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Austria Embarks on Two-Year Tax Plan

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This Week's Top News

Austria Embarks on Two-Year Tax Plan

by Markus Christoph Stefaner

Shortly after taking office, Austrian Minister of Finance Karl-Heinz Grasser announced his long-term goal to lower the tax burden in Austria to 40 percent of gross domestic product by 2010. According to estimates, tax cuts of €10 billion to €12 billion will be needed to reach that goal. The new government will attempt to realize the tax reform in a two-step approach starting in the current election period, with tax cuts of about €3 billion forecast for 2004-2005. (For prior coverage, see *Tax Notes Int'l,* 10 Mar. 2003, p. 933, *2003 WTD 43-3,* or *Doc 2003-5691 (1 original page)*.)

Anticipated Changes for 2004

Individuals

One proposed change, which aims to strengthen economic growth, is relief for low-income earners. Annual income up to €14,500 will be tax-free, amounting to a tax reduction of up to about 3 percent for the lower income bracket. For annual income of €19,600, the value of the tax benefit would be reduced to about €180 a year, and for annual income of more than €24,500, the benefit would be barely recognizable at about €20 a year. The total aggregated benefit for Austrian employees and retired persons is estimated at €385 million.

Trades and Businesses

Partnerships and sole proprietors, which are treated as transparent entities under Austrian tax law, are meant to benefit from less burdensome taxation of retained profits. The profits of those trades and businesses are taxed at the ownership level, at the regular tax rate,[1] regardless of whether profits are retained or distributed to shareholders. A subsequent distribution of earnings — unlike distributions of profits by corporations[2] — does not trigger any further tax consequences.

That treatment will change, starting in 2004. The proposed changes provide for the taxation of profits that are not distributed at half the average individual tax rate, which ranges from zero percent to 50 percent. However, a minimum tax rate of 20 percent will apply to those retained earnings. This will decrease the tax advantage of corporations, as their retained profits are taxed at 34 percent. Their tax advantage will be decreased even if the corporate tax rate is lowered, as is intended, to 31 percent in 2005, as the tax rate for individuals is expected to be reduced from the current maximum marginal rate of 50 percent at the same time.

This measure is designed as a reinvestment incentive for owners of trades and businesses. The aim is to strengthen the equity base of Austrian

[1] Sections 21(2)(2), 22(3), and 23(2), Austrian Individual Income Tax Act (IITA).

[2] Section 27(1)(1), Austrian IITA.

Finance Minister Karl-Heinz Grasser recently outlined his ambitious long-term tax reform plan.

Photo courtesy Austrian Press and Information Service, Washington, D.C.

businesses, boosting the economy as a whole. The total tax benefit triggered by this measure is expected to amount to about €400 million.

Another measure that will enter into force in 2004 is a reduction of companies' incidental wage costs. Taxes on incidental wages will be lowered by 3 percent for women older than 56 and for men older than 58. For employees older than 60, the taxes will be lowered by 10 percent. The focus on older employees is designed to reduce layoffs and to make qualified older employees competitive. This is especially necessary, as the government plans to raise the effective age of retirement. This measure is expected to decrease tax revenue by €140 million.

Moreover, the tax reform will lead to the abolition of VAT prepayments. Currently, entrepreneurs subject to VAT have to pay the difference between VAT amounts they have collected and input VAT once a month.[3] However, in December, taxpayers must pay an additional 1/11 of a year's VAT payment. That prepayment cannot be deducted from the business's VAT debt until January of the subsequent year, effectively making it an interest- free loan to the government.

That prepayment will be abolished, starting in 2004. Because no tax payments will be lost in the long run, the change will not result in any additional costs for the government; it will result only in a one-time timing effect. And from the taxpayer's point of view, it will increase liquidity.

Pitfalls of the 2004 Reforms

The tax benefits of the 2004 stage of the tax reform will be financed partly with tax increases. Those tax increases will, at the same time, serve an ecological purpose. Taxes on all kinds of fossil fuels will be increased: Hard coal, brown coal, and coke will be taxed at €0.05 per kilogram, and taxes on natural gas will be increased by €0.0226 per cubic meter.

The increase in energy taxes is expected to result in additional tax revenue of about €129 million. Petroleum taxes will be increased as well. Taxes on diesel will increase by €0.035 per liter, while taxes on gas will increase by €0.025 per liter. Taxes on low-sulfur diesel and gas will increase at a lower rate of €0.02 and €0.01 per liter, respectively. It is not yet clear whether low-sulfur fuel will be available throughout Austria by 1 January 2004. OMV, Austria's biggest fuel production company, has expressed confidence that the new fuel will be widely available. Additionally, taxes on light and heavy fuel oil will increase by €0.029 and €0.024, respectively. As an offset, energy refunds for special businesses will increase by about €79 million.

Those measures are expected to lead to an aggregated increase in tax revenue of €401 million, not including a consecutive increase in VAT revenue.

The net effect of the 2004 portion of Austria's tax reform is expected to bring tax relief amounting to about €400 million to €500 million. The resulting decrease in tax revenue will be covered, on the one hand, by a decrease in civil service costs and by reforms of Austria's retirement and health insurance systems. On the other hand, there are deficits planned in Austria's budgets from 2003 on. Those deficits are expected to be between 0.7 percent and 1.5 percent of GDP.

One pitfall of the 2004 portion of the reform is that the tax cuts are targeted mainly at specific groups of taxpayers, while the negative effects will strike everyone. Those negative effects may be offset by the second phase of the tax reform, which is scheduled to begin in 2005.

Anticipated Changes for 2005

Few details concerning the second phase of the tax reform are available yet. Ideas that have been made public so far include a net reduction of the tax burden by €2.5 billion. That goal will be reached through a general reduction of tax rates and a flatter progression in the Individual Income Tax Act. In addition, the corporate income tax will be lowered to 31 percent, and tuition fees might become tax-deductible if the studies are connected to the student's job. However, it remains unclear whether they

[3]Section 21(1), Austrian VAT Act. There is an exception for small businesses, which only have to pay the amount every three months, in section 21(2).

would be fully deductible or if a deduction would be allowed only for an amount combining tuition fees with a donation to charitable organizations.

Grasser also does not exclude the possibility that the 2005 stage of the tax reform might lead to an additional tax burden for some taxpayers. That could come in the forms of higher property taxes and higher fees for services rendered by public administrative bodies.

Grasser and Chancellor Wolfgang Schüssel also have pointed out that the second phase of the reform will be implemented in 2005 only if economic growth is sufficient and attempts to cut expenses in the area of public services have been successful. With the next elections set for 2006 at the latest, it is improbable the second part of the tax reform will be delayed. If that occurs, further reforms would be in the hands of the next government.

Conclusions

The tax changes planned for 2004 are only the first step in what is called Austria's biggest tax-cut plan ever. This first step will bring about significant tax relief for some groups of taxpayers, but will also increase the tax burden for everyone on the consumption side. Whether this reform will lead to the biggest tax cuts in Austria's history remains to be seen after the second step is implemented in 2005.

All of the measures are linked to economic and budgetary conditions. Only on that basis will the long-term goal — a decrease in the aggregated total tax burden of about 10 percent of GDP by 2010 — remain achievable. Initial indications concerning that probability might be revealed in the 2003-2004 budget, which will be finalized in May, and in any subsequent changes in Austrian tax laws.

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