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# Austrian Budget Introduces Long-Term Tax Cuts, International Changes

by Markus Christoph Stefaner

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# *News & Country Digest*

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## This Week's Top News

### Austrian Budget Introduces Long-Term Tax Cuts, International Changes

*by Markus Christoph Stefaner*

Austria's draft budgets for 2003 and 2004 were presented to the public on 7 May, shortly after the 29 April presentation in Parliament of the governmental draft of Budget Law 2003.[1] To boost the economy, budget deficits of 1.3 percent and 0.7 percent of gross domestic product are planned for fiscal years 2003 and 2004, respectively. Because the budget for 2003 won't be effective for the first half of this year, the budget deficits will not decline until 2004.

Once approved, Budget Law 2003 will initiate the first step of a long-term tax cut plan that is expected to reduce the country's overall tax burden to 10 percent of GDP. (For prior coverage, see *Tax Notes Int'l*, 24 Mar. 2003, p. 1083, *2003 WTD 49-2*, or *Doc 2003-6462 (4 original pages)*.) Most changes introduced by Budget Law 2003 would enter into force in 2004 or later.

[1]As of 23 May 2003, all drafts and acts can be downloaded at http://www.parlinkom.gv.at.

#### Individual Income Tax Act (IITA) Changes

**Transparent Trades and Businesses**

Because trades and businesses (including partnerships, but not corporations) are treated as transparent in Austria, their profits are directly attributed to the owners of the trade or business. Therefore, under current law, even retained earnings, although not effectively distributed to the owners of the business (partners), are subject to income taxation at full tax rates.

Under section 11a of Budget Law 2003, if those owners are individuals, they would be eligible for a special tax regime for those retained earnings. The special regime would be applicable only to entrepreneurs (or partners of partnerships) who earn profits from business enterprises (section 23, IITA) or agriculture and forestry (section 21, IITA) and who make up balances according to section 4(1) or section 5 of the IITA.

Those taxpayers would be allowed to tax the year's increase in equity at half the average tax rate (section 11a(1), in connection with section 37(1), IITA). If that special rate is lower than 20 percent, the increase in equity would be taxed at 20 percent (section 11a(1), IITA).

The increase in equity is calculated by combining retained earnings and capital contributions, if they are necessary for the trade or business, minus withdrawals. Capital contributions are included only if they are necessary for the trade or business to prevent the practice of making short-term contributions for the sole purpose of obtaining a better tax rate. To

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prevent the multiple use of capital gains in multi-tier transparent partnerships, section 11a(2) of the IITA (in Budget Law 2003) states that capital gains may be taken into consideration only at the highest-tier trade or business.

If there is a decrease in equity as a result of withdrawals, it must be taxed to balance the preferential treatment. This subsequent taxation is limited to amounts that were taxed preferentially during the preceding seven years (section 11a(3), IITA, in Budget Law 2003). Taxation is required only if the decrease in equity is a result of withdrawals; losses do not lead to subsequent taxation. These rules would apply not only to taxpayers resident in Austria, but also to permanent establishments of nonresident taxpayers.

***Budget Law 2003 introduces a new regime for foreign participations.***

Section 36 of the IITA introduces a beneficial taxation of profits resulting from creditors waiving their claims (in insolvency proceedings) to prevent bankruptcy of the debtor. A similar rule was removed from Austria's IITA in 1998 because it was said that it was no longer necessary with the introduction of unlimited loss carryforward. However, it turned out that, in practice, the claiming of taxes was impossible in most of those cases, resulting in possible bankruptcy. As a result, the tax administration abandoned its tax claims in certain cases in the same proportion that the creditors abandoned their claims. That practice has been incorporated into the IITA by Budget Law 2003.

### Individuals

Contrary to earlier rumors, university tuition fees will be tax-deductible in Austria from 2004 on, according to the Budget Escort Law. However, those fees will be deductible only if they are directly connected to a current or future job (section 4(4)(7) through section 16(1)10, IITA, in Budget Law 2003). Therefore, retirees who study at universities will not be eligible to deduct the tuition fees.

Under current law, the taxation of investment income differs according to whether the investment is in Austria or abroad. For capital investment income listed in section 93 of the IITA — mainly dividends of Austrian corporations, interest from balances at Austrian banks, and bonds kept in Austrian depots — the IITA provides for source taxation of 25 percent of the gross earnings.

For individuals, that source taxation satisfies the liability to pay taxes in most cases (section 97, IITA). If the taxpayer would be better served by an assessment, he or she can opt for assessment and taxation at half the average tax rate (for dividends) (section 37(4)(1), IITA) or at the full tax rate (in all other cases).

