Austria

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With regard to local legal or regulatory provisions, administrative practices, the result of tax audits or case law, what is the position in your jurisdiction on the following transfer pricing issues that arise in the financial services sector:

I. Issue One

The use of residual profit split models in the global trading of financial instruments (i.e. the reward for research, structuring, sales, trading and back office functions).

The residual profit split method is one of two subcategories of the transactional profit split methods pursuant to which the net or gross profits derived from a transaction (or combined transactions) are split between entities according to the relative contribution of the enterprises involved. The profit to be split may either be the entire net or gross profit earned by the enterprises involved (contribution analysis) or — in case of the residual profit split method — the residual profit after the enterprises involved have each been allocated a basic functional reward (residual analysis).

As far as we can see, the Austrian tax administration does not explicitly refer to the use of the residual profit split method with respect to the global trading of financial instruments. As regards intra-group financial services, the Austrian Transfer Pricing Guidelines 2010 (*Verrechnungspreisrichtlinien*; VPR 2010) only refer to intra-group interest (para 87 et seq.), guarantees and letters of comfort (para 96 et seq.), factoring (para 99 et seq.) and cash management (para 101 et seq.). Therefore, as far as the global trading of financial services is concerned, general principles should apply.

According to general principles, the appropriateness of the method for a particular case should depend on the nature of the controlled transaction (functional analysis), the availability of reliable information (in particular on uncontrolled comparables) and the degree of comparability between controlled and uncontrolled transactions (including the reliability of potentially necessary comparability adjustments). Pursuant to para 43 VPR 2010, where traditional transaction methods (i.e. the comparable uncontrolled price method, resale price method and cost plus method) and transactional profit methods (i.e. transactional net margin method and transactional profit split method) can be applied in an equally reliable manner, the traditional transaction methods shall be preferred. However, in cases where reliable gross margin information may neither be gained from publicly available information on third parties nor from internal comparables, transactional profit methods might be considered as the more appropriate methods. As a consequence, the residual profit split method (as sub-category of the transactional profit methods) should only be applied where reliable gross margin information may neither be gained from publicly available information on third parties nor from internal comparables. Further, according to the OECD Transfer Pricing Guidelines 2010 (*OECD-TPG*), the main strength of the transactional profit split method is that it can offer a solution for highly integrated operations for which a one-sided method would not be appropriate. In this respect, para 2.109 OECD-TPG explicitly refers to the discussion regarding the appropriateness and application of profit split methods to the global trading of financial instruments between associated enterprises in Part III, Section C of the OECD's Report on the Attribution of Profits to Permanent Establishments (Authorised OECD Approach; *AOA*). As the Austrian tax administration typically follows guidance provided by the OECD, this reference should also be relevant with respect to the global trading of financial instruments in Austria.

II. Issue Two

The determination of the reward for providing capital in financial services businesses, e.g. global trading, including the extent to which it is deemed to be provided from the jurisdiction in which the decisions are made that put it at risk.

The reward for providing capital in financial business should be allocated in line with the functions carried out by the respective group company or branch. According to para 184 of the VPR 2010, a detailed examination of those functions is particularly important in case of permanent establishments located in countries having concluded a tax treaty with Austria applying the exemption method as the transfer of profits to such countries would result in a reduction of tax in Austria. Due to the specific situation within the banking and insurance sector, para 185 of the VPR 2010 provides for the application of the "key entrepreneurial risk-taking function" (*KERT*) approach as provided for in the AOA to determine the relevant functions within a company. As regards banks, the relevant KERT functions are considered to be carried out by the part of the company negotiating the financial

assets and taking care of its risk management. With respect to insurance companies, the decision regarding the assumption of risk is considered to be the relevant KERT function. As a consequence, the reward for providing capital could generally be considered to be attributed to the jurisdiction in which the decisions are made that put it at risk.

With respect to intra-group interest, para 87 of the VPR 2010 states that — in line with general transfer pricing principles — the arm's length interest rate should be determined by application of the comparable uncontrolled price method (*CUP method*) if comparable uncontrolled transactions can be determined at the money or capital market. However, if the comparable uncontrolled price shall be determined by comparison to commercial banks it would be necessary, that either (i) none of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions could materially affect the price in the open market or (ii) that reasonably accurate adjustments can be made to eliminate the material effects of such differences (see also para 2.14 OECD-TPG). However, according to para 88 of the VPR 2010, a direct comparison between financing by commercial banks and intra-group financing should in many cases not be possible as commercial banks and other companies usually follow different entrepreneurial objectives.

