PwC Austria
Tax

PwC Austrian Tax News*

Issue 16, April 2008

In this issue

Direct Taxes

Utilisation of the advantageous DTA Austria-Kazakhstan for foreign investments in Kazakhstan

Due to its vast natural resources, Kazakhstan has evolved into an important area for foreign investors. Following a rather chaotic and non-transparent fiscal era in the first years of Kazakhstan's independence after the collapse of the Soviet Union, the Tax Code of 2001 provided more stability and predictability for taxpayers in Kazakhstan. Due to Kazakhstan's aggressive approach in taxing capital gains involving, either directly or indirectly, Kazakh property, tax planning for a future exit is usually necessary when structuring direct investments into Kazakhstan. Due to the beneficial capital gains provisions in the Double Tax Treaty between Kazakhstan and Austria (DTA), Austria has become a frequently used holding location for Kazakh investments.

Under Kazakh Tax Law, capital gains derived by a foreign resident from the sale of shares in Kazakh or non-Kazakh companies are subject to Kazakh tax at 20% if the income is deemed Kazakh source. Generally, this is the case if the value of the alienated shares is directly or indirectly composed of property located in Kazakhstan.

However, if an Austrian resident shareholder derives a capital gain, it should be exempt from Kazakh taxation under Article 13 DTA, even if this capital gain is regarded as "Kazakh source". Kazakhstan has only concluded a few Double Tax Treaties with comparable exemptions of capital gains. As regards substance requirements of the Austrian holding, currently a certificate of residence should be sufficient for the Kazakh tax authorities to apply a tax treaty. However, this may change in the near future given the rapidly changing tax legislation and enforcement practice in Kazakhstan.

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Direct Taxes

The taxation of a construction consortium in Austria

The Austrian Federal Ministry of Finance outlined in a recent ruling, dated 24 September 2007, its view on the taxation of international construction consortiums. In this article we consider the various legal forms a construction project could take.

The ruling dealt with the joint construction of a power plant in Austria by German and Slovak companies. The construction was lead by the German company, with the Slovak company participating in the construction for less than twelve months. Whether the Slovak entity is subject to Austrian non-resident taxation on its part of the overall profit depends on the type of cooperation.

According to Austrian Fiscal Code a construction site constitutes a permanent establishment if activities continue at the site for a period of greater than six months. Most Austrian tax treaties, including the Slovak Treaty, provide – in line with the OECD Model Convention – that a period of twelve months construction is needed to deem a site a permanent establishment.

A joint venture between a general contractor and a subcontractor is not usually structured as a partnership. The general contractor is usually engaged and liable to establish the plant. The subcontractor is given a separate contract by the general contractor to perform part of the construction work. The subcontractor is only liable to the general contractor, but not to the client of the general contractor. For both the general contractor and the subcontractor the constitution of a permanent establishment has to be considered separately. The activities of a Slovak subcontractor at the construction site must last more than twelve months to constitute a permanent establishment in Austria.

However, the activities of the subcontractor in Austria have to be attributed to the general contractor. The latter could therefore be deemed to have a permanent establishment in Austria even if his own activity at the construction site takes less than twelve months.

The cooperation may also be performed as a construction consortium. The consortium is engaged on the construction project by the client. The partners of the consortium are jointly liable for the execution of the project. A consortium is not registered in the company's register and is treated as transparent vehicle for income tax purposes. This means the consortium is not subject to tax itself. The income of the consortium is attributed to the partners of the consortium. The partners are therefore subject to income tax on their part of the income of the consortium. In the case of a construction consortium the term of the project determines the existence of a permanent establishment for all partners in the consortium. This means that any partner of the consortium is deemed to have a permanent establishment and therefore taxable business income in Austria if the whole construction project lasts more than twelve months, even if the activities of the individual partner are limited to few days or weeks. This approach of the Austrian tax administration corresponds with the conclusion in the OECD Partnership Report.

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Intercompany loans

Austrian Tax Authorities tend to look closely at intercompany transactions, especially intercompany loans. The Austrian Ministry of Finance has recently expressed, in a letter ruling, its opinion on the adequacy of interest rates applied between affiliated companies. Though letter rulings are not legally binding, tax inspectors usually subscribe to the view expressed therein.

