summary

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double taxation treaties between austria and developing countries

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a legal and economic analysis

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This research builds on an interdisciplinary approach, combining both a legal and an economic perspective. The legal analysis explains (i) the various functions of the main international tax agreements, (ii) Austria's double tax treaty (DTT) policy, and (iii) the potential benefits and risks faced by developing countries under a DTT with Austria. In the economic section, by using empirical methods we analyze whether or not DTTs contribute to encourage Austrian foreign direct investment (FDI) in developing countries.

Due to the fact that the OECD Model Tax Convention has been used as a basis for most tax treaty negotiations, it is mostly the capital importing country (i.e. typically a developing country) that foregoes tax revenue when there are two countries with an asymmetric investment pattern. Although developing countries are free to negotiate DTTs as they see best, in practice this is not always the case. Developing countries may be at a disadvantage, for three main reasons: (i) they often lack strong negotiation and bargaining powers, such as enough expertise to negotiate DTTs, (ii) they have a prevailing and urgent need to attract FDI, and (iii) there is pressure to meet internationally accepted standards.

Austria's favourable tax system coupled with its large tax treaty network may play a role in a company's decision to invest in Austria. While formerly, Austrian tax treaty negotiators primarily aimed to boost tax revenues for Austria, increasing the attractiveness of Austria as a business location is now seen as the main function of its DTTs.

Austria is quite successful in establishing itself as an attractive business location. About 300 foreign firms have established regional headquarters to serve the Central and Eastern European (CEE) markets and over 1000 MNEs coordinate their CEE activities from a base in Austria. Austria also positions itself as an attractive location for Special Purpose Entities, or SPEs. These are entities with little economic activity in Austria that are used to manage the flow of funds within a multinational group. Even though there were only about a dozen of these SPEs located in Austria, they made up about a third of Austria's outbound and inbound FDI stocks in 2011. Some SPEs might arguably be used for tax avoidance purposes to channel investments and intra-group financing from one country to another through conduit structures.

Austria has concluded 87 double tax treaties, of which 40 are with developing countries (37 in force, three are signed but not yet in force). Austria has negotiated treaties mainly with countries with which it has close economic ties. Accordingly, Austria's treaty network with developing countries in Asia is quite narrow, and it has very few DTTs with African and Latin American countries. Only five treaties with countries in Latin America and one treaty with a sub-Saharan country (South Africa) are in place.

Austria's tax treaties closely follow the OECD Model Tax Convention. With its DTTs, Austria pursues four goals, namely to: (i) prevent international double taxation, (ii) foster bilateral economic relations, (iii) increase legal certainty, and (iv) prevent international tax avoidance and tax evasion.

Concerning the allocation of tax revenues between Austria and its treaty partners, Austria seeks to reduce source taxation as much as possible. With regards to passive income, royalties are generally exempted in the source country and, therefore, exclusively taxed in the residence country (which typically, in relation to developing countries, is Austria). Austria also tries to keep the taxation of interest income and dividends as low as possible, going even beyond the OECD standards.

With regards to active income, a delicate issue of DTTs with developing countries is the so-called "Service PE" provision, which Austria tends not to include in its double tax treaties, as it is not part of the OECD Model Tax Convention. In the absence of this Service PE provision in Austrian tax treaties, services rendered by, for example, Austrian companies would technically not constitute a PE in other countries, but they would be treated as business profits which are exclusively taxed in the residence country (i.e. Austria). This may open the possibility of shifting taxable profits to Austria by charging management fees to a company located in a developing country.

All Austrian DTTs (except for the one with Luxembourg) provide for the exchange of information concerning tax matters. For a long time, Austria has had major information exchange clauses only with OECD countries. Other countries, especially developing countries, were only offered minor exchange clauses. A minor clause only allows the exchange of information that is relevant for the application of DTT provisions. One reason might be that offering "too much" administrative assistance to other tax authorities, may constitute a "competitive disadvantage" for Austria.

From our legal analysis we can conclude that Austria (i) disproportionally allocates taxation rights to the residence country (which typically, in relation with developing countries, is Austria) thus potentially inducing a loss in revenue for developing countries, and (ii) limits a developing country's access to satisfactory exchange of information according to OECD standards. Therefore, developing countries that sign a DTT with Austria can only hope that revenue sacrificed is offset with the attraction of new FDI that a DTT may bring. But is this the case?

The econometric analysis suggests that DTTs significantly encourage the number of Austrian FDI projects in developing countries. As Austria mainly has DTTs with middle-income countries (except for Tajikistan and Nepal), our results are in line with some academic research that finds that the presence of DTTs triggers increased FDI in middle-income countries. Our results suggest that the number of Austrian investment projects in middle income countries increases by 25.2% to 33.7% when a DTT is in place.

However, these figures should be taken with some caution. It is not totally clear, whether DTTs trigger more FDI or whether rather Austria signs DTTs with countries where Austrian firms are already active. Second, the method used captures short term-effects only. In the long run, the impact of DTTs on FDI may be different. Finally, it should also be considered that about a third of Austrian FDI projects in developing countries actually originate from third countries, as international firms use their Austrian subsidiaries for investing in other countries, including developing countries. In the econometric analysis, it is impossible to prove or discredit whether firms that invest in a respective developing country via Austria are doing so simply because of a DTT between Austria and a respective developing country. That is, our results may capture some treaty shopping, which could also lead to an overestimation of the effect of DTTs on Austrian FDI activity.

Our general conclusion is that signing a tax treaty with Austria entails both potential benefits and risks for developing countries. It would be advisable for developing countries to conduct tax treaty impact analyses in order to be able to estimate their potential effects. Such analyses could also shed light on which provisions to be included (e.g. the exchange of information in line with OECD standards, allocation of taxation rights in line with the UN Model that is more favourable for developing countries, etc.) or to be adapted to achieve desired goals (e.g. for the exchange of information, for attracting FDI, for political reasons such as responding to pressure either from other countries or international organizations, etc.). In the case that attracting FDI is the main goal for developing countries to enter into DTT settlements, caution should be exercised with whom and under which terms tax treaties are negotiated. This is, for instance, to avoid "treaty shopping" scenarios, where foreign investors may prefer to use conduit companies established in countries with more favourable tax treaty networks (i.e. less taxation rights for the source country) rather than investing directly in a given country.

Also for Austria, the results of this study are relevant. The growing internationalization of the Austrian economy implies that its international tax policy impacts other countries. In its Development Cooperation Law (Entwicklungszusammenarbeitsgesetz), Austria commits to consider the goals and principles of its developmental policy in all policy areas that affect developing countries.[1] In the light of this "policy coherence" principle, Austria might, for example, need to re-examine how its tax treaty policy with regard to withholding tax rates affects resource mobilization in developing countries.

Finally, there is ample room for further research. Most economic studies, including the present one, assume all tax treaties to be identical. Surprisingly little is known about how these different types of tax treaties impact on FDI. In addition, further empirical evidence on how tax treaties affect tax revenues of signatory states is needed. Corporate taxes, as well as withholding taxes, can be a significant source of revenue for developing countries. Also, case studies analysing the benefits and disadvantages of individual tax treaties could be very insightful. However, not least because of the scarcity of available data, conducting such studies may be very challenging.

[1] Austria has embraced the principle of Policy Coherence for Development in its national law:"Der Bund berücksichtigt die Ziele und Prinzipien der Entwicklungspolitik bei den von ihm verfolgten Politikbereichen, welche die Entwicklungsländer berühren können." (Entwicklungszusammenarbeitsgesetz, §1 (5))

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