While the banking sector seeks to make business profits by lending money, other groups of companies usually aim at the maintenance of liquidity, an optimal allocation of capital within the group and an optimisation of interest income. Therefore, the debit interest rate applied by commercial banks may only serve as an upper limit of an arm's length interest rate. Whether such upper limit may be applied is dependent on the factual situation at hand and has to be assessed by the local tax office in consideration of currency and duration of the credit, the credit worthiness of the borrower, inevitable currency risks and possible refinancing cost vis-à-vis third parties. With respect to the credit worthiness of the borrower, one will also have to consider that within multinational groups of companies, the top company is usually in the position to influence the capital structure and, therefore, the credit worthiness of the borrowing group companies. Therefore, it is also considered to be within the sphere of influence of such top company to provide collaterals for loans taken out by its group companies. As a consequence, pursuant to para 89 of the VPR 2010, only an interest rate for collateralised loans may serve as comparable interest rate. On the other hand, the credit interest rate of commercial banks may serve as comparable if the lending group company is in possession of sufficient liquidity, because in such a scenario, according to the Austrian tax administration, it cannot be expected that the financing of group companies results in a higher profit than bank deposits (see para 90 VPR 2010).

III. Issue Three

The appropriate transfer pricing methods to be used for the allocation of investment management fees (i.e. for investment management, sub-advisory, marketing and administration).

If the strategic management of a multinational group of companies is performed by a foreign group company, any remuneration for these management services charged to Austrian group members must be at arm's length (i.e. such remuneration must correspond to fees generally charged for respective management services on the market; see also Austrian Ministry of Finance, Express Answering Service; *EAS* 312). In general, only charges in relation to the business of the Austrian group member may be deducted as expenses in Austria, while services rendered by foreign group companies in their capacity as shareholder may not be deducted (shareholder activities). According to the Austrian Ministry of Finance, the following expenses may not be deducted if charged to an Austrian subsidiary (see para 85 of the VPR 2010):

- costs of the management board, supervisory board and shareholders' meeting, unless those costs are directly related to the business of the subsidiary (e.g. the management board of the parent company negotiates contracts on behalf of its subsidiary);
- costs in relation to the legal organisation of the group as such (e.g. consolidation of the group balance sheet);
- costs of the top group company regarding statutory reporting obligations (e.g. costs for US-SOX-Reporting);
- costs relating to the administration and organisation of the group, determination of group policy, financial planning and restructurings;
- costs regarding the acquisition and holding of the participation in the subsidiary;
- costs for all other activities required by company law (contrary to *in personam* obligations);
- costs for obtruded services which are not wanted/needed by the subsidiary;
- costs in relation to the support of the group including the right to use the group name;
- costs in relation to the granting and using of advantages resulting from an increase in efficiency and synergy effects in the group.

However, pursuant to para 86 of the VPR 2010, Austrian group members may deduct expenses charged in connection with the following services:

- consultancy services in relation to economic and legal matters of the Austrian subsidiary including accounting matters;
- temporary secondment of personnel (including management);
- training and education of personnel employed in the Austrian subsidiary;
- certain on-call services in line with market conditions where the necessity for such services within the subsidiary can be documented;
- regulation of production and investment if performed in the interest of the subsidiary;
- costs of an on-going group audit if the subsidiary is relieved from the requirement of an own audit;
- consulting for and financing of the acquisition of participations by the subsidiary;
- management fees.

With respect to such intra-group services, the associated enterprises should, in general, adopt direct-charging agreements, particularly where services similar to those rendered to associated enterprises are also rendered to independent parties. However, if

such direct-charge method is economically unacceptable, especially because of the cost allocation, an indirect-charge by way of a group apportionment may be applied (see para 75 VPR 2010). In such a case, a group apportionment agreement is required (for further details, see para 82 VPR 2010). Contrary to mere cost contribution agreements, such apportionment agreements have to foresee a mark-up as the profit may not be influenced by the method to charge such services.

