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"The debt-equity conundrum"
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Liechtenstein

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Summary and conclusions

With the new Liechtenstein tax law decision neutrality, especially relating to investment and financing activities, was introduced. Equity and debt financing of corporations are treated alike. Furthermore – especially because of the binding rules under European law – the tax law does not distinguish between domestic or foreign investors or investments.

If the creditor is a Liechtenstein corporation, the interest income is subject to tax with the corporate income tax at the flat rate of 12.5 per cent; therefore it is irrelevant whether the recipient of debt capital is located in Liechtenstein or abroad. If the debtor of the loan is a Liechtenstein corporation the interest paid is a business expense. Regarding loans between affiliated companies, the arm's length principle has to be considered.

Dividends arising from participations in domestic or foreign legal persons to a shareholder with unrestricted tax liability in Liechtenstein are tax exempt. A minimum shareholding and/or a minimum holding period are not necessary for the participation exemption. Furthermore, capital gains from the sale or liquidation of participations in domestic or legal foreign persons are also tax exempt. Notwithstanding the tax exemptions, expenses regarding the participation are fully deductible from corporate income.

The goal of the allowance for corporate equity in the form of a notional interest deduction (NID) is that for tax purposes, equity and debt financing are treated the same way. The company should be free in its financing decisions and there should be no tax advantage for debt financing which leads to increased leverage and thin equity capitalization. As equity, other than debt, does not bear a fixed interest, the company is granted an NID, rather than allowing the company to deduct actual payments on equity (e.g. dividends). Thus, assuming a market interest rate equal to the notional interest rate, the overall tax effects of debt and equity are the same. The choice of financing option can therefore be made without tax effects and exclusively in accordance with entrepreneurial criteria. Moreover, the effective tax rate is reduced thanks to the NID (depending on the return on equity).

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An appropriate definition of the assessment basis for the NID (modified equity capital entered in the balance sheet, reduced in particular by participations and net assets of foreign places of business) ensures that the effects of the NID only obtain once, irrespective of the organization of entrepreneurial activity. At the same time, it is ruled out that the NID can be abused through circumvention measures: a double benefit is not possible and nor is there a danger that companies will henceforth be "overcapitalized" to achieve an excessive NID through unproductive capital.

Therefore reasonable interest paid on the modified equity capital to the amount of the notional income set out in article 5 Liechtenstein Tax Act (LTA) – in 2011 4 per cent – is deemed a commercially justified expense. The rate for the calculation can potentially be adjusted by the Liechtenstein Parliament in the Finance Act, but it is linked to the notional interest rate that is applied for the purpose of the wealth tax on individuals (i.e. when calculating the notional income according to article 14 paragraph 2(I) LTA). If the rate to be applied to the NID is changed, so will the rate to be applied when calculating the notional income be changed as both rates are defined by making reference to article 5 LTA.

Partnerships are treated as tax transparent. This means that the net assets of partnerships are subject to wealth taxation while net income is subject to individual income taxation (*Erwerbssteuer*) if an interest in the partnership is held by individuals subject to taxation in Liechtenstein. For the determination of taxable income an adequate interest that would be paid on the own capital employed in the business to the amount of the nominal income as referred to in article 5 LTA is deducted. If the individual participating partner gives debt to the partnership, the interest income – in compliance with the arm's length principle – is not subject to tax because it is derived from the shareholding that was subject to wealth tax. If an interest is held by corporations, the net income of the partnership is subject to corporate income taxation, including interest income if the corporation gives debt to the partnership (regarding the arm's length principle). The corporation is also entitled to an NID of 4 per cent based on the modified equity.

Liechtenstein's treaty policy regarding the allocation of taxing powers on dividends, interest, and capital gains in principle follows the latest OECD model, but tries to further reduce or even entirely eliminate source taxation. This is understandable from an economic point of view, given that any source taxation of these types of income often triggers (at least) economic double taxation, and thus would be in conflict with the aim of achieving capital export neutrality where possible.

1. Overview of regulatory and market conditions

The Principality of Liechtenstein is located in the heart of Europe and is a member of the EFTA and the EEA.[1] Liechtenstein has evolved in the last 40 years from an agricultural state into an industrialized country. Liechtenstein has a diversified

[1] Wenz and Wünsche, "Liechtenstein", in Lang and Pistone (eds.), *The EU and Third Countries, Direct Taxation*, Vienna: Linde, 2007, p. 741.

economy with a substantial focus on exports.[2] Regarding economic relations Liechtenstein is closely connected e.g. with Germany: Liechtenstein's direct exports to Germany in 2008 amounted to approximately CHF 906 million (21 per cent of Liechtenstein's total direct exports). Germany takes most exports from Liechtenstein, followed by the USA and Austria (not counting trade in goods with Switzerland due to the customs union). In 2008, direct imports from Germany amounted to approximately CHF 1,011 million (41 per cent of Liechtenstein's total direct imports). Germany is Liechtenstein's most important import partner, followed by Austria.[3]

Liechtenstein has several forms of business organization. Legal persons with a corporate element are, for example, the public limited company, *Aktiengesellschaft*[4] or the private company limited by shares, *Gesellschaft mit beschränkter Haftung*.[5] Furthermore, Liechtenstein company law contains legal persons that may exist without members or where the presence of members is excluded e.g. the establishment (*Anstalt*)[6] or foundation (*Stiftung*).[7] The most common types used for economic activities in Liechtenstein are public limited companies and establishments because of the minimum capital of only CHF 50,000 or CHF 30,000 and the limitation of liability only to the company's assets.[8] Liechtenstein company law also distinguishes companies without legal personality but they are not important in practice.

