Income Tax Treatment of Corporate Finance in Austria

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1. Introduction

The current legal basis of income tax on individuals, including partners from partnerships, in Austria is the *Einkommensteuergesetz* (EStG) (individual income tax act) enacted in 1988. Income tax of corporations is based on the *Körperschaftsteuergesetz* (KStG) (corporate income tax act) enacted also in 1988. The EStG is primarily applicable to individuals but as the KStG often refers to the regulations of the EStG the individual income tax act is also highly relevant for corporate taxpayers. Corporations that either have their seat or their place of management in Austria are subject to unlimited corporate income taxation and are taxed on their worldwide income. The statutory tax rate for corporations is 25%.[2] Austria applies a shareholder-relief-system on dividends distributed to individual shareholders with a 25% capital yield tax withheld by the distributing corporation.[3] Dividends distributed to corporate shareholders are exempt from tax at the parent´s level.[4] However in certain situations[5] (shareholding of less than 25% or indirect shareholding for a domestic parent; shareholding of less than 10% for a foreign parent) the distributing corporation is obliged to withhold 25% capital yield tax that will then be credited to the shareholder’s overall corporate income tax liability or will be refunded.[6]

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[2] § 22(1) KStG.
[3] § 93 et seq EStG.
[4] § 10 KStG.
[5] § 94 EStG and § 94a EStG.
[6] § 94 and 94a EStG.

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In case of debt finance, Austria applies rather liberal rules on the tax deductibility of interest payments. Generally, an Austrian corporation is even for tax purposes free to decide how to finance its corporate business (*freedom of finance*).[7] Interest payments therefore are in general deductible irrespective of whether they are fixed rate, floating rate or profit participating. Neither the Austrian tax code nor case law of the Austrian Supreme Administrative Court provides for an explicit definition of deductible interest payments for corporations.

The article examines in further detail the tax treatment of equity and debt finance of corporations[8] in a domestic and in a cross-border setting, and relates it to the ideal of tax neutrality. It is structured as follows: In section 2, the typical tax burden on equity and on debt finance is described, in a domestic scenario as well as in a cross-border setting. Section 3 covers specific topics such as shareholder loans, thin capitalization, hybrid finance, and other rules denying interest deductibility. Sections 4 and 5 then analyze the compliance of the Austrian tax regime on corporate finance with two distinct benchmarks: the concept of tax neutrality on the one hand, and principles of EC law on the other hand. Section 6 concludes.

2. Taxation of Equity and Debt in Austria

2.1 Domestic

2.1.1. Financee

According to the general tax principles operating expenditures are tax deductible if they are business related i.e. caused by business activities.[9] Pursuant to tax practice, expenses are caused by the business if there is an objective connection with an operative business, if the expenditures are subjectively destined to the business and if they are not subject to a restriction on tax deductions.[10] Therefore interest payments are generally tax deductible if the underlying loan serves a business.[11] Austrian tax law

[7] *Schuchter*, Branch Report – Austria, IFA Cahiers, Vol 93B, 105.
[8] Finance of partnerships is excluded from the scope of this article.
[9] § 4 (4) EStG.
[10] Sec 1079 EStR.
[11] VwGH 30.11.1999, 99/15/0106.

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however provides for some limitations regarding the tax deductibility of interest payments:

- *Interest payments related to tax exempt income*:[12] interest payments related to tax exempt income, non-taxable income or income taxed at a reduced tax rate are in general not tax deductible. Hence interest incurred relating to foreign income that is tax exempt under a tax treaty or under domestic tax law is not tax deductible. However, in spite of that general rule, a special provision in § 11 (1) 4 KStG[13] establishes the tax deductibility of interest payments connected to tax exempt dividend income of a corporate parent.
- *Interest payments regarding concealed equity*:[14] interest payments are tax deductible if they refer to debt financing. In contrast profit distributions resulting from equity participations are tax neutral. The Austrian tax code does not provide for specific provisions limiting debt finance ratios and consequently limiting the tax deductibility of interest payments. Insofar there are no explicit thin capitalization rules in Austria. However if a debt financing instrument in substance constitutes (hidden) equity (esp a shareholder loan) a reclassification of debt into equity for tax purposes may occur. Yield payments from such *concealed* equity are not tax deductible. Although a reclassification of debt into equity for bankruptcy law purposes, which may occur in insolvency procedures and which is covered by a specific code[15], does not automatically lead to a reclassification for tax purposes but may be an indication for reclassification for tax purposes and vice versa.
- *Interest payments regarding hidden profit distributions*: Shareholder loans and intercompany loans have to comply with the arm's length principle to ensure full tax deductibility of the interest payments. Excess interest payments to shareholders or related parties that

[12] § 20(2) EStG.
[13] § 11 (1) 4 KStG.
[14] See further under 3.1. and 3.2.
[15] See Eigenkapitalersatzgesetz (EKEG).

