Bulletin

No. 27 · January 2015

Allgemeines Treuunternehmen

since 1929

Reform of Liechtenstein's tax law

(Update on Bulletin No. 22)

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1. Overview

The aim of the amendments to Liechtenstein's tax law, which took effect on 1 January 2011, is to modernise the present legal order with regard to taxation by taking into account international developments. This should ensure that Liechtenstein continues to have a tax system which is attractive both nationally and internationally in future, while complying with the European requirements (especially fundamental freedoms and the regulations prohibiting state aid, including ring-fencing).

On 15 February 2011, the EFTA Surveillance Authority (ESA) approved the provisions for private asset structures and three-year transitional provisions contained in the new Liechtenstein Tax Act *(Steuergesetz – SteG)*. The ESA subsequently found fault with certain provisions on the ground that the calculation of the modified equity capital is incompatible with freedom of establishment and the free movement of capital in the case of foreign permanent establishments. This has made it necessary to amend the provisions.

Legal persons which are taxable in Liechtenstein and engaged in economic activity are subject to corporate income tax and the supplementary tax on gains from the transfer of real property. No capital tax is levied. From now on, corporate income tax at a uniform rate of 12.5% applies to a company's net income/profit, irrespective of the size of that profit and its distribution. Income and capital gains from participating interests are exempt, and there is no time limit on the use of losses carried forward (30% of current taxable income cannot be set off against losses, see Article 57(1) of the Tax Act). Furthermore, a notional interest deduction has been introduced. Other innovations contained in the Tax Act will also be important for Liechtenstein's development as an economic centre: group taxation for associated undertakings and conditions for handling revenue from intangible property rights. The Tax Act also contains conditions for the tax treatment of national and cross-border restructurings.

Moreover, the Tax Act has introduced modern taxation in groups for associated undertakings, which allows worldwide set-off of intra-group losses within the same period.

As a result, Liechtenstein now has an internationally competitive system of taxation of undertakings carrying on business, commerce or trade, of financial and other service companies, and of holding companies. However, a reduction of foreign tax deductions at source on dividends, interest and royalties is only achievable by means of double taxation conventions and by application to Liechtenstein of the Parent-Subsidiary and Interest and Royalties Directives.

Legal persons classifiable as private asset structures (PAS – see below) will generally remain eligible for the CHF 1,200 minimum corporate income tax.

The former 4% coupon tax has been abolished. However, old reserves must be taxed by the end of 2015 by applying a tax rate of 2.5%.

Below we explain the repercussions of the Tax Act on the various types of legal persons and dedication of assets. We limit ourselves to the most frequently asked questions to date, which will be the most important in daily practice.

2. Basic information on the tax amount

The following deals with all structures which are covered by the new provisions.

One innovation is that liability to tax is limited to net taxable income. Capital tax has been abolished and replaced by a tax on net income of 12.5% or, at least, by a minimum corporate income tax amounting to at least CHF 1,200. The minimum income tax forms part of corporate income tax, and the actual minimum amount can be offset against it.

Taxable persons whose sole object is to engage in business on a commercial basis and whose average balance-sheet total over the past three financial years has not exceeded CHF 500,000 are charged no minimum corporate income tax. Article 62(3) of the Tax Act is designed not to overburden small businesses which have legal personality but earn consistently low income, with minimum corporate income tax.

Trusts (settlement) are dedications of assets without personality, and pay only the minimum corporate income tax (CHF 1,200). Under Article 65 of the Tax Act, they are not assessed for tax.

Nevertheless, under Article 44, they still have a limited tax liability on their inland income.

Foundations (in this context, private-benefit foundations) are deemed legal persons in tax law. This means that they are subject to ordinary corporate tax on net income, like establishments, registered trust companies, private limited companies *(Gesellschaft mit beschränkter Haftung – GmbH)* and public limited companies *(Aktiengesellschaft – AG)*.