Through membership in the EEA, banks and investment companies benefit from easy and equal access to the European market. Investor protection is awarded high priority under the Liechtenstein Fund Act. The state supervisory authorities and audit firms monitor compliance with legal provisions. As a fund location – managed assets per October 2011 approximately CHF 36.4 billion – Liechtenstein benefits from a stable banking centre with a highly efficient banking system and moderate taxation.[9]

In 2009, the Liechtenstein government endorsed a draft law that completely revised the Tax Act that effectively dates back to the 1960s. The reform process was officially initiated in 2006. The new tax law becomes effective as from 2011 and the government has tried to meet several criteria and objectives:

- Tax justice has to be ensured by distributing the tax burden on the taxpayers based on their ability to pay and tax tradition has to be preserved by adopting selected provisions of the Tax Act.
- Decision neutrality should ensure that the interference of the tax system with the market process is kept at the least extent possible.

2 Image Liechtenstein (eds.), *Liechtenstein – Industrial location*, 2010, p. 2.
3 Government of the Principality of Liechtenstein, *Factbox: Economic relations between Liechtenstein and Germany*, 2011.
4 Arts. 261–367 PGR (*Personen- und Gesellschaftsrecht* Law on Persons and Companies).
5 Arts. 389–427 PGR.
6 Arts. 534–551 PGR.
7 Art. 552 §§1–41 PGR.
8 Arts. 122 para. 1, 261 para. 1, 548 para. 1 PGR; Government of the Principality of Liechtenstein, *Landtag, Regierung und Gerichte 2010, Bericht des Landtages, Rechenschaftsbericht der Regierung an den Hohen Landtag, Berichte der Gerichte, Landesrechnung*, Vaduz: 2011, p. 318.
9 LAFV, *Locational advantages*, 2011; LAFV, *Statistics* 2011.

- By reducing the number of different taxes, by simplifying the assessment of the tax base and the calculation of the tax due, the simplicity and transparency of the tax system should be improved.
- Due to a reduction in tax rates and due to several provisions aimed at avoiding excess tax burdens for international business, the competitiveness and attractiveness of the tax system should be improved.

As with any other reform, there are certain elements of the framework that define the leeway of the tax reform: the new Tax Act must be in conformity with the constitutional law by e.g. distributing the tax burden based on the ability to pay and by exempting the minimum income needed to exist from taxation.

Liechtenstein has had balanced budgets for several years and the tax reform provides for tax relief for individuals as well as corporations. Nonetheless, in the long run, the tax reform should leave the budget unchanged and revenue neutrality has to be ensured.

By enhancing the international compatibility of the new tax system, for example by the new definition of residency, the interaction of the new Tax Act with the tax systems of other countries is improved while ring-fencing elements are abolished.[10]

2. Summary of key tax principles

2.1. Natural persons in Liechtenstein tax law

Individuals who have a domicile (*Wohnsitz*) or habitual abode (*gewöhnlicher Aufenthalt*) in Liechtenstein are subject to unlimited wealth and income tax liability.[11] After the tax reform, the wealth and income tax (*Vermögens- und Erwerbssteuer*) can still only jointly be seen as a general taxation of income.[12] Gross wealth less deductible liabilities constitutes the taxable net wealth.[13] Net wealth is now taxed together with the rest of the income by reconciling net wealth to a special type of income.[14] Where income is derived from assets that are subject to wealth tax, the actual income is not taxed as the deemed income calculated on the net wealth is already taxed.[15] Other types of income are usually calculated on a net basis.[16] The taxable income (including notional income from net wealth) is then multiplied by the applicable progressive tax rate and the applicable municipal multiplier.[17]

10 Wenz and Linn, "The Liechtenstein Tax Reform from the Perspective of Community Law", *EStAL*, 2009, pp. 453 *et seq.*
11 Art. 15 para. 1a LTA.
12 Government of the Principality of Liechtenstein, *The Future of the Liechtenstein Tax Location, Concept for a total revision of the Law on National and Municipal Taxes*, 2009, Vaduz, pp. 14 *et seq.*
13 Art. 9 para. 1, 11 para. 1 LTA.
14 Art. 6 para. 1 LTA.
15 Art. 15 para. 1a LTA.
16 Arts. 14 para. 1, 2, 16 para. 1 LTA.
17 Arts. 19, 23 para. 5, 75 LTA.

2.2. Legal persons in Liechtenstein tax law

Legal persons e.g. corporate bodies, investment undertakings as referred to in the Investment Undertakings Act, trust enterprises with legal personality, along with their entire corporate income, are subject to unrestricted tax liability if their domicile or effective place of management is in Liechtenstein.[18] The tax liability commences with the formation of the legal person or the relocation of its domicile or effective place of management to Liechtenstein (unrestricted tax liability).[19] Corporate income tax (*Ertragssteuer*) is determined according to taxable net corporate income. Taxable net corporate income is calculated on the basis of the annual accounts prepared in accordance with the Law on Persons and Companies. The taxable net corporate income consists of the totality of corporate income reduced by commercially justified expenses.[20] The corporate income tax is 12.5 per cent of the taxable net corporate income.[21] Legal persons with unrestricted or restricted tax liability are subject to a minimum corporate income tax to the amount of CHF 1,200, which is fully allowable against corporate income tax.[22]

2.3. Tax treatment of debt

With the new Liechtenstein tax law decision neutrality, especially relating to investment and financing activities, was introduced. Equity and debt financing of corporations are treated alike. Furthermore – especially because of the binding rules under European law[23] – the tax law does not distinguish between domestic or foreign investors or investments.

