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

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01 INTRODUCTION

On 23 November 2023, the Luxembourg Administrative Court (Cour Administrative, the "**Court**", which is the instance of appeal) held its decision[1] (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 (the "**Tribunal**") of 23 September 2022[2] which confirmed the position of the Luxembourg tax authorities ("**LTA**"). The LTA classified the IFL as a hidden capital contribution (rather than a debt instrument) which had significant tax consequences in the case at hand.

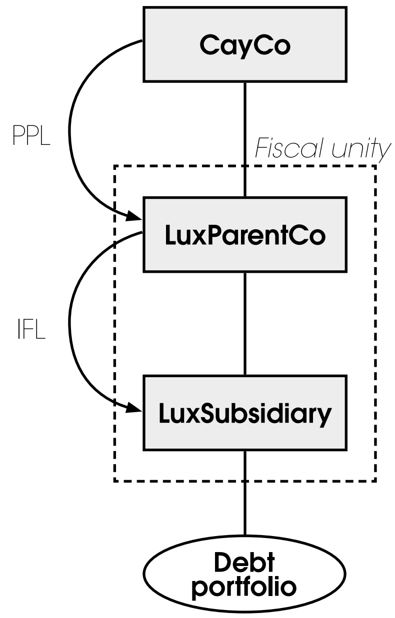
In our ATOZ Report (released in March 2023) we carefully analysed the classification and tax treatment of the IFL and reached the same conclusions as the Court. Considering the wide-spread use of IFLs to finance Luxembourg companies, the importance of the Decision cannot be overstated. Indeed, over the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

02 FACT PATTERN OF THE CASE

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. Such debt instruments are commonly acquired at a price below nominal value.

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 invested the funds received from LuxParentCo mainly into distressed debt instruments.

The following chart depicts the investment structure:



[1] Decision Nr. 48125C.

[2] Judgment Nr. 44902.

The IFL granted by LuxParentCo to LuxSubsidiary was formalised on 19 December 2016, whereas the funds had already been transferred on 29 April 2016. This belated formalisation of the IFL has been explained by LuxSubsidiary with the speed and attention required to make the underlying investments. It has further been brought forward by LuxSubsidiary that since the loan had been concluded between related parties, there was no reason not to trust each other.

As from fiscal year 2017, LuxParentCo and LuxSubsidiary formed a fiscal unity (Article 164bis of the Luxembourg Income Tax Law, "**LITL**"). LuxParentCo and LuxSubsidiary filed a request for the application of the fiscal unity regime on 11 May 2017 which was confirmed by the LTA on 2 June 2017.

Apparently, LuxParentCo and LuxSubsidiary intended to apply the fiscal unity regime already as from fiscal year 2016 (i.e. the year in which both companies had been incorporated). This has been mentioned in the 2016 financial statements of LuxSubsidiary that expressly stated that the company was part of a fiscal unity with its sole shareholder. As such, it has been assumed by the Tribunal that the two companies omitted to file a request for the application of the fiscal unity regime in 2016.

LuxParentCo and LuxSubsidiary are Luxembourg companies that are subject to corporate income tax ("**CIT**") and municipal business tax ("**MBT**") at an aggregate rate of 24.94%. In addition, both companies are subject to net wealth tax ("**NWT**") at an annual rate of 0.5% applied on the companies' unitary value (that is an adjusted net asset value). Given that the fiscal unity regime only applied as from 2017, both companies have been taxed on a standalone basis in 2016.

In 2016, LuxSubsidiary realised a gain in relation to its distressed debt portfolio which was subject to CIT and MBT. In its 2016 corporate tax return, LuxSubsidiary further performed a downward adjustment in relation to the IFL in order to account for deemed interest expenses that would have been due under arm's length conditions. The downward adjustment was made 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.

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.

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 adjustment) were made in respect of the IFL. The absence of tax adjustments in the 2017 corporate tax returns has been 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 being made 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 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; it is no indication for the classification of the IFL by the taxpayers.

03 DECISION OF THE LUXEMBOURG TAX AUTHORITIES

On 5 December 2018, the LTA informed the borrower that they were considering to deviate from the tax return for the fiscal year 2016, disregarding the downward adjustment made in respect of the IFL.

The IFL was treated as a debt instrument by the borrower and the lender that, respectively, performed a downward adjustment (i.e. deemed interest expenses) and an upward adjustment (i.e. deemed interest income) in their corporate tax returns to reflect arm's length conditions.