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would not have been paid to third party lenders are not tax deductible. Instead they are taxed as (hidden) profit distributions.[16]

- *Interest payments regarding contributions by "the way of use"*: Shareholder loans that pay little or no interest are qualified as contributions by the way of use (*Nutzungseinlage*) and are deemed equity. Therefore interest paid for such loans is not deductible in domestic situations. In cross-border situations an arm's length interest rate will be applied.[17]
- *Documentation or procedural requirements*: interest payments are only deductible if evidence of the occurrence of the expense is provided.[18] Moreover, at the request of the tax authorities the lender resp. the recipient of the interest payments has to be disclosed by the borrower otherwise the interest payment is not tax deductible. Regarding lenders resident in a tax haven or lenders identified as a letter box company, the actual beneficiary or beneficial owner has to be disclosed in order to accomplish the request by the tax authority.[19] The demand of the disclosure of the recipient is a discretionary power of the tax authority.[20] An inexact identification of the lender is deemed a refusal of identification and leads to a denial of tax deductibility.[21] The rationale of this regulation is to ensure income taxation of tax deductible interest payments in the hands of the lender.[22]

Dividend payments in general are not deductible for the dividend paying corporation. The operating income of the corporation is fully taxed at the statutory tax rate of 25% and the remaining after-tax income may then be distributed as dividend to the shareholders. A special regime for retained earnings does not exist in Austria. Interests are deductible if the actual cash-flow of the dividend payment is debt financed.[23] The corporation's obligation to withhold 25% capital yield tax depending on the shareholders

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[16] See further under 3.1.
[17] *Schuchter*, Branch Report – Austria, IFA Cahiers, Vol 93B, 105.
[18] Sec 1100 EStR.
[19] VwGH 11.7.1995, 91/13/0154.
[20] Ritz BAO, § 162 Tz 6.
[21] VwGH 14.5.1962, 1656/59.
[22] VwGH 9.3.2005, 2002/13/0236.
[23] VwGH 19.12.2006, 2004/15/0122.

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quality (individual or corporate with minor shareholding or corporate with substantial shareholding) may be considered.

2.1.2. Financer

The taxation of the financer differs depending on the form of the financing (debt or equity) and on the legal form of the financer (individual or corporation). We therefore distinguish the tax consequences for corporate shareholders and individual shareholders subsequently.

2.1.2.1. Parent Company

Austrian parent companies are tax exempt with dividends received from Austrian subsidiaries. That exemption is unconditional as no minimum shareholding requirement and no minimum holding period exist. Tax possibly withheld by the Austrian subsidiary[24] is credited against the overall corporate income tax burden of the parent company or refunded. Interest paid by the parent company to a third party for the loan taken to purchase the shares of the subsidiary is tax deductible even though the dividends thus received are tax exempt.[25]

Capital gains and capital losses of domestic shareholdings are taxable or tax deductible respectively. However realised and unrealised capital losses (write-downs) have to be portioned evenly and are only recognised for tax purposes over a period of seven years (one seventh each in the year of the sale of the shares and the subsequent six years).[26] Depreciations due to excess dividend distributions are not (at all) tax deductible. Revaluations of depreciated financial assets up to the historical acquisition cost have to be recognized for tax purposes and will offset not yet recognized portions of prior write-downs. Revaluation above historical cost is not allowed.

If the Austrian parent company finances its Austrian subsidiary via debt (shareholder loan) the interest received by the parent is taxable as

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[24]The subsidiary is obliged to withhold capital yield tax when a domestic corporate shareholder holds less than 25% in spite of the dividend as such being not taxable in the hands of the corporate shareholder.

[25] § 11 (1) 4 KStG.

[26] § 12 (3) KStG.

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operating income. Whether a withholding tax is withheld at the level of the debtor depends on the details and specifics of the loan contract (e.g. whether a security paper has been issued).

2.1.2.2. Individual

For dividend received by individual shareholders, two different tax regimes exist. Under the first tax regime, which normally applies, income tax for individual investors is withheld at source (capital yield tax) at a rate of 25%. The capital yield tax is a final tax as there is generally no tax assessment of dividend income, ie. no obligation to include the investment income in the income tax return. Under the second tax regime, dividend income is assessed and is then taxed at half the average personal tax rate of the individual tax payer.[27] The second regime is eligible and reasonable only if total income and thus progression is low and the withholding tax is therefore (partly) refunded. In all other cases, the final withholding tax regime applies.

The taxation of realized capital gains and losses as well as depreciations and following revaluations of financial assets (up to historical cost) depends on whether the individual shareholder holds the shares for business purposes (eg. a sole-trader) or for private reasons of wealth management. If held for business purposes, those gains and losses are fully taxed or fully tax deductible respectively. A partitioning of the depreciation amount or the capital loss onto seven years (as mentioned above for corporate shareholders) is not provided for in the individual income tax code. If held for private wealth management, taxation distinguishes between a) profits from speculation in securities, b) profits from the sale of a qualifying shareholding, and c) other gains and losses.

a) Profits from speculation are only taxable if the securities are disposed of within one year after their purchase.[28] Speculative losses can only be offset with speculative gains and cannot be carried-forward or carried-back.

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[27] § 37 (4) EStG.
[28] § 30 EStG.

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b) Capital gains from qualifying privately held shareholdings are always taxable, irrespective of the one-year period. A shareholding is qualifying if the shareholder has held at least 1% of the outstanding shares once during the last five years prior to the disposal of the shares.[29] Capital losses of a qualifying shareholding can only be offset with capital gains of a qualifying shareholding and cannot be carried-forward or carried-back.
c) Capital gains and losses that are not taxed under a) or b) are not taxable nor tax deductible.
Interest received by an individual from a non-bank does in general not qualify for the final taxation of the capital yield tax.[30] The interest payments have to be included into the individual income tax return and are taxed at the statutory tax rate (progressive tax rate up to 50%[31]). If capital yield tax was withheld at source the withholding tax is credited against the individual's income tax liability.

2.2. European Union

2.2.1. Dividends distributed by an Austrian company

As a member state of the European Union Austria has implemented the EC Parent-Subsidiary-Directive[32] (PSD) and the EC Interests and Royalties Directive[33] (IRD). Therefore no withholding tax on dividends paid from an Austrian subsidiary to its EU-parent company is levied if the parent company holds at least 10% of the outstanding stock for a period of at least 1 year.[34] The Austrian subsidiary is obliged to withhold 25% capital yield tax of the distributed dividends if these minimum requirements are not met.