If the issuer of debt is a Liechtenstein corporation, the interest income is subject to tax with corporate income tax at the flat rate of 12.5 per cent; it is therefore irrelevant whether the recipient of debt capital is located in Liechtenstein or abroad.[24] If the debtor of the loan is a Liechtenstein corporation the interest paid is a business expense.[25]

Regarding loans between affiliated companies, the arm's length principle has to be considered. Where corporate income or expenses of a taxpayer arising from a business relationship with persons with a close relationship are changed in such a way that other conditions are taken as a basis than what mutually independent third parties would have agreed under otherwise identical circumstances, the determination of taxable net corporate income assumes the corporate income and expenses that would have applied in a relationship between independent third parties.[26]

[18] Art. 44 para. 1 LTA.

[19] Art. 46 para. 1 LTA.

[20] Art. 47 para. 1, 3 LTA.

[21] Art. 61 LTA.

[22] Art. 62 para. 1, 2 LTA.

[23] Government of the Principality of Liechtenstein, *op. cit.*, 2009, pp. 8, 12; Government of the Principality of Liechtenstein, *Vernehmlassungsbericht der Regierung betreffend die Totalrevision des Gesetzes über die Landes- und Gemeindesteuern (Steuergesetz) sowie Abänderung der entsprechenden Spezialgesetze*, 2009, pp. 9, 15.

[24] Art. 47 para. 1, 61 LTA.

[25] Art. 47 para. 3 LTA.

[26] Art. 49 LTA.

The Liechtenstein tax authority issues a yearly circular, which indicates the maximum interest rate for loans between companies and shareholders/persons with a close relationship.[27] Interest expenses exceeding this rate are not deductible for tax purposes with the debtor. Special rules relating to limitation on the deduction of interest or similar thin capitalization rules do not exist in Liechtenstein tax law.

2.4. Tax treatment of equity

Dividends arising from participations in domestic or foreign legal persons to a shareholder with unrestricted tax liability in Liechtenstein are tax exempt.[28] A minimum shareholding and/or a minimum holding period are not necessary for the participation exemption. Furthermore, capital gains from the sale or liquidation of participations in domestic or legal foreign persons are also tax exempt.[29] Notwithstanding the tax exemptions, expenses regarding the participation are fully deductible from corporate income.[30]

Corporations doing business in Liechtenstein are entitled to an NID of 4 per cent (subject to change under the annual Finance Act) based on the modified equity.[31] With the introduction of NID the discriminatory tax treatment of equity invested in a company versus investments financed with external debt was abolished and decision neutrality achieved.[32] The technical details of the NID are given in detail in section 6.

2.5. Withholding rates and tax treaty policy

Liechtenstein's treaty policy regarding the allocation of taxing powers on dividends, interest, and capital gains in principle follows the most recent OECD model, but tries to further reduce or even entirely eliminate source taxation. This is understandable from an economic point of view, given that any source taxation of these types of income often triggers (at least) economic double taxation and, thus, would be in conflict with the aim of achieving capital export neutrality where possible.

Minimizing source taxation is in the interest of Liechtenstein as the LTA does not allow taxes at source on dividends and interest earned by resident persons or by non-resident persons[33] except for the landed property capital gains tax (*Grundstücksgewinnsteuer*).

2.5.1. Dividends and interest

In the case of Liechtenstein the application of low source taxation rates in as many cases as possible, i.e. with low thresholds concerning interest in a corporation paying

27 Liechtenstein Tax Authority, *Merkblatt betreffend Zinssätze 2011 für die Berechnung der geldwerten Leistungen*, 2011. See also section 4.
28 Art. 48 para. 1(e) LTA.
29 Art. 48 para. 1(f) LTA.
30 Government of the Principality of Liechtenstein, *op. cit.*, 2009, p. 32 (Infobox).
31 Art. 54 para. 1, 5 LTA.
32 Government of the Principality of Liechtenstein, *op. cit.*, 2009, p. 29.
33 Non-resident persons are not subject to tax on their capital income, see art. 31 para. 1 LTA.

dividends, helps to balance the taxes paid on dividends when dividend flows between both contracting states exit in both directions. Given that neither the previous nor the current LTA provides for source taxation of dividends paid to non-residents, a full balance of relative tax revenue can only be achieved through zero source taxation in the other contracting state. To a certain extent this is achieved in the treaties with Luxembourg and San Marino, where unlike what is stated in paragraph 6 of the OECD commentary to article 10, under certain circumstances, the source state of dividends has no right to tax such payments at all or at a zero rate if the stake held by the recipient qualifies.[34] The treaty with Hong Kong even excludes the source state from taxing dividends without any further requirements (i.e. dividends "shall only be taxable" in the state of residence). In the special case of the treaty with Luxembourg, such treatment ensures equivalence of the bilateral dividend provisions with the provisions of the Parent–Subsidiary Directive so that Liechtenstein entities, in relation to Luxembourg, enjoy the same benefits concerning cross-border dividend payments as entities resident in an EU Member State. The treaty with Austria, where the contracting states agreed upon taxation at source at a maximum rate of 15 per cent for all persons resident in the other contracting state, does not reflect this new treaty policy as the treaty was concluded several decades ago.