As stated, income tax amounts to 12.5% of taxable net income. It is important to note that a notional interest deduction is also claimable as a justified business expense. Hence the actual income tax will normally be lower. A foundation may well incur no tax liability apart from the minimum income tax if it only holds fixed-term deposits and bonds plus a participating interest, all of which are equity financed. This is because dividends and capital gains are exempt from the tax, and the fixed-interest deposits only yield income of 3%, for example.

3. Notional interest deduction

The actual tax amount depends not only on the 12.5% rate of corporate income tax, but also on the deductible interest on equity capital, claimable as a justified business expense. The notional interest deduction cannot result in or increase current losses. The target rate of notional interest on income is set annually and amounted to 4% from 2011 to 2015. This interest payment, justified as a business expense, is then calculated on

- paid-in share capital;
- plus taxed reserves (reserves constituting equity);
- minus own shares;
- minus participating interests in legal persons;
- minus non-operating assets;
- minus a deduction of 6% of all assets (excluding own shares, participating interests in legal persons and non-operating assets).

Thus everything on the assets side which is not liable to income taxation must be deducted. As dividends and capital gains are exempted, this means that participating interests, for example, must be deducted. Valuation takes place as of the beginning of the financial year. It must count acquisitions and disposals (equity and deductibles) of the current financial year. If the modified equity capital is negative, the equity capital interest deduction amounts to CHF 0.

Additions to equity capital in the current year from direct and indirect capital contributions as well as reductions in equity capital in the current year through capital reductions and capital repayments and direct or indirect distributions must be taken into pro rata temporis when determining the modified equity capital. In this connection, the additions and disposals occurring during a quarter must be consolidated and treated as if they had occurred in the middle of the quarter. The deductions from the equity capital, for example participations, must be recognised at their respective average value during the financial year for the purposes of determining the modified equity capital. The average value is calculated on a quarterly basis.

In practice, accounts are only drawn up once a year in the case of smaller structures. Then the sum of the initial and final values, divided by two, gives the weighted average.

The result of these calculations leads to a modified equity capital, from which the notional interest paid is worked out. From the notional interest deduction so determined, the difference between the actual interest rate and the interest rate on equity capital must be deducted in the case of claims against shareholders, founders and beneficiaries or persons related to them, who are taxed at the interest rate on equity capital. The necessity for the interest adjustment ceases, however, if the claims derive from the main activity of the legal person.

This rule suggests that mixed-income amounts and administrative costs, which count as taxable and non-taxable income, must be allocated to the cost centres in quotas or by cause. This would mean that only the expenditure attributable to taxable income would be deductible from the income, as business expenses. Alternatively, a debt-to-equity ratio may be introduced for the different activities, as in Switzerland.

The Tax Act merely refers to a modification of equity capital. A complex amendment of these problem areas cannot be expected. The Tax Administration has ruled this out, on the grounds that the Tax Act does not leave this room for manoeuvre.

3.1 Example

Balance sheet as of 31.12.

Liquid assets	100,000	Current liabilities	100,000
Receivables	350,000	Long-term liabilities	500,000
Shareholder loans (2 % interest)	50,000		
Participating interests (existing on 01.01.)	50,000		
Property, plant and equipment	450,000	Equity capital	400,000
Total	**1,000,000**		**1,000,000**

Calculation:	
Equity capital	400,000
less:	
- participating interest	-50,000
- assets (excl. weighted participating interest) = 950,000 × 6 %	-57,000
= modified equity capital	293,000
4 % notional interest deduction	11,720
2 % interest on shareholder loans: 1'000	
4 % interest on shareholder loans: -2'000	-1,000
Relevant notional interest deduction	**10,720**