As regards the determination of the arm's length price, the CUP method should be preferred. However, in case of a lack of comparables, services should generally be charged by applying the cost plus method and considering all direct and indirect costs necessary to render the service (see para 76 VPR 2010; EAS 312).

IV. Issue Four

The appropriate transfer pricing methods to be used for the allocation of insurance premiums (i.e. between product development, sales, underwriting, captive reinsurance (especially), asset management and claims handling/administration).

As far as we can see, the Austrian tax administration does not provide general guidance regarding the appropriate transfer pricing method to be used for the allocation of insurance premiums. Therefore, as the Austrian tax administration usually follows the guidelines issued by the OECD, the general principles as laid down in part IV of the AOA should apply.

In addition, Art 7(5) of the tax treaty between Austria and Switzerland provides for a provision regarding the attribution of income to permanent establishments of insurance companies pursuant to which the profit of the permanent establishment shall be calculated by applying the so called gross-premium-ratio (*Rohprämienschlüssel*; i.e. the ratio of the gross premiums collected by the permanent establishment to the total gross premiums collected by the enterprise) to the overall profit of the enterprise. A similar provision with explicit reference to the attribution of profits of insurance companies was also included in the Protocol regarding the tax treaty between Austria and Germany of 1954 (i.e. before its revision in 2000). In August 2000, such tax treaty was revised in line with the respective provision of Art 7(4) OECD-MTC (before its revision in 2010). Pursuant to this provision, profits of a permanent establishment may be determined indirectly on the basis of an apportionment of the total profits of the enterprise to its various parts, insofar as such approach has been customary in the other contracting state and if the result of the adopted method is in accordance with the principles contained in Art 7 OECD-MTC (in this respect, see also para 247 et seq. VPR 2010). Although this new provision of the tax treaty concluded with Germany did not contain any reference to insurance companies or a specific method for such apportionment of the total profits, the Austrian Ministry of Finance states that such revision was not intended to amend the method regarding the attribution of profits to permanent establishments of insurance companies as it was previously applied between Austria and Germany. Therefore, the gross-premium-ratio should, in principle, also be applicable under tax treaties concluded by Austria which contain a provision corresponding to Art 7(4) OECD-MTC (before its revision in 2010). Further, an insurance company should also be allowed to apply another method for the attribution of profits to a PE that does not exclusively refer to the gross-premium-ratio if such method (and finally the ratio for the attribution of profits) is agreed with the tax administration of the other contracting state (see EAS 2668 regarding the attribution of profits to Austrian permanent establishments of German insurance companies).

V. Issue Five

The attribution of capital (and its reward) to branches of banks and insurance companies.

As regards the attribution of capital to permanent establishments and its reward, one has to distinguish between the attribution of non-interest bearing free capital and interest bearing debt. In case of foreign enterprises establishing branches in Austria, the Austrian tax administration generally seeks to attribute free capital in accordance with internationally accepted approaches to guarantee a uniform attribution of free capital in both jurisdictions (e.g. EAS 728 and 753 regarding German banks and EAS 818 and 942 regarding Dutch banks establishing branch offices in Austria). As regards the attribution of free capital to permanent establishments, the Austrian VPR 2010 refer to the principles provided for under the AOA. Therefore, a permanent establishment is generally treated as having an appropriate amount of capital in order to support the functions it performs, the assets it uses and the risks it assumes. Pursuant to para 199 of the VPR 2010, free capital is not only considered a share in the company's equity and retained profits but also a share in any supplementary capital (*Ergänzungskapital*), if the remuneration paid to the respective investors is non-deductible for income tax purposes (as is the case with dividends paid to shareholders). As a consequence, capital derived from the issuance of jouissance rights considered as equity for income tax purposes (*Substanzgenussrechte*) would also have to be considered as free capital from an Austrian perspective.

