Bulletin

Nr. 23 · January 2012

Allgemeines Treuunternehmen
since 1929

Tax planning for Liechtenstein companies with permanent establishments in Switzerland

Author
lic. iur. Ralph Thiede
Swiss Certified Tax Expert

Present situation

Switzerland and Liechtenstein have traditionally maintained close, neighbourly economic relations. The same cannot be said, however, in reference to tax matters. A "rump agreement" that primarily regulates taxation of cross-border commuters and other tax issues has been in place between the two countries since 1995, but this agreement does not cover Swiss withholding tax or Liechtenstein's coupon tax (which although abolished as of 1 January 2011 still applies to the distribution of earnings and reserves that already existed prior to that time). When, for example, a Swiss company, be it a public limited company (AG) or a private limited company (GmbH), pays a dividend to a shareholder with a registered office or place of residence in Liechtenstein, swiss withholding tax in the amount of 35% is levied and remitted to the Swiss Federal Tax Administration, which means the shareholder receives 65% of the actual payout. There are, however, no provisions for obtaining a refund of this withholding tax. This major tax disadvantage is also not likely to be abolished in the foreseeable future. As a result, the question arises as to the availability of planning options that would make it possible to eliminate or at least reduce the impact of this disadvantage in practice.

a) *Involvement of an intermediate holding company located outside Liechtenstein* in a jurisdiction from which it is possible to claim a refund of the 35% withholding tax from the Swiss tax authorities (and which itself imposes no tax at the source or only a very low tax on dividends as compared with Liechtenstein).

   In order to rule out the possibility that such an intermediate entity is considered to be nothing more than a vehicle for tax avoidance, it must not only physically exist (which entails maintenance of operational offices with personnel and the corresponding infrastructure) but also be amenable to demonstration of strategic, entrepreneurial (non-fiscal) grounds for its existence (e.g. holding entity structured to bundle all strategic investments of the Liechtenstein company). The expense entailed by such an intermediate holding entity should not be underestimated and can be justified only if the tax savings will consistently exceed the cost of maintaining the entity.

Asset structuring and asset protection, family office, succession planning, international tax advice and tax planning, legal advice, trusts, foundations and companies, holding and patent management companies. ***Focus on: Tax planning for Liechtenstein companies with permanent establishments in Switzerland.*** *Processing of corporate business, bank selection, investment funds and insurance matters, accounting and auditing, change of residency, asset structuring and asset protection, family office, succession planning, international tax advice and tax planning, legal advice, trusts, foundations and companies, holding and patent management companies, processing of corporate business, bank selection, investment funds and insurance matters, accounting and auditing, change*

b) *Registration in a third country for tax purposes of a company domiciled in Liechtenstein* in a jurisdiction from which it is possible to claim a refund of the 35% withholding tax from the Swiss tax authorities.

   This option requires that the company itself remain registered in Liechtenstein while transferring its tax residency abroad, for example by relocating "management or ultimate control" from Liechtenstein to another country. In order to ensure that Switzerland actually does refund the withholding tax to the shareholder, registration in a third country for tax purposes will also necessitate proof to the effect that the company's management or ultimate control has actually been relocated abroad, and it will be necessary to fulfil the same conditions as regards its physical presence abroad as in the case of the involvement of an intermediate entity. Furthermore, the refund must not result in tax avoidance.

c) *Transfer of taxable income of the Swiss company to another country under an arm's length agreement* to reduce the potential anticipatory tax liability. In practice, it is often difficult to provide the Swiss tax authorities with a convincing arm's length comparison in the case of related companies as neither country's legislation recognises explicit guidelines for the treatment of transfer pricing.

   This often results in challenging questions at the level of fiscal practice. For example, what possibilities exist for accurate determination of permissible compensation for managerial activities performed in Liechtenstein for the Swiss company? Or what other expenses can be charged to the Swiss company without resulting in financial benefits or hidden dividends, which would even increase the withholding tax liability to 54% (in the event the withholding tax is not paid and is passed on to shareholders)?

