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Direct Taxes

OpCo/PropCo Structures – Tax perspective

New types of investments are booming as the demand for commercial real estate property investments increases.

In several business sectors companies hold significant real estate integral to the operation of the business. Value locked up in such property portfolios may be released via an OpCo/PropCo structure. This idea separates property assets into a special purpose property company (PropCo) within the group, distinct from the main operating company (OpCo), enabling an entrepreneur to raise additional funds.

The use of the OpCo/PropCo structure allows the entrepreneur to finance both companies separately and maximise borrowings. Access to low-cost real estate capital markets provides better financing terms including higher leverage and lower rates than corporate debt markets, therefore reducing the aggregate cost of capital.

It is important to structure an OpCo/PropCo transaction as tax efficiently as possible. There are several tax issues concerning the reorganisation of a group which need to be taken into account in order to decide on a specific OpCo/PropCo structure.

There are three different methods by which a separation of the real estate from the operational part of the business may be achieved. First, a company may separate the real estate assets from the business. Second, they may separate the operational part of the business from the property. Finally, the company may separate both parts into two new entities allowing the remaining shell entity to become a pure holding company.

There are two main tax issues that arise from all three methods. First, the potential realisation and taxation of hidden reserves in the company holding the real estate. Second, transaction costs, in particular real estate transfer tax, may be triggered. Both potential tax burdens could be substantial and might result in an OpCo/PropCo transaction becoming unviable.

Separating the real estate assets from the business

Real estate assets may be separated from the business by a straight sale of the assets to a new entity. The potential tax benefits of such a transaction are:

- Where a sale and subsequent lease back of the property (land and building) is undertaken, the rental fee is generally tax deductible for the lessee;
- The sale will lead to a step-up in tax depreciation for the purchasing entity, as a result of the sold pro-

perty being accounted for by the purchaser at acquisition cost (representing the market value) which is likely to be higher than the book value.; and,

- The debt-financing costs are generally tax deductible for the purchaser.

However, a sale of real estate assets would lead to a realisation of hidden reserves within the property. The taxable gain for a selling entity is the difference between the tax book value of the real estate and the selling price; the gain taxable at the rate of corporate income tax in Austria (currently, 25%). Transaction costs such as real estate transfer tax (3.5% of the purchase price) and the registration fee (1% of the purchase price) would also be triggered. The sale is generally exempt from value added tax, but a company may opt for VAT to apply at a tax rate of 20%. VAT on the purchase price can then be claimed by the purchaser as input VAT where the real estate is leased back with VAT by the seller. Property sales where companies do not opt to apply VAT would lead to a partly recapture of input VAT on construction costs claimed in the previous 10 years by the selling entity.

Separating the business from the real estate assets

Here the operating business is separated from the property assets. When selling the operational part of the business, the realised hidden reserves again are taxed at the rate of corporate income tax in Austria.

As the property assets are not transferred, real estate transfer tax does not apply. However, other transaction costs, such as stamp duties, could be triggered. The purchasing entity would have the advantage as before of a tax step-up of the book values that would lead to increased depreciation.

Further, when transferring the business, Austrian tax law allows the transfer on a tax neutral basis under the Austrian Tax Reorganisation Act (ATRA). Possible ways to perform such a reorganisation include a contribution or spin-off of the business. Therefore the reorganisation would not lead to a taxation of hidden reserves of the transferred assets.

To summarise, regardless of how the OpCo/PropCo structure is achieved, it is important to consider the tax effects carefully and up-front.

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Ministry of Finance confirms Argentinean/ Austrian Double-non-taxation structure

With regard to interest income, the Austria-Argentina Double Taxation Agreement (DTA) provides for the right of exclusive taxation in the source state. In conjunction with Austrian national legislation interesting “double-non-taxation” opportunities arise from this. The Austrian Ministry of Finance recently communicated its opinion via a letter ruling on one of these planning ideas.

The subject matter of the letter ruling was an idea where an Austrian holding company is established to hold foreign participations by Argentinean investors. The funds for the acquisition of the participations are provided by the shareholders; 20% granted as equity and 80% as debt (interest-bearing bonds).

Contrary to the OECD Model Convention, the DTA provides for the exemption from Argentinean tax of the interest income paid by an Austrian company to Argentinean investors. Although Austria is entitled to limited taxation under the DTA, according to its national tax law interest income derived by non-residents is not subject to tax except under specific circumstances (e.g. where the debt is secured by mortgage). In the case of (non-mortgage-secured) bonds, no Austrian withholding tax is levied. As a result, the interest income is not subject to any tax.

