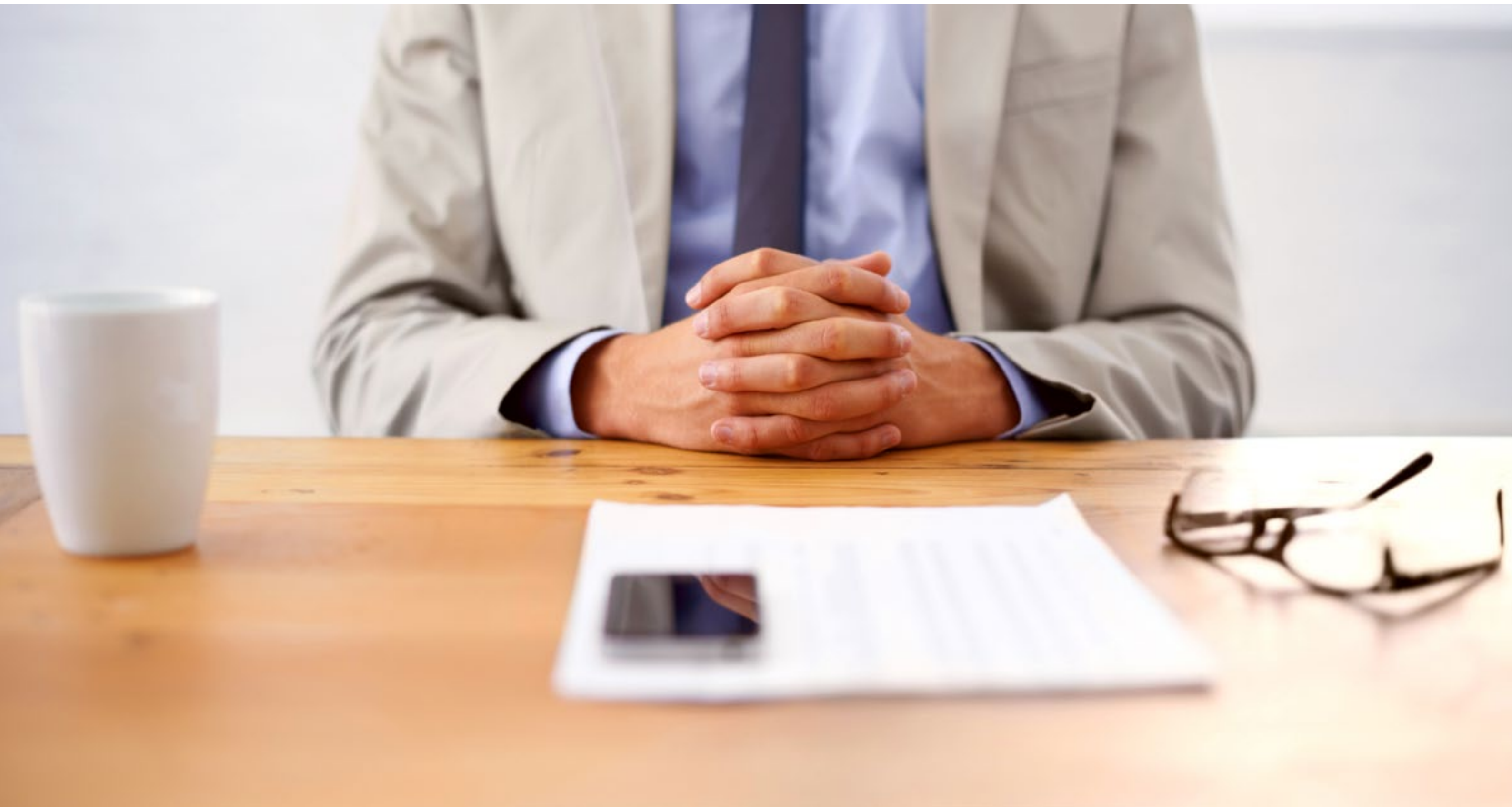
Tightening of tax rules for Liechtenstein companies



Executive Summary

In connection with developments concerning the EU Code of Conduct, Liechtenstein has decided upon significant amendments to the Tax Act with effect from 1 January 2019. The most relevant amendments can be summarized as follows:

- Tax exemption on income from participations for low-taxed participations with passive income will be abolished
- Tax exemption of capital gains will be abolished for participations of which distributions are no longer tax-exempt
- Tax deductibility of losses on participations is abolished
- The anti-abuse provisions for the notional interest deduction on equity are extended

Companies subject to tax in Liechtenstein are recommended to clarify the implications of these changes and to consider possible measures in the business year 2018, with a view to the entry into force of the provisions with effect from January 1, 2019.

Overview of the major changes

On June 7, 2018 the Liechtenstein parliament has decided upon a number of amendments to the Tax Act which will particularly affect Liechtenstein tax resident companies. The reasons for these changes are the requirements of the EU and its Code of Conduct on Business Taxation Group (COC Group). The Code of Conduct on Business Taxation is a code of conduct for EU Member States, aimed at eliminating harmful practices in corporate taxation and preventing the creation of new harmful practices in the future. In that context the EU has demanded that various countries outside the EU adapt national tax laws and has decided to publish a blacklist of countries which in its opinion are to be treated as "uncooperative". In order to avoid being placed on this blacklist, Liechtenstein has promised to amend the criticized regulations in the Tax Act by 31 December 2018. Among those reviewed regulations are the unrestricted tax exemption of income from participations, the unrestricted tax exemption of capital gains on participations, the asymmetric treatment of capital gains and capital losses on participations as well as the anti-abuse provisions concerning the interest deduction on equity.