All three of these planning scenarios have in common that the reduction or elimination of the withholding tax liability will entail expense and planning effort that should not be underestimated. The tax adviser can also provide no guarantee that the desired tax reduction will in fact materialise. Legal certainty will regularly be possible only if the solution adopted is negotiated with the responsible tax authorities proactively and agreed upon in writing (tax ruling).

Permanent establishments in Switzerland

a) No withholding tax liability for permanent establishments

Another option involves treatment of operating activities in Switzerland as though they were carried out by a "permanent establishment" of the Liechtenstein company (headquarter). According to Swiss tax regulations, a permanent establishment is a non-independent entity with a limited tax liability that is exempt from payment of withholding tax on its income.

The simplified example presented below shows how opting for a (non-independent) permanent establishment can be more advantageous than for an (independent) public limited company or private limited company as far as tax considerations are concerned:

	AG	PE	
Income *before* taxes CH	100	90	
Income *before* taxes LI		10	(Assumption: percentage for management LI = 10%)
Tax rate CH	21.17%	21.17%	(Effective 2011 tax rate Zurich, cantonal and federal)
Tax rate LI		12.50%	
Tax CH	21.17	19.05	(90 x 21.17%)
Tax LI		1.25	(10 x 12.50%)
Total tax	21.00	20.30	
Income *after* taxes and *before* distribution	79.00	–	
Distribution to company (LI)	79.00	–	
Minus 35% withholding tax	27.65	–	
Income *after* distribution	51.35		
Tax LI	0		(Dividends exempt from taxation)
Income *after* taxes	51.35	79.70	
Total tax liability	**48.65%**	**20.30%**	

This comparison shows that the total tax liability of a public limited company will be more than twice as high as that of a permanent establishment.

b) Definition of a permanent establishment

For the purpose of *Liechtenstein* tax law, the term "permanent establishment" covers any permanent entity used, partially or entirely, to engage in the economic activity of a company or independent contractor. Any of the following may constitute a permanent establishment:

i. Location of actual management;
ii. Branch;
iii. Office;
iv. Production;
v. Sales or procurement office;
vi. Workshop;
vii. Facility for the exploitation of mineral resources;
viii. Plant for the exploitation of water power;
ix. Construction project or building site with a duration of more than six months.

From the *Swiss* perspective, the term "permanent establishment" is used to designate an entity created for the purpose of assuming responsibility for all or part of the operating activities of a company such that a significant percentage, in terms of quality and quantity, of the activities of a company whose central management is otherwise located elsewhere is carried out, sporadically or consistently, with a certain degree of autonomy. The term "permanent establishment" is used for the purposes of tax law and may, but need not, differ from the term "branch".

Unlike Liechtenstein, Switzerland explicitly rules out the "location of actual management" as a permanent establishment. On the other hand, a "permanent representative office" may acquire the designation of a permanent establishment. A construction project or building site must have a duration of at least 12 months.

c) Taxation of permanent establishments

As far as *Liechtenstein* is concerned, income generated by a permanent establishment in another country is exempt from taxation. Under new Liechtenstein tax legislation, a permanent establishment also need not be registered as a branch in the country in which it is based. Tax treatment as a permanent establishment suffices to shield the income of a foreign permanent establishment from taxation.

A permanent establishment in *Switzerland* of a foreign legal person is taxed on the basis of cantonal and federal regulations governing legal persons. Such an establishment's tax liability is limited to the income generated by or attributable to the permanent establishment. The tax base will be determined on the basis of the profit or loss shown in the separate accounts of the permanent establishment. In the event the permanent establishment does not keep separate accounts, its income will be determined on the basis of supporting evidence (according to its assets, sales revenues, personnel, wages, etc.). Taxable equity (endowment capital) will as a rule be determined on the basis of the entity's (capitalised) assets.

According to both Swiss and Liechtenstein tax regulations, income generated by a permanent establishment in another country is not taxable. Given this situation, the absence of a double taxation agreement represents no disadvantage for Liechtenstein. The domestic legislation of both countries – normally – precludes tax conflicts between headquarter and its permanent establishment.