In the letter ruling, the Austrian Ministry of Finance acknowledged that under this structure “double non-taxation” occurs as a result of the DTA. Thus, the structure cannot be regarded as abusive. Though letter rulings are not legally binding, tax inspectors usually subscribe to the view expressed therein. It can therefore be regarded as a confirmation that Argentinean “double non-taxation” structures can (at least under certain circumstances) be implemented without triggering a significant tax exposure in Austria.

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New Administrative High Court ruling on abusive inter-company financing

The Austrian tax authorities may challenge certain financing structures if an affiliated lender located in a tax-privileged jurisdiction does not have commercial sufficient substance or if they do not have independent staff and a sound business reason cannot be provided.

Under Austrian tax law an anti abuse clause in the Austrian Fiscal Code ("Bundesabgabenordnung") states that a tax liability cannot be avoided or reduced by an abuse of civil law provisions. Consequently, despite the external appearance and form of a transaction, taxes shall be levied on the basis of its economic substance.

Based on current administrative and court practices, the structures deemed to be abusive are those that include "unusual" and "inadequate" legal structures with the intent to minimise tax. Companies must ensure that a chosen structure remains commercially reasonable even if the beneficial tax effect is disregarded. Also certain legal structures may be "unusual" despite the fact they are used by other taxpayers as well. A "common" structure therefore is not immune to be deemed "unusual". Additionally, a chosen structure is compared to possible alternatives and might be seen as "inadequate" and therefore abusive if the alternative structure is less complex yet has the same economic effect. This qualification is even more likely if the only advantage of the (more complex) structure is the tax saving effect (and the company cannot provide a substantial non-tax rationale).

In the case at hand, an Austrian company created a "Limited Company" in Guernsey. Financed by equity, the Guernsey company used its funds to grant loans within the group. In addition to this financing function the company conducted a trade business, ran an office and employed on-site staff.

Profits were distributed to the Austrian parent, which under the old Austrian participation exemption declared such dividend income tax-free (following an amendment in 2004 such dividend income from passive subsidiaries is no longer exempt). This structure clearly resulted in an interest deduction in high-tax jurisdictions and tax-free income in Austria.

In the course of a tax audit the structure was challenged by the Austrian tax authorities and "deemed" inadequate, that is, its only purpose was to save tax. Reasons provided by the Austrian company were the closeness to the U.K. capital market, the common finance pooling structure, the substance of the operation (in particular the existing office structure and trade business) and the existence of alternative ways to avoid Austrian income tax.

The tax authorities objected that the closeness to the U.K. capital market is not a sustainable argument. In addition, they argued that a trading business is not automatically deemed as non-abusive, given the transfer of funds in the group and the fact that the executives of the Guernsey corporation did not operate independently but only copied and concluded ready-made resolutions.

In his decision, the Austrian Administrative High Court ruled that single steps (e.g. establishing a financing corporation abroad) should not be considered in isolation. The crucial issue is the overall picture. In the case above the court decided that the corporation did not fulfil a sustainable economic function and that the directors only executed pre-determined business decisions. This led to the re-qualification of the "dividends" as the taxable interest income of the Austrian parent.

The Court ruling underlines the fact that having substance (office facilities, staff, etc) is not a safe harbour for financing subsidiaries from an Austrian income tax perspective. Companies must demonstrate sound business reasons for the transfer of financing or other functions abroad, such that they receive actual economic benefits apart from the tax savings effect.

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Transfer prices as taxable base for Value Added Tax and customs value

Although it is common for corporate income tax and customs duty purposes to require arm's length pricing, the Austrian VAT Act does not provide for any transfer pricing rules. However, the European Union has recently introduced transfer pricing rules in the European VAT Directive which can optionally be implemented by the Member States.

Customs value

The customs value is assessed on basis of the price which is paid for goods determined to be exported into the European Union (the so called "transaction value"). Therefore, the price paid for transactions between related parties is accepted in cases where the relationship did not influence the price. This, however, has to be evidenced. Transfer prices which are accepted to be at arm's length by the Austrian tax authorities in a corporate income tax audit, do not always comply with the view of the Austrian customs duty authorities.

Value Added Tax (VAT)

The arm's length principle for supplies of goods or services carried out between related businesses only applies in a very restricted way in the Austrian VAT Act, as, in principle, the actual consideration paid is deemed to be the taxable base for VAT. Where goods are sold or services carried out between group companies at prices significantly below an arm's length price, it is questionable whether these transactions qualify as supplies of goods or services from a VAT point of view. In such cases the motivation of the supplier is relevant.

If the supplier aims to carry out transactions for consideration, the transactions qualify as supplies of goods or services from a VAT point of view. The actual consideration paid is deemed to be the taxable base even though the price reduction was driven by the group relationship.

