A COMPREHENSIVE REVIEW OF THE LIECHTENSTEIN TAX ACT WITH A FOCUS ON CORPORATES

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INTRODUCTION

In September 2010 the Liechtenstein Parliament ratified a new Liechtenstein Tax Act (Steuergesetz 2011), which came into force on 1 January 2011. The aim of this complete revision of the Liechtenstein tax law was to modernise the Liechtenstein taxation system, and to establish a competitive legal framework by taking international developments into account. The intention when setting up this new piece of legislation was to foster Liechtenstein's attractiveness both in a national and international context, and to create a taxation system that complies with European legal requirements, and is based on the principle that any income should not be taxed more than once in the hands of the taxpayer.

This article will give an overview of the Liechtenstein tax regulations for legal entities, and – as the Tax Act has been in force for nearly 2 years now – will review whether the ambitious targets of the Liechtenstein lawmakers have been met.

TRANSITIONAL PERIOD

Previously, a special tax (special company tax) applied to Liechtenstein-based domiciliary and holding companies. This exception will be abolished after a transitional period of 3 years has elapsed since there was a latent risk of infringement of the statutory principle of prohibition of state aid under the European Economic Area (EEA) Agreement. However, until 31 December 2013 the special company tax is still applicable to legal entities that were subject to this tax before 1 January 2011, only the minimum tax charge was increased from CHF 1,000 to CHF 1,200.

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There will be no other changes applicable to these companies during the transitional period, and even after the new Tax Act applies to these companies, there will in fact be only small changes to the tax burden for the majority of commercial domiciliary and holding companies.

RULES OF TAXATION OF LEGAL ENTITIES

Contrary to its old tax system, Liechtenstein no longer distinguishes between onshore and offshore businesses, which marks the end of the period in which Liechtenstein could be considered as an offshore jurisdictions. No matter whether the business is commercially run (for example, trading business or production) or non-commercial (for example, holding of participations), the same taxation rules apply. The only exemption to this is if a company fulfils certain criteria and actively opts into the private investment structure (PIS) scheme.

Most Liechtenstein legal entities used for international estate and wealth planning such as the foundation (*Stiftung*), company limited by shares (*Aktiengesellschaft*), establishment (*Anstalt*), and investment undertakings are deemed legal entities according to tax law. An exception to this is the Liechtenstein trust, which does not have the status of a legal entity and is therefore treated differently (see below).

CONNECTING FACTOR FOR TAXATION

The key criterion for the assessment of the tax liability of a company is, as in most jurisdictions, the domicile or effective place of management, which has to be Liechtenstein in order for the legal entity to become subject to unrestricted tax liability in Liechtenstein.

Legal entities with a non-domestic permanent establishment, however, have a limited tax liability in respect of their domestic earnings. Such domestic earnings are deemed to constitute income from the management of land used for agricultural or forestry purposes, rental and lease income from real estate located in Liechtenstein, as well as the taxable net earnings generated by permanent establishments with Liechtenstein locations.

TAX RATE

Corporate income tax is levied on the net taxable income and amounts to a 12.5% flat tax rate.

As will be demonstrated below, to calculate the corporate income tax the modified equity capital interest deduction needs to be taken into account which is claimable as a justified business expense. In many cases taking this into account the effective tax rate would be significantly lower than 12.5%.

MINIMUM CORPORATE INCOME TAX

In order to secure a minimum tax revenue on all legal entities domiciled in Liechtenstein, a minimum corporate income tax applies that amounts to CHF 1,200 irrespective of the net taxable income generated by the legal person. The minimum corporate income tax is fully allowable against the corporate income tax.

MODIFIED EQUITY CAPITAL INTEREST DEDUCTION

To attract capital investment in Liechtenstein companies, the Liechtenstein Tax Act favours companies with substantial capitalisation over poorly capitalised ones. This aim is reached as a notional interest is being calculated. This notional interest is paid on the so-called modified equity capital at a current rate of 4%[1] (notional interest deduction). The notional interest amount is deemed a commercially justified business expense and has the effect of reducing taxable income. The notional interest deduction may give rise to or even increase a current loss which can be carried forward for an unlimited period of time.