On 30 January 2019, the LTA issued the 2016 tax assessment. Here, the LTA challenged the debt classification of the IFL and considered that the IFL represented a hidden capital contribution. Consequently, the LTA declined the tax adjustment (notional interest deduction) performed by the Luxembourg subsidiary (the taxpayer in the case at hand).

Moreover, the classification of the IFL as equity had an impact on the net wealth tax basis of the borrower that invested into taxable assets for net wealth tax purposes.

On 30 April 2019, the borrower filed a claim against the tax assessment of the LTA which was rejected by the Director in charge on 23 January 2020.

04 DECISION OF THE TRIBUNAL

4.1. Opening comments

On 24 August 2020, the borrower filed a claim with the Tribunal against the decision of the Director of the LTA. Here, the Tribunal had to decide whether the IFL granted by LuxParentCo to LuxSubsidiary should be classified as a debt instrument or as equity (the latter being the position of the LTA). Furthermore, should the IFL be classified as a debt instrument, the Tribunal would have to analyse whether the transfer pricing adjustment was consistent with the arm's length principle.

The Tribunal correctly proceeded on the assumption that the classification of a financing instrument must follow the economic approach ("*wirtschaftliche Betrachtungsweise*") which requires that, for tax purposes, the economic reality prevails over the legal form (also referred to as "substance over form" principle).

If the IFL is viewed as a debt instrument, transfer pricing adjustments might be required under Article 56 of the LITL. Conversely, the IFL might be reclassified into equity in accordance with the concept of hidden capital contribution ("*apport cache*", "*verdeckte Einlage*") or the concept of hidden capital ("*capital caché*", "*verdecktes Stammkapital*").

A hidden capital contribution refers to a contribution in cash or in kind made by a shareholder to a company without any change in the subscribed and paid-up share capital. The concept of hidden capital refers to a situation where a shareholder has directly or indirectly granted a loan to a company, whereas an independent creditor, acting in accordance with market practice, would not have granted such a loan (but financed the company with equity).

4.2. Features of the IFL that have been considered by the Tribunal

For the classification of the IFL as either debt or equity, the Tribunal considered the following features of the IFL agreement:

- Limited recourse clause

The IFL agreement provided for a limited recourse clause according to which the borrower (here, LuxSubsidiary) would be required to repay the loan only to the extent that the investments held by (and/or the income received by the borrower with respect to those investments) are sufficient to enable the borrower to make the relevant payment.

A limited recourse clause was a common feature of debt instruments at that time (in the context of financing debt instruments) and an explicit requirement under the former transfer pricing regime applicable to Luxembourg finance companies until the end of 2016. While LuxSubsidiary did technically not fall within the scope of the Luxembourg transfer pricing circular (as the company acquired debt instruments owed by third parties, not by related parties), the same remuneration model may be considered appropriate in case of third-party debt funding.[3]

As such, it would be wrong to attach too much importance to a feature that was common (and even required) at the time the IFL was granted. Moreover, the IFL must be repaid if LuxSubsidiary's assets allow the company to do so. While the Tribunal emphasises that the IFL does not provide for additional guarantees, LuxSubsidiary is a private limited company that has a limited liability towards its creditors (as such, the limited recourse clause does not change much from an economic perspective).

- Contribution of the IFL

The IFL provided that the lender (here, LuxParentCo) may decide at any time that the IFL be contributed, in full or in part, to the borrower against the issuance of shares in accordance with a ratio of one share of 1 EUR in exchange for any portion of the loan (which outstanding amount was equal to such a par value).

While the IFL provided for an explicit clause that allowed for the contribution of the IFL in exchange for shares, the IFL could in any case be contributed to the (share) capital of LuxSubsidiary without any limitation.

- Interest

The IFL did not bear any interest.

- Transfer of funds and formalisation of the IFL

While the loan was made available to the borrower as from 29 April 2016, the related contract was formalised only on 19 December 2016.

4.3. Assessment by the Tribunal

Considering the features of the IFL and the timing of its formalisation, the Tribunal concluded that the IFL could only represent capital (through the classification of the IFL as a hidden capital contribution) and was not a debt instrument.

The Tribunal presumed that the intention of LuxParentCo was to finance LuxSubsidiary with equity rather than to act as a lender (realising interest income and recovering the principal amount of the loan within a reasonable period of time).