4. Taxable and tax-exempt income

Taxable net income consists of the totality of income minus justified business expenses. In particular, taxable net income includes:

a) The balance of the profit and loss account
b) All parts of the trading result segregated for calculation of the balance which are not used to meet justified business expenses
c) Depreciation, amortisation, write-downs and provisions not justified for business purposes
d) Transfers to the reserve funds, not justified for business purposes, except any provisions enjoying tax relief (pursuant to Article 60 of the Tax Act)
e) Distribution of profits and undisclosed profits of non-participating rights (like usufruct rights or founders' rights) to members or associates or owners or persons related to them
f) Tax costs
g) Remuneration for the relinquishment of foreign capital to associated undertakings and shareholders, or persons related to them, provided that its level is compatible, not least, with the arm's length comparison principle
h) Voluntary payments of money to legal persons and special asset dedications based in Liechtenstein which are exempted from the tax liability, because their purposes are exclusively and irrevocably non-profit-making, where these payments exceed 10 % of the taxable net income before application of Articles 57 and 58 of the Tax Act; the same applies to legal persons and special asset dedications based in another member state of the European Economic Area or in Switzerland which are exempted from the tax liability in their country of establishment, because their purposes are exclusively and irrevocably non-profit-making and provided, also, that they meet the conditions for an application for tax relief
i) Penalties, money fines and similar legal consequences of a pecuniary nature, where punishment is the main feature
j) Repayments under article 307 of the Criminal Code *(Strafgesetzbuch)* (= corruption of public officials and similar offences)
k) The annual earnings of the fund in the cases of investments in undertakings for collective investment/investment funds

The following do not count as taxable net income pursuant to Article 48 of the Tax Act:

a) Income from the cultivation of foreign land used for agriculture and forestry, and from any other agricultural and forestry production abroad
b) Profits from permanent establishments abroad
c) Lease and rental income from real estate located abroad
d) Capital gains from real estate in Liechtenstein, where subject to capital gains tax on property in Liechtenstein, and capital gains from the disposal of real estate abroad
e) Shares of profit due to participating interests in legal persons in Liechtenstein or abroad
f) Distributions from foundations, foundation-like establishments and special dedications of assets with personality
g) Capital gains from the disposal, liquidation or unrealised gains in respect of participating interests in legal persons in Liechtenstein or abroad
h) Income from assets under management of undertakings for collective investments in transferable securities pursuant to the Undertakings for Collective Investment in Transferable Securities Act *(Gesetz über bestimmte Organismen für gemeinsame Anlage in Wertpapieren – UCITSG)*, of investment entities for other assets or real estate pursuant to the Investment Undertakings Act *(Investmentunternehmensgesetz – IUG)*, of alternative investment funds pursuant to the Alternative Investment Fund Managers Act *(Gesetz über die Verwalter alternativer Investmentfonds – AIFMG)* or a similar undertaking for collective investment organised under the law of another country
i) Income from the net assets of legal persons governed by the Pension Funds Act *(Pensionsfondsgesetz – PFG)*, provided that such assets are exclusively and irrevocably dedicated to occupational old-age pension provision

In addition, according to Article 47(4) of the Tax Act:

j) Capital contributions of members of corporations and cooperatives, including extra pay and non-returnable payments
k) Capital growth from inheritances, legacies or gifts
l) Capital contributions to foundations, foundation-like establishments organised in a way similar to a foundation and special dedications of assets with personality by the founder or beneficiary

Note that every investment is defined as a participating interest, irrespective of amount and/or length of time held.

Fund units which generate both interest income and capital income must be analysed accordingly for tax purposes (using the transparency approach). Fund units do not count as equity securities, even when they are in the form of SICAVs or SICAFs. However, a simple framework consisting of three categories has been created for mixed funds (percentage of shares over 50 %, percentage of shares between 20 % and 50 %, and percentage of shares under 20 %). The proportional tax exemption from net income for the year is worked out as a lump sum for each category, and the same percentage is used to determine the proportion of the share comprised of equity securities as well as for the purposes of determining the modified equity capital.

An amount of 80 % of total positive revenues from intangible property rights counts as a justified business expense. The government has regulated the details by ordinance.

5. Tax liability of establishments, registered trust companies, Aktiengesellschaften, GmbHs and foundations (= legal persons)

No distinction exists between a non-commercial business (e.g. holding activity) and a commercial business (e.g. trading in goods). The provisions follow the requirements of the EFTA Surveillance Authority (ESA). The legislation has included private asset structures (PAS – see below).

