.e. the provision of the voucher is not associated with future sales, the issuer of the voucher is not allowed to reduce the tax base.

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Expatriates

Income tax on speculative gain arising from sale of home abroad

Taxpayers coming to Austria may sell their home abroad in order to save costs for double household. However, the tax-favourable ruling for gains on the sale of Austrian family residences is unavailable in these cases.

According to Austrian tax law, the income derived from the sale of a home which has been used as a person's main residence for at least two years is not taxable. Income generated from the sale of other homes is taxable if the residence is sold within ten years of acquisition ("speculative period").

Taxpayers who move their centre of vital interest to Austria and subsequently sell their home abroad, creating a gain, will not be able to take advantage of the reduced speculative period even if this foreign home was used as their main residence for a two year period. The Austrian tax authorities argue that the 'main residence' exemption only applies for Austrian homes. Even if the home is within one EC member state, the exemption will not be applied. It is argued that EC Law does not generally prohibit different tax rulings for taxable events occurring domestically or overseas.

Where credit relief is available under the provisions of the applicable foreign Double Tax Treaty, the speculative gain achieved by sales of homes abroad within the ten year speculative period is subject to taxation in Austria at the normal progressive income tax rates. The foreign income taxes are creditable against Austrian income tax. The applicable Double Tax Treaties can also provide for exemption of this income subject to progression. If no Double Tax Treaty is applicable the double tax relief may be claimed directly in the Austrian income tax return. The overseas average tax rate must exceed 15%. The taxpayer will need to provide evidence of the amount of the foreign income tax paid and how the overseas income tax rate has been computed.
Speculative gains from selling a home abroad arising before an individual becomes resident in Austria are not taxable under Austrian income tax law.

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Specific tax privilege also for employees of Swiss companies

The income of employees of Swiss companies may be exempt from Austrian income tax, if they are working abroad on a tax-favoured construction site. This Austrian tax privilege is no longer restricted to employees of Austrian companies.

Income from work carried out by employees on construction sites abroad such as setting up foreign plants, surveillance of foreign construction sites, service and maintenance of plant and machinery can be tax-exempt in Austria. The duration of work abroad must be performed for at least one month without interruption. Until now, the tax exemption was only granted to employees of Austrian companies. Following a recent decision of the Independent Finance Senate, this tax exemption may also apply to Austrian resident employees of a Swiss employer, where their income is liable to Austrian income tax due to the respective Double Tax Treaty. The new view of the Independent Finance Senate on that issue is based on the Free Mobility Agreement which Switzerland signed with the EC member states on 21 June 1999 and which came into force on 1 June 2002.

As this new view is based on the principle of Free Mobility, it is not limited to Swiss employers, but has to be applied to all employers based within an EC member state.

Please note that this new view is a decision of the Independent Finance Senate which may be modified by the Supreme Court. Due to the fact that this new view is definitely contrary to that currently held by the Federal Ministry of Finance, we will monitor any developments in this tax exemption.

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Austrian Tax Facts & Figures

Taxation of corporations

Corporate income tax rate (Basis – adjusted statutory accounts)	25%
Dividend withholding tax	25%
Witholding tax on licences/royalties	20%
Interest	0%
Significant allowances	
Research & Development (R&D) (Alternatively premiums in cash: 8%)	up to 35%
Learning & Education (L&E) (Alternatively premiums in cash: 6%)	up to 20%

Non-deductible expenses (examples)	
Long-term accruals	20%
Business meals	50%
Excessive car expenses for luxury cars	
Tax loss carry forwards	
Losses may be carried forward for an indefinite period of time	
Usage of tax losses: 75% of taxable income	

Double taxation agreements
with 68 countries – mainly exemption method

International participation exemption for holding companies	
Conditions: Investments >10%, 1 year holding	
Dividends	0%
Capital gains	0%
Thin capitalization rules	None
CFC rules	None

Group taxation
valid from January 2005

Consolidation of tax losses with taxable profits
Conditions: Qualifying participations > 50%
Group agreement and agreement on allocation of cost
Losses of foreign participations may be offset against profits of group leader

Annual taxable		Income Tax		Effective Tax Rate	Marginal Tax Rate
to	€ 10,000	€ 0		0%	0%
over to	€ 10,000 € 25,000	(EK - 10,000) x 5,750 / 15,000		0 - 23%	38.333%
over to	€ 25,000 € 51,000	(EK - 25,000) x 11,335 / 26,000	+ 5,750	23 - 33.5%	43.596%
over	€ 51,000	(EK - 51,000) x 50%	+ 17,085	> 33.5%	50%

Social security on monthly earnings up to EUR 3,630			
Employer's share	up to 21.9%	Payroll related taxes	approx. 8.0%
Employee's share	up to 18.0%		
Income cap for social security contributions, social security totalisation agreements with various states			

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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