The notional interest is calculated on:

- paid-in nominal capital;
- plus reserves which constitute own assets;
- minus own shares;
- minus participations in legal persons;
- minus net assets in foreign real estate;
- minus net assets in foreign permanent establishments;
- minus assets not operationally necessary.

The valuation of the notional interest is performed as of the beginning of each business year. Any accruals and decreases in equity such as capital reductions, capital repayments and direct or indirect distributions during the current business year must be taken into account *pro rata temporis* on a quarterly basis.

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1 There are currently discussions under way to reduce this rate to 2%.

If the modified equity capital is negative, the notional interest deduction amounts to CHF 0.

Example 1

Calculation of notional interest	CHF
Nominal equity	2,730,000
less real estate, abroad	-630,000
less investments in participations/subsidiaries	-800,000
Modified equity capital	1,300,000
4% notional interest	52,000

The notional interest is calculated from the nominal equity minus foreign real estate and investments in participations. This produces a modified equity capital of CHF 1,300,000. The notional interest of 4% of the modified equity capital amounts to CHF 52,000.

DEDUCTION OF INCOME FROM INTELLECTUAL PROPERTY

Eighty per cent of the sum of positive income from intellectual property (IP) rights such as trademarks, patents, models and utility models, provided they are filed with a domestic, foreign, or international register are considered a commercially justified expense and are deductible from the income. The basis for the assessment of the deductible amount is the income from the use, realisation, or sale of the IP rights minus the associated, tax-relevant expenses.

DETERMINATION OF THE TAXABLE NET CORPORATE INCOME

In essence the taxable net income is computed from the total amount of income minus justified business expenditure. The notional interest and deduction of income from IP are considered as business expenditures. It is calculated on the basis of the annual accounts prepared in accordance with the general rules of arts 1045 et seq for the draw up of balance sheets in the Liechtenstein Law on Persons and Companies (Personen- und Gesellschaftsrecht, PGR). It is important to note that the notional interest is not bookable in the balance sheet and is calculated and carried forward for tax purposes only.

Taxable corporate income

In particular, the taxable net corporate income consists of:

(1) the balance of the profit and loss statement;

(2) all parts of the operating result separated out in the calculation of the balance of the profit and loss statement that are not used to cover commercially justified expenses;

(3) write-downs, value adjustments and provisions, to the extent they are not commercially justified;

(4) allocations to the reserve fund, to the extent they are not commercially justified, subject to any tax-privileged provisions under art 60;

(5) profits distributed to the members or partners of the undertaking or to holders of non-membership dividend rights (participation certificates, founder's shares) or to persons with a close relationship to them as well as hidden profit distributions;

(6) tax expenses;

(7) payments for the transfer of borrowed capital to associated undertakings and partners or persons with a close relationship to them, to the extent the amount of such payments does not at least correspond to the arm's length principle;

(8) voluntary monetary payments to legal persons and special asset dedications with domicile in Liechtenstein which are exempt from tax liability in light of exclusively and irrevocably charitable purposes, to the extent they exceed 10% of the taxable net corporate income;

(9) fines, monetary penalties, and comparable legal consequences relating to wealth, provided the penal nature predominates;

(10) payments pursuant to § 307 of the Criminal Code (corruption of public servants and similar crimes).

As taxable net corporate income may not be considered as:

(1) capital brought in by members of capital companies and co-operatives, including premiums and payments with no hope of a return;

(2) capital growth due to inheritance, bequest or gift.

