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Direct Taxes

Austrian Supreme Administrative Court ruling on finance base companies

Recently the Austrian Supreme Administrative Court ruled on a basecompany’s case, extending its jurisprudence in this area. This ruling focused on the abuse of group financing via a Jersey finance company. Instead of granting a loan to its German subsidiaries to purchase new businesses abroad, an Austrian company established an offshore financing letterbox company in Jersey to grant loans to the German group companies. The Jersey FinCo did not have any substance, although in a later period however the FinCo granted loans to third parties on arm‘s length terms. The Jersey FinCo was financed by equity provided by its Austrian parent. The interest paid by the German subsidiaries to the Jersey FinCo was then distributed as a dividend to the Austrian shareholder; this being tax exempt under the Austrian international participation exemption.

The court ruled that this structure was an abuse of law, seeing it as economically and commercial inadequate and unusual. The structure was only designed to save taxes, by transforming taxable interest income into a tax exempt dividend in the Austrian parent company. Abuse was assumed by the court irrespective of the minor loans granted to unrelated parties in later periods. According to the courts view, a more normal structure giving the same commercial effect would have been direct loans from the Austrian parent to its German subsidiaries, without interposing an offshore letterbox company.

The court decision underlines the tendency for a wide interpretation of abuse by the Austrian Supreme Administrative Court, even where third parties are involved in the underlying transactions. Therefore, it is necessary that similar structures held via Austria have adequate substance, and that commercial reasons can be demonstrated for interposing the FinCo.

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The European company (SE) - taxation and structuring models

For more than a year, a new legal form of company has been available in Austria, the European company. This article outlines the possible tax advantages of the creation of an SE, and how the small number of SEs registered with the Austrian Companies´ register is probably more attributable to the complex interplay of the international rules than to the attractiveness of the SE structure.

No direct tax advantages

The EC-Statute does not provide any specific rules concerning the taxation of the SE; the provisions of the Member States´ law are therefore applicable in the area of taxation. The Member States are however required to treat the SE as if it were a public limited company formed in accordance with the law of the respective Member State. The Austrian tax law only provides minor special rules for the SE, e.g. with respect to the minimum corporate income tax and the tax deductibility of compensation for the board of directors. Accordingly, there are no "direct" tax advantages. So what makes the SE interesting from a tax point of view? This is due to particular aspects of Austrian Company law which allow for cross-border mergers as well as transfers of the legal seat of a company abroad. These special rules give opportunities for a number of tax structures.

Use of tax loss carry forwards by foreign subsidiaries

The formation of a SE by way of a cross-border merger of foreign subsidiaries into an Austrian SE may allow for better use of any tax losses. Current losses and even tax losses carried forward by the foreign subsidiary can be utilized in Austria after the merger. The use of the tax losses carried forward must not be merely a case of tax losses carried forward shopping. This would be assumed for the subsidiary's tax losses incurred before the Austrian entity became the shareholder.

However, Decree 2005/56/EC on the merger of companies from different Member States has to be effected by December 15, 2007. Then the formation of a SE will no longer be a prerequisite for the cross-border use of tax losses carried forward. The European Court of Justice (ECJ) has also stated by its decision of December 13, 2005 in the case of Sevic that a general exclusion of cross-border restructurings is not admissible.

Tax optimised emigration of hidden reserves abroad

The newly introduced basis for cross-border mergers and transfers of legal seats, as well as certain recent decisions of the ECJ initiated an amendment of the so-called exit taxation in Austria. In the past, there have even been discussions about whether the mere transfer of a company's head office leads to the taxation of a liquidation gain at the company.

Under the Tax Amendment Act 2004, upon application, the levying of tax may be delayed until a later sale or other removal of the assets from the foreign business property. This applies provided the assets are transferred to another EC Member State or a Member State of the EEA with which a comprehensive administrative and enforcement assistance is in place. If the assets are disposed of by the foreign business after the statutory period of limitation of 10 years no income tax will fall due in Austria. The exit however has to be structured properly as the right to apply is dependant on the transfer of single assets under certain conditions only. Accordingly, profit potential (e.g. inherent in patents) may be tax-neutrally transferred to other low-tax EC Member States.

Transfer of the legal seat to enter into a beneficial tax or civil law

The transfer of the legal seat of a company allows it to switch to a beneficial tax or civil law which could enhance its locational competition considerably. From a tax point of view, withholding taxes and the tax treaty network as well as potential double dip structuring opportunities (for interest/royalties loss usage) are of particular relevance in this context. Also company law factors such as multiple voting shares or more generous squeeze-out conditions in preparation for an IPO can be important drivers for transferring legal seat.

Austria itself particularly vis-à-vis Germany comes close to a tax-haven. Therefore, quite a number of German companies are considering moving to Austria (as future SE's).