In short, a legal person will only match the required characteristics of a PAS if it pursues no economic activity. One example is the investment of assets at banks (fixed-interest deposits, bonds and equities) without trading for commercial gain; another is the holding of gold, paintings and similar valuables, likewise without trading. Investments by a legal person in participating interests which are actually under the influence of one of the stakeholders (including beneficiaries) are incompatible with the law on the PAS.

In principle, therefore, legal persons have an unlimited tax liability on their world net income. The rate of taxation of this income is 12.5 %. This is definitely attractive, provided that these legal persons are recognised abroad, can invoke the double taxation network to be developed, etc. A practitioner versed in tax law will, however, quickly realise that, if the other parameters are extended (especially the freedom of movement of persons), Liechtenstein will have an uphill task to persuade other countries to depart from the existing measures against abuse so that Liechtenstein's structures can also be used abroad with legal certainty. From this point of view, foreign clients will then become insistent that it makes little sense to pay corporate income taxes in Liechtenstein while, in some circumstances, there is no recognition of the company abroad. The approach to results from permanent establishments abroad which are not counted as taxable net income might, at least, offer a remedy to this.

The liability of legal persons to pay income tax is associated with the criteria of registration in Liechtenstein or place of effective management (unlimited tax liability) or to the existence of a permanent establishment in Liechtenstein (limited tax liability). This enhances international compatibility.

The place of effective management means the centre of the senior business management. The place where strategic management decisions which have a decisive effect on the respective undertaking are taken is the place of effective management. In construing the place of effective management, it must be noted that senior management will not be in Liechtenstein if a site is bound, from within, by the instructions of a business owner abroad.

In a position statement dated 24 August 2010 (Position Statement No. 83/2010), the government of Liechtenstein reiterates: "The government proposal defines the place of effective management as the location of the senior business management and, therefore, the point giving rise to the unlimited tax obligation and the element giving rise to regulation as business branches. The location of the senior business management is wherever strategic decisions of management are made. It is immaterial where these decisions are implemented or become effective. These strategic decisions of management must determine the respective undertaking's fate. A one-off resolution is not sufficient for this purpose, neither is limited decision-making authority within clearly predetermined bandwidths. Thus a choice between several investment items, within the bounds of a clearly predetermined investment strategy, does not, of itself, constitute a strategic decision of management. Nevertheless, the government contends that it is neither feasible nor desirable to give a universal and, at the same time, precise statutory definition of this term. Comparison with other countries' equivalent rules has shown that no such statutory definition is given since locating the place of effective management mostly proves less contentious. The exact delineation of this criterion is a matter for practice and legal precedent, and the requirement is to apply the rule reasonably and proportionately."

This means that a Liechtenstein undertaking de facto pursues its activity/makes its sales in a foreign permanent establishment, by virtue of the answerability of the Liechtenstein organ to the instructions of the foreign mandator. The foreign country often accepts this without much ado, on the grounds of the foreign provisions against abuse. Accordingly, the Liechtenstein undertaking will certainly keep books relating to permanent establishments and file a tax return in Liechtenstein. However, if the facts are as described, it will only pay the minimum corporate income tax. Nevertheless, it would be desirable if Liechtenstein could work towards dismantling the provisions against abuse, in the context of this new Tax Act. Until then, establishments, registered trust companies and *Aktiengesellschaften* will not uncommonly come under a foreign permanent establishment, provided that a Liechtenstein trustee serves as an organ. This applies to the company forms listed above, no matter whether they trade in goods, merely administer/exploit patents or are engaged in the holding and real-estate sectors. Thus, in terms of the tax system, it is already possible to speak of opting in to a given set of facts.

This solution can hardly be open to foundations, because the foundation board is not bound by instructions. It would also be an inappropriate solution. A foundation administering assets will have no permanent establishment abroad, because it makes its strategic management decisions in Liechtenstein. It would still be possible to base most of the organs abroad and take all decisions abroad. As indicated, this would not be appropriate or productive.