Liechtenstein's current tax treaty policy to allocate the taxing powers concerning interest to the residence state of a person only is more common in an international context. Such allocation provisions, according to the OECD commentary, are not necessarily in the interest of every contracting state, but may be agreed upon without a significant distortion of the fiscal balance between the state of source and the state of residence.[35] Whereas article 11 of the treaty with Austria still allows for source taxation,[36] both the treaties with Luxembourg and San Marino in their respective article 11 prohibit any source taxation on income from debt claims. The treaty with Hong Kong prohibits source taxation with regard to interest. The treaty with Uruguay allows for limited (i.e. 10 per cent) source taxation for interest subject to certain exceptions.

Table 1 gives an overview of the right of the source state to tax dividends and interest that Liechtenstein has agreed to in its tax treaties with Austria, Hong Kong, Luxembourg, San Marino and Uruguay as well as in the tax treaty with Switzerland.

Differences between the treaties of Liechtenstein with Luxembourg, San Marino and Uruguay and the OECD model occur in the holding percentage necessary to obtain full treaty benefits for dividends. Even though holding percentages of 10 per cent, as they have been concluded in article 10 of the treaties with Luxembourg, San Marino and Uruguay and as they are also suggested in the UN model, do not explicitly form part of the OECD model, paragraph 14 of the OECD commentary to article 10 explicitly leaves the opportunity for the contracting states to agree on

[34] The withholding tax rates in Liechtenstein's tax treaties are thereby in line with para. 13 of the OECD commentary to art. 10 as they do not exceed the rates of art. 10 of the OECD model 2008.

[35] See para. 3 of the OECD commentary to art. 11. The possibility to agree "even lower rates" does, without saying, also include the agreement on a zero per cent source taxation, which is equivalent to a concluding allocation provision.

[36] So does art. 4 of the treaty with Switzerland, which only covers income from debt claims secured by mortgage based in the state in which the interest arises.

Table 1. Withholding tax rates according to Liechtenstein tax treaties		
Treaty with	**Dividends**	**Interest**
Austria 1969	All cases: 15 per cent	10 per cent
Luxembourg 2009	10 per cent[a] + 12 months: 0 per cent 10 per cent: 5 per cent All other cases: 15 per cent	0 per cent
San Marino 2009	10 per cent + 12 months: 0 per cent All other cases: 5 per cent	0 per cent
Hong Kong 2010	All cases: 0 per cent	0 per cent
Uruguay 2010	10 per cent: 5 per cent All other cases: 10 per cent	10 per cent
Switzerland 1995	–	10 per cent[b]

[a] Interest worth at least 1.2 million euro held continuously for at least 12 months qualifies, too.
[b] Allowed only if the debt claim is secured by mortgage based in the state the interest arises in.

holding percentages of less than 25 per cent, so that Liechtenstein is well in line with the provisions of the OECD model.

However, material differences between the OECD model and the treaty with Luxembourg occur with regard to the definitions of dividends and interest in articles 10 and 11 of the respective treaties.[37] According to article 10 paragraph 3 of the treaty with Luxembourg, the term "dividends" not only includes those parts of income described in article 10 paragraph 2 of the OECD model, but also includes income from certain profit participating loans as well as specific top-up interest payments that are connected with the amount of dividends paid to shareholders. Through this enlargement of the term "dividends", additional issues arise as to how dividends and interest payments can be distinguished: profit participating debt claims and specific interest could be covered by both article 10 and article 11. Unlike the OECD model, article 11 paragraph 2 of the treaty with Luxembourg resolves that issue by giving priority to the definition of dividends. This definition gives the source state the right to tax certain debt based income as dividends if the relevant shareholding does not meet the threshold of article 10 paragraph 2(a), whereas this right to tax would not exist under the definition of dividends according to article 10 paragraph 3 of the OECD model, as interest may only be taxed in the residence state under the treaty with Luxembourg.

2.5.2. Capital gains

Regarding the taxing powers for capital gains, Liechtenstein's treaty policy seems to be dependent on the treaty partner. Whereas the treaty with Austria and the treaties with San Marino and Uruguay fully reflect the latest OECD model, the treaty with

[37] In this respect, the treaties with Austria and San Marino follow the respective latest version of the OECD model.

Luxembourg lacks a provision equivalent to article 13 paragraph 4 of the OECD model, so that shares in companies deriving most of their value from landed property are, for the purposes of the treaty, treated just like shares in ordinary companies. In both cases the exclusive right to tax such income lies with the alienator's state of residence according to article 13 paragraph 4 of the treaty with Luxembourg. The treaty with Hong Kong includes such a provision, but exempts certain transactions, such as where the alienated shares are quoted on a stock exchange or are transferred in the course of a tax-neutral restructuring.[38]

2.5.3. Agreement on the taxation of savings

In 2004, the EU and the Principality of Liechtenstein concluded an agreement on taxation of savings income in the form of interest payments, which came into force in July 2005. Interest payments made to beneficial owners who are resident in an EU Member State by a paying agent established on the territory of the Principality of Liechtenstein are subject to a withholding tax on the amount of the interest payment.[39] In addition, Liechtenstein provides for a procedure that allows the beneficial owner to avoid the withholding tax by expressly authorizing his paying agent in Liechtenstein to report the interest payments to the competent authority of that state. This authorization covers all interest payments made to the beneficial owner by that paying agent. The minimum amount of information to be reported by the paying agent in the case of an express authorization by the beneficial owner consists of the identity, residence of the beneficial owner, the name and address of the paying agent, the account number of the beneficial owner or, where there is none, identification of the debt claim giving rise to the interest and the amount of the interest payment calculated.[40] According to the agreement, the rate of withholding tax is 20 per cent until June 2011; it will be 35 per cent thereafter.[41]

2.6. Other considerations

Because of the fact that the Liechtenstein tax law takes the principle of financial neutrality as a basis, decisions are independent from taxes and may not affect the choice between debt and equity.