Repatriation of the funds of low-taxed, passive income subsidiaries

The repatriation of a subsidiary's funds not qualifying for the international participation exemption should be possible tax neutrally by way of an inbound merger of the foreign subsidiary.

Optimisation of input VAT for banks, insurance companies and pension funds

The change-over to an EC-wide permanent establishment structure may be advantageous for banks, insurance companies and pensions funds, who are largely not entitled to an input VAT deduction, as any transaction between the SE (head office) and the permanent establishments would not be deemed taxable.

Potential downsides

There is not one SE but 28 different ones as most of the regulatory scope is determined by the individual Member States. Thus, the interplay of the appli-

cable rules remains complex. Further, in individual cases the procedure for employee participation at formation or substantial change of structure may be time-consuming and costly.

In cases of a formation by cross-border merger civil law issues such as liabilities in the case of a branch structure or different capital preservation levels may carry authority.

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Expatriates

Management, a "risky job": Measures to reduce the risks

There are numerous liability risks associated with managing a company. Adequate risk management is the only way to protect managers against risky contingencies.

Decision-makers not only have to live with the general risks and uncertainties of the market, but they should also take into account the various legal risks associated with management. A management position in a public or private limited company is a job facing several liability risks. The best way to reduce these risks to a tolerable, manageable level is to implement an adequate risk management policy.

The managing directors of private limited companies and the board members of public limited companies are primarily responsible for the comprehensive, professional management of the company. This might sound relatively simple; however, it encompasses several elements. It involves among other things, the performance of tasks, such as the development of appropriate principles of business policy and the organization of the company. This has to be managed in such a way as to enable and promote the optimal realization of the business purpose. Special attention has to be paid to orderly book-keeping and adequate accounting systems. These systems have to take into account the requirements of the company, as well as the needs of staff, and general compliance with all administrative laws. These include trade law, regulations protecting employees, environmental law and competition regulations. Special attention also has to be paid to the timely and complete payment of all charges and social security contributions; as well as registering the necessary facts with the commercial register.

Constant monitoring

Further basic duties of managing directors of private limited companies and executive officers of public limited companies include the constant monitoring of the company's financial situation and the obligation under Insolvency Law to file for insolvency, if the company is insolvent or overly indebted. If the management is late in filing for insolvency, they will be liable not only to the company, but also to its creditors. This liability is extensive, as it is direct, personal and unlimited. An additional penalty for the violation of creditors' interests is also possible.

Measure of diligence

Looking at the range of duties mentioned above, it seems obvious that the position of a managing director of a private limited company and that of an executive officer of a public limited company carry numerous risks and obligations. In performing their tasks, executive officers and managing directors are liable to their companies by reference to an objective measure of diligence of a prudent and responsible businessman. This means that managers cannot deny their responsibility by claiming they lack the abilities and skills necessary for the diligent execution of their position. It has to be borne in mind, however, that the objective level of diligence specifically relates to that particular company. So the measure of duties is geared to the industry, the size of the company and the respective situation.

As a result, fewer skills are expected from the managing director of a small private limited company dealing in junk goods, than from an executive officer of a large public limited company with net sales of several billion euros, a host of shareholders and employing thousands of staff in its plant locations.

Obligation of loyalty

One of the basic duties of any executive officer or managing director is to preserve and promote the well-being of the company and to be loyal to the company at all times. The use of company funds for personal, private purposes obviously runs counter to that.

For instance, the use of company funds to finance a private birthday party or construct a swimming pool is clearly unlawful. Also unacceptable is the payment of excessive salaries or the relinquishment of an automobile or other asset for private use for no or inadequate consideration. Violating the strict separation of corporate and private assets is not only unlawful under Corporate Law, but can also result

in a personal liability to the manager under Austrian Civil or Criminal Law (§ 153 StGB (Austrian Penal Code, embezzlement)).

Limitation of risk

In view of their duties and the liability risks they face, managing directors of private limited companies and executive officers of public limited companies are well advised to look for ways to limit these risks and minimize their liability. To achieve this, several different approaches can be adopted: Among other ideas, it is already common practice with majority companies or controlling group companies to enter into agreements to release directors from their liability.

A special risk management policy to eliminate numerous liability risks

Agreements between managing directors of private limited companies or executive officers of public limited companies, for that matter, and their companies is not advisable. As such agreements will be considered invalid under civil law, and it is uncertain whether such agreements are lawful in the first place. Additionally, a person can be appointed to be in charge of different administrative issues, who will be responsible for the compliance with the relevant administrative regulations, for instance those regarding the protection of employees. With regards to trade law, it is mandatory to appoint a manager assigned to trade law issues, who will be responsible for compliance with all trade law regulations.

