

ATOZ ALERT

Luxembourg Administrative Tribunal rules on the tax treatment of share class redemptions

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On 27 January 2023, the Administrative Tribunal (the “**Tribunal**”) ruled on the Luxembourg tax treatment of the redemption of a class of shares by a Luxembourg Company.

The Tribunal decided that the redemption is to be considered as a sale of shares, not as a dividend distribution. However, when the redemption price exceeds the fair market value of the redeemed share class, the excessive amount should be qualified as a hidden dividend distribution (which is, in principle, subject to 15% Luxembourg dividend withholding tax) if the excessive price is not justified by economic reasons.

In this ATOZ Alert, we provide a clear and concise overview of the judgment of the Tribunal and analyse its potential implications. However, it remains to be seen if the judgment will be appealed before the Administrative Court.

Understanding of facts

In 2014, a Luxembourg Company (“**Luxco**”) redeemed one of 10 classes of shares held by its single shareholder (a Cayman Island Company, “**Cayco**”). Prior to the redemption, Cayco held 12,500 ordinary shares of one euro each as well as 10 different classes of shares (classes A to J), each class being composed of 1,425 shares of one euro each. The classes of shares were created at the same time and did not track the performance of specific investments. Class J was the first share class that was redeemed, as the bylaws provided for share class redemptions in reverse alphabetic order. The redemption was followed by a cancellation of the shares with a decrease of the share capital of Luxco.

The redemption of share class J followed a disinvestment (i.e. the repayment of a loan that was granted in 2012 to a third party operating company). The redemption price of share class J was determined on the basis of all investments made by LuxCo at the time of the redemption.

Depending on the tax treatment of the proceeds on the share class redemption as either a (hidden) dividend distribution or as a sale of shares (resulting in capital gains), the redemption was either subject to 15% withholding tax (i.e. the Cayman parent company would not benefit from a withholding tax exemption under the Luxembourg participation exemption regime or a reduced withholding tax rate under an applicable tax treaty), or not be subject to withholding tax.

Qualification of the share class redemption from a Luxembourg tax point of view

Position of the tax authorities

The Luxembourg tax authorities (“LTA”) qualified the share class redemption as a hidden dividend distribution that is subject to 15% withholding tax. Based on the bylaws of Luxco, a preferred profit allocation was made to the remaining classes of shares, whereas the remaining profits (of all investments) were allocated to the last outstanding class of shares that was redeemed (and subsequently cancelled). The LTA denied the qualification of the redemption as a partial liquidation within the meaning of Article 101 of the Income Tax Law (“ITL”) on the grounds that the classes of shares lacked different economic or legal rights. A partial liquidation would not be subject to Luxembourg withholding tax.

Position of the taxpayer (Luxco)

Luxco argued that the redemption of the share class followed by a cancellation of the shares (resulting in a capital decrease) was to be qualified as a partial liquidation. Thus, the transaction resulted in the realisation of capital gains and not a payment of dividends which is consistent with the case law of the Luxembourg Administrative Court of 23 November 2017 (Case 39193C). Accordingly, no withholding tax should apply. Luxco considered that Cayco reduced its investment in Luxco upon the end of an investment, so that the redemption proceeds were not ordinary income comparable to a dividend, but a disinvestment impacting the very substance of the investment.

Luxco further argued that article 101 of the ITL would not require distinct legal or economic rights being allocated to the different classes of shares.

While LuxCo agreed on the absence of different legal rights based on its bylaws, it argued that there were different economic rights due to the redemption order (in reverse alphabetic order) and the allocation of different profit rights to the classes of shares. The redemption of a class of shares gave a preferential and priority right to receive all the available net assets, as well as the amounts allocated to a reserve at the time of the redemption. As a consequence, Luxco considered that the last redeemable classes of shares had a much lower economic value than the first redeemable classes, insofar as the first redeemable classes provided an immediate entitlement to the amounts available while the other classes of shares may only be redeemed once previous classes are redeemed (with entitlement to the amounts available).

Position of the Tribunal

The Tribunal ruled that a redemption of a class of shares is in principle not a profit distribution, but a transaction which triggers a capital gain that is not subject to withholding tax. As a principle, all transactions between the shareholder and the company that affect the substance of the shares within the meaning of article 101 of the ITL, including the repurchase of a participation by the company with a corresponding capital decrease, fall within the scope of article 101, (1) ITA (i.e. “**proceeds of a disposal of the participation**” within the meaning of article 100 of the ITL). According to the Tribunal, this characterization applies to the present case insofar as the repurchase of the J share class resulted in a reduction of the share capital corresponding to the nominal value of these shares.

However, the Tribunal considered that this qualification does not preclude the application of the concept of hidden dividend distributions if and to the extent that the redemption price of a class of shares exceeds its fair market value (assuming that the overpricing is not justified by valid economic reasons but can only be explained by the existence of the shareholder relationship).

The Tribunal noticed that based on the information available, the different classes of shares did not provide for different legal rights. As far as the economic rights are concerned, the Tribunal addressed Luxco's argument that a differentiation of share classes would be made from an economic point of view because of their redemption ranking (in reverse alphabetical order). Here, the Tribunal considered that the argument of LuxCo was not convincing insofar as the price of the redeemed shares corresponded to almost the entirety of LuxCo's monetary assets, whereas the share class in question represented only approximately 5% of the share capital.

On this basis, the Tribunal concluded that the LTA were right to qualify the share class redemption and subsequent cancellation as a hidden dividend distribution to the extent the redemption price exceeded the fair market value of share class J. However, the Tribunal clarified that the entire amount of the redemption price could not be classified as a hidden dividend distribution (subject to Luxembourg withholding tax), but only the excessive amount.

The fair market value of share class J had yet to be determined by the LTA and the Tribunal was unable to do so in the absence of any evidence submitted to it in this respect. Therefore, the Tribunal referred the case back to the tax office in charge to determine the fair market value of the shares.

The Tribunal further concluded that it was no longer necessary to analyse the potential existence of an abuse of law within the meaning of §6 of the Tax Adaptation Law. This is unfortunate as some guidance in respect of the potential application of the concept of abuse of law in the context of classes of shares and their redemption would have been much appreciated.

Outlook

As the judgment can be appealed within 40 days, it remains to be seen whether the Administrative Court will be involved in this case. Should an appeal be filed, some legal uncertainty in relation to the tax treatment of a redemption and cancellation of a share class will remain.

However, the Administrative Court confirmed already in its decision of 2017 that a share class redemption is not a profit distribution and therefore not subject to Luxembourg withholding tax, as long as the redemption price adheres to the arm's length standard. Hence, the determination of the fair market value of share class J by the LTA will be crucial even though the valuation should arguably follow the mechanism provided in the bylaws of LuxCo.

Recommendations

Taxpayers have to carefully draft the articles of incorporation when classes of shares are implemented. The mechanisms of share classes may vary significantly from one case to another and should be tailored to the situation of the company. The different classes of shares should generally be vested with different economic rights (for example, classes of shares tracking specific investments).

Ultimately, the financing of a Luxembourg company should always provide for sufficient flexibility in terms of cash repatriation (considering the expected cash flows and lifetime of the investments) and classes of shares should ideally be used for the repatriation of irregular cash flows to the shareholders (for example, a refinancing or a partial exit).

Do you have further questions?



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