On this basis, the Tribunal assessed that the IFL constitutes a disguised shareholding in the form of a loan and that the normal method of financing, dictated by genuine economic or legal considerations, would have been a capital increase.

[3] The scope of circular n°164/2 of 26 January 2011 encompassed debt funding of related parties that is funded by debt, be it intra-group or third-party debt. As LuxSubsidiary invested into third-party distressed debt instruments, LuxSubsidiary did not perform financing activities within the meaning of the circular.

It follows from the reclassification of the IFL into capital that the Tribunal rejected the recognition and deduction of deemed interest expenses (at the level of LuxSubsidiary) and deemed interest income (at the level of LuxParentCo).

While the decision also includes some information on the transfer pricing approach that has been adopted regarding the determination of an arm's length remuneration on the IFL (which was detailed in the transfer pricing documentation filed by the taxpayer together with its tax return), the Tribunal did not take any decision in this respect as this was considered superfluous given the equity classification of the IFL.

According to the Tribunal, a loan granted by a shareholder to a corporation is to be recharacterised as a hidden capital contribution if the normal way of financing, dictated by serious economic or legal considerations, would have been an increase in capital and it is clear from the circumstances that the form of the loan may have been chosen only for tax reasons.

However, as a principle, taxpayers are free to structure their affairs in the way that is most tax efficient, unless a specific anti-abuse rule applies, or an arrangement represents an abuse of law that can be tackled under the general anti-abuse rule[4] ("**GAA**").

05 DECISION OF THE COURT

5.1. Overview

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

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 few characteristics of the loan agreement under review.

5.2. 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 could be drawn from the fact that the actual date on which the funds were made available differed from the date on which the IFL agreement was formalised.
- The allocation of the funds lent was relevant. Here, the loan received was not allocated to long-term fixed assets. Therefore, it was not an indication of the existence of a disguised shareholding in the form of a loan.
- The debt/equity ratio had to be assessed considering the debt/equity-ratio requirements at the time the funds were made available.

5.3. 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 (these are all important debt features).

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

- The IFL did not provide for an option for the borrower to unilaterally convert the loan into capital (according to the loan agreement, the lender had the right to require, at its sole discretion, a conversion of the IFL into capital).
- While the IFL agreement provided for the possibility of repayment of the loan in cash or in kind (this possibility was 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 repayment in kind), a repayment in kind could only be made with assets owned by the borrower (not with shares of the borrower).

[4] Section 6 of the Steueranpassungsgesetz.

- 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 was free to assign its rights and obligations, whereas the borrower needed to consent to transfer its rights and obligations.
- The loan agreement provided for a maturity of the IFL (10 years) and an obligation to repay at maturity. However, a maturity of 10 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. As a result, it did 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:

- 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 did not provide for a guarantee in favour of the lender and subordinated the 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 at litigation level (after the end of the relevant transactions), the Court concluded that the IFL was indeed executed by the parties as a loan that was repaid even well before the contractually agreed maturity.

5.4. Classification of the IFL

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

06 CONCLUSION

The Court held that the classification of the IFL as equity or debt should follow an overall assessment of all relevant criteria. In the present case, most of the relevant features of the IFL were debt features which led the Court to classify the loan as a debt instrument. Hence, the Court overturned the decision of the Tribunal that confirmed the position of the LTA.

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 principle of 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 reestablished long-standing principles (i.e., economic approach, substance over form) with respect to the classification of financing instruments as debt or as equity. 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.

APPENDIX: TECHNICAL ANALYSIS OF THE CLASSIFICATION AND TAX TREATMENT OF THE IFL

01 OVERVIEW

This appendix includes a comprehensive analysis of the tax treatment of the IFL for Luxembourg tax purposes.

The analysis begins with a review of the features to be considered when classifying financing instruments as either equity or debt, and examines the terms and conditions of the IFL in the case at hand.

It further includes an analysis of the concepts of hidden capital contribution (*verdeckte Einlage*) and hidden capital (*verdecktes Stammkapital*) that have been considered by the LTA and the Tribunal in their decisions.

Finally, it analyses the application of Article 56 of the LITL and possible transfer pricing adjustments (upward and downward adjustments) in relation to the IFL.

02 CLASSIFICATION OF FINANCING INSTRUMENTS

2.1. Opening comments

Luxembourg tax law does not provide for any specific rules regarding the classification of financing instruments as either equity or debt. Therefore, this determination must be based on general Luxembourg tax principles.