[29] § 31 EStG.
[30] See for further details below.
[31] § 33(1) EStG.
[32] Council Directive of 23 July 1990, 90/435/EEC.
[33] Council Directive of 3 June 2003, 2003/49/EC.
[34] § 94a EStG.

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2.2.2. Dividends received by an Austrian company

Dividends received from subsidiaries domiciled within a member state of the European Union or within a member state of the European Economic Area with which Austria has concluded a legal and administrative cooperation treaty (currently only Norway) (hereafter: EEA*) are exempt from Austrian corporate income tax. No further requirements, such as minimum amount of shareholding or minimum holding period, apply, thus dividends from EU/EEA* subsidiaries are treated equal to domestic dividends. Foreign withholding tax cannot be credited against Austrian corporate tax, as the dividends received are exempt. The Austrian corporate income tax act provides for a switch-over from exemption-method to credit-method for dividend income that is not subject to (sufficient) foreign corporate income tax (or comparable tax). In such cases, dividend income is fully liable to Austrian corporate income tax, foreign corporate income tax (or comparable tax) and withholding tax can be credited.[35]

The tax treatment of capital gains and capital losses, write-downs and revaluations distinguishes between substantial shareholdings and minor ("portfolio") shareholdings. Minor shareholdings are treated equally as domestic shareholdings thus capital gains and revaluations are taxable and capital losses and write-downs are tax deductible partially over a period of seven years (see 2.1.2.1).[36] For substantial shareholdings (at least 10% of the outstanding stock) two options of tax treatment exist.[37] The Austrian parent may opt for either the *tax-exempt status* or the *tax-effective status* of the shareholding.[38] The *tax-exempt status* means that capital gains and capital losses as well as write-downs and revaluations are tax neutral thus capital gains remain untaxed and losses are not deductible. Final losses realized on the liquidation of such a tax-exempt foreign subsidiary are nevertheless tax deductible to the extent they exceed the previous five years' tax-free dividends.[39] The *tax-effective status* on the other hand

[35] § 10(5), (6) KStG
[36] § 10(1) KStG.
[37] § 10(3) KStG.
[38] See *Zöchling/Hasenauer/Wiesner/Unger*, Taxation of Companies in Austria, BIT 2004, 403.
[39] § 10(3) KStG.

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means that capital losses and write-downs are tax deductible and that capital gains and revaluations are taxable. The Austrian parent company has to decide between the two options in the fiscal year of the purchase of the shareholding (or of the purchase of the shares that extend a minor shareholding to a substantial shareholding) and the decision is not revocable.[40]

2.2.3. Interest paid by an Austrian company

Regarding interest paid to a foreign corporation, the income tax act differentiates between interest generated via an Austrian permanent establishment and interest income that is derived from a direct investment in Austria. Interest payments to a permanent establishment located in Austria is attributed to the Austrian permanent establishment[41] and is therefore subject to regular tax assessment in Austria (normally 25% corporate tax).[42] Interest payments on direct investments that are not attributable to a domestic permanent establishment are usually not subject to Austrian limited income taxation. In particular interest payments on unsecured (intercompany) loans, bank deposits or publicly offered securities are not subject to income taxation in Austria.[43] However interest payments to foreign investors from the following Austrian sources are subject to Austrian income tax:

- interest payments on loans backed with mortgages or with other collaterals registered with the Austrian ship register which have not been securitized and publicly offered and have not been incorporated in a public debt register;[44]

[40] See *Zöchling/Hasenauer/Wiesner/Unger*, Taxation of Companies in Austria, BIT 2004, 403.
[41] § 98(1)3 EStG.
[42] § 102(1) EStG and § 24(1) et seq KStG.
[43] Sec 7971 EStR; see also *Schuchter*, Branch Report – Austria, IFA Cahiers, Vol 93B, 118.
[44] See further *Petutschnig/Six*, § 99a EStG – Quellensteuerfreiheit auch bei Veranlagung? ÖStZ 2007, 349; *Schneider*, Austria, Implementation of the Interest and Royalty Directive, DFI 2005, 30.

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- interest payments that are reclassified as dividend payments according to Austrian tax law[45] for which capital yield tax has been withheld at source;
- variable interest payments on a silent partnership or from profit participation rights similar to equity instruments if capital yield tax has been withheld at source.[46]

Thus, in general a foreign creditor is subject to Austrian income taxation only in very specific situations. The most important exception to the general tax exemption of interest income of foreign investors is the collateralized (intercompany) loan, as outlined. As mortgaging and collateralizing is common especially to arrange an arm's length interest rate the foreign (intercompany) lender will usually be subject to Austrian income taxation. Withholding tax is not levied on intra-group interest payments if the interest is paid to an associated EU company. One company is an 'associated company' of another company if the first company has a direct minimum holding of 25 % in the capital of the second company, or vice-versa, or if a third company has a direct minimum holding of 25 % in the capital of both the first and the second company.[47] Though the legislator transformed the EC Interest and Royalty Directive[48] into Austrian tax law the wording of the respective code section seems to only prevent the withholding of the capital yield tax but does not avoid the tax assessment of the foreign investor and therefore does not effectively ban Austrian income taxation.[49]

2.2.4. Interest payments received by an Austrian company

Interest payments received from a foreign or a domestic borrower is subject to Austrian corporate tax. Foreign withholding tax (so there is) is credited.

[45] See below.
[46] § 98(1)5a EStG.
[47] § 99a (6) EStG.
[48] Council Directive 2003/49/EC of 3 June 2003.
[49] Please refer to section 5.

