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Economic Substance Requirements under new AML Law in Liechtenstein

Introduction

At very short notice, to be specific a few weeks before the revision of the criminal offence of money laundering (Article 165 of the Liechtenstein Criminal Code; StGB) came into force on 1 July 2019, the Liechtenstein banks surprised the players in the financial centre by announcing that, as of the date of the revision coming into force , the banks would regard business relationships involving the use of active companies (active in production, trade, or service providers) without physical substance, as a means of tax optimization and thus potentially classify them as tax fraudulent.

For the carrying out of future business using banking operations, such companies would have to provide evidence that an appropriate substance exists at the place of actual management and that the company makes economic sense. In the event that the requested proof cannot be provided, the banks would unilaterally take measures in the form of transaction blocks up to forced exit by account closure.

The focus of the banks was in particular on potentially insubstantial domiciliary companies as well as on commission payments without an economic background, since in these cases tax

fraud is assumed by virtue of the regular use of forged or falsified documents, which coincidentally commits a predicate offence to money laundering. Such circumstances would lead to a corresponding money laundering reporting obligation for the banks and possible criminal liability in the event of failure to report.

In this context the banks fear that, as a result of the law revision with its new inclusion of “saved expenses” as an asset component and thus an object of money laundering, fairly any bank transaction could potentially fulfil the criteria of money laundering and thus potentially the banks, their employees and management bodies could be held liable and hence prosecuted for aiding and abetting money laundering.

AML Law Revision

Article 165 para 5 StGB stipulates in its new valid version that a tax fraud as predicate offence to money laundering is deemed to be given, if by a tax fraud a pure tax saving was attained. If it was so far a prerequisite for tax fraud that under involving of forged or falsified documents an asset inflow effectively took place, it newly shall be sufficient that there is no or too little asset outflow. Such saved expenses are thus also treated as an asset component, by which money laundering can be carried out.

In the wake of the OECD lanced activities to combat tax evasion (BEPS), this amendment is primarily aimed at domiciliary or management companies without own personnel or business premises, which do not conduct business activities and are used for money laundering. It therefore concerns the misuse of legal tax planning resources by the use of financing and management companies, holding companies, purchasing or re-invoicing companies for the purpose of tax fraud.

Their interposition does not in itself constitute tax fraud, but it will be necessary to meet the stricter requirements for the proof of economic substance of these companies in the sense that they actually perform the functions serving their corporate purpose and thus generate added value.

Proof of sufficient tax substance in potentially critical transactions

Outside the scope of consideration are, in any case, situations in which companies develop a real economic activity and this activity is directed towards generating income. The banks started to consider rather uncritical transactions (purchase/sale) concerning real estate and other assets, which are to be held in the long term for the purpose of management for the persons beneficially entitled to them, to be critical and therefore also serve as a long-term investment. Transactions that serve the administration and maintenance of these assets (salary payments, payments for the maintenance of real estate, etc.) are also fully out of scope as well as transactions relating to the purchase/sale of financial investments and the resulting dividends and interest payments, provided this is done as part of asset management.

To the contrary, transactions that represent income from services, commissions, consulting fees, licensing revenues, royalties, etc., are regarded as potentially critical. Further, loans or

collateral to other domiciliary companies even for use in an operating context are earmarked to be critically evaluated.

Apart from the fact that a case-by-case assessment will be carried out, it can be assumed that sufficient tax substance will always be on trial when key operative business decisions are not made by the company concerned, but outsourced to third service providers or are delegated to a sub-company within the group. Such delegation is particularly problematic with regard to the company's core functions, which according to their scope and complexity, represent its essential business activity. Though, when assessing the tax substance, it shall regularly be harmless to outsource ancillary services. In a nutshell, if the company does not develop on its own and fails to pursue its own business purpose, the company will be qualified as solely exerting the function of an empty shell which lacks the necessary substance from an economic and tax point of view.