Some insurance groups offer liability insurance for financial losses incurred by managing directors of private limited companies and executive officers of public limited companies. These are also referred to as “Directors and Officers Insurance” or D&O. In Austria, however, no insurance company is currently prepared to assume this liability risk to the company. Another option to reduce the liability risk is to enter into an agreement on the allocation of duties between several executive officers or managing directors, respectively. The law, however, mandates overall responsibility for all executive organs with regard to certain issues, so each managing director or executive officer – despite the allocation of duties – remains fully liable. These issues include the required registration with the commercial register, the timely filing for insolvency proceedings and the fulfillment of various duties regulated by public law.

Special measures

In cases of extraordinary or particularly risky business transactions managing directors of private limited companies are advised to receive instruction from the shareholders, and executive officers of public limited companies to secure a resolution of the supervisory board. Moreover, the management board can also request a resolution via the shareholders’ meeting on important issues. Finally, risks relating to certain tasks can be shifted by outsourcing activities such as accounting, preparing the financial statements or even internal controls to third parties. For individual projects or decisions it is crucial to secure advice or the expertise of an external consultant. With regards to outsourcing, however, there remains a duty to carefully select the respective service provider and an obligation to supervise their activities to a certain extent.

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Remuneration of Austrian managing directors of a company with limited liability (“GmbH”): Less is more

The reduction of the corporate income tax in 2005 offers new perspectives for shareholding managing directors of a “GmbH” and for other advisory employees.

The tax optimal structure of contracts for managing directors in an Austrian GmbH is for most companies a challenging subject, largely due to the additional salary related costs that are due in Austria on remuneration paid.

The common contract for managing directors is an employment contract. Employed managing directors are treated as normal employees. They are subject to monthly wage tax withholding and social security contributions. As employees they enjoy the tax beneficial treatment of the 13th and 14th salary which is taxed at a flat rate of 6 %.

The company pays salary related costs of up to 9,43 % of the total gross remuneration of employees and employed managing directors. Salary related costs consist of contributions to family allowance funds (4,5 %), municipal taxes (3 %), surcharges to contributions to family allowance funds (0,40 % in Vienna) and pension care funds (1,53 %). In addition, there is the employer’s contribution to the mandatory social security.

Managing directors can be employed up to a maximum participation of 25 % and must not have a blocking minority.

If the participation exceeds 25 % the shareholding managing director is working on an independent basis and has to file annual tax returns.

Due to a recent court decision the remuneration of independent shareholding managing directors is also subject to the salary related costs for contributions to family allowance funds (4,5 % and 0,40 %) and municipal taxes (3 %) even though they are independent taxpayers. The argument is that these individuals are integrated into the company's organization and thus comparable to employees.

The salary related costs are levied only on remuneration, not on distributed dividends.

A cost saving alternative therefore is to benefit from the reduced corporate income tax rate of 25 %. As of 2005 there is the possibility to achieve a lower overall tax rate by reducing managing directors' remuneration. The remuneration should be reduced and allocated to dividend distributions. Corporate income tax at 25 % and 25 % tax on dividend income results in a total income tax liability of only 43,75 %; whereas the top marginal individual income tax rate is 50 % for annual income of more than EUR 51.000,--.

Already for remuneration income over EUR 25.000,-- p.a. an overall tax reduction can be achieved compared to normal income tax and the additional salary costs rounded to 8 %.

The reduction in the remuneration income should be a reasonable level for tax purposes, though there are not yet any clear Austrian Court decisions available on this aspect.

Additional issues, such as social security aspects should be considered. Independent shareholding managing directors are covered by the Trading Social Security. The contributions amount to 24,35 % of a maximum annual basis of EUR 52.500,-- p.a. In addition an accident insurance contribution of EUR 87,60 p.a. is payable. The social security contribution for employees (including the employer's portion) amounts to 39,90 % based on the same maximum level.

Dividend income received has to be notified to the social security authority and increases the basis for social security contributions within the maximum limits.

The total social security and tax obligation should be computed by a specialist in advance and specific professional advice on all aspects will be required in order to obtain an optimal solution for both the managing director and the company.

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M&A

Asset deal vs share deal – Austrian tax aspects

Most acquisitions of businesses are made by way of a share deal. However, from a tax perspective, an asset deal is often more advantageous for the buyer, mainly because they can claim a tax deduction for the goodwill amortisation. This drawback of share deals was partly removed by the new Austrian tax grouping rules implemented in 2005. The following article highlights the differences between asset and share deals from a buyer's perspective under the current tax law.

Asset Deal

Corporate Income tax

From a corporate income tax perspective, an asset deal typically allows for an increase in the tax base cost of the assets purchased. The total consideration paid has to be allocated to the different tangible or intangible assets purchased. The assets are depreciated under the general rules, usually on a straight-line basis over their remaining useful life.