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2.3. Third Countries

2.3.1. Dividends distributed by an Austrian company

An Austrian subsidiary of a foreign (not EU/EEA*) parent company is obliged to withhold 25% capital yield tax from distributed dividends. This withholding tax may be reduced as a result from an applicable tax treaty.[50]

2.3.2. Dividends received by an Austrian company

The Austrian corporate income tax act provides for a two tier taxation system for dividends received by an Austrian parent company from a foreign subsidiary depending on the percentage of equity held by the Austrian parent. Dividends from a substantial shareholding in foreign subsidiaries are exempt from Austrian corporate income tax if the following requirements are met:[51]

- the subsidiary satisfies the requirements of Art 2 of the Parent-Subsidiary Directive or is legally comparable to an Austrian company;
- the parent company holds at least 10% in the capital of the subsidiary (formal share capital or other forms of holding). An indirect shareholding (e.g. via a partnership) also qualifies for the exemption; and
- the shareholding exists for a minimum holding period of one year[52] prior to the distribution of the dividend.

The "legal comparability" requirement is usually met if the foreign company is a separate legal entity, has fixed share capital, offers more than one shareholder the possibility to participate, and all shareholders have only limited responsibility in respect of the company's liabilities and have the chance to participate in a shareholders' meeting, thus influencing the

[50] Austria has concluded tax treaties with roughly 80 countries. The vast majority of the treaties complies with the OECD-Model Convention.
[51] § 10 (2) KStG.
[52] Decisive for the one-year holding period is the date of the legal acquisition of the interest.

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management.[53] However, the exemption of such dividends received is connected to foreign withholding tax not being credited. Also here, a switch-over-clause provides for a switch over from exemption-method to credit-method for dividends from foreign corporations with passive income and a foreign corporate tax burden of 15% or less.[54]

Dividends from minor shareholdings (below 10% of the outstanding stock) of subsidiaries domiciled outside a member state of the EU/EAA* are subject to Austrian corporate income tax at a tax rate of 25%. A foreign dividend tax withheld at source will be credited to the corporate income tax liability according to an applicable tax treaty.

The treatment of capital gains and capital losses is similar to the tax treatment of capital gains and losses of EU/EEA* shareholdings. Capital gains and losses, write-downs and revaluations of minor shareholdings are tax-effective meaning that losses (write-downs) are deductible and gains (revaluations) are taxed. The above described options for substantial shareholdings also apply for third country shareholdings.

2.3.3. Interest paid by and received by an Austrian company

The above described tax treatments of interests payments to a foreign creditor and from a foreign borrower also apply in relation to third country investors. The statutory capital yield tax of 25% may be reduced if a tax treaty is applicable.[55]

3. Special Situations – Special Regulations

3.1. Shareholder Loan

In general, contractual relationships between shareholder and corporation are permitted and tax effective. The outcomes of the contractual relationships are respected for tax purposes. Any person as a matter of

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[53] Sec. 551 KStR; *Zöchling/Hasenauer/Wiesner/Unger*, Taxation of Companies in Austria, BIT 2004, 403.

[54] § 10 (4) KStG

[55] Austria has concluded tax treaties with roughly 80 countries. The vast majority of the treaties complies with the OECD-Model Convention.

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principle is free to decide how to finance its business. This holds in general also true for shareholder loans. However the case law of the *Verwaltungsgerichtshof* (*VwGH*) (Austrian Supreme Administrative Court) has established rather casuistic guidelines for the reclassification of shareholder loans and intercompany loans into (hidden) equity. As this case law in substance also confirms the principle of freedom of finance, such reclassification is not frequently found, the standards for reclassification are rather rigorous.[56] The criteria can be summarized as follows:[57]

- a shareholder loan may be reclassified as hidden equity if the shareholder loan objectively replaces equity which is the case if the increase in capital has been economically necessary.[58]
- In case of a strong disproportion between the shareholders' equity and the economically essential equity, a reclassification as equity may apply. However, if the equity ratio of the borrower is within the industry's average of the relevant business sector, the shareholder loan does not replace shareholders' equity.[59]
- The loan is granted under circumstances that are considered not to be at arm's length. The absence of a written loan contract, a clear agreement on the terms of repayment, an arm's length collateral and interest yield may indicate hidden equity.[60]
- A proportionate partial payment of the additional funds by all shareholders reflecting their shareholding may indicate hidden equity.[61]
- Loans from persons related to a shareholder may be classified as hidden equity if the shareholder has induced a contribution that does not meet the arm's length criteria.[62]

The classification of the shareholder loan as debt or as (hidden) equity depends on the economic situation at the time of the signing of the contract. A change in the economic situation of either the lender or the

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[56] VwGH 23.101983, 83/14/0257; VwGH 30.3.1953, 565/51.
[57] See further *Schuchter*, Branch Report – Austria, IFA Cahiers, Vol 93B, 111.
[58] VwGH 18.101989, 88/13/0180.
[59] VwGH 23.10.1984, 83/14/0257.
[60] VwGH 26.7.2006, 2004/14/0151; VwGH 14.12.2000, 95/15/0127; VwGH 28.4.1999, 97/13/0068;VwGH 23.10.1997, 94/15/0160; sec 681 et seq. KStR.
[61] VwGH 4.3.1983, 81/17/0102.
[62] VwGH 18.12.1990, 89/14/0133, 0134.

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borrower at a later point of time does not lead to a reclassification.[63] Neither does a possible reclassification of the shareholder loan in course of insolvency procedures automatically lead to reclassification for tax purposes.