Tax-exempt corporate income

Proceeds from the following sources are not included in the taxable net corporate income:

(1) corporate income from the cultivation of foreign real estate used for agriculture or forestry, and from any other agricultural or forestry production abroad;

(2) foreign permanent establishment results;

(3) rental and lease income from real estate situated abroad;

(4) domestic real estate capital gains, to the extent they are subject to the real estate capital gains tax in Liechtenstein, and capital gains from the sale of foreign real estate;

(5) dividends arising from participations in domestic or foreign legal persons. There are no thresholds, neither in respect of the duration of holding nor of the capital ownership percentage, that have to be met in order to qualify as a participation in this respect;

(6) capital gains from the sale or liquidation of participations (again no thresholds apply) in domestic or legal foreign persons;

(7) corporate income from the managed assets of investment undertakings in accordance with the Investment Undertakings Act;

(8) corporate income from the net assets of legal persons subject to the Pension Funds Act, provided these assets are allocated exclusively and irrevocably to occupational retirement provision.

In the case of restricted taxpayers, the following shall not be included in the taxable net corporate income:

(1) domestic real estate capital gains, to the extent they are subject to the real estate capital gains tax in Liechtenstein;

(2) dividends arising from participations in domestic or foreign legal persons;

(3) capital gains from the sale or liquidation of shares in domestic or legal foreign persons.

Example 2

Profit and loss account	CHF	CHF
Net sales	2,218,000	2,205,000
Expenses	-1,800,000	-1,800,000
Income from participation	500,000	500,000
Realised profit from sale of participation	100,000	100,000
EBITDA	**1,018,000**	**1,005,000**
Depreciations and amortisations	-250,000	-250,000
EBIT	**768,000**	**755,000**
Interest and similar expenses	-100,000	-100,000
Net income for the year	**668,000**	**655,000**
Calculation of tax liability	CHF	CHF
Net income for the year	668,000	655,000
Less income from participation	-500,000	-500,000
Less realised capital gain from sale of participation	-100,000	-100,000
less 4% notional interest (see example 1)	-52,000	-52,000
Taxable corporate income	**16,000**	**3,000**
12.5% Corporate income tax	**2,000**	**375**
Effective tax expense	**2,000**	**1,200**

The profit and loss account of a company lists (1) net sales of CHF 2,218,000 or (2) net sales of CHF 2,205,000. After the deduction of expenses, depreciation, armortisation and interest the company has a net income of the year of (1) CHF 668,000 or (2) CHF 655,000. From this amount the income from participation and realised capital gain from the sale of participation have to be deducted as they are tax exempt. Taking into account the notional interest from example 1 the taxable corporate income of the company is reduced to (1) CHF 16,000 or (2) CHF 3,000. The taxable corporate income is based on computation of the corporate income tax of 12.5%, which amounts to (1) CHF 2,000 or (2) CHF 375. As the minimum corporate income tax amounts to CHF 1,200 the effective tax expense (1) amounts to CHF 2,000 and (2) is being increased to CHF 1,200.

LOSSES

Losses incurred may be carried forward for an unlimited period. They may be deducted from the positive taxable net corporate income in any given year. In effect, the loss carried forward at the end of a business year shall be equal to the loss carried forward at the end of the previous year augmented by any loss and reduced by any amount offset.

In addition, losses from a foreign permanent establishment may be offset with taxable net corporate income, to the extent these losses are not already taken into account in the country where the permanent establishment is situated or in any other country.

GROUP TAXATION

An important step to modernise the Liechtenstein tax system was the implementation of a group taxation scheme. According to art 58 of the Tax Act upon application at the Liechtenstein tax authority, associated legal entities may form a corporate group and compensate losses arising in a given year within the corporate group with profits generated during the same year. The compensation may be carried out by attributing the loss from the group members to the group parent or – to the extent a loss remains after offsetting any attributable losses with the taxable net corporate income of the group parent – from the group parent to a group member that is subject to unrestricted tax liability in Liechtenstein.