The preparatory note of the LITL of 4 December 1967 related to Article 114 (now Article 97 of the LITL) on income from capital states that the "substance over form" principle and the economic approach (i.e. "*wirtschaftliche Betrachtungsweise*") apply when characterising a financing instrument and the nature of income derived therefrom.

On this basis, 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.

2.2. Step 1: Key features to be considered

The following features should be considered when analysing financing instruments:

2.2.1. Civil law qualification and accounting treatment

The analysis of financing instruments should generally begin with a classification under Luxembourg Civil Law.[5] This classification should generally be followed under Luxembourg General Accepted Accounting Principles ("**GAAP**").

[5] Article 1 of the Commercial Law; Art. 1832 f. of the Civil Law ("Contrat de société"), Articles 1874 and foll. of the Civil Law ("*Contrat de prêt*").

Moreover, the tax treatment generally follows the accounting treatment[6], unless there are specific rules or concepts that require a different treatment for tax purposes (here, this could be the economic approach and the substance over form principle).

A loan is defined as a contract whereby one party delivers to the other one either an asset which the recipient can use with the obligation to return it after use[7] or a certain amount of fungible goods with the obligation to return the same amount or number of goods of an equal type and quality.[8]

A company contract is defined as a contract by virtue of which two or more persons (except for a "single shareholder private company") agree to contribute funds or assets with a view to sharing the profits (and losses) that may arise therefrom.

The main (cumulative) criteria to decide whether an instrument should be classified as debt or equity from a legal perspective include:

Debt obligation

- The holder is entitled to the return of its investment after a predetermined period;
- The loan carries a predetermined fixed return, which is not linked to the company's result;
- In the event of the debtor's liquidation or bankruptcy, the investor ranks above the shareholders, i.e. it has the right to be repaid before any funds are made available to them.

Equity

- Equity fully exposes the investor to the risk of the business (no assurance with respect to reimbursement of the original investment or with respect to the return);
- Vests in its holder the right to receive part of the liquidation surplus;
- Provides shareholder rights to the investor (e.g. voting rights, right of supervision, etc).

The legal classification should be analysed based on the essential features of the contract considering the real intention of the parties as opposed to the form or label given by the parties.

2.2.2. Maturity

The maturity of a financing instrument is an important feature. While a right of repayment after a specified period of time is a characteristic of a debt obligation, a permanent commitment of funds is an equity feature.

However, even when a financing instrument has a fixed maturity, the long-term nature of the maturity might, in accordance with the parliamentary documents[9], point to the classification as an equity instrument.

Based on German case law, a maturity of up to 29 years (i.e. less than 30 years) should be considered as a debt feature, whereas a long-term maturity of 30 years and longer is an indication of an equity instrument.[10]

2.2.3. Remuneration of the financing instrument

The remuneration of the financing instrument is another important characteristic. While a (unlimited) participation in a company's profit would be an equity feature, the mere remuneration with a fixed interest rate would be a clear-cut debt feature.

However, in practice a variety of remuneration models might be agreed upon. For example, the remuneration of a financing instrument may be linked to the income generated by the borrower in relation to a specific asset that is financed by the instrument (asset-linked or income participating instruments). Parties may also agree on a participation in the borrower's profits (which may be capped in one way

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6 Grundsatz der Maßgeblichkeit, Art. 40 (1) of the LITL.

7 Article 1875 of the Civil Law – in this definition, the lender remains the owner of the asset.

8 Article 1892 of the Civil Law – in this definition, legal title to the goods is transferred to the borrower – the contract can be interest-bearing.

9 Projet de loi concernant l'impôt sur le revenu, doc. parl. 571[4],

10 Some practitioners consider a 50-year (or longer) maturity as being the dividing line for a long-term financing instrument, whereas a maturity of maximum 49 years would be a debt feature.

or another). While income or profit participation tends to be an equity feature, the debt character of the instrument may be reinforced through the inclusion of a (small) fixed interest rate.

When the payment of a fixed interest is limited by the amount of (accounting) profit or income derived from a certain asset, or subject to the condition that the borrower has sufficient cash for the payment of the interest, the remuneration model is still rather a debt feature.

When a financing instrument provides for a zero interest rate, the transaction is not an arm's length transaction and might require tax adjustments.[11] A zero-interest rate is an equity feature.