2.6.1. Rate structure

A dual income tax system or similar is unknown in Liechtenstein.

It has to be pointed out that the gross taxable wealth less the deductions and exemptions is multiplied by a deemed interest rate of 4 per cent in order to calculate a notional income which is then taxed together with the other income earned. The rate for the calculation can potentially be adjusted by the annual Finance Act. The rate is linked to the interest rate used for the calculation of the NID for

38 Wenz *et al.*, "Liechtenstein", in Lang *et al.* (eds.), *The Impact of the OECD and UN Model Tax Conventions on Bilateral Tax Treaties*, 2011, forthcoming.

39 Art. 1.1 Agreement on the Taxation of Savings Liechtenstein–EU.

40 Arts. 2.1, 2.2, *ibid.*

41 Arts. 1.1, 2.2, *ibid.* See also in detail Wenz and Wünsche, *op. cit.*, pp. 763–767.

corporations. The taxable income (including notional income from net wealth) is then multiplied by the applicable tax rate and the applicable municipal multiplier.[42]

2.6.2. Considerations relating to the tax treatment of business entities

Partnerships are treated as tax transparent. This means that net assets of partnerships are subject to wealth taxation while net income is subject to individual income taxation (*Erwerbssteuer*) if an interest in the partnership is held by individuals subject to taxation in Liechtenstein.[43] For the determination of taxable income an adequate interest that would be paid on the own capital employed in the business in the amount of the nominal income as referred to in article 5 LTA is deducted.[44] If the individual participating partner gives debt to the partnership, the interest income – in compliance with the arm's length principle[45] – is not subject to tax because it is derived from the shareholding that was subject to wealth tax.[46]

If an interest is held by corporations, net income of the partnership is subject to corporate income taxation, including interest income if the corporation gives debt to the partnership (regarding the arm's length principle).[47] The corporation is also entitled to an NID of 4 per cent based on the modified equity.[48]

Under the new Tax Code, basically all reorganizations (i.e. change of legal form, split-up and split-off, merger and contribution of a business as well as exchange of shares) can be tax neutral on a roll over basis where applicable if and insofar as the taxation rights of Liechtenstein are not excluded or restricted due to the reorganization. Upon a change of legal form, a split-up or split-off and a merger, a universal succession for tax purposes is assumed for the receiving entity. Retroactivity for tax purposes of not more than eight months is allowed.[49]

Apart from the full dividend exemption, a comprehensive international group taxation regime ensures that losses incurred by one entity can be offset with the taxable income of another (related) entity. A tax group can be formed if one company owns more than 50 per cent of the shares in another company. Domestic as well as foreign subsidiaries can be included in the tax group without any distinction. Only domestic entities qualify as actual head of group but as foreign subsidiaries qualify as deemed head of a subgroup when calculating the attributable losses, group taxation is not limited to the first-tier foreign entity but can include lower-tier foreign entities as well. Under the group taxation regime, each group entity keeps its own loss carryforwards but current losses can be transferred to another group entity. There are numerous recapture rules (combined with a reversal of the burden of proof, i.e. the taxpayer has to prove that recapture is not triggered) to ensure that losses are only temporarily transferred but cannot be offset more than

[42] See above, section 2.
[43] Arts. 9 para. 2, 12 para. 3, 14 para. 2(b), 4 LTA.
[44] Art. 16 para. 2(b) LTA.
[45] Art. 49 LTA.
[46] Art. 15 para. 1a LTA.
[47] Art. 47 para. 1 LTA.
[48] Art. 54 para. 1, 5 LTA.
[49] Art. 52 LTA.

once.[50] However, between the group entities there is no consolidation. As a consequence, loans between the companies – under the arm's length principle – and dividends from the subsidiary to the shareholder are still possible.

3. Classification as debt or equity

3.1. General approach to characterization

In Liechtenstein the classification of an instrument as debt or equity capital for tax purposes follows the instrument's classification for financial accounting purposes. Special provisions or approaches do not exist regarding a classification. For example, preferred stocks are equity and bond issues like zero-bonds are debt. Multiple instruments are treated with a disaggregation approach. The treatment of profit participating loans follows an economic apportionment.

3.2. The role of the tax authorities

To reduce administrative uncertainty the Liechtenstein tax authorities will provide an advance ruling regarding the treatment of particular transactions.[51]

4. Targeted government approaches to address issues raised by classification rules

In principle, the Liechtenstein tax system does not affect decisions on the various choices of economic agents e.g. choices between financing options. Therefore, the Liechtenstein Tax Law does not have any special reclassification or thin capitalization rules.