1. Abolition of tax exemption on distributions for low-taxed participations with passive income

Up until now the principle was that distributions from participations are in general exempt from Liechtenstein corporate income tax insofar as the distribution was not treated as a tax deductible expense at the level of the participation.

The exemption of distributions is henceforth restricted. The restrictions concern participations for which the following prerequisites are cumulatively fulfilled:

Prerequisite	Explanation
Investment in a foreign company	The criterion is whether the company is subject to **unrestricted taxation** in Liechtenstein.
More than 50% of the total income of the investment company consists sustainably of "passive income"	**Passive income** is defined as interest or other income from financial assets, royalties or other income from intellectual property and income from financial leasing. Likewise, distributions from direct or indirect **subsidiaries** which for their part have received passive income, are also deemed "passive income". **Operational business** activities in the principal purpose of the company do not count as passive income. Examples would be the interest business of a bank or trading activities of an entity in a low-tax jurisdiction. In this context, sustainable means that the generation of passive incomes is intended on a long term basis.
The net profit of the investment company is subject to no tax or is subject to low taxation abroad	A distinction is made for the level of participation: • For **participations below 25%** low taxation means a tax rate below 6.25%. • For **participations of 25%** and higher, the effective tax burden abroad is compared with the hypothetical tax burden in Liechtenstein. If the effective tax burden abroad is less than half of the theoretical tax burden in Liechtenstein, it is seen as low taxation.

Distributions from investments that have been held prior to January 1, 2019 benefit from a transition period of three years. Income from such investments will only be subject to the new anti-abuse provision for distributions as of the tax year 2022. There are, however, uncertainties attached to this grandfathering provision. Thus, we recommend analysing and implementing potential measures already in the tax year 2018.

2. Abolition of tax exemption on capital gains in participations of which distributions would henceforth be subject to tax

If the income from a participation is not tax-exempt due to the above-mentioned provision, a capital gain in the event of disposal of the participation is not tax-exempt either. This provision can lead to a considerable (deferred) tax burden in case of participations in countries with low tax rates. It is strongly recommended to consider measures to optimize the deferred tax burden.

Corresponding to the above-mentioned distributions there is also a grandfathering provision until 2021 for the new anti-abuse provision on capital gains in case the investment has been held by the Liechtenstein parent entity before January 1 2019. However, there are uncertainties in regard of the grandfathering provision. Thus, we recommend analysing and implementing potential measures already in the tax year 2018.

3. Capital losses on participations are no longer deductible

Up until and including 2018, tax deductions can be claimed for realized and unrealized losses on participations. From January 1, 2019 onwards, losses on participations are no longer treated as deductible expenses for corporate income tax purposes.

The existing system for recaptured depreciations is to be continued. This means that write-offs and capital gains which relate to earlier depreciations (which led to a tax deductible depreciation) remain taxable income.

4. Restrictions to the notional interest deduction on equity

In the opinion of the COC Group, there can be situations in which Liechtenstein tax resident entities can claim an undesired (i.e. too high) notional interest deduction on equity. Therefore, the following additional restrictions and anti-abuse provisions on the notional interest deduction on equity are introduced:

- If the parent company has a high level of debt financing and for its part finances a subsidiary company with equity, the parent company can claim a tax deduction for the interest on the debt and the subsidiary can claim the notional interest deduction on equity. This can lead to high combined interest deductions. To restrict double deductions, an anti-abuse provision is introduced. This means that all subsidiaries which want to claim notional interest deduction on equity must be financed with equity at the parent company's level. Lacking equity financing at the parents level will result in taxable amendments of interest deductions at the level of the parent company.
- The acquisition of business operations, contributions or the transfer of participations between related parties that are executed to generate a higher notional interest deduction on equity, are deemed abusive and the corresponding notional interest deduction on equity is disallowed. The specific cases of application of this anti-abuse provision and in particular the proof that these transactions were not driven by tax considerations, but rather by business or other significant reasons will have to be defined through case law.

Need for action

The tightening of rules concerning distributions from participations and capital gains on participations represent a challenge for Liechtenstein as location for holding companies. In particular, entities with participations in low-tax countries will have to consider adjustments in accounting and sometimes the company structure in order to reduce detrimental tax effects. Furthermore, there is an increase in the need for information and administration for international participations. The grandfathering provision for implemented structures until 2021 may provide some time to evaluate and implement measures. However, considering the uncertainties attached to the grandfathering provisions, we recommend from a risk perspective to evaluate and implement measures in 2018 as far as possible. The review of the current structures should also be used to verify potential implications of the tightened rules around the effective place of management for qualifying underlying companies.

With a view to the abolition of the deductibility of capital losses on participations, these are to be re-valuated per December 31, 2018.

The additional anti-abuse provisions concerning the notional interest deduction on equity should have less practical significance for most companies. The implications (particularly for domestic holding structures) are to be examined on a case by case basis.

The changes will enter into force for the tax year 2019. It is therefore imperative that tax planning considerations be undertaken and implemented in 2018.

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