Legal entities shall be deemed associated provided that a legal person with domicile or effective place of management in Liechtenstein (group parent) has held since the beginning of the business year without interruption, directly or indirectly, more than 50% of the voting rights and more than 50% of the rights pertaining to the nominal capital, capital stock, or share capital of one or more other domestic or foreign legal persons (group members). Legal persons who have essentially terminated their activity may neither be the group parent nor a group member.

Losses may be attributed in proportion to the amount of the direct participation, attributable to the Liechtenstein business assets, of the group parent in the nominal capital, capital stock, or share capital of each group member (participation quota). The losses attributable to a group member shall be limited to the proportion of the taxable net corporate income of that group member corresponding to the participation quota. Any loss carried forward of a group member existing prior to submission of the application may not be attributed to the group parent or a group member, but may only be offset with positive taxable net corporate income of the group member which suffered the losses.

Example 3

	Parent company	**Subsidiary company 1** (100%)	**Subsidiary company 2** (67%)
Year 1			
Taxable corporate income	30	-20	-15
Transfer of loss of subsidiary 1	-20	20	
Transfer of loss of subsidiary 2	-10		10
Taxable corporate income year 1	0	0	0
Year 2			
Taxable corporate income	50	-30	-18
Transfer of loss of subsidiary 1	-30	30	
Transfer of loss of subsidiary 2	-12		12
Taxable corporate income year 2	8	0	0
Year 3			
Note: parent sold 100% of subsidiary 1 in year 3			
Taxable corporate income	20		-15
Compensation of tax deductions from subsidiary 1	50		
Transfer of loss of subsidiary 2	-10		10
Taxable corporate income year 3	60		0

A parent company holds two participations (subsidiary 1 and 2) with which it forms a group. The parent company is profitable, both participations produce losses. As subsidiary 1 is a 100% subsidary of the parent company, the total loss of CHF 20 may be deducted from the taxable corporate income of the parent company. As it holds only 67% of subsidiary 2, only two-thirds of the loss of subsidiary 2, ie CHF 10, may be deducted. The same applies for year 2. In year 3 subsidiary 1 is sold and the deferred losses incurred in year 1 and 2 have to be compensated in the full amount of CHF 50.

THE PIS

For the taxation of private wealth a new regime has been put in place by implementing the PIS taxation system. All legal entities such as foundations, establishments and stock corporations may qualify as a PIS. They may be used by individuals to manage their assets in an independent legal entity at very low tax burden as only the minimum income tax of CHF 1,200 is charged. It is an annual tax and is determined for each tax year which is in line with the calendar year.

When using PIS structures it is important to note that they are usually not eligible to double tax treaties (DTT).

Even though the PIS may appear attractive to investors from abroad at first glance, in many cases it will not even be necessary to opt into the PIS scheme, since the income a PIS usually receives tends to be tax-exempt in Liechtenstein irrespective of the tax status (for example, rental and lease income from real estate situated abroad, dividends and capital gains, see 'Tax-exempt corporate income' above). Income which is not tax exempt (for example, interests on time deposits and bonds, capital gains from the sale of bonds and derivatives, see 'Taxable corporate income' above) and therefore subject to normal taxation will in practice frequently only be taxed if it exceeds 4% because of the notional interest deduction.

Restrictions on PIS

The low tax burden of a company with PIS tax status comes with various restrictions. A legal entity may only apply for the PIS status if:

- it does not carry out any economic activity in the pursuit of its purpose, especially if it exclusively acquires, possesses, administers and sells financial instruments as well as participations in legal persons, liquid monies and bank account balances;
- its shares or units are not publicly placed and are not traded on a stock exchange and whose possession is reserved to private wealth investors;
- it neither solicits shareholders and investors nor receives remunerations or reimbursements for expenses from shareholders, investors, or third parties for its activities; and
- its articles entail that they are subject to the restrictions applicable to private investment structures.