The case law of the Austrian Supreme Administrative Court has been heavily criticized by legal scholars for being too casuistic and not consistent.[64] Recent Court decisions have specified that the main argument to reclassify a shareholder loan into (hidden) equity is the lack of typical qualities of an arm's length loan agreement; examples for not at arm's length terms are no collateral, subordinate debt, no term for repayment, no interest rate, no written agreement.[65]

From the perspective of the borrower, the reclassification of a shareholder loan into hidden equity leads to non-deductibility of interest and all other contributions resulting from that loan. At the level of the lender correspondingly interest income from reclassified hidden equity is taxed as dividend received. Depending on the shareholder's legal form and residency the respective regulations for dividends apply.[66]

Moreover, specific documentation requirements apply for intercompany loans. Subsequently to the case law of the Austrian Supreme Administrative Court the following conditions for the acceptance of loan contracts between related parties for tax purposes have to be met:[67]

- the loan agreement has to be sufficiently documented;
- the contractual agreements have to be clearly and definitely specified, and
- two independent parties would have agreed on the same contractual agreements (arm's length principle).

The deductibility of interest payments occurred due to a loan agreement lacking such pivotal points will regularly be rejected by the fiscal authority.

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[63] VwGH 23.10.1984, 83/14/0257; sec 709 EStR.

[64] See among others *Gassner/Lang,* Verdecktes Eigenkapital im österreichischen Steuerrecht, GesRZ 1987, 195 et seq; *Gassner*, Branch Report – Austria, IFA Cahiers, Vol 81B, 315 et seq.

[65] Sec. 708 KStR.

[66] See above.

[67] VwGH 3.9.1997, 93/14/0095.

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3.2. Thin capitalization

As mentioned above the Austrian income tax law does not contain any explicit thin capitalization rules; especially no debt-to-equity-ratios are stated that trigger a reclassification of debt into equity or that would hinder the tax deductibility of interest payments. The Supreme Administrative Court was as yet rather reluctant to draw a clear line between acceptable and excessive debt-to-equity-ratios. In two decisions issued in 1999 and 2004 the tax authorities had, in a tax audit, challenged the debt character of shareholders' loans.[68] The tax authorities inter alia used the argument of a debt-to-equity-ratio that was far less than the specific industry's average. In both judgments, the Supreme Administrative Court confirmed the view of the tax authorities that the loans had to be treated as hidden equity but in the judgments reasoning did not speak about any particular debt-to-equity-ratios being acceptable or not. Instead, the Supreme Administrative Court stated that debt-to-equity-ratios were not relevant in the specific circumstances of the cases, as the loans in dispute lacked the typical qualities of an arm's length loan agreement (a written format, a clear agreement on the terms of the repayment, collateral and arm's length interest rates, see above). The Supreme Administrative Court further stated that the loans were clearly not at arm's length on these rather formal grounds and would, therefore, have to be treated as hidden equity. Accordingly, the Supreme Administrative Court concluded that the issue of thin capitalization did not need to be examined in more detail in the two cases in question.[69]

Even though (or because) there is no clear legal guidance or case law available on acceptable debt-to-equity-ratios, tax inspectors in practice often successfully use the argument of thin capitalization during tax audits.[70] Finding the right level of debt financing by not excessively exceeding industry standards is, therefore, an important component of tax

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[68] VwGH 28.4.1999, 97/13/0068; VwGH 14.12.2000, 95/15/0127.

[69] See further *Doralt/Feyl*, A comparative study of the thin capitalization rules in the member states of the European Union and certain other states: Austria, ET 2005, 370.

[70] *Doralt/Feyl*, A comparative study of the thin capitalization rules in the member states of the European Union and certain other states: Austria, ET 2005, 370.

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planning in Austria. It should be noted that, in this respect, compared to EU or US standards, Austrian businesses traditionally have a comparatively narrow equity base, which many economists regard as a problem for the Austrian economy. In practice, third party debt financing of up to 90% is not a rare exception.[71]

3.3. Hybrid Instruments

The basic distinction between equity and debt does not fully cover the enormous diversity of business finance available in reality. Some financial instruments cannot be exclusively classified as either equity or debt and are therefore referred to as hybrid instruments.[72] The spectrum of hybrid instruments ranges from corporate shares with features typical of loans to loans with features usually associated with equity investments.[73] The vast variety of different combinations of characteristics of equity participation and loan features makes it necessary for tax authorities to define classifications for the various financial instruments.

In Austria as mentioned above, a taxable person is free to decide whether its business is financed by debt or equity (freedom of finance). As a general rule, interest expense is tax deductible if it refers to debt instruments attributed to business (principle of inducement).[74] In contrast, profit distributions resulting from equity participations are tax neutral and, therefore, do not have an impact on the amount of the company's taxable income.[75] Hence, the deductibility of interest payments depends on the classification of the underlying (hybrid) financial instrument as debt or equity. Austrian income tax law, however, does not have an explicit definition for debt or equity.

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[71] *Doralt/Feyl*, A comparative study of the thin capitalization rules in the member states of the European Union and certain other states: Austria, ET 2005, 370; *Bergmann/Hirschler/Rödler/Kronberger*, Treatment of Holding Companies in Austria, BIT 2004, 424.

[72] *Six*, Hybrid Finance and Double Taxation Treaties, BIT 2009, 22.

[73] *Eberhatinger/Six*, Taxation of Cross-Border Hybrid Finance: A Legal Analysis, INTERTAX Vol 37, Issue 1; *Six*, Hybrid Finance and Double Taxation Treaties, BIT 2009, 22.

[74] See § 4(4) EStG.

[75] § 8(2) KStG.