According to the Austrian tax administration, any equity disclosed for accounting purposes of a PE can only be relevant for tax purposes if it was determined in accordance with one of the capital allocation methods authorised by the OECD. While the Austrian tax administration makes particular reference to the allocation of capital in the banking sector (by referring to part II of the AOA), as far as we can see, no such reference is made with respect to the insurance sector. However, as the Austrian tax administration generally follows a dynamic approach in considering the guidelines provided by the OECD, the approaches described in part IV of the AOA 2010 should apply. Para 200 of the VPR 2010 refers to the following capital allocation methods authorised by the OECD:

- *Capital allocation approach:* As regards the application of the capital allocation approach to branches of banks, para 204 of the VPR 2010 refers to the risk-weighted allocation of capital following the Basel standardised regulatory rules as described in part II of the AOA (2008). Under this approach, a

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bank's free capital (i.e. the free capital used to assume the risks from the bank's operations) is allocated in accordance with the attribution of financial assets and risks (by first attributing assets and risks and then risk-weighting the assets following the Basel standardised regulatory rules). Capital is allocated to the permanent establishment on the basis of the proportion that the risk-weighted assets of the permanent establishment bear to the total risk-weighted assets of the entity as a whole (the BIS ratio approach). So if, for instance, the permanent establishment has 10 percent of the bank's risk-weighted assets, 10 percent of the bank's free capital will have to be attributed to the permanent establishment (see also para II/98 et seq. AOA 2010 regarding banks and para IV/131 et seq. AOA 2010 regarding insurance companies).

- *Economic capital allocation approach:* The economic capital allocation approach focuses on the economic capital assessed in accordance with bank internal risk models (rather than risk allocated in accordance with regulatory provisions). Therefore, this approach also takes into account aspects and factors that are not considered under regulatory provisions (see also para II/106 AOA 2010). Pursuant to para 205 of the VPR 2010, such approach may not be applied to enterprises outside the banking sector.
- *Thin capitalisation approach:* Pursuant to para 206 of the VPR 2010, the thin capitalisation approach requires a permanent establishment to have the same amount of free capital as an independent enterprise carrying on the same or similar activities under the same or similar conditions in the country of the permanent establishment by undertaking a comparability analysis of such independent banking enterprises (a thin capitalisation approach). In case of differences between the comparables, certain adaptations in the calculation may be required. If the allocated free capital is below such arm's length result, interest relating to the difference between allocated capital and the arm's length capital requirements becomes non-deductible for tax purposes (see also para II/107 et seq. AOA 2010 regarding banks and para IV/153 et seq. AOA 2010 regarding insurance companies).
- *Quasi thin capitalisation/regulatory minimum capital approach:* Under the quasi thin capitalisation approach, a permanent establishment is required to have at least the same minimum amount of free capital as the regulator in the host country would set for an independent banking enterprise operating in the host country (see also para II/112 et seq. AOA 2010 regarding banks). Pursuant to para 207 of the VPR 2011, such quasi thin capitalisation approach may only be applied in the banking sector (apparently contrary to para IV/156 et seq. AOA 2010 regarding insurance companies).

As regards the reward for the provision of interest-bearing debt to a permanent establishment, see Issue Two above.

VI. Issue Six

Transfer pricing issues arising from the restructuring of banks — for instance, where one subsidiary administers the loans of another subsidiary which is not permitted to make new loans, or where one subsidiary transfers complex financial assets to another subsidiary.

Austrian tax law does not contain specific provisions regarding transfer pricing issues in connection with business restructurings. Although the Austrian VPR 2010 deal with transfer pricing issues related to business restructurings in para 129 to 147, they do not explicitly refer to the restructuring of banks.

However, under general principles, any business restructuring should be reviewed from the perspective of the arm's length principle. Although the arm's length principle as such does not require compensation for loss of profit/loss potential per se, a company with considerable rights and/or other assets at the time of the restructuring must be appropriately remunerated in order to justify the sacrifice of a loss of profit potential. In this respect an analysis of functions before and after the restructuring is necessary to determine the amount of compensation the transferring company is entitled to receive and to determine which group companies are obliged to pay such remuneration. In this respect, it also has to be taken into account whether the companies — as fictitiously independent parties — could have refused to participate in the restructuring, because they had alternative business opportunities (see para 134 of the VPR 2010). Therefore, as regards the above mentioned subsidiaries not permitted to make new loans or the subsidiaries transferring the financial assets, it would also have to be considered whether or not these companies suffered a loss in profit potential and whether they had alternative business opportunities. If this is the case, an adequate compensation would have to be paid.

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