Foreign-source investment income is taxed at the full rate, and income-related expenses are deductible. Because the full tax rate is often higher than 25 percent, this is a disadvantage for investments abroad. This different treatment might be a breach of the Austrian Constitution[2] and raise issues of incompatibility with the EC Treaty.[3]

To overcome this discrimination, Budget Law 2003 provides for equal treatment of foreign investment income. If source taxation is not possible, income from foreign investment must be assessed and is taxed at 25 percent of the gross income (sections 20(2) and 37(8), IITA, in Budget Law 2003). Additionally, the law would grant the same possibility to be assessed at the normal, or half the average, tax rate as for comparable domestic cases (section 37(4), IITA, in Budget Law 2003).

To help with the spread of broadband Internet, connection fees and monthly service fees would be deductible, with maximums of €50 for the installation fee and €40 for the monthly fee. Those deductions would be limited in time, to the end of 2004, and would apply only to installations after 30 April 2003. This provision might raise issues of incompatibility with the Constitution regarding monthly fees.

## Corporate Income Tax Act (CITA) Changes

Under current law, capital gains resulting from the sale of a shareholding of at least 25 percent in a foreign corporation by an Austrian corporation are — in contrast to gains of a domestic shareholding — tax-free (section 10(2)(2)(b), CITA). Nevertheless, depreciations of foreign shareholdings are deductible under the same circumstances as for domestic shareholdings. This is considered a harmful tax practice by the EU Council of Economic and Finance Ministers in the code of conduct for business taxation.

Therefore, Budget Law 2003 introduces a new regime for foreign participations (sections 10(2) and 10(3), CITA, in Budget Law 2003). The basic rule is that international participations would be tax-free, but losses resulting from foreign participation would not be tax-deductible. Only losses from the winding-up of the subsidiary would be deductible. However, the Austrian parent would have the option of taxa-

[2]Austrian Constitutional Court 2002/03/07, G 278/01.

[3]Conclusions of AdvGen *Tizzano* 2002/01/29, *Case C-516/99, Schmid*, ECR 2002, I-4573.

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tion with every single participation, in which case, depreciation and losses would be deductible, and all profits resulting from the participation would be taxable.

Some other points relating to foreign participations would be changed. The minimum participation would be reduced to 10 percent, and the minimum holding period would be reduced to one year. The criteria for tax-free dividends of an Austrian subsidiary parent to an EU parent would correspondingly be reduced to a minimum participation of 10 percent and a minimum holding period of one year (section 94a, IITA, in Budget Law 2003). Indirect participations, via a transparent partnership, also would be eligible for the benefits of section 10(2) and (3) of the CITA.

Nevertheless, there still is the issue of incompatibility with the EC Treaty, as no minimum participation or minimum holding period is necessary for the benefits of domestic dividends to be tax-exempt. Furthermore, foreign dividends would not be exempt from CIT, but foreign tax that is below a certain amount would be credited, provided that the majority of shares in the Austrian corporation are held by Austrian residents (section 10(4), CITA, in Budget Law 2003). Under the new rules, the foreign dividends would not be exempt, regardless of whether the majority of shareholders were Austrian residents. The details of this change of the antiabuse rule of section 10(4) of the CITA remain to be seen.

In addition, the beneficial treatment of profits resulting from creditors waiving parts of their claims due to insolvency proceedings to avoid bankruptcy because of a judicial ruling would be treated the same way as for transparent trades and businesses (section 23a, CITA, in Budget Law 2003).

## VAT Act (VATA) Changes

The most notable changes in the VATA are the abolition of the extra VAT prepayment and the introduction of a special treatment for EU entrepreneurs in the business-to-customer field of e-commerce (section 25a, VATA, in Budget Law 2003). This is an adoption to article 26c of the Sixth EC Directive, which provides that those EU entrepreneurs can opt to be subject to VAT in only one member state.

## Conclusions

If passed, Budget Law 2003 will result in a considerable tax reduction. It eliminates some discrimination, such as the treatment of foreign investment, and introduces notable changes such as the more lenient prerequisites for international participations and options for the treatment of those participations, the treatment of retained earnings in partnerships, and the treatment of profits from the recapitalization of companies.

The political discussion in Parliament is not likely to lead to major changes, as it is focused on the nontax parts of the law. However, the discussions are quite controversial, and it is not clear if Budget Law 2003 will be finalized on 4 July, as planned.

✦ *Markus Christoph Stefaner is an assistant professor in the Department of Austrian and International Tax Law at the Vienna University of Economics and Business Administration.*