A general anti-avoidance rule is applicable, if legal or actual structures that appear inappropriate to the economic circumstances, and whose sole economic purpose consists in attaining tax advantages, are considered abusive if the granting of this tax advantage would violate the object and purpose of this Act; and the taxpayer is unable to present any economic or other substantial reasons for the choice of this structure and if the structure does not yield any independent economic consequences.[52] For example there is no possibility of abusing the NID by "overcap - italization" to achieve an excessive NID through unproductive capital because assets not necessary for business operations are deducted from the modified equity capital.[53]

50 Art. 58 LTA.

51 See also Felder, "Liechtenstein Corporate Taxation", in van Boeijen-Ostaszewska (ed.), *European Tax Handbook 2011*, Amsterdam: IBFD, 2011, p. 497.

52 Art. 3 LTA.

53 Art. 32 para. 3, 6 LTO (Liechtenstein Tax Ordinance). Government of the Principality of Liechtenstein, *op. cit.*, 2009, p. 31. See also section 6.

5. Financial market responses to tax and other constraints on achieving desired goals

5.1. Example 1: related and unrelated party debt

Because of the neutrality of the tax system, Liechtenstein does not distinguish between related party debt and unrelated party debt. Regarding loans between affiliated companies, the arm's length principle has to be considered. Where corporate income or expenses of a taxpayer arising from a business relationship with persons with a close relationship are changed in such a way that other conditions are taken as a basis than those that mutually independent third parties would have agreed under otherwise identical circumstances, the determination of taxable net corporate income assumes the corporate income and expenses that would have applied in a relationship between independent third parties.[54] The LTA issues a yearly circular, which indicates the maximum interest rate for loans between companies and shareholders/persons with a close relationship.[55] Interest income exceeding this rate is subject to corporate income tax of the issuing company.[56]

Financing a company by a direct loan from a bank, the taxable income of the company is reduced by the interest expense for the loan, e.g. 2 per cent. In contrast, if the shareholder (irrespective of whether it is an individual or a corporate shareholder) takes the loan from a bank and gives it as equity to its company, the taxable income of the company is reduced by the NID of 4 per cent. The shareholder refunding the capital by a bank loan has to pay the interest expenses, e.g. of 2 per cent.

Alternatively, if the shareholder gives the capital as a loan to the company, the maximum interest rate of 2 per cent for loans between companies and shareholders has to be observed.[57] Rates exceeding the maximum interest rate are hidden distributions with a requalification as tax exempt dividends at the level of the shareholder.[58]

If the company makes a loan – resulting from equity – to the shareholder, the taxable income of the issuing company is reduced amounting to the NID of 4 per cent. Interest income from the loan is charged at least at 2 per cent[59] and increases the taxable income of the issuing company to that amount. Interest rates which fall below this limit are not accepted and the minimum interest rate of 2 per cent is assumed.

If the company issues a loan – resulting from debt e.g. from a separate bank loan – to the shareholder, the taxable income of the issuing company is reduced by the

54 Art. 49 LTA.

55 Liechtenstein Tax Authority, *Merkblatt betreffend Zinssätze 2011 für die Berechnung der geldwerten Leistungen*, 2011.

56 Arts. 47 para. 3(g), 49 LTA.

57 Liechtenstein Tax Authority, *Merkblatt betreffend Zinssätze 2011 für die Berechnung der geldwerten Leistungen*, 2011.

58 For corporations as shareholder see art. 48 para. 1(e) LTA; for individuals as shareholder see arts. 9 para. 1, 15 para. 1(a) LTA.

59 Liechtenstein Tax Authority, *Merkblatt betreffend Zinssätze 2011 für die Berechnung der geldwerten Leistungen*, 2011.

interest expenses for the bank loan, e.g. 3 per cent. The minimum interest rate between the company and the shareholder is the costs plus 0.5 per cent, at least 2 per cent, in this case the rate is 3.5 per cent. Interest rates which fall below the minimum rate are not accepted and the minimum interest rate is assumed.

5.2. Example 2: subordinated debt

Because there are no special rules relating to the treatment of subordinated debt in Liechtenstein tax law, it is recommended to contact the Liechtenstein tax authorities for an advance ruling.[60]

5.3. Example 3: withholding taxes on dividends and interest

In Liechtenstein tax law there are no withholding taxes on dividends or interest,[61] i.e. the treatment of dividends and interest in Liechtenstein as the source state is the same.

6. Structural changes to address the debt–equity distinction

6.1. Financial neutrality as a guiding principle in Liechtenstein tax law

One of the guiding principles of the tax reform was to achieve decision neutrality where possible and to avoid (judicial and economic) double taxation. Whereas natural persons were already granted some kind of NID prior to the tax reform, the tax reform:

- established a closer link between the taxation of legal persons and shareholders;
- extended the NID to legal persons; and
- eliminated the previous tax disadvantages of equity financing.

Interest paid on debt is tax deductible as a regular business expense at the level of the debtor company. This "tax shield" of debt often gives rise to excessive debt financing as the after-tax cost of equity capital is increased compared to debt financing. The goal of the allowance for corporate equity in the form of an NID is that for tax purposes, equity and debt financing are treated the same way. The company should be free in its financing decision and there should be no tax advantage for debt financing which leads to increased leverage and thin equity capitalization. As equity, other than debt, does not bear fixed interest, the company is granted an NID rather than allowing the company to deduct actual payments on equity (e.g. dividends). Thus, assuming a market interest rate equal to the NID, the overall tax effects of debt and equity are the same.