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An indication of the content of the term "equity" for income tax purposes can be derived from the specification of (qualifying) profit participation rights pursuant to § 8(3) KStG.[76] Under this provision, profit participation rights granting the right to participate in the issuer's current profits and the liquidation proceeds ("*Substanzgenussrechte*") are classified as equity participations.[77] In order to qualify as an equity instrument, it is essential that the lender participates in both the profit and the liquidation proceeds of the corporation (i.e. the goodwill and the hidden reserves).[78]

Based on the above a financial instrument is considered a debt instrument if these two criteria (profit participation and participation in the liquidation proceeds) are not cumulatively fulfilled.[79]

The participation in the liquidation proceeds criterion is met if the financer has the right to participate in the liquidation proceeds and the amount is variable and depends on the actual goodwill and hidden reserves (unrealized gains) at the time of liquidation. Redemption before liquidation does not harm the classification as long as the financer participates in goodwill and hidden reserves accrued at the time of redemption. Contributing life time capital to a company may indicate an equity instrument but is not a constitutive prerequisite. The agreement of a cap or a floor of the participation in goodwill and hidden reserves may not harm the classification as equity as long as the liquidation participation is variable according to the economic substance of the transaction.[80] The profit participation criterion is met if the holder of the financial instrument is entitled to a variable contribution according to the total annual profit of the company. The corporate income tax act only demands participation in the profit and liquidation results but not in an operating loss of the company.[81]

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[76] See *Staringer* in *Bertl et al* (eds), Eigenkapital (2004), 258 et seq; *Six*, Hybride Finanzierung im Internationalen Steuerrecht (2008), 30 et seq.

[77] See further sec 6138 et seq. EStR; sec 537 et seq. KStR.

[78] § 8(3) KStG.

[79] See *Kirchmayr*, Besteuerung von Beteiligungserträgen (2004), 59 et seq.; *Jann*, Kapitalertragsteuer und Endbesteuerung bei Genussrechten (1998), 46 et seq.; *Staringer* in *Bertl et al* (eds), Eigenkapital, 259 et seq; *Six*, Hybride Finanzierung im Internationalen Steuerrecht, 30 et seq; *Schuchter*, Branch Report – Austria, IFA Cahiers, Vol 93B, 110.

[80] VwGH 23.2.1994, 93/15/0163; sec 541 et seq KStR.

[81] § 8(3) KStG. However the fiscal authority's interpretation of the wording of the law is somewhat unclear as the fiscal guidelines demand a profit and loss participation in one section (sec 6141 EStR) but only a profit participation in another section (sec 539 KStR).

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As both criteria have to be met cumulatively interest income from hybrid, convertible, subordinated and deep-discount bonds are tax deductible if the related financial instrument does not offer both a profit participation and a participation in the liquidation proceeds of the corporation. Thus, the distinction depends on the underlying contractual terms of the hybrid financial instrument.[82]

Hybrid financial instruments containing both debt and equity features often produce qualification conflicts in cross-border situations since Austria mostly bases income qualification of hybrid financial instruments on principles constituted by domestic tax law.[83] For tax treaty purposes, however, according to the practice of the fiscal authorities the income qualification as set forth by the foreign tax law is usually relevant.[84] The same principles apply for the reclassification of debt instruments into equity instruments due to thin capitalization rules of the foreign tax law.

3.4. Other Limitations to Deductibility of Interest Payments

Other cases that can lead to a refusal of deductibility of interest payments are as outlined above generated by the borrower's refusal or inability to disclose the recipient of the payment especially in cross-border situations and by the two contractors' failure to agree upon and to document terms esp. interest yields that are at arm's length.

4. Conformity with General Principles of Taxation and Economic Principle of Finance Neutrality

The Austrian taxation of corporate finance is greatly influenced by the Austrian Supreme Administrative Court's support of the principle of freedom of finance. As mentioned above an Austrian business is in general free to decide on its structure of business finance. Explicit thin capitalization rules including statutory debt-to-equity-ratios do not exist in the Austrian tax

[82] *Schuchter*, Branch Report – Austria, IFA Cahiers, Vol 93B, 110.
[83] See *Six*, Hybride Finanzierung im Internationalen Steuerrecht, 119 et seq; *Six*, Hybrid Finance and Double Taxation Treaties, BIT 2009, 22.
[84] See EAS 1676 of 12.6.2000.

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code. A reclassification of debt into equity mainly applies when the terms of the loan contract are not at arm's length. This arm's length criterion is based more on formal grounds than on the level of leverage. Usually for tax purposes debt (esp. shareholder loans that are at arm's length) will not be reclassified as (hidden) equity and thus interest payments will usually be deductible. However it should be noted that in company law and in insolvency law shareholder loans can be reclassified into equity when the business is in or approaches the state of accounting insolvency, without immediate effect on taxation.

Even though there are no apparent legal and judicial preferences for either debt or equity finance some differences in the tax treatment of different alternatives of financing exist. The question thus arises whether the Austrian income tax system is tax neutral for equity and debt finance and therefore provides not only legal freedom of finance but also economic freedom of finance. Decision neutrality exists if the managerial decisions of taxpayers are unaffected by tax considerations.[85] A tax system is regarded neutral with regard to corporate finance in a broader sense, when the amount of money that a taxpayer is ready to invest, is not changed by her tax payments. In a narrower sense, finance neutrality means that no finance contract is changed with respect to taxes. In its narrowest sense, finance neutrality means that all forms of corporate finance are subject to the same tax burden, thus tax does not influence the cost of capital.[86]

Therefore when ever tax law treats finance alternatives differently the tax system cannot be regarded tax neutral. The Austrian tax system possesses some specifics that lead to a different tax treatment of finance (and investment) alternatives.