Any portion of the total consideration not allocated to specific assets is treated as goodwill. Goodwill is amortised over a period of 15 years for tax purposes.

Interest incurred for financing asset purchases is tax deductible. Interest paid to non-resident businesses is usually not subject to withholding tax unless real property or related rights secure the debt.

Transaction costs incurred (e.g. due diligence costs and advisory fees) are in general tax deductible for corporate income tax purposes by the purchaser. In certain cases, the costs may have to be capitalised and amortised over the useful life of the underlying assets purchased.

Tax losses relating to the acquired business assets cannot be transferred to the purchaser but remain with the seller.

VAT

Austria has not implemented an exception for transfers as a going concern in the case of asset deals. Therefore, the transfer of assets triggers VAT at the applicable rate (standard rate: 20%) on the purchase price allocated to the various assets. The transfer of certain

assets (e.g. accounts receivable) is exempt from VAT. There are schemes to avoid cash-flow disadvantages in connection with the financing of the VAT (mainly offsetting the output VAT of the seller with the input VAT credit of the buyer).

Real estate transfer tax
Austrian located land/real estate transferred attracts a real estate transfer tax of 3.5% (plus a 1% registration duty) of the consideration allocated to the real property.

Capital tax and stamp duties
The transfer of receivables as well as certain contracts and rights may trigger stamp duty (0.8%-2%). 1% capital tax on equity and 0.8%-1.5% stamp duty also has to be considered in relation to the financing of the Austrian company acquiring the assets.

In many cases techniques are available to mitigate capital tax and stamp duties.

Share Deal

Corporate Income tax
Basically, there is no increase in the tax base cost of the assets of the target company. The purchase price for the shares (including incidental acquisition costs such as transaction costs) forms the purchaser's tax base cost of the shares acquired. Write-offs of shareholdings, where there has been a loss in value of the shares, are usually tax deductible (spread over seven years).

Austrian tax law does not provide for a general goodwill amortisation in the case of share deals. However, an opportunity for a partial tax deduction of goodwill amortisation was introduced as part of the new Austrian tax grouping rules in 2005. The forming of a tax group may therefore result in a significant reduction in the (effective) acquisition costs (for details, please see below).

Since 2005 interest incurred by Austrian companies in connection with the acquisition of shares is tax deductible. Transaction costs are not tax deductible. These costs are treated as incidental acquisition costs thus increasing the tax base cost of the shares purchased.

Tax losses of the target company are in general not affected by the share transfer and remain with the target company. As an exception, tax losses of the target company are lost in a share deal if the transfer of more than 75% of the shares in the target is combined with a significant change in the management as well as the business structure of the company.

Group taxation and goodwill
Austrian companies are taxed on a stand-alone basis (corporate income tax at a flat 25% rate) unless they form part of a tax group. In this case, the group parent is subject to corporate income tax on the basis of the group's combined taxable profit. Following the acquisition, interest incurred by the acquiring company can be offset by the target company's profit.

Besides the tax consolidation, there is another tax incentive for forming tax groups:

As outlined above, there is no tax effective goodwill amortisation in the case of a share deal. However, the group parent qualifies for tax-deductible goodwill amortisation equal to the difference between the share purchase price and the net equity of the target less hidden reserves in non-depreciable assets. This goodwill has to be amortised over a period of 15 years. The amount of the goodwill is limited to 50% of the acquisition costs as a maximum and excludes acquisitions of shares from related companies. Further, the amortisation is restricted to target companies with unlimited tax liability in Austria operating an active business (i.e. mere holding companies do not qualify for the goodwill amortisation).

If an acquired subsidiary joins the group after acquisition, amortisation is restricted to the remaining amortisation period. Therefore, the annual amortisation for the period between the acquisition and the joining/establishment of the group is lost (and cannot be regained), as a tax group can usually not be established during the year. In practice, this often results in the loss of the first 1/15 of the amortisation.

Since there are some restrictions for tax groups, it is important to start the planning before the acquisition in order to maximise the tax relief for the tax group.

VAT
The transfer of shares is VAT exempt.

Transfer taxes and stamp duties
Typically, no transfer taxes or stamp duties occur in the case of shares in the target company being transferred. As an exception, real estate transfer tax of 3.5% will be triggered if 100% of the shares in a company owning Austrian located land/real estate are acquired by one legal entity. In this case, tax is based on a specific tax value assessed by the tax authorities. Under the current practice, a taxable event can simply be eliminated where a second entity acquires a minority stake in the target company. The financing of an Austrian company used as the acquisition vehicle may be subject to capital tax and stamp duty. As for the asset deals, mitigation techniques are available for these duties.

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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	

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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