[60] See Felder, *op cit.*, p. 497.
[61] *Ibid.*, pp. 498 *et seq.*

Moreover, the effective tax rate is reduced thanks to the notional interest rate (depending on the return on equity).[62]

However, financial neutrality requires more than the introduction of an NID. To avoid double taxation at the corporate level, taxable income should be subject to taxation once, using a group taxation regime, an imputation system, or an exemption system,[63] as article 48 Abs. 1(e)(f) LTA allows. In the old LTA legal rules for participation exemptions were lacking, but administrative practice granted a deduction for participations when calculating the capital tax and the corporate income tax, in order to prevent double taxation of participations and distributed profits of a subsidiary.[64]

The tax reform grants legal persons the NID previously only granted to commercially active natural persons.[65] Consequently, tax neutrality with respect to decisions concerning legal and organizational forms is complemented.

Under the old tax law, legal persons were subject to a capital tax (*Kapitalsteuer*) on their equity with a tax rate of 0.2 per cent,[66] which was an infringement of the neutrality with respect to decisions concerning financing. The tax reform abolished the capital tax and so tax neutrality was achieved. The tax reform avoids taxation with an impact on equity, which under the capital tax could occur in years with weak earnings.[67]

The old tax rate of the income tax varied between 7.5 per cent and 20 per cent, depending on the return on equity and the amount of distributions made. Additionally, a 4 per cent coupon tax (*Couponsteuer*) was generally levied on dividend distributions.[68] The tax reform also abolished the coupon tax,[69] completely revised the tax rate structure with the implementation of a flat rate tax of 12.5 per cent[70] on taxable net profit and granted a comprehensive participation exemption.[71] At the level of legal persons, the tax reform implements the criterion of tax neutrality with respect to decisions concerning the appropriation of profits.[72]

6.2. Application of the NID

Article 54 of the Tax Act also applies to legal persons with an effective place of management in Liechtenstein (which also triggers unlimited corporate income tax liability) and to non-resident legal persons who are subject to limited corporate income tax liability, e.g. due to a business activity carried out through a permanent establishment (e.g. a place of management, a branch, an office, a factory, a workshop, and similar fixed places of business) in Liechtenstein. Thus, wherever the Liechtenstein corporate income tax applies to income earned by a legal person, the

62 Government of the Principality of Liechtenstein, *op. cit.*, 2009, p. 30 Infobox.
63 Fane, "Neutral taxation under uncertainty", *Journal of Public Economics*, 1987, pp. 95 *et seq.*
64 Liechtenstein Tax Authority, *Wegleitung zur Steuererklärung 2010 für juristische Personen*, p. 17.
65 Government of the Principality of Liechtenstein, *op. cit.*, 2009, p. 30.
66 Arts. 76 para. 1, 79 para. 1 LTA (previous version before 2011).
67 Government of the Principality of Liechtenstein, *op. cit.*, 2009, pp. 27, 29.
68 *Ibid.*, p. 27.
69 Arts. 88d para. 1(a), 88h para. 1(a) LTA (previous version before 2011); please note the continued validity of law previously in force in art. 158 LTA.
70 Art. 61 LTA.
71 Art. 48 para. 1(e)(f) LTA.
72 Government of the Principality of Liechtenstein, *op. cit.*, 2009, p. 31.

NID applies when calculating the taxable income subject to corporate income tax in Liechtenstein.

In the case of restricted tax liability,[73] only the share of equity capital shall be taken into account which is attributable to the assets generated by domestic income as referred to in article 44 paragraph 3 LTA.[74] If the business year does not extend to 12 months, the NID may be claimed *pro rata temporis*.[75]

6.3. Definition of the modified equity capital

An appropriate definition of the assessment basis for the NID (modified equity capital entered in the balance sheet, reduced in particular by participations and net assets of foreign places of business, see section 6.4) ensures that the effects of the NID only obtain once, irrespective of the organization of entrepreneurial activity. At the same time, it is ruled out that the NID can be abused through circumvention measures: a double benefit is not possible and nor is there a danger that companies will henceforth be "overcapitalized" to achieve an excessive NID through unproductive capital.[76]

The modified equity capital encompasses paid-in nominal capital, capital stock or share capital and the reserves constituting own assets. Assets not operationally necessary are deducted.[77] Assets not necessary for business operations means assets that do not predominantly serve the actual object of the business.[78]

The starting value for calculating modified equity capital is the equity capital determined in accordance with articles 18 or 21 LTO, taking account of taxed added and reduced values. In the case of investment undertakings, only the equity capital shall be used which is not attributable to the assets managed in accordance with the Law on Investment Undertakings.[79]

6.4. Deductions

When calculating modified equity capital, the following shall be deducted from the starting value:

(a) personal participation as referred to in article 151 PGR;
(b) any participation in other domestic and foreign legal persons;
(c) foreign immovable property, after deduction of the debts attributable to that property (net landed property assets);
(d) assets of foreign permanent establishments, after deduction of the debts attributable to that property (net permanent establishment assets);
(e) assets not necessary for business operations.[80]

Net assets of foreign permanent establishments and foreign landed property are excluded from the NID. Net assets are assets attributable to the foreign permanent

[73] Art. 44 para. 2 LTA.
[74] Art. 32 para. 2 LTO.
[75] Art. 32 para. 7 LTO.
[76] Government of the Principality of Liechtenstein, *op. cit.*, 2009, p. 31.
[77] Art. 54 para. 2 s. 1 *et seq.* LTA.
[78] Art. 32 para. 6 LTO.
[79] Art. 32 para. 1 LTO.
[80] Art. 32 para. 3 LTO.

establishment or foreign landed property less any liabilities attributable. The reason for this is the attribution of both liabilities as well as equity to the domestic (and taxable) part of the activities of the legal person and to the foreign (and tax exempt) activities of the legal person in order to treat debt and equity alike also in a cross-border context.