But there is always an exception to any rule:

d) Location of actual management at the location of the permanent establishment

If the management of a legal person is located in Switzerland although the entity is actually registered in another country, the foreign company may be fully liable for payment of Swiss income and capital tax. In such a case, a company registered in Liechtenstein, for example, would have to file a tax return in Switzerland and pay income and capital tax. In the worst case, the company's income will be exposed to double taxation. Due to the absence of a double taxation agreement, such double taxation cannot always be avoided.

The phrase *"location of actual management"* is subject to interpretation and essentially corresponds to the phrase "actual management" as commonly used in the context of international tax law. Switzerland's Federal Supreme Court has ruled on this specific issue several times. In summary, it can be stated that *conduct of current business is in principle the determinative activity.*

The location of "mere administrative management" or "subordinate operating activities" is not determinative for the purpose of establishing the location of actual management. The activity of a company's ultimate corporate bodies may, however, be determinative. In the event the function of the ultimate corporate bodies (e.g. president or delegate of the administrative board, officers of the company or group) at the location where the activity takes place remains limited to control and certain decisions of principle, this will not suffice to consider that location to be the location of actual management. However, the greater the involvement in ongoing business activities at the operational level, the greater the risk becomes that the location of the ultimate corporate bodies will be assumed to be the location of actual management.

e) Withholding tax liability for permanent establishments

In addition to the location of "management in Switzerland", "operating activities in Switzerland" also represent a prerequisite for "residency" for the purpose of establishing liability for payment of withholding tax. According to prevailing opinion, this means *active involvement in the Swiss market that results in a flow of revenue from Swiss sources.* In recent years, the term "residency" for the determination of withholding tax liability has essentially become synonymous with the term as used for taxes on income.

Since a permanent establishment located in Switzerland qualifies as a non-resident entity, it is exempt from payment of withholding tax. However, if the headquarter location in another country is nothing more than a “phantom company”, this company may qualify as a resident entity, in which case the income of the permanent establishment in Switzerland and dividends paid by the parent location to its shareholders would then be subject to payment of withholding tax.

A phantom company will in practice be allowed to recover withholding tax only if it qualifies as a “resident entity” and is fully liable for income and capital tax. Even then, there is no guarantee that the tax will be refunded since the right to reimbursement presupposes payment of the stamp duty. But since a permanent establishment is not subject to payment of the stamp duty, there could be some question as to whether the refund is justified.

f) Requirements to be met by the Liechtenstein headquarter company

In order to avoid problems with tax constructs involving permanent establishments in Switzerland, the headquarter entity located in Liechtenstein must fulfil certain minimum criteria:

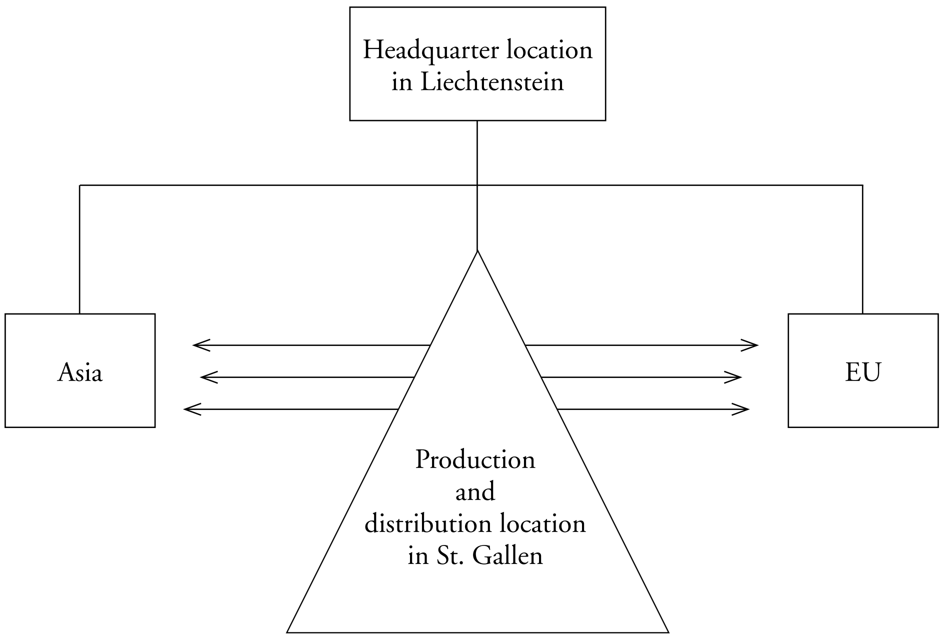
- *Local physical presence:* occupation of adequate offices with workstations;
- *Presence of personnel:* effective management from Liechtenstein, if possible under contract (management fee or salary split agreements), including documentation of strategic decisions, organisation and administration;
- *Financial means:* proof of adequate assets and/or sound financial and debt ratios for the headquarter company;
- *Organisational independence:* clear separation of headquarter and the permanent establishment, communication with own letterhead, telephone, fax, business cards, Internet, separate accounts for registered office and permanent establishment;
- *Fiscal independence:* compensation for major decisions and activities of the headquarter location in Liechtenstein in the form of an allocation quota in the amount of 5–20% that is taxed in Liechtenstein.