4.1. Finance Neutrality in the eyes of the borrowing company

For the financed company involved, debt finance is in general advantageous as interest payments are tax deductible while dividend payments are not. Additionally the Austrian income tax act does not provide for a notional

[85] *Schneider*, Investition, Finanzierung und Besteuerung (1992), 193.
[86] cp. *Schneider*, Investition, Finanzierung und Besteuerung, 204.

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interest deduction for cost of equity and the deduction of interest is usually not limited under thin capitalization rules. Interest payments thus in general reduce the company's tax burden.
However, the question of finance neutrality must be answered not only with a view to the financed company, but must include the financer, both a corporate and an individual financer.

4.2. Intra Group Finance Neutrality

The preference for debt finance vanishes when not only the financed company, but also the financing person is considered. In an exclusively domestic parent-subsidiary situation in which the parent provides the subsidiary with additional debt funds, the interest reduces the subsidiary's tax burden and at the same time increases the parent's tax burden. In profitable periods this will only shift the tax burden within Austria from one corporate entity to the other. Given a flat corporate income tax rate, the overall tax burden will remain constant. In a cross-border situation the (almost) unrestricted deductibility of interest expenses can be used to minimize the overall combined tax burden of the parent and the subsidiary. Vice versa, domestic intra-group equity finance leads to a corporate tax burden at the subsidiary´s level and to tax exemption at the parent´s level. Again, the overall tax burden will remain constant and equals the overall tax burden for debt finance. Thus, in profitable periods, intra-group finance is tax neutral.
In a cross-border setting, the group can take advantage of differing tax rates. Generally speaking, in case of a lower foreign corporate tax rate as compared to the domestic rate, the group will give preference to equity finance of the foreign corporation. In case of a higher foreign tax rate, it will give preference to debt finance. This general statement is of course subject to profitability, tax deductibility of interest payments and preferential treatment of dividends received and does not consider anti-abuse clauses.

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4.3. Finance neutrality for an individual lender

For an individual lender the tax system is not neutral as it provides for different tax treatments of debt and equity investments. Individuals may invest in capital investments that are subject to the capital yield tax at a flat rate of 25%. According to § 93 EStG, such capital investments are e.g. bank deposits, securities (shares, bonds), shares in investment funds and convertible bonds. The tax rate on interest income and dividends is in fact the same, but distributed corporate profits are beforehand subject to the corporate income tax at the level of the corporation. Therefore the economic profit of the investment in a business is taxed twice, first with the corporate income tax (25%) and then with the capital yield tax (25%), which amounts to 43.75%. Economic profit "distributed" as interest payment from bonds or bank deposits is only taxed once at 25% (capital yield tax). This one-sided preferential treatment for specific forms of debt financing has distorting effects since the tax burden is higher in the case of dividends.[87] Distorting tax effects and differing tax burdens are almost inevitable.

From an individual taxpayer's perspective, the tax treatment of investments in financial assets is more favorable than the tax treatment of investments in business operations. In other words, the tax system provides an incentive to withdraw money from business operations (irrespective of the legal form) and invest it in specific financial assets. As investments in shares are evidently discriminated against, companies will certainly adjust their capital structures accordingly in trying to provide investors with the highest possible after-tax income.

A major exception to this preferential treatment of financial assets for individual taxpayers produces the taxation of private and not securitized loans that are not publicly advertised. Interest income from such private loans and shareholder loans is taxed at the regular individual income tax

[87]See *Eberhartinger/Quantschnigg/Rief*, Determination of Company Profits in Austria, BIT 2004, 413; *Wagner*, Konsumorientierte Reform der Einkommens- und Gewinnbesteuerung – Stand und Perspektiven ihrer Realisierung in Österreich, ÖStZ 1998, 406.

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rate of up to 50%.[88] Such investment opportunities for a small group of individuals that are in general somehow related to the loan's issuer are therefore discriminated against.

To summarize, an individual financer may face an overall tax burden of 25% for privileged debt, 43.75% for corporate equity, or up to 50% for non-privileged debt. Such differential treatment of corporate finance is evidently not neutral. However, the same rates apply respectively for a domestic individual financing a foreign corporation. In that sense, the Austrian tax system provides capital export neutrality.

4.4. Asymmetric taxation hindering finance neutrality

Two features, both a result of asymmetric taxation, restrict the general advantageousness of debt finance for the borrower, and impede tax neutrality of intra-group equity and debt. The one feature is the minimum corporate income tax and the other feature is the restricted offset of loss-carry-forwards with annual profits.

The minimum corporate income tax is levied annually irrespective of a profit or a loss. The amount of the minimum corporate income tax depends on the legal form. For the two most common legal types of corporate entities in Austria, the *GmbH* (private limited company) and the *AG* (public limited company), the minimum corporate income tax amounts to € 1.750 (*GmbH*) and € 3.500 (*AG*) per fiscal year.[89] If the regular corporate income tax on profits (profit tax) exceeds the minimum corporate income tax the profit tax is levied but if the corporation produces insufficient profits or if it produces losses, the minimum tax is levied. In a subsequent profitable period minimum tax paid before is credited. Given that tax deductible interest payments may lead to a small profit or a loss, and given that minimum tax is still due, the advantageousness of debt finance is thus reduced.[90]

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[88] § 97 (1) EStG.

[89] § 24(4) KStG.

[90] See further *Eberhartinger/Pummerer*, Hybride Konzernfinanzierung, in *Urnik/Fritz-Schmied/Kanduth-Kristen* (eds.), Steuerwissenschaften und betriebliches Rechnungswesen – FS Kofler (2009), 723 et seq.