2.2.4. Participation in liquidation proceeds and latent capital gains

Financing instruments may provide for a participation in the liquidation proceeds of the borrower or latent capital gains inherent in (certain) assets owned by the borrower. The existence of such a clause is a strong equity feature. However, as long as the instrument does not, in addition, provide for a participation in losses incurred by the borrower, the instrument may still qualify as a debt instrument.

2.2.5. Loss participation

Participation in the borrower's (accounting) losses or losses incurred in relation to a specific investment (or activity) is an indication of an equity instrument. Debt instruments generally do not provide for a participation of the lender in the losses incurred by the borrower. However, this is not an absolute criterion and in specific cases, parties may agree on loss participation without jeopardizing the debt classification of the financing instrument.

2.2.6. Conversion feature

Financing instruments may also include a conversion feature that provides for the possibility to convert the instrument into shares of the borrower. When the conversion can be requested by the borrower (instead of a repayment of the principal amount), this is a strong equity feature.

Likewise, a mandatory conversion clause according to which the instrument is automatically converted at a predefined date and rate is an indication of an equity instrument. If the company is liquidated before the conversion date, the instrument may either be repaid at face value or automatically be converted into shares of the borrower. In this regard, an automatic conversion clause would be a much stronger equity feature than a provision that (at least optionally) provides for a repayment at face value.

When the financing instrument may be converted upon request of the investor, this would be rather a debt feature, in particular when the instrument provides for an alternative redemption at market value.

2.2.7. Label of the financing instrument

The label of the financing instrument generally provides a first indication as to whether a financing instrument should be classified as equity or debt.

However, as the label of the financing instrument is not necessarily consistent with the other characteristics of the instrument, this feature is ancillary to other features that are more significant in the analysis.

2.2.8. Political and voting rights

A shareholder may generally participate in the life of the company and may vote in the general meetings as well as all extraordinary shareholder' meetings. The shareholder further generally has voting rights and the right to be kept informed of major developments that may have an impact on the company's situation.

However, as companies may also issue non-voting shares, voting rights are not a strong equity feature. Rather, this feature is an equity indication that together with other criteria may result in an equity classification.

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[11] Tax adjustments may be required in accordance with the concept of hidden dividend distributions (Article 164 (3) of the LITL) or based on Article 56 of the LITL.

2.2.9. Modalities of the yield payment

When the payment of the remuneration due under a financing instrument is at the discretion of the board of directors under a procedure similar to the one applicable to dividend distributions, this is an indication of an equity instrument. Another equity feature would be if the payment of yield depends on the borrower having sufficient reserves or retained earnings available.

In contrast, when the payment is not subject to any procedure or condition, this would be a characteristic of a debt feature.

2.2.10. Ability to accelerate (call) the instrument

Where early repayment or redemption is possible, this would be a debt feature. Conversely, the absence of an early repayment or redemption clause is an equity indication.

The party that may request early repayment or redemption will also be an indicator. In case the repayment or redemption can be requested by the investor, this would be an indication of a debt instrument. In contrast, if early repayment or redemption can be requested by the borrower, this would be an equity indication.

2.2.11. Event of default clause

A debt instrument generally includes an "event of default" clause that may provide for an accelerated maturity or increased yield payments if the borrower fails to comply with its obligations under the instrument. In contrast, equity instruments do not include such a clause.

2.2.12. Ranking

One of the factors commonly used to distinguish debt from equity instruments is their relative ranking in the company's capital structure. In case of default, the holder of a debt obligation has the right to be repaid before any funds are made available to the shareholders.

However, there may be only a very small gap between the most subordinated debt obligation and equity instruments. As a principle, subordination is an equity feature, whereas the absence of subordination is a strong debt feature.

2.2.13. Transfer rights

Shareholders and bondholders generally have the right to freely transfer their shares or bonds to another party. Hence, a transfer right is neither a clear indication of an equity or a debt instrument.

However, should the instrument provide for a stapling clause according to which the instrument is only assignable together (on a pro-rata basis) with shares of the borrower, this is an indication of an equity instrument.