According to article 48 paragraph 1(a) LTA "corporate income from the cultivation of foreign real estate used for agriculture or forestry and from any other agriculture or forestry" and according to article 48 paragraph 1(b) of the Tax Act "foreign permanent establishment results" are fully tax exempt in Liechtenstein in order to avoid international double taxation.[81] As a consequence, the equity invested in these assets is also excluded from the NID. The reason behind this is that even where a legal person is subject to unlimited tax liability, Liechtenstein does not extend its taxing rights to income earned in foreign permanent establishments (similar to a territorial system). If Liechtenstein did not exclude net assets of foreign permanent establishments from the NID, notional interest would be calculated on equity that generates income which is not taxed in Liechtenstein, possibly giving rise to a double deduction. Assuming that Liechtenstein would not exclude the net assets invested in a foreign permanent establishment and assuming that this foreign state would have the same tax system as Liechtenstein, the NID would be granted twice (which would actually be the case if a Liechtenstein legal person had a permanent establishment in Belgium and Liechtenstein did not exclude the net assets of this permanent establishment from the NID).

It has to be noted that choosing to exclude net assets in foreign permanent establishments from the NID is only a technical aspect of the non-taxation of income earned in foreign permanent establishments. If NID had to be calculated also on net assets in foreign permanent establishments, this would not mean that the NID could be offset against income taxable in Liechtenstein. As described above, Liechtenstein exempts income from foreign permanent establishments (i.e. net income) from taxation. This means that, e.g. to the extent business expenses are attributable to this permanent establishment, they will effectively not be deductible in Liechtenstein. Thus, if an NID were calculated on equity attributable to a foreign permanent establishment, the expenses would be deducted against the income of the permanent establishment and would as such lower the amount of income that is tax exempt in Liechtenstein. This is exactly the case with debt attributable to a foreign permanent establishment. Any interest paid on this debt will only be deducted against the (tax exempt) income of the foreign permanent establishment. Such attribution of income and deductions to foreign permanent establishments and the domestic head office follows international guidelines and principles.

In addition to the exclusion of net assets in foreign permanent establishments and foreign landed property, the equity attributable to domestic and foreign shareholdings is also not subject to the NID. The reason for this is similar to the exclusion of net assets of foreign permanent establishments and foreign landed property. The legal person that is granted the NID will be taxed neither on the income from the foreign permanent establishment nor on the income of its shareholdings. In the case of a domestic shareholding, NID will be granted at the level

[81] Please note that the following only refers to foreign permanent establishments for reasons of readability. The argumentation *mutatis mutandis* also applies to foreign landed property.

of the subsidiary, meaning that equity attributable to this shareholding has to be excluded from the NID at the level of the parent company in order to prevent double deductions. In the case of a foreign shareholding as well as in the case of foreign permanent establishments, the allocation of taxing rights to the other state means that Liechtenstein does not tax the income and therefore does not grant NID.

6.5. Calculation of the modified equity capital

A valuation shall be performed as of the beginning of the business year; accruals and decreases in assets during the current business year shall be taken into account. If the modified equity capital is negative, the NID shall be CHF 0. The NID may give rise to or increase a current loss.[82]

Equity capital increases during the current year by way of open and hidden deposits as well as equity capital decreases during the current year by way of capital reductions and repayments and by way of open or hidden distributions shall be taken into account *pro rata temporis* when calculating modified equity capital; increases and decreases in a given quarter shall be aggregated and deemed to have occurred in the middle of the quarter. The modified equity capital shall also be increased or reduced by half of the annual result relevant for tax purposes. The annual result relevant for tax purposes shall correspond to the balance of the values referred to in article 47 paragraph 3(a)–(e)(g) LTA.[83]

The deductions referred to in article 32 paragraph 3 LTO shall each be taken into account according to the average value of the business year when calculating modified equity capital. The average shall be determined on a quarterly basis; increases and decreases in a given quarter shall be aggregated and deemed to have occurred in the middle of the quarter. If these data are not available, another method may be applied upon application. In special cases – especially in the case of participations in legal persons and assets not necessary for business operations – the fiscal authority may demand a more precise determination of the average.[84]

6.6. Rate for the NID

Therefore reasonable interest paid on the modified equity capital in the amount of the notional income set out in article 5 LTA – in 2011 4 per cent[85] – is deemed as a commercially justified expense.[86] The rate for the calculation can potentially be adjusted by the Liechtenstein Parliament in the Finance Act, but it is linked to the notional interest rate that is applied for the purpose of the wealth tax on individuals (i.e. when calculating the notional income according to article 14 paragraph 2(I) LTA). If the rate to be applied to the NID is changed, so will the rate to be applied when calculating the notional income be changed as both rates are defined by making reference to article 5 LTA.[87]

82 Art. 54 para. 2 s. 3 *et seq.*; para. 1 s. 2 LTA.
83 Art. 32 para. 4 LTO.
84 Art. 32 para. 5 LTO.
85 Art. 3 Finance Act 2011.
86 Art. 54 para. 1 LTA.
87 Government of the Principality of Liechtenstein, *op. cit.*, 2010, p. 68.

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