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The restrictions on the offset of a loss carry forward amplify this asymmetric taxation of positive and negative corporate income. Unused loss carry forwards may be carried forward for an unlimited period of time. However, the Austrian income tax code limits the tax effective offset of loss carry forwards to 75% of the taxable profit,[91] which results in an early taxation of fictitious income. For a debt financed, loss making subsidiary, the effect is that the loss carry forward regularly increases due to the fixed unconditional interest rate, without any reasonable chances to set it off in the near future. The loss offset limitation partially postpones the positive tax effect of the loss carry forward and in combination with traditional debt finance hinders and possibly prohibits the offset of loss carry forwards. For the borrower, the advantageousness of debt finance vanishes. Within the group, the effective tax burden on debt turns out to be higher than on equity. [92]

To sum up, the Austrian tax system cannot be identified as being tax neutral for finance (and investment) decisions. Depending on the legal form and quality of the taxpayer (individual, corporation) the tax treatment of investment alternatives and financing alternatives affects the taxpayer's decision in one way or in the other. Moreover Austria's current tax system as a whole is definitely not tax neutral because it is conceived as a means for fiscal policy, to regulate and control taxpayers' behavior. Taxpayers are encouraged to make their decisions in socially or politically desired ways.[93]

5. Conformity with EU Law

Austria as a member state of the European Union is obliged to transform EC directives into domestic law. The relevant EC directives on direct taxation especially the Parent-Subsidiary-Directive[94] (PSD) and the Interest-and-Royalty-Directive[95] (IRD) have been transformed and incorporated into the Austrian corporate income tax act and into the Austrian individual income

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[91] § 2(2b) EStG.
[92] See further *Eberhartinger/Pummerer*, Hybride Konzernfinanzierung, in *Urnik/Fritz-Schmied/Kanduth-Kristen* (eds.), Steuerwissenschaften und betriebliches Rechnungswesen – FS Kofler, 726 et seq.
[93] *Heinhold*, Zur Entscheidungsneutralität konsumorientierter Steuersysteme, in *Altenburger/Janschek/Müller* (eds) Fortschritte im Rechnungswesen – FS Seicht (1999), 79.
[94] Council Directive of 23 July 1990, 90/435/EEC.
[95] Council Directive of 3 June 2003, 2003/49/EC

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tax act respectively. As mentioned above the withholding tax for dividends and interest payments constitutes one of the focal points of the Austrian system of taxing capital income. Since withholding taxes are widely banned by the PSD and the IRD the legislator also reduced the number of events triggering an obligation to withhold capital yield tax. Therefore at a first glance the Austrian income tax code complies with the conditions set by the EC directives. However, a more detailed analysis of the Austrian individual income tax code and the Austrian corporate income tax code shows some conformity issues of the domestic tax code with the EU Law.

The transformation[96] of the IRD into Austrian income tax law appears to be somewhat ambiguous. § 98(2) EStG provides that income in the sense of § 98(1) EStG is not taxable in Austria if the conditions for an exemption from withholding tax as set forth in § 99a EStG EStG which have been taken almost word-for-word from the IRD are met. However in some of the cases included in § 98(1) EStG especially shareholder loans that are secured by an Austrian mortgage the income tax is not levied by withholding but by assessment. Therefore even though the legislator transformed the Interest and Royalty Directive into Austrian tax law the wording of the respective code section does not cover every interest paid by an Austrian borrower to its related party lender resident in another EU member state. It thus seems to only prevent the withholding of the capital yield tax but it does not avoid the tax assessment of the foreign investor in Austria and therefore does not effectively ban Austrian income taxation. [97]

The Austrian tax treatment of dividends received from minor shareholdings (not more than 10% of the outstanding shares) discriminates between shareholdings of a domestic, EU/EEA* corporation on the one hand and shareholdings of a third country corporation on the other hand.[98] The former are tax exempt and the latter are taxable and a foreign withholding tax is credited. The question whether these different treatments conflict the freedom of movement of capital has been raised shortly after the code's

[96] See § 98(2) and § 99a EStG.
[97]See further *Petutschnig/Six*, § 99a EStG – Quellensteuerfreiheit auch bei Veranlagung? ÖStZ 2007, 349; *Six*, Hybride Finanzierung im Internationalen Steuerrecht, 41 et seq; *Schneider*, Austria, Implementation of the Interest and Royalty Directive, DFI 2005, 30.
[98] See § 10(1) and § 10(2) KStG.

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latest amendment in 2009 and is already the subject-matter of a preliminary ruling procedure before the ECJ.[99]

6. Summary

Austria´s tax system has a very straight-forward approach to corporate finance: as a general rule, interest payments are tax deductible for the borrower and taxable for the lender. Only few exceptions apply, in particular thin capitalization rules and restrictions for shareholder loans hardly exist. Specific forms of debt finance enjoy preferential treatment at the individual lender´s level. Dividend distributions are subject to corporate tax for the company, tax-exempt for the corporate shareholder and taxable at a reduced rate for the individual shareholder. As a result, the overall tax burden for the individual financer is lowest for preferred debt finance (25%), high for equity finance (43.75%) and highest for other debt finance (up to 50%). The tax system is thus not neutral with regard to finance decisions of an individual taxpayer. Within a corporate group, debt finance and equity finance are taxed at the same rate overall, so here, with a limited scope, neutrality exists.

In a cross-border setting, basically the same rules apply. Austria complies in general with primary and secondary EC law in major aspects and treats outbound finance equal to domestic finance. Foreign withholding tax on interest/dividend received is generally credited with the exemption of an Austrian corporation as recipient, where the dividend received is tax exempt and thus no foreign withholding tax credit is granted.

[99] See C-436/08 Haribo.

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