NFI
STEUERBERATUNG

Liechtenstein: Tightened practice on Thin Capitalization

Tightened practice

Since the 2017 tax period, interest on borrowed capital to the extent of the over-indebtedness of the Liechtenstein company has been denied for corporate income tax purposes, which is to be understood as a thin capitalization tax requirement. The Liechtenstein tax administration has now expanded this practice and has begun to critically examine the relationship between debt and equity if the Liechtenstein company is mainly financed with debt from related parties and holds participations. The tax administration is of the opinion that part of the borrowed capital takes on the function of equity from an economic point of view. Tax regulations on minimum equity capitalization for debt financing by related parties are widespread internationally and are not unique to Liechtenstein.

Impact

The tightened practice means that the tax-deductible interest on borrowed capital is limited to the "recognized" borrowed capital, even if there is no over-indebtedness. The new practice applies exclusively to domestic companies with participations that are heavily financed by related parties. In principle, the notional interest deduction on equity (NID) would be applicable to the portion of the borrowed capital which economically has the function of equity. Since the modified equity for the purpose of the NID is reduced in full by the investment value of the participations, the new practice leads to a reduction in the interest deduction without a simultaneous increase in the NID.

Arm's length principle

The tax administration justifies its tightening of practice with the arm's length principle according to Art. 49 of the Liechtenstein Tax Act. The arm's length principle states that income and expenses between related parties are to be assessed for tax purposes as they would have been incurred in a relationship between independent third parties. In this context, the extent to which an independent third party would have financed the company's balance sheet with borrowed capital is now also being assessed.

In our opinion, this line of argument can be followed in principle. In practical application, however, it must also be taken into account that there is a connection between the debt financing ratio and the applicable interest rate. The more the balance sheet is externally financed with debt, the higher the risk of the external capital provider, which has to be compensated with higher interest rates. The safe haven interest rates published annually by the Liechtenstein tax authorities naturally reflect average debt financing rates and should therefore generally be lower than the third-party interest rate in the case of higher risks. Another element within the framework of the arm's length principle are the provable hidden reserves on the balance sheet. When considering the allocation of debt, an independent third party would consider this as equity of the company. In our opinion, it would therefore be appropriate that the provable hidden reserves are also taken into account for the assessment of the tax-recognized debt capital.

Principle of financing neutrality

In addition to the arm's length principle, Liechtenstein's tax law is also based on the principle of financing neutrality. When drafting the law, it was the will of the legislator that the choice of financing form could be made solely based on entrepreneurial aspects without being influenced by taxes. Against this background, the equity interest deduction was introduced so that financing with equity capital is treated the same as financing with debt capital.

Naturally, there is a tension between financing neutrality, which does not want to favor or impede any form of financing for tax purposes (i.e. the aim is freedom of financing) and the arm's length principle, which aims to limit the tax-recognized expenses to third-party comparison. In our opinion, the application of the arm's length principle limits financing neutrality but does not violate it. This is especially true against the background that the tax authorities continue to allow the interest deduction in the case of debt-financed participations on the debt capital that an independent third party would have financed. Thus, the limitation of the interest deduction only affects that capital which no one other than the shareholder would be willing to finance and which therefore has the character of equity.

Conclusion

Due to the principle of financing neutrality stipulated in the tax law, intervention by the tax authorities in the choice of a company's form of financing should be carried out rather cautiously. If, under the arm's length principle, a company is partially denied the debt capital character of loans from related parties, we believe that the taxpayer must still be able to prove the arm's length comparison. This applies both to the applicable interest rate on borrowed capital and to eligible equity in the form of hidden reserves.

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