New letter ruling

The subject of the letter ruling was the calculation of the interest rate on an intercompany loan granted to an Austrian affiliated company. Based on the circumstances of the case, the competent tax authority considered the intercompany interest rate of EURIBOR +1% not to be adequate. Instead, it applied a rate of EURIBOR +0,25%, leading to lower tax interest expenditure in Austria. The Austrian Ministry of Finance stated that an even lower interest rate may be adequate, and justified it as follows:

An interest rate of EURIBOR +1%, customary in banking, cannot be applied on intercompany loans since banks and intercompany transactions are not comparable. Within affiliated

Direct Taxes

companies the reliability of a particular affiliate can be strongly influenced (positively), leading to a lower credit risk compared to that which banks have to bear.

The ruling is however based on a specific case and its specific circumstances. It should also be noted that in case of intercompany interest income derived by an Austrian financing affiliate, Austrian Tax Authorities often demand higher interest rates, arguing that the lack of affiliated financing companies around which to spread their risk should lead to higher interest rates compared to those charged by banks.

Transfer Pricing – Determining the adequate interest rate

Intercompany relationships have, in general, to be structured on an arms' length basis. In the case of intercompany financing of Austrian entities, it has to be tested whether a third party financer would be willing to provide the financing, given the company's reliability i.e. its ability to serve the debt and to repay the loan (based on forecasted cash flows). If the test is not met, Austrian Tax Authorities may qualify the debt as equity, consequently denying the interest deduction from the Austrian tax base. In practice, the debt equity: ratio of the borrowing company is frequently used as an indicator of its reliability. Although no save haven rule exists in this respect, a debt equity ratio of 3:1 is widely accepted.

If the financing can be qualified as debt, an adequate intercompany interest rate has to be determined. Generally, according to the arms' length principle, an adequate interest rate depends on the implied risk of the overall investment, the reliability and solvency (cash flow) of the lender, as well as on the conditions of the finance agreement. Repayment of the nominal value and the respective interest at the end of the term would, for instance, lead to a higher credit risk and consequently a higher interest rate. The provision of securities for the loan would reduce the credit risk and result in a lower interest rate. The subordination of debt is another factor that in practice plays an important role in determining the interest rate.

Determining the adequate interest rate for intercompany financing is a critical issue and should be subject to a detailed case by case examination.

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Austrian holding structures for Brazilian multinationals – Tax optimisation using the favourable DTA between Austria and Brazil

Brazil is an economically fast developing country with a soaring economy and resident multinationals that generate investments as well as dividend income in and out of Brazil. But they have to deal with many different types of tax-regulations which make it very difficult to optimise the tax efficiency of any investment.

Corporate income tax (IRJP) rate is flat at 25% for income exceeding approximately US$ 120,000. The net income of the corporation is further subject to a rate of 9% social contribution (CSLL) to the Federal Government. Thus, an overall effective tax rate of 34% applies on income. However, taxes other than corporate tax contribute to a much larger part of the total tax burden as compared to other countries.

An important tax topic of Brazil is the taxation of controlled foreign companies (CFC). Brazil CFC-regime considers a company controlled if effectively 10% of the votes are held by a Brazilian company. Profits earned by CFC-companies and any dividend income received in Brazil are subject to the combined corporate tax rate of 34% but may be offset by any foreign tax attaching to that income.
The Double Tax Treaty (DTT) between Brazil and Austria offers beneficial provisions which amongst others remove Brazil's ability to operate the CFC-legislation.

The DTT removes Brazil's right to tax any dividends received from Austria. According to Article 23 of the DTT the dividends received from an Austrian subsidiary are exempt from taxation in

Direct Taxes

Brazil if the Brazilian company holds at least 25% of the capital shares of the Austrian company paying the dividend. The repatriation of dividends to Brazil comes at the cost of 15% Austrian Withholding Tax but there are techniques available which allow a mitigation of this Withholding Tax. Another beneficial regulation is that Austria does not levy taxes on dividends received from foreign participations if the Austrian company holds at least 10% of the stated share capital of the foreign subsidiary for a minimum of one year. The Austrian tax exemption for dividend income, together with the beneficial provisions of the Double Tax Treaty, qualify Austria as a preferable jurisdiction for the foundation of holding structures to shield foreign investment from Brazilian CFC-regulations.