6. Private asset structures (PAS)

The private asset management principle derives from a statutory provision in Luxembourg. It has been adapted for Liechtenstein. A PAS can claim tax privilege if it pursues no business activity. In this context, the term "business activity" is very broadly construed. The text of the bill is drafted as follows on this point:

1) All legal persons meeting the following conditions shall be deemed private asset structures:

a) Those which, pursuant to their objects, engage in no economic activity, especially if they only acquire, hold, manage and dispose of financial instruments as per the Asset Management Act Article 4(1) (g) *(Vermögensverwaltungsgesetz)* and participating interest in legal persons
b) Those whose shares or units are not publicly listed, not traded on a stock market and which are reserved to be held by the investors as per paragraph 3, or which favour no investors other than those listed in paragraph 3 of this Article of the Tax Act
c) Those which neither advertise for shareholders or investors nor receive remuneration or reimbursement of expenses from them or from third parties for their activity as per a) above
d) Those whose Articles of Association state that they shall be bound by the restrictions on private asset structures

2) A private asset structure shall only hold participating interests in the terms of paragraph 1a) on condition that it, or its shareholders or beneficiaries, shall exercise no actual control, by direct or indirect influence, over the management of such companies.

3) An investor in the terms of this Article shall be:

a) A natural person acting in the context of the management of his/her private assets
b) An asset structure acting solely in the interest of the private assets of one or more natural persons
c) An intermediary acting on behalf of investors as per a) or b) above

4) The taxpayer shall confirm to the Tax Administration on formation, and thereafter in case of major changes, that the conditions of paragraphs 1 to 3 are met. An auditor may issue such confirmation in the case of private asset structures which are required, under the provisions of the Persons and Companies Act *(Personen- und Gesellschaftsrecht – PGR)*, to arrange for an auditor to audit their annual accounts.

5) After submission of the confirmations required under paragraph 4, the Tax Administration shall decide on the status as a private asset structure. The taxpayer may lodge an appeal in the terms of Article 117 of the Tax Act against this ruling within 30 days.

6) The Tax Administration shall be bound to check the status as a private asset structure. It shall in particular be entitled and bound to check compliance with the conditions of paragraphs 1 to 3. The Tax Administration may delegate the checking of the conditions of paragraphs 1 and 3 to third parties.

7) The government shall regulate the details by ordinance. This shall include the times and forms of submission of confirmation as per paragraph 4, procedure for implementing checks as per paragraph 6, and the charging of fees.

8) Private asset structures shall be liable exclusively to minimum income tax.

Thus, beyond the scope of items listed in Article 4(1)(g) of the Asset Management Act, a PAS may hold investment items not pertaining to a business activity in the terms of European aid law. Therefore, the permitted field of activity of a PAS must remain very narrow, in order to remain in conformity with the rules of European aid law. In principle, it is possible to hold portfolios of gold, paintings and similar valuables. The exercise of property rights as such by the owner is not deemed an economic activity. The same applies to disposal. However, this must not constitute trading in holdings of gold or similar valuables on a commercial basis. A PAS is also permitted to use real estate for its own purposes, since this does not constitute economic activity offered on the market. However, if the PAS does not use the property itself, but makes it available free or for paid consideration, that may possibly be deemed economic activity. The same applies to granting loans and holding private equity interests.

There is also a group-wide aspect to aid law. Therefore, when holding participating interests, it is necessary to check whether economic activity benefiting from the tax advantage granted to the PAS is taking place at shareholder level. The EU Commission does tend to attribute an indirectly conferred advantage to the last person to profit from it.

A beneficiary/shareholder of the PAS who then exerts influence over the companies held by the PAS thereby engages in economic activity. Any advantage conferred by the PAS would then be attributed to the beneficiary/shareholder, not as end user, but in the capacity of an economically active entity (a business).

7. Annual tax settlement

Trustees are going to find the annual tax assessment challenging.

All legal persons that are taxed ordinarily will be assessed on the same date.