Where the motivation of the supplier is to supply goods free for charge or to carry out services free of charge, the supply of goods or services is treated as a self supply. In this case, the VAT is based on the cost of the goods or services supplied rather than on the consideration paid.

The End of a Transfer Pricing-Free VAT System in the European Union?

Until recently, the European VAT Directive did not include any VAT rules governing how businesses had to set prices for related-party transactions. However, on 12 August 2006 the European VAT Directive was amended with respect to transfer pricing rules. The Member States may choose now whether they want to implement transfer pricing rules in their local VAT legislation. However, the application of the new transfer pricing rules is limited in several ways:

- Limitation as to the territory;
- Limitation as to the objective of the transfer pricing rules;
- Limitation as to the relations between parties and
- Limitation as to the type of transactions.

In reality no harmonisation across the European Union is likely in respect of VAT-related transfer pricing rules as Member States have a free choice with regard to the scope and the practical measures of the VAT transfer pricing rules. In practice, this means that the scope of the VAT transfer pricing rules as well as the practical arrangements, for example with regard to documentation, may differ from country to country.

Currently, it is uncertain whether the VAT transfer pricing rules will be implemented in the Austrian VAT Act.

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EU Anti-Avoidance Principle – Indirect Tax

If a bank uses a property partnership structure when fitting out a branch building, in which the property partnership leases the building back to the bank, this can be regarded as abusive if the partnership is interposed solely for the purposes of input VAT recovery on the building.

Banking and financial services are generally VAT exempt. Accordingly, a bank fitting out a building is not entitled to recover the VAT in connection with the construction of the building. This restriction does not apply to a partnership which is involved to set up the building. However, interposing a partnership solely for the purposes of VAT recovery can be regarded as abusive. Consequently, no VAT recovery can be allowed to the partnership.

The European Court of Justice (ECJ) approved on 21 February 2006 (Rs C-255/02, “Halifax”) the application of the abuse-of-rights doctrine to value added tax (VAT). The ECJ went on to state that the Sixth Directive must be interpreted as precluding any right of a taxable person to deduct input VAT where the transactions from which that right derives constitute an abusive practice.

An abusive practise exists where, firstly, the transactions concerned (notwithstanding formal application of the conditions laid down by the relevant provisions of the Sixth Directive and of national legislation enacting it) result in the accrual of a tax advantage, the grant of which would be contrary to the purpose of those provisions. Secondly, it must also be apparent from a number of objective factors that the essential aim of the transactions concerned is to obtain a tax advantage.

Moreover, it is clear from case-law that a taxable person´s choice between exempt transactions and taxable transactions may be based on a range of factors, including tax considerations relating to the VAT system. Where the taxable person chooses one of two transactions, the EC VAT Directive does not require him to choose the one which involves paying the highest amount of VAT.

Tax mitigation structures of this type are commonly used by public administrations in Austria: for example, the regional authorities outsource their properties to partnerships or corporations which are opted for VAT, benefit from input VAT recovery (from the manufacturing of the building project) and afterwards lease these properties back to the regional authorities.

It is our view that such an outsourcing of the properties by a bank to a partnership is to be seen within the course of normal commercial operations and, hence, cannot be regarded as abusive.

So far the Austrian Supreme Court has not ruled on the interpretation of the Halifax Case. However, in its decision dated 30 March 2006 the Austrian Supreme Court indicated, that the anti-abuse principle established in Case Halifax are also relevant for the Austrian VAT Act.

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Phase out of Austrian inheritance tax, abrogation procedure regarding gift tax

Recent decisions of the Austrian Constitutional Court are likely lead to the elimination of inheritance and gift taxation.

In a decision of 7 March 2007 the Austrian Constitutional Court held that the inheritance tax regulations in their current form violate constitutional principles. This is due to an inequitable treatment of the inheritance of domestic real estate as compared to other assets. The tax base of most assets is set at the asset’s fair market value while the tax base of domestic real estate is far lower.

The Austrian Parliament now has the opportunity to amend the Inheritance Tax Act in order to comply with the constitutional principles. In the absence of legislative actions, inheritance tax will automatically phase out on 31 July 2008. At first, the government coalition parties disagreed on how to react. While the Conservative Party welcomed the prospect of an elimination of the inheritance tax, the Socialist Party wanted to maintain the tax. However, the Socialists later gave up the resistance and it is now broadly believed that inheritance tax will indeed phase out.

The above decision did not directly affect gift tax. However, the principles of inheritance tax which were found to be in violation of constitutional principles by the Court are also found in the gift tax regulations. Unsurprisingly, the Constitutional Court now has decided to open an abrogation procedure to review the Austrian Gift Tax as well. The Court intends to start the procedure of reviewing the Austrian Gift tax in June 2007.