Tax planning options

a) Production and distribution location

An internationally active company based in Vaduz establishes a new location in St. Gallen for the production of semiconductors. The company’s shareholders reside in South America, where the group is headquartered. The administrative board consists for the most part of family members who reside in South America. Finished goods are sold to customers in neighbouring countries. The company has a total of 40 employees. Four people are employed at the headquarters in Vaduz (one executive officer from South America, one assistant and two managerial employees in the areas of sales and finance/accounting). The semiconductors are produced by the permanent establishment in St. Gallen, which operates as a branch and is registered as such in the Commercial Register. The semiconductors are sold by the branch, but Vaduz handles coordination of procurement and sales as well as invoicing.

In the case of this example, there would most likely not be the slightest doubt as to the existence of the Liechtenstein undertaking from the Swiss point of view. Liability for withholding tax would not be an issue here. Functions are clearly assigned to the headquarter and its production and distribution location. The latter would be taxed as a permanent establishment in Switzerland. The tax base would consist of that income that is generated through the production and distribution of the semiconductors as determined on the basis of the accounts of the permanent establishment.



In order to compensate the headquarter entity for its functions, the income of the permanent establishment would be allocated to the two entities such that a quota in the amount of, for example, 10% is assigned to the parent entity, which would then be taxed at a rate of 12.5%. As a result, 90% of the income would remain with the permanent establishment and be taxed at a rate of 16.88% (effective tax rate in St. Gallen, cantonal and federal, fiscal year 2011).

Total tax liability (exclusive of cantonal capital tax):

Headquarter:	10 x	12.50%	1.25
Permanent establishment:	90 x	16.88%	15.19
Total	100		16.44

Total tax liability: 16.44%

b) Commercialisation of intellectual property/patent management

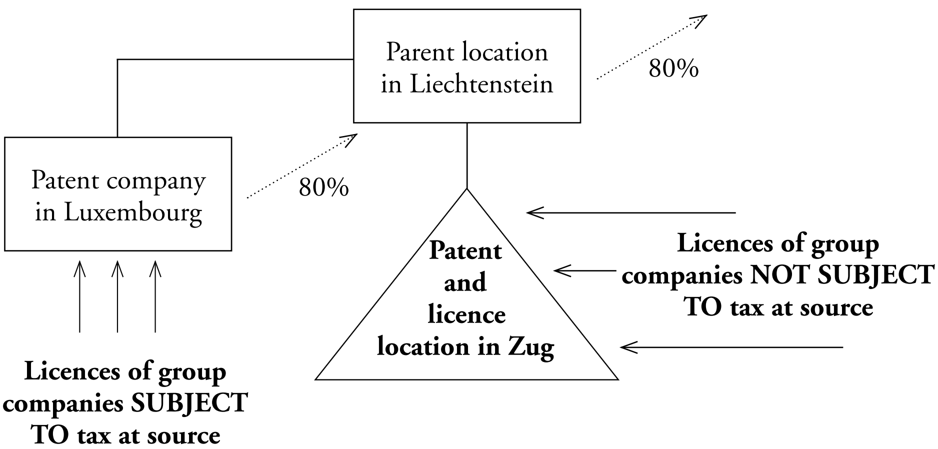
A pharmaceutical company based in India establishes a company in Liechtenstein to handle commercial exploitation of its intellectual property and patents. The contemplated purpose of this location is to support centralised registration, management and exploitation of all present and future patent rights. A total of nine specialists who are already employed by the group are to be assigned to these activities. It turns out to be difficult for them to obtain permission to reside in Liechtenstein. Only a single employee (head of the group's patent department) receives the required residence permit.