Criteria for passing the test of substance

The recommendations of the OECD/G20 countries in the frame of the BEPS initiative to combat international profit cuts and profit shifts (Base Erosion and Profit Shifting – BEPS) in any case will serve as prominent and essential reference. The reports published by the OECD in October 2015 and the BEPS action plan of measures adopted by the governments at the G20 summit in Turkey on 16 November 2015 defined 15 action points and adopted recommendations to be implemented in national law by the participating states. At least the Action Point 5 on transparency and substance, Action Point 6 on the prevention of abuse of tax treaties and Action Points 8 to 10 on intangible assets, capital and risks as well as other transfer pricing aspects deal with the subject of substance in greater depth.

A common feature of all the fields of action mentioned therein is that, with regard to the business purpose pursued by a structure or specific company, its function and business activity, the lack of economic substance will be regarded as an indication of harmful practices. As a result, three main substance-related criteria have emerged internationally, namely economic substance on **appropriate use of personnel and infrastructure**, **functional substance** and the proof of sufficient **financial substance**.

To fulfil its business purpose, a company needs the appropriate personnel and infrastructure. Depending on the specific activity and industry, this can be done by the company's own personnel on site, but also by external service providers, provided that no operational business decisions are delegated in such a way that the company is deprived of its own business activity. The company purpose regularly determines the required level of qualification and skills of the personnel. In any case the personnel must have the capability to handle the total volume of business. Further, sufficient infrastructure through office space and technical equipment must assure the proper conduct of business activity.

Appropriate proof may be presented by means of employee lists with the corresponding employment contracts, invoices (telephone, etc.), account statements and contracts (rental contract, maintenance and service contracts, etc.). With regard to managerial staff,

information from curriculum vitae may give evidence on required skills and qualification. It may also be the subject of the audit whether the books of account are kept at the registered office of the company.

Under functional substance it is examined whether the economic development of the company is directed towards value creation and whether the purpose of the company is thus maintained and the economically founded structure of the company is also lived. Thus, it is checked whether an effective business activity is taking place. As a decisive criteria stands the requirement that the responsibility for the decision-making in respect of the pursuit of the company's purpose is actively exercised and not delegated. So if there is an independent decision-making authority of the local board of directors, this would generally speak in favour of a high functional substance.

Further, economic substance may be proven with sufficient financial substance, meaning that the company under consideration has appropriate financial resources for the pursuit of its purpose and business activity. Such capital resources shall take into account the given risk environment, so that capital is not merely "placed", but is actually available and used for the company's economic business activity.

Since a case-by-case assessment must be made for each specific case, the following principles should be observed in summary when carrying out an assessment:

- Each company with a specific defined company purpose pursues its corporate objective and fulfils certain and defined core functions in pursuit of this purpose. The associated business activity represents the core activity of the company. The necessary resources are human (personnel), infrastructural, functional and financial in nature and constitute the "substance" of economic development. This development is aimed at creating value as a result of effective economic and purposeful activity.
- A company regularly performs a core function, which cannot serve as a subject of delegation. When it comes to outsourcing of company services, it must be ensured that the operational decisions within the framework of the core activity are in any case taken by the company itself and outsourcing only relates to ancillary services.
- With regard to the specific function and business activity of each individual company, the main elements of economic substance such as appropriate skilled personnel, at least in the area of the core activity, suitable technical and spatial infrastructure, the meeting of the official authorisation or licensing requirements for the exercise of the business activity (e.g. trade licence) as well as technical know-how at management level shall be available.

Provided these criteria are observed, the evidence of an appropriate level of economic substance should be evident.

ML contamination of entire assets?

Tax liability in general follows the world income principle and the new ML-regulation

encompasses the omitted outflow of assets considering that there will be no concrete identifiable asset component resulting from the criminal offence. As a basic approach, the unjustified tax advantage thus covers the total assets.

However, the legislator recognised and took into account that such an “overall contamination” of the assets would be disproportionate and thus unconstitutional and that this would lead to an unjustifiable proliferation of the scope of money laundering. Consequently, the legislator himself interprets said provision in a way, that a portion of the total assets of the taxpayer should be segregated in such a way that the tax saving occurs in the country in which the tax evasion was located.

Thus, in the event that the expenses saved in the country of tax evasion are covered by sufficient assets, the assets located in Liechtenstein cannot be the subject of money laundering. Conversely, in the case of a tax evasion conducted in Liechtenstein, assets located abroad cannot be subject to money laundering as long as there are sufficient assets in Liechtenstein to cover the tax liability.

