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TAX ADVISERS LUXEMBOURG

ATOZ ALERT

Administrative Court clarifies the tax treatment of an interest-free loan (IFL) and overturns the decision of the Tribunal

04 December 2023

Introduction

On 23 November 2023, the Luxembourg Administrative Court (*Cour Administrative*, the "**Court**", which is the instance of appeal Court) held its decision (the "**Decision**") in a case concerning an interest-free loan ("**IFL**") which was granted by a Luxembourg company to its wholly-owned Luxembourg subsidiary.

The Decision overturns the decision of the Administrative Tribunal of 23 September 2022 which confirmed the position of the Luxembourg tax authorities ("**LTA**") that classified the IFL as a hidden capital contribution (rather than a debt instrument).

In our ATOZ Report (released in March 2023) we carefully analysed the classification and tax treatment of the IFL and reached the same conclusions as the Court. Considering the wide-spread use of IFLs to finance Luxembourg companies, the importance of the Decision cannot be overstated. Indeed, over the last year, some Luxembourg tax advisers became extremely concerned when considering the implementation of IFLs. As such, the Decision of the Court has contributed to much-needed legal certainty.

Background

The case involved a company resident in the Cayman Islands ("**CayCo**") that invested, as from 2016, via a Luxembourg investment platform into (distressed) debt owed by third parties. CayCo financed its Luxembourg subsidiary ("**LuxParentCo**") by a mixture of equity and a profit-participating loan ("**PPL**"). LuxParentCo used the funds received to finance its Luxembourg subsidiary ("**LuxSubsidiary**", the taxpayer) by a mixture of equity and (mainly) an IFL. In the Decision, it is stated that the IFL-to-Equity ratio was approximately 90:10 in 2016. LuxSubsidiary (the borrower) invested the funds received from LuxParentCo (the lender) mainly into distressed debt instruments.

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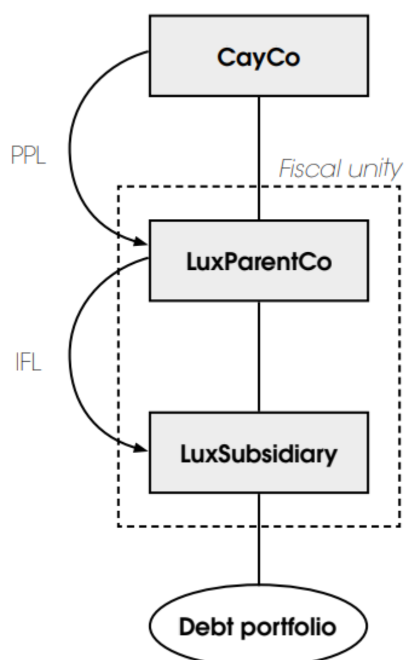
The following chart depicts the investment structure:



The IFL granted by LuxParentCo to LuxSubsidiary was formalised on 19 December 2016, whereas the funds had already been transferred on 29 April 2016.

LuxParentCo and LuxSubsidiary are Luxembourg companies that are subject to corporate income tax ("**CIT**"), municipal business tax ("**MBT**") and net wealth tax ("**NWT**").

In its 2016 corporate tax return, LuxSubsidiary performed a downward adjustment in relation to the IFL in order to account for deemed interest expenses that would have been due at arm's length. The downward adjustment was made in accordance with Article 56 of the Luxembourg income tax law ("**LITL**").

There are no indications that LuxParentCo realised any taxable income in 2016. However, LuxParentCo recognised deemed interest income in its corporate tax return (corresponding to the amount of the deemed interest expenses reflected in the 2016 corporate tax return of LuxSubsidiary). The upward adjustment was performed in accordance with Article 56 of the LITL.

The investments of LuxSubsidiary should be taxable assets for NWT purposes, whereas the IFL should be a deductible liability that reduces the company's unitary value if the IFL is classified as a debt instrument for tax purposes.

As from 2017, LuxParentCo and LuxSubsidiary formed a fiscal unity. Accordingly, the taxable income of both companies was aggregated at the level of LuxParentCo that reported the consolidated taxable income in its corporate tax return.

In 2017, no tax adjustments (upward or downward adjustments) were made in respect of the IFL. The absence of tax adjustments in the 2017 corporate tax returns was viewed by the LTA as an implicit acknowledgement that the IFL is not a debt instrument but a hidden capital contribution.

While the LTA may, for consistency purposes, require the same tax adjustments to be made as in the fiscal year 2017 (onwards), the deemed interest income and expenses would fully offset each other in the tax base of the fiscal unity. Thus, the recognition of deemed interest income and expenses would be merely a theoretical exercise without

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any practical implications in terms of tax liabilities. Therefore, the LTA should not attribute too much importance to the approach taken by the taxpayers as from 2017 as it is no indication for the classification of the IFL by the taxpayers.