The group then decides to locate its patent management activities in Zug. Since the quota in Switzerland has not been filled, the remaining eight specialists receive residence permits for Switzerland and locate in that country. The company then leases the necessary premises in Zug and registers the office as a branch.

For tax purposes, the headquarter company or, as the case may be, the permanent establishment holds only those patents involving payments that are not subject to any foreign tax at source. The parent entity also establishes a company in Luxembourg. This company holds those patents that involve payment of royalties which are subject to payment of a tax at source in another country. Due to the existence of a network of double taxation agreements that spans the globe, this company can claim reimbursement of part or all of the tax withheld from royalties.

If a local presence is established that is organisationally independent (office and infrastructure), the Swiss authorities are likely to recognise Liechtenstein as the location of operational management. Even if only a single individual is employed at the headquarter for the purpose of handling the management and treasury functions associated with the respective royalty income, this would suffice to justify a profit margin (including an allocation quota for management services) for the headquarter in the amount of, for example, 60%.

After deduction of expenses, income from the exploitation of patents would be taxed at a rate of 12.5%, but new Liechtenstein tax legislation allows the company to transfer a flat 80% to its parent entity to cover the cost of the licence.



Taxation in Switzerland – This example is based on a permanent establishment that accounts for 40% of income (60% = headquarter). Since the permanent establishment is subject to tax regulations governing legal persons, it may apply to be treated as a "mixed company" at the cantonal level for the purpose of taxation of its business activities, which for the most part take place abroad (with an office with eight employees, the tax rate comes to 15% of income; see guidelines published by the Tax Administration of Zug, Taxation of Administrative Companies/ Mixed Companies). The effective tax rate on royalty income comes to approximately 9% (Zug, cantonal and federal).

Taxation in Luxembourg – Royalty income is subject to Luxembourg income tax in the amount of 28.8% (2011), but Luxembourg's IP box regime also permits transfer of a flat 80% to the parent location to cover the cost of the licence. Due to the new double taxation agreement between Luxembourg and Liechtenstein, the company would be able to distribute the remaining income (20%) to the parent location without incurring any tax losses.

Total tax liability (simplified, exclusive of cantonal capital tax):

Parent location:		
	60 minus 80% x 12.50%	1.50
	80 minus 80% x 12.50%	2.00*
Permanent establishment:		
	40 x 9.00%	3.60
Luxembourg:		
	20 x 28.60%	5.72
Total 200		12.82

Total tax liability: 6.41%**

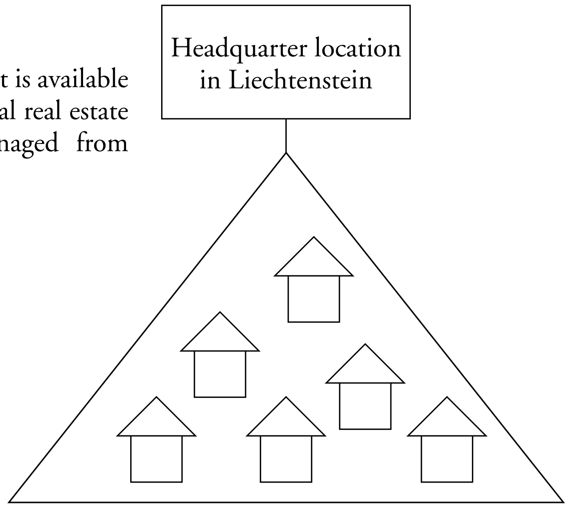
* Transferred royalty income from Luxembourg

** Assumption: no losses due to payment of foreign tax at source

In the case of this planning scenario, it would be necessary to take into account that the desired tax effect is achieved only if no foreign anti-abuse provisions apply that could conflict with the Liechtenstein IP box regime at the shareholder level (or at the level of the group companies making payment).

c) Investment/real estate management

An attractive planning variant is available for investments in commercial real estate in Switzerland that is managed from Liechtenstein:



Investment properties in Switzerland

Taxation in Switzerland – Swiss real estate is taxed where it is located (situs principle) regardless of the place of registration (in the country or abroad) of the real estate company that owns it. When real estate is held by a Liechtenstein company, management must actually be located in Liechtenstein as determined in accordance with Swiss criteria. In the case of a professional real estate broker or an insurance company that is effectively involved in managerial activities in Liechtenstein, compliance with these requirements is not likely to be questioned.