Assets to be held

In principle a company with PIS tax status may hold any kind of bankable assets, including financial instruments (for example, futures, swaps, negotiable securities), liquid monies, bank account balances and shares or units in legal entities and other valuables (for example, precious metal and stones, paintings, vintage cars, and other kinds of collectibles). However, certain restrictions apply so as to abide by the condition not to engage in economic activity.

Further, a PIS may only hold real estate property if it does not engage in an economic activity (for example, by renting the property out). The holding of real estate is acceptable especially if:

- the utilisation of the property is left to a beneficiary or shareholder of the company with PIS tax status free of charge;
- the property is used by the PIS company for its own purposes and does not generate income.

In addition, a PIS may hold participations only under the condition that it or its shareholders or beneficiaries do not exert actual control on the management of such companies through either direct or indirect influence.

Potential investors

Potential investors (either beneficiaries or shareholders) in a PIS are limited to (1) natural persons, acting in the capacity of managing their private wealth, (2) entities which themselves have PIS tax status and are acting in the capacity of managing the private wealth of one or more natural persons, (3) intermediary legal entities acting on account of one of the former. Intermediaries may be Liechtenstein legal entities or legal entities from other jurisdictions, as long as they comply with Liechtenstein's PIS rules.

Commercial undertakings are barred from being a beneficiary or holding any shares, directly or indirectly, in a legal person with PIS tax status.

TAX EXEMPTION FOR CHARITABLE LEGAL ENTITIES

Under art 45 of the Tax Act charitable legal entities may apply for full exemption from corporate income tax if:

- they are a legal person;
- they limit their distributions;

- their articles rule out the payment of emoluments;
- they serve charitable purposes to the exclusion of any economic activity; and
- upon dissolution, their articles assign the assets remaining after repayment of the capital not received in the form of donations by third parties to similar causes.

TAXATION OF TRUSTS

As trusts are not considered as legal entities in the Liechtenstein legal system, special taxation rules apply. Trusts pay only the minimum corporate income tax which amounts to CHF 1,200 and are not assessed further for tax purposes. However, they will still have limited tax liability with respect to their domestic income.

TAXATION OF INVESTMENT UNDERTAKINGS (INVESTMENT FUNDS)

Investment undertakings with contractual or corporate law structures (ie a collective trust or stock corporation with variable capital) are essentially tax exempt and are merely required to pay the minimum earnings tax.

Essentially it is the case that the principle of fiscal transparency applies to investment undertakings, which means that tax is imposed solely at the investor level.

Investment undertakings in the legal form of a collective trust are moreover exempt from the requirement to pay stamp duty and value added tax.

CONCLUSION

Some aspects of the Tax Act are currently under scrutiny, and it is as yet unclear whether minor changes will be implemented in the course of the next year. However, the new Tax Act is a modern piece of legislation which makes Liechtenstein an attractive centre for foreign investors, commercial enterprises and financial services companies. Particularly noteworthy is the extremely attractive regular taxation of legal entities with a flat rate of 12.5%, whereby income and capital gains on participations are tax exempt. Additionally, no capital ownership percentage is necessary for a participation to benefit from this regulation. The deduction of notional interest with a flat rate of 4% also reduces the tax burden and may frequently lead to a moderate effective tax rate below the flat rate of 12.5%.

The group taxation scheme allows the formation of groups of companies which makes it possible to reduce the tax burden of one group company by making use of a loss of another group company.

A further positive aspect of this regulation is Liechtenstein's increased openness towards international co-operation. The tax legislation has to be seen within the context of the establishment of international tax accords. Liechtenstein has shown a clear commitment to negotiate and conclude OECD-model tax information exchange agreements (TIEAs) and DTTs. At the moment DTTs with Uruguay, Hong Kong, Austria, San Marino, Luxemburg and Switzerland are in force. DTTs with Germany and the UK have been signed but are not in force yet. This perspective combined with the competitive tax regime which is compliant with European standards should help to develop Liechtenstein's reputation as a holding centre.

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