An exception are structures which continue to pay minimum income tax on the date of formation and are therefore not assessed for tax (PAS and Trust Settlement).

In all other cases, the date on which the tax is due is 31 August each year, irrespective of formation. On that date, the tax is established on the net income for the preceding calendar year. Income tax is levied based on the tax return, the last final assessment or the presumed amount of tax owed. This is a provisional levy, payable within 30 days. These provisionally assessed and paid taxes are offset against the tax actually payable. It can be expected that the financial intermediaries will not be able to cope with administering this innovation (annual accounting, tax returns, and procurement of liquidity on a single given date). Therefore, as a temporary measure, no default interest will be charged on the difference between tax provisionally paid and tax actually owed and paid.

Legal persons, including those not bound to do so in commercial law, are thus obliged to carry out proper bookkeeping, because of their tax liability. It is left to discretion, in the individual case, whether a collection of documents and contracts is still sufficient to compile the tax return.

8. Double taxation conventions

Liechtenstein has concluded various double taxation conventions and is in the process of negotiating further ones. Currently, the following double taxation conventions exist:

- Double taxation convention of 5 November 1969 between the Republic of Austria and the Principality of Liechtenstein, Liechtenstein Law Gazette 1970 No. 37, LR 0.672.910.22
- Convention of 5 November 1969 between the Republic of Austria and the Principality of Liechtenstein with respect to the deduction of withholding tax, Liechtenstein Law Gazette 1971 No. 43, LR 0.672.910.221
- Convention of 22 June 1995 between the Swiss Confederation and the Principality of Liechtenstein with respect to interest from mortgage loans, dependent personal services, pensions, annuities and capital payments, Liechtenstein Law Gazette 1997 No. 87, LR 0.672.910.10 (including remuneration of a similar kind from public service), which entered into force on 1 January 1995
- Double taxation convention of 26 August 2009 between Luxembourg and the Principality of Liechtenstein, Liechtenstein Law Gazette 2010 No. 434, LR 0.672.911.11, which entered into force on 17 December 2010
- Double taxation convention of 23 September 2010 between San Marino and the Principality of Liechtenstein, Liechtenstein Law Gazette 2011 No. 128, LR 0.672.915.31, which entered into force on 19 January 2011
- Double taxation convention of 12 August 2010 between Hong Kong and the Principality of Liechtenstein, Liechtenstein Law Gazette 2011 No. 96, LR 0.672.915.21, which entered into force on 8 July 2011
- Double taxation convention of 18 October 2010 between Uruguay and the Principality of Liechtenstein, Liechtenstein Law Gazette 2012 No. 287, LR 0.672.916.21, which entered into force on 3 September 2012
- Double taxation convention of 17 November 2011 between the Federal Republic of Germany and the Principality of Liechtenstein, Liechtenstein Law Gazette 2012 No. 416, LR 0.672.910.31, which entered into force on 19 December 2012
- Double taxation convention of 11 June 2012 between the United Kingdom of Great Britain and Northern Ireland and the Principality of Liechtenstein, Liechtenstein Law Gazette 2012 No. 418, LR 0.672.911.41, which entered into force on 19 December 2012
- Double taxation convention of 27 September 2013 between the Government of Malta and the Principality of Liechtenstein, Liechtenstein Law Gazette 2014 No. 178, LR 0.672.916.91, which entered into force on 1 July 2014
- Double taxation convention of 27 June 2013 between the Republic of Singapore and the Principality of Liechtenstein, Liechtenstein Law Gazette 2014 No. 210, LR 0.672.914.41, which entered into force on 25 July 2014

The interesting conventions are the ones concluded with Austria, the UK, Luxembourg, Uruguay and Singapore since they will allow, as from 1 January 2015, a variety of opportunities for asset structuring and the use of protected cell companies (PCCs) as asset holding vehicles. A PCC is a structure which provides an alternative to CFC and abuse rules that are, in our view, EEA-incompatible.

The authors of this article, Roger Frick and Ralph Thiede, of Allgemeines Treuunternehmen, would be pleased to provide you with further information.

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

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