It should be noted though that the above mentioned tax exemption is switched to a tax credit system with full taxation at the Austrian Corporate Flat Tax Rate at 25% and a tax credit for any underlying foreign taxes paid if the subsidiary earns mainly certain passive income and is taxed outside Austria at an effective tax rate of 15% or less. There are structures available to optimise these switch-over provisions.

Furthermore in Austria a 1% capital duty on equity contributions has to be noted. However, certain techniques allow for mitigation of this Transfer Tax. Due to the numerous rules and exemptions the International Tax Planning and Structuring of Brazilian multinationals via Austria requires deep understanding and professional assistance to obtain the best possible achievement.

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Indirect Taxes

Facing up to 60 EU infringement proceedings

A swathe of European lawsuits is covering Austria, ranging from issues related to reduced tax rates for the delivery of horses to VAT on car leasing arrangements in other countries through to the imposition of taxes on dividends.

Articles 226 and 227 of the Treaty on the European Union set out that the European Commission may, should it so wish or upon request of another member state, instigate formal infringement proceedings against a member state for failing to fulfil an obligation under Community Law. If the European Commission is of the opinion that a breach of Community Law has been made by the member state, it will first issue a letter of formal notice in which it requests the member state to submit its observations on the case. As a general rule, the member state will have two months to comply, however the Commission is entitled to considerably reduce this timeframe.

In instances where the member state in question does not comply with the request, or where the Commission considers the response of the member state to be inadequate, the Commission may then take further steps. It is empowered to issue the member state with a reasoned opinion setting out the reasons why it is demanding that the violation be accordingly dealt with. If the member state concerned fails to comply with the reasoned opinion the Commission may refer the case to the European Court of Justice. If the Court of Justice is satisfied that there has been a breach of Community Law, the member state will be obliged to take such measures necessary to ensure future compliancy. The Commission may intervene again regarding the same matter where a member state continues to fail to comply following the judgment of the Court of Justice, in which case the member state may face the imposition of compulsory fines and compensation payments of a considerable amount.

Facts and figures

According to the Constitution Office of the Austrian Chancellery there have been 75 instances since 2002 where the Commission has referred a matter to the European Court of Justice against Austria due to violations of Community Law. During this same period Austria has received unfavourable rulings in 44 different cases. At the end of 2007 eight different cases involving action due to breach of Community Law were pending with the Court of Justice. According to the Permanent Representation of Austria at the EU in Brussels there are, at present, some 60 cases pending with the Commission against Austria relating to breach of Community Law.

The most recently published annual report on the situation of infringement proceedings relating to breach of Community Law states that, at the end of 2006, there were 3,255 cases pending, approximately half of which had originated in the course of that year. In 2006 alone 2,518 instances were taken up by the Commission. At

Indirect Taxes

the beginning of 2007 most of these infringement proceedings pending were against Italy, followed by Spain, France and Germany.

Ongoing infringement proceedings

According to the Commission the setting of a minimum price for a packet of cigarettes distorts competition, and is therefore not compatible with Community Law. In July 2007, the Commission issued a reasoned opinion to Austria. Austria has so far omitted to comply accordingly, as a consequence of which the Commission will be referring the matter to the European Court of Justice.

The "Normverbrauchsabgabe" (a one-off vehicle registration fee) is classified by the EU as an unacceptable facet of the Value Added Tax assessment basis. The Commission has formally requested Austria to change the corresponding statutory positions in relation to turnover tax which are in violation of Community Law. Austria has been given two months to comply, failing which the Commission may threaten to refer the matter to the European Court of Justice.

As a further example, the Commission is of the opinion that the delivery of horses should be subject to conventional tax rates and that a reduced rate of turnover tax should not apply (which it does in Austria). Austria has therefore been asked to provide information regarding this practice and has been given two months in order to provide a response to the Commission.