This does not apply when the taxpayer does not (or no longer) have sufficient assets in that country. The taxpayer must then expect that assets located abroad (or transferred there) will be subject to a criminal asset freeze there and that they will lose their ability and right to dispose of these assets with impunity. However, there is a strict limit to the amount which is not (or no longer) available in the country of the tax evasion and by no means includes all assets located abroad.

Sanctions along with Article 165 StGB

Article 165 para 1 StGB provides for a prison sentence of up to three years for delinquents who conceal assets arising from offences under Article 140 of the Tax Law or Articles 88 and 89 of the VAT Act, in particular by making false statements in legal transactions about the origin or true nature of those property elements, the ownership in or other rights to them, or where they are located. To be qualified as tax fraud, such misrepresentation requires the deliberate use of forged or falsified documents.

This contains in particular of business records, balance sheets, income statements, certificates or enclosures to the tax return. The legislator assumes that such documents are regularly involved in the use of companies that are completely without substance and function (the materials to the law explicitly mention these companies) and in the payment of commissions without any economic background. However, it is important in this context that the tax return itself is qualified as a pure declaration of intention, not of knowledge and is therefore not considered a document which qualifies under the provisions of tax fraud.

Article 165 para 2 StGB provides for a sentence of up to two years’ imprisonment for delinquents who knowingly brings to himself, takes into custody, converts, utilises or transfers to a third party such asset components which result from a tax fraud under Art. 140 Tax Law or (even without knowledge) from a tax offence under Art. 88 or 89 VAT Act. Thus, in contrast to para 1, para 2 also covers the economic transfer of assets which, in principle, have been

executed on a legal basis.

The range of sentences as laid down under Article 165 para 1 and 2 StGB increases up to a maximum of ten years' imprisonment, if such offence is committed with respect to a value exceeding the amount of Swiss Francs 75'000.00 or as a member of a criminal organisation or community.

Proceedings and convictions in absentia

In connection with the above outlined new AML-regulation, the legislator introduced an adjustment of the criminal procedural law, which has been and still is discussed as being quite controversial.

The new Article 295 Para. 1 of the Code of Criminal Procedure (StPO) allows the court to conduct proceedings regarding Article 165 StGB and passing the respective judgment in absentia.

With regard to criminal proceedings conducted before court in which the accused did not appear for the final hearing, it has already been admissible that the court may conduct the proceedings in absentia if certain conditions were met. So for example, if the defendant was already questioned in pre-trial detention and the summons to the final hearing were delivered to him personally.

The said article has now been supplemented by adding offences of money laundering with explicit reference to Article 165 StGB. The intention of the legislator was to prevent that proceedings pending before court could not be completed and concluded with a judgment, since the foreign delinquent ignored the proceedings in Liechtenstein. With this adjustment in procedural law, it should in future be possible to conduct money laundering proceedings in the absence of the accused and to terminate them with a judgment in absentia.

In principle, questions arise that this new provision will collide with the right to a fair trial guaranteed by Article 6(1) of the European Convention on Human Rights. According to the ruling practice of the European Court of Human Rights (ECHR), criminal proceedings conducted in the absence of the accused are only admissible if the accused has expressly waived his right to participate in the trial or if there are concrete indications that the accused intends to flee the proceedings.

Under this premise the legislator therefore declared its intention of taking into account the relevant case-law of the European Court of Human Rights appropriately, so that a judgment in absentia should only take place if the accused cannot be extradited to Liechtenstein beforehand with appropriate measures provided by bilateral extradition agreements. How this will be specifically handled in practise remains an open question at the present time.

Outlook and critical view

It follows from the adjustment of Article 165 of the Criminal Code that saved expenses in

connection with tax offences now also qualify as a potential and punishable act of money laundering. If the tax authorities are deceived about the true income, even if it originates from legal business activity, or if fictitious expenses lead to an illicit low assessment of tax, the resulting omitted outflow implements the fact of a saved expenditure in the sense of the said provision and is therefore newly qualified as an act of money laundering. The provision was taken from German criminal law (there: Article 261 StGB), where its practical relevance is still assessed very controversial and critically. The future will show whether and how this new provision will be applied.