Decision of the Court

OVERVIEW

According to the Court, the intention of the Luxembourg legislator (expressed in the parliamentary documents of the LITL) requires that the classification of a financing instrument follows the economic approach ("***wirtschaftliche Betrachtungsweise***"). This approach involves, for tax purposes, the economic reality prevailing over the legal form (also referred to as the "substance over form" principle).

Hence, it is necessary to analyse all relevant features of a financing instrument to determine the overall character of the instrument as either debt or equity. In this respect, the parliamentary document of the LITL indicates that it is necessary to carry out an overall analysis of the transaction rather than focusing on one or a few characteristics of the loan agreement under review.

CIRCUMSTANCES ASSESSMENT

The Court held in respect to the circumstances of the case that contrary to the position of the tax authorities:

- No useful conclusion can be drawn from the fact that the actual date on which the funds were made available differs from the date on which the IFL agreement was formalised.
- The allocation of the funds lent is relevant. Here, the loan received was not allocated to long-term fixed assets. Therefore, it does not constitute an indication of the existence of a disguised shareholding in the form of a loan.
- The debt/equity ratio must be assessed considering the debt/equity ratio requirements at the time the funds were made available.

ASSESSMENT OF THE FEATURES OF THE IFL

The Court noted that the loan agreement did not allow the lender to participate in the borrower's profits or liquidation proceeds and did not grant voting rights to the lender, all important equity features.

In addition, the Court considered in favour of a debt qualification of the IFL that:

- The IFL did not provide for an option of the borrower to unilaterally convert the loan into capital (according to the loan agreement, the lender had the right to require a conversion of the IFL at its sole discretion into capital).
- While the IFL agreement provides for the possibility of repayment of the loan in cash or in kind (this possibility is subject to the lender's acceptance and to agreement between the lender and the borrower on a method of valuation of the asset used for a repayment in kind), a repayment in kind may only be made with assets owned by the borrower (not with shares of the borrower).
- The IFL did not contain a stapling clause that would prevent the lender from transferring its rights and obligations arising from the IFL. On the contrary, the lender may freely assign its rights and obligations, whereas the borrower needs the consent of the lender to transfer its rights and obligations.
- The loan agreement provided for a ten-year maturity of the IFL and an obligation to repay the loan at maturity. However, a maturity of (only) ten years is not long enough to be an indication of the lender's intention to behave as an equity investor.
- The IFL contained a limited recourse clause, which, according to the Court, transferred risks to the lender but did not annul *ex ante* the borrower's repayment obligation. Consequently, it does not give rise to a presumption of the existence of a disguised participation in the form of a loan.

The Court further considered the following elements:

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- Debt instruments frequently provide for a remuneration in the form of interest. Hence, the interest-free element of the loan is an equity feature.
- The IFL agreement does not provide for a guarantee in favour of the lender and subordinates repayment of the loan amount in the event of the borrower's bankruptcy to prior repayment of any debt owed by it to a bank. However, third-party creditors (in particular a bank) requiring preferred creditor status in relation to the borrower's intra-group creditors is common in practice and cannot be taken as a conclusive equity feature.

As a last important element, the Court reiterated that the borrower made only very limited use of the credit facility and that the loan was repaid on 31 December 2018. Thus, in accordance with the principle of substance over form, and with the hindsight inherent in the analysis carried out by the Court (after the end of the relevant transactions), the Court concludes that the IFL was indeed executed by the parties as a loan that was even repaid well before the contractually agreed maturity.

CLASSIFICATION OF THE IFL

As the majority of the IFL's relevant features are debt features, the Court concluded that the IFL should be classified as a debt instrument.

Conclusion

The Court held that the classification of the IFL (as equity or debt) must follow an overall assessment of all relevant criteria. In the present case, most of the relevant features of the IFL were debt features. Therefore, the Court classified the loan as a debt instrument.

As the subject matter of the court case was the classification of the IFL as debt or as equity and the Court is limited by the grounds on which it has been involved, it could not itself review the downward (and upward) adjustment in principle (i.e. notional interest) and the arm's length nature of the notional interest rate declared by the borrower. However, the Court stated that it is led to hold that it was wrong to recharacterise the IFL as equity and to refuse to admit the amount put forward as notional interest.

Hence, the Court re-established long-standing principles with respect to the classification of financial instruments as debt or as equity (i.e. economic approach, substance over form). This contributes to much needed legal certainty regarding this fundamental tax question. Ultimately, considering the wide-spread use of IFLs to finance Luxembourg companies, the importance of this decision cannot be overstated.

Do you have further questions?

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