Tax arrangements in Austria can lead to dividend payments abroad being taxed at a higher rate compared to domestic dividend payments. While the latter is only taxed on a very low basis, if at all, dividend payments abroad are subject to a withholding tax of between five and 25%. The Commission regards this as a wrongful instance of discrimination and has already submitted a reasoned opinion setting out its concerns. Should Austria fail to act in this instance, the Commission may refer the matter to the European Court of Justice.

With regard to direct taxation, certain tax deductibles only apply in part where foreign revenue is involved alongside domestic revenue. In the case of wholly domestic based earnings, however, such tax deductibles apply in their entirety. The European Commission has given Austria two months in order to eliminate this form of discrimination.

Austrian sales tax legislation provides for a reduced tax rate of 10% for the transportation of objects in relation to wastewater and refuse disposal. This is construed as a violation against EU Value Added Tax regulations since the reduced tax rate is only foreseen for the rendering of services, and is thus not intended to cover the transportation of objects in relation to wastewater and refuse disposal.

In order to prevent those subject to tax in Austria from leasing their cars from other member states where a deduction on input tax is possible, Austria has levied a Non-deductible Sales Tax which has been applicable in such instances since 1995. The Commission is of the view that this arrangement is a violation of Community Law. Back in December 2006 it issued a reasoned opinion in which it stated its objections. The two months period given to respond came and went without any further action being taken.

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Tax office shifts the risk of loss of VAT revenue

Fraudulent evasion of VAT causes huge tax deficits. In Austria, the fiscal authorities try to recover the VAT deficit from 'innocent' companies.

As of 1 January 2008 an entrepreneur is not allowed to deduct input VAT, if he knew or should have known that he was participating in a transaction connected with fraudulent evasion of VAT. VAT fraud is still growing, with "carousel" fraud the most common. In this scheme local supplies of goods with VAT and intra-community supplies without VAT are combined. The goods go round in circles and the VAT charged is not paid to the tax office. VAT fraud is punished by penalties and imprisonment. The most common problem is that the tax authorities do not get hold of the missing trader or of the VAT due. Therefore, the tax authorities try to clear the VAT deficit through measures against the business partners of the missing trader. In Austria the customers would not be allowed to deduct input VAT if an invoice did not include all criteria of the VAT Act. In particular, the tax authorities focus on the precise description of the goods or services supplied.

As of 1 January 2008 the new Article 12 para. 1 No. 1 of the Austrian VAT Act becomes effective, which provides that the recipient is not allowed to deduct input VAT if he knew or should have known that he was participating

Indirect Taxes

in a transaction connected with fraudulent evasion of VAT. This applies to any supply in a chain prior, or subsequent, to the fraudulent supply. The meaning of “should have known” is not clear. Therefore, it might occur that the Austrian Tax Authorities assume VAT fraud in cases where special favourable conditions are agreed or where the delivery or payments appear to be unusual. The Austrian Tax Authorities will also use the new provision for periods before 1 January 2008.

The Austrian legislation is based on the decision of the ECJ as of 6 July 2006, C-439/04, “Axel Kittel”. This case concerns a carousel fraud from Belgium to Luxembourg and back to Belgium. The Belgium company did, and could not, know about the fraud. From a Belgium Civil Law point of view the contract regarding the transaction of goods was null and void. Therefore, the national Belgium Law affects that the taxable person loses the right to deduct the VAT he has paid. The ECJ decided that a taxable person loses the right to deduct the VAT only if he knew or should have known that he was participating in a transaction connected with fraudulent evasion of VAT, independent of the validity of the contract according to the Civil Law.

The Austrian Tax Authorities have already tried to fight the VAT fraud through Article 27 para. 9 of the Austrian VAT Act. This article held the recipient liable if the supplier did not pay the VAT to the tax office and the recipient knew about it. At the end of 2007 this clause was abolished. Another measure in the Austrian VAT Act against the VAT fraud (Article 27 para. 4 Austrian VAT Act) indicates that the recipient has to withhold the VAT and pay it to the tax office in the name and on account of the recipient, if the supplier is a non resident company. The recipient can be held liable for any VAT deficit.