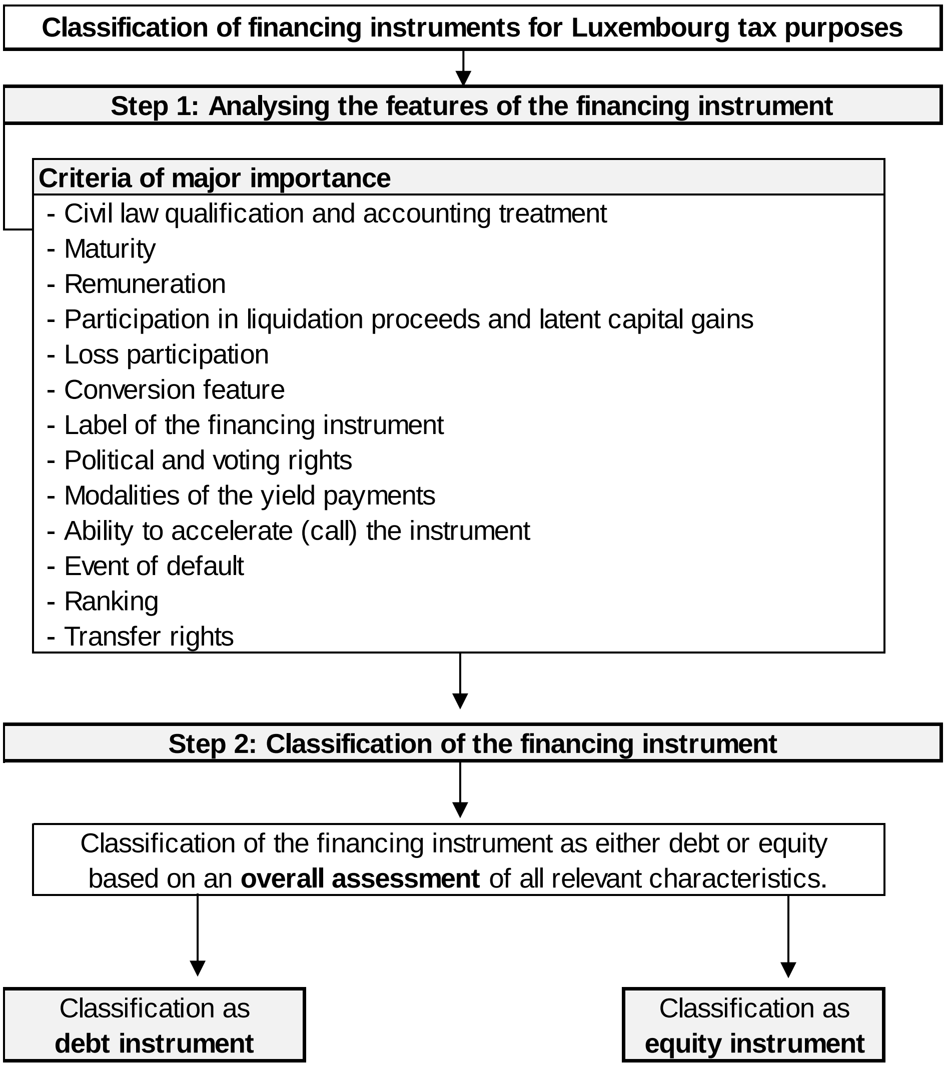
2.3. Step 2: Assessment

The classification of a financing instrument as either debt or equity follows an in-depth analysis of all relevant characteristics of the financing instrument. There is no single criterion that would be decisive for the assessment. Rather, the assessment is based on the overall character of the financing instrument.

However, not all the characteristics are equally important. Some characteristics are of major importance as they provide clear-cut debt and equity indications, whereas other characteristics may be less relevant as they are less binary. These characteristics may, nonetheless, be useful to inform the analysis.

While in most cases the assessment is straight forward, in some cases, the presence of both equity and debt features may make the classification of financing instruments a more intricate exercise. In the latter case, it might be considered by the parties to align some of the features with the desired classification for Luxembourg tax purposes.

The following checklist depicts the features that need to be considered when analysing financing instruments.



2.4. Application to the case at hand

The tax treatment should generally follow the accounting treatment unless a provision of the Luxembourg tax law or a specific tax concept requires a different treatment for tax purposes ("*Massgeblichkeitsprinzip*").[12] The classification of the IFL as either debt or equity is no exception to this principle.

Thus, while the classification of the IFL as debt for accounting purposes is the starting point of the tax analysis, the economic approach and the substance over form principle may require a different classification for tax purposes if the overall assessment of all relevant features points to a classification as an equity instrument.

[12] See Article 40 of the LITL.