Taxation in Liechtenstein – Income from real estate located in other countries is exempt from taxation in Liechtenstein. Assuming no flat fee is paid for management services, the minimum corporate income tax will be CHF 1,200 per year.

This planning variant is especially worth considering in the case of Liechtenstein-based companies that hold sizeable real estate portfolios through a Swiss holding entity since withholding tax would then become a genuine cost factor. It is in practice possible to make the transition to a "permanent real estate establishment", especially since the treatment of restructured real estate complexes is tax-neutral or at least acceptable in most cantons.

d) Loan financing

An asset management company in Liechtenstein with foreign investors would like to pursue its asset management activities from Zurich and at the same time achieve optimal tax efficiency. As far as Liechtenstein is concerned, the activities in Zurich constitute a permanent establishment for tax purposes. At the intra-company level, the headquarter company finances this asset management arm with a loan (at 2.0% interest). The company then refinances this loan with a group loan (at 1.0% interest). The presentation of the corresponding entries for tax purposes is shown below:

Headquarter (HQ)

		Loan (1.0%)	2,000
Loan to PE (2.0%)	3,000	Equity	1,000
Total	**3,000**		**3,000**

Permanent establishment (PE)

Assets	3,500	Loan from HQ (2.0%)	3.000
		Endowment equity	500
	3,500		**3,500**

Taxation in Switzerland (not including capital tax) – Interest in the amount of 60 (2.0%) represents a tax-deductible expense that can be offset against income, which in the case of this example is also 60. There is therefore no income tax liability:

Income statement of PE

Interest expense (2.0%)	60	Income from financing activities	60
	60		**60**

Taxation in Liechtenstein – The interest expense in the amount of 20 (1.0%) incurred because of the group loan can be offset against the interest income of the permanent establishment in the amount of 60. Under new Liechtenstein tax legislation, 4% (interest rate for 2011) of the taxable equity can also be deducted, i.e. 40. As a result, there is no (consolidated) taxable income from financing activities:

Income statement of HQ

Interest expense (1.0%)	20	Interest income (2.0%)	60
Interest on equity (4.0%)	***40***		
Total	**60**		**60**

This simplified example shows that (consolidated) taxable income can be reduced by transferring activities (purely for tax purposes) from a headquarter location to a permanent establishment.

Conclusions:

New tax legislation in Liechtenstein contains regulations governing corporate taxation that Liechtenstein companies can also use to their advantage by doing business through Switzerland, with which no double taxation agreement exists. Since income from foreign activities is not taxed in either Liechtenstein or Switzerland, the use of a permanent establishment in Switzerland (but also in other countries) for tax purposes enables structuring that entail no losses due to payment of withholding tax or foreign tax at source. This presupposes, however, that clients are willing to bear the cost expense of maintaining the required presence of the Liechtenstein company in order to "buy" a tax effect that significantly exceeds that outlay.

The author of this article, lic. iur. Ralph Thiede, of Allgemeines Treuunternehmen, a Swiss Certified Tax Expert and Head of International Tax Services, will be pleased to provide you with further information.

ATU Bulletin is published in German, French, English and Italian. ATU Bulletin is an occasional publication of Allgemeines Treuunternehmen, Vaduz. The content serves only to provide general information and is no substitute for legal advice.

Allgemeines Treuunternehmen
since 1929

Allgemeines Treuunternehmen

Aeulestrasse 5 · P.O. Box 83
9490 Vaduz
Principality of Liechtenstein

T +423 237 34 34
F +423 237 34 60
info@atu.li · www.atu.li