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Transfer Pricing

Application of the cost plus method in Austria

Austria is among the few European countries that have not yet issued specific legislation or significant interpretative guidelines on transfer pricing. Consequently, the treatment of transfer pricing issues by taxpayers and the Austrian Tax Authority is primarily based on the 1995 OECD-Guidelines and its subsequent supplements, which Austria published in the form of administrative decrees. Despite the lack of specific legislation, however, transfer pricing is becoming increasingly important and this is reflected by the growing number of tax inspectors specializing in international transactions. Although it is unclear at the moment when Austria would be ready to issue its own specific Transfer Pricing Legislation or detailed documentation rules, it is evident from the tax inspectors’ approach that the Austrian authorities follow international transfer pricing developments closely and are aware of relevant Guidelines issued by other countries.

The increasing focus on transfer pricing is also evident from the growing number of EAS replies issued by the Austrian Ministry of Finance that deal with transfer pricing issues. An EAS reply is provided by the Ministry in response to a specific question by a taxpayer in the form of non-binding comments on the legal aspects of a transaction, without company-specific data but summarising the relevant facts.

In a recent EAS reply (EAS 2893 of 8 October 2007), the Ministry of Finance discusses the application of the cost plus method in the context of the provision of intercompany services, when the calculation of the cost base may be problematic due to the effect of specific tax-related elements, such as investment tax premiums. In the response, the Ministry expresses support for the use of the cost plus method for determining the reward for intercompany services, in the specific case the remuneration of central logistical function.

The cost plus method is generally used where inter-company transactions relate to semi-finished goods supplied by contract manufacturers, sales support functions or services supplied as “group services”. A perennial problem in applying this method is the determination of those costs which should be marked up. In practice one should mark up all rele-

Transfer Pricing

vant direct costs and a proportion of overheads allocated on a reasonable basis.

The OECD-Guidelines refer to the particular difficulty of ensuring comparability when using the cost plus method due to potential accounting inconsistencies. The Austrian Ministry of Finance confirms that the calculation of the cost base should be consistent with the company's choice of accepted cost accounting methods. Consequently, if the cost base of the cost plus calculation includes distribution and administrative expenses and the effect of tax incentives, such as an investment related premium, is accounted for among administrative expenses (by decreasing the expenses) this would be the basis of the cost plus calculation and hence effectively decrease the service fee. If, however, the company uses another cost accounting policy, where the effect of tax incentives is accounted for as part of other income, there should be no subsequent reduction of the basis of the cost plus calculation to take into account the effect of tax incentives.

The EAS response contains two further points that may be relevant to transfer pricing problems in general. The Ministry briefly refers to a range of results when discussing the margin that may be applied on the cost base, implicitly reinforcing the need for a comparables study to determine the arm's length mark-up. Secondly, the response states that in the case of a disagreement between the Austrian and foreign (in the particular case, German) authorities on the treatment of a transfer pricing issue that may result in double taxation for the taxpayer, mutual agreement procedure may be applied.

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Expatriates

Managing directors in the employee provision fund system

From 1 January 2008 managing directors of stock corporations and financial institutions, as defined in Article 4 section 1 subsection 6 Act of General Social Security Law (ASVG), come within the employee provision fund system.

Managing directors are now required to make monthly contributions to the employee provision fund. These contributions are equal to 1.53% of gross remuneration, including special payments and stock options, provided they are not tax free.

Transitional arrangements in Article 73 section 7 Act on Employee Provision Funds (BMSVG) mean that directors on existing contracts (that were in place on 31 December 2007) and which contain a contractual right to claim severance payment, are not required to make contributions. Contributions are still not required on follow up contracts, even they are signed after 1 January 2008.

Existing contracts which do not contain severance payment clauses do, however, fall within the new regulations and contributions are required from 1 January 2008.
For new management contracts, entered into after 1 January 2008, contributions only start from 1 February 2008 as the first month is non-contributory. The inclusion or otherwise of a contractual severance payment clause is irrelevant for new contracts.

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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 20%	Usage of tax losses: 75% of taxable income	

Double taxation agreements
with 68 countries – mainly exemption method

Group taxation
valid from January 2005

International participation exemption for holding companies		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	

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 3,930			
Employer's share	up to 21.9%	Payroll related taxes	approx. 8.0%
Employee's share	up to 18.1%		
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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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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