It is broadly expected that a decision similar to that regarding inheritance tax will follow, which might finally lead to the elimination of Austrian gift tax as well. It is not clear yet if the government coalition will also accept the elimination of the gift tax.

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Tax Reform Act 2007

On 24 April 2007 the Tax Reform Act 2007 was enacted by the Austrian parliament. Contrary to what was proposed in the draft legislation, interest expenses relating to debt financed profit distributions will remain tax deductible. Further to our report in the 11 April 2007 edition of ATN, the following article outlines major elements of the Tax Reform Act 2007.

Interest expenses relating to debt-financed dividends

As outlined in the 11 April 2007 edition of ATN, the draft legislation included a rule, whereby interest expenses from the debt financing of dividend distributions were not tax deductible. That was viewed to be an attempt by the Ministry of Finance to overrule a recent decision of the Administrative High Court. However, in the course of the parliamentary proceedings, this provision was eliminated. Thus, interest expenses relating to debt financed profit distribution remain tax deductible. This should provide opportunities for debt-push-downs. However, interest expenses relating to debt financed repayments of registered capital or capital reserves are not tax deductible (even if the capital repayment is effected in the legal form of a dividend).

Waivers of shareholder loans

Waivers of shareholder loans are basically income tax neutral for both the shareholder and the company. However, the treatment of shareholder loan waivers, where the loan was not fully recoverable was subject to debate. In a recent decision, the Administrative High Court held that the waiver is tax neutral for the borrowing subsidiary. The Tax Reform Act 2007 effectively overrules this court decision by stipulating that the borrower is taxed on the difference between the nominal value and the lower fair market value of the loan receivable. The new rules apply as from the date of formal publication of the Tax Reform Act, which was on 23 May 2007. It is important to note that apart from the above, waivers of shareholder loans might be subject to 1% capital duty.

Stamp tax exemption for software licence agreements

Software licence agreements are exempt from stamp taxes. This exemption applies retroactively starting from 1 January 2002.

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The regulations on early retirement considerably increase personnel administration

Politicians are still discussing whether certain types of work are considered in a fair and adequate way when it comes to calculating pension entitlements. Nevertheless, effective from January 2007, employers have to check if work performed preceding retirement meets certain criteria and if the criteria are met, the employers have to notify the competent authority accordingly. Individuals who have been working under 'hard conditions' for a long period of time shall be entitled to earlier retirement with smaller wage/salary deductions. From 1 January 2007 insured persons can claim early retirement from their 60 birthday, upon being insured for 45 insurance years (540 insured months) and upon having at least performed 10 years (120 months) of work under hard working conditions within a period of the past 20 years (240 calendar months). The regulations on early retirement list all work considered to be performed under hard conditions and also provide for provisions on notification requirements.

Work under 'hard conditions' is defined as

- heavy physical work (minimum consumption of kcal 2,000 for men and of kcal 1,400 for women during an 8 hours working day; the lists on www.sozialversicherung.at/mediaDB are merely guidelines - each individual's case has to be examined)
- shift work or irregular shifts (minimum of 6 hours of irregular night shifts between 10 p.m. and 6 a.m. on at least 6 working days within a calendar month)
- work under regularly hot or cold conditions (hot condition = work under condition of 30 degrees Celsius during more than 50% of working time and 50% of relative humidity and air speeds of 0.1 m per second; cold conditions = predominantly being in cold storage rooms with temperatures lower than -21 degrees Celsius, continuous change between cold storage rooms and other places of work)
- work under chemical and physical influence, if this causes decrease in work capacity by at least 10% (vibrations harmful to health, wearing of breathing- or diving apparatus, permanent hazard resulting from harmful substances). The assessment will be done retro-actively by the accident insurance company.
- professional care for sick or disabled persons who require for special treatments or care (hospice and/or palliative care) in an appropriate institution, including outpatient care.
- work performed by people receiving nursing allowance from level 3, if their capacity to work is reduced by at least 80% and they had been entitled to nursing allowance of level 3 after 30 June 1993.

For each calendar year, work performed by men over 40 years old and women over 35 years old the Health Authority has to be notified by the end of February of the subsequent year at the latest. The required information is exact work performed, names and social security numbers and periods of such work under hard conditions of the individuals in question. In case of temporary personnel the employment agency has to take care of the notification; for people earning less than a certain monthly amount ("geringfügig Beschäftigte") no notification has to be sent. A standardised notification form will not be expected prior to mid-2007, however, it is advisable to start keeping records on required information as from these dates.

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Austrian VAT refund claims for 2006 have to be filed by 30 June 2007 at the latest!

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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