The features of the IFL are summarised in the following table:

Criteria of major importance	Features of the IFL	Indication
Civil law qualification and accounting treatment	The loan has been qualified as debt from a civil law perspective and for accounting purposes	debt
Maturity	The loan has to be repaid, in cash or in kind, after 8 years	debt
Remuneration	The loan was "interest-free"	equity
Participation in liquidation proceeds and latent capital gains	The lender was not entitled to receive any liquidation bonus	debt
Loss participation	The loan provides for a limited recourse clause that may entail a participation in the company's losses	equity
Conversion feature	The loan may be converted into shares upon the option of the lender. The borrower has no option to convert the loan into capital by unilateral decision	rather equity
Label of the financing instrument	The loan has been labelled "interest free loan agreement"	debt
Political and voting rights	The loan does not provide for any voting rights	debt
Modalities of interest payments	n/a	-
Ability to accelerate (call) the instrument	The borrower has a right to make an early repayment.	debt
Event of default	In case of an event of default upon maturity, the interest-free loan would become interest bearing	debt
Ranking	The loan is unsecured but ranks higher than share capital, share premium or other equity contributions	debt
Transfer rights	The loan did not include any "stapling clause" preventing the transfer of the loan independently from the shareholding in LuxSubsidiary	no clear indication

In the present case, there are only three features that are (rather) equity features. On the contrary, the terms and conditions of the IFL provide for several strong debt features such as (i) the (debt) classification from a legal and accounting perspective, (ii) a relatively short maturity, (iii) the absence of a participation in liquidation proceeds and latent capital gains, (iv) the absence of political and voting rights, and (v) the ranking of the IFL above the equity.

While the IFL contains few equity features, an overall assessment of all the relevant features clearly points to a classification as a debt instrument. For the IFL to be classified as an equity instrument, the IFL would need to include additional equity features.

Despite the belated formalisation of the IFL, at the time the funds have been transferred by LuxParentCo to LuxSubsidiary, both companies should recognize, respectively, a receivable (LuxParentCo) and a liability (LuxSubsidiary) in their balance sheets – absent a waiver or an explicit contribution of the receivable by LuxParentCo. Given that the parties did not agree on a remuneration for the granting of funds, the loan was interest-free as from the beginning.

The formalisation of the IFL before the end of the year is the legal manifestation of the intention of the parties. While it would have been better to properly document the IFL alongside the implementation of the investments, it can be assumed that this was a mistake that has only been realised after several months. This is consistent with the statement of the plaintiff that the attention was focused on investing.

03 HIDDEN CAPITAL CONTRIBUTIONS ("*VERDECKTE EINLAGE*")

3.1. Opening comments

Contributions to Luxembourg companies may be made either in the form of a regular contribution, as provided for in Luxembourg commercial law, or in the form of a hidden capital contribution.

While the IFL granted by LuxParentCo to LuxSubsidiary should be classified as a debt instrument, the question arises whether (i) the IFL itself or (ii) the advantage granted through the IFL (i.e. the arm's length interest expenses) might be the object of a hidden capital contribution.

Both, the LTA and the Tribunal seem to have considered this concept to be relevant in the present case.

3.2. Characteristics of hidden capital contributions

3.2.1. General

Luxembourg tax law does not provide for a definition of hidden capital contributions. Rather, the concept of hidden capital contributions has been extensively shaped and modelled by decisions made by both the German Reich Tax Court (*Reichsfinanzhof*) and the German Federal Tax Court (*Bundesfinanzhof*).[13] In accordance with relevant case law, hidden capital contributions bear the following characteristics:

- a shareholder or a related party of the shareholder
- grants an advantage to a company that may be reflected in the balance sheet, i.e. either an increase in assets or a decrease in liabilities (insofar as the shareholder does not receive an arm's length compensation)[14],
- the advantage is motivated by the shareholding relationship; and
- the contribution is not a regular contribution (pursuant to Luxembourg commercial law).[15]

3.2.2. The object of a hidden capital contribution

3.2.2.1. Liabilities

As a principle, contributions increase the net equity of a company which is reflected in the receiving company's (tax) balance sheet. The object of a hidden capital contribution must, therefore, directly relate to balance sheet items, i.e. an increase in assets or a reduction in liabilities. Accordingly, only advantages that may be contributed within the framework of regular contributions may be classified as hidden capital contributions.[16]

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[13] For further details see Oliver R. Hoor "Hidden dividend distributions and hidden capital contributions: A technical guide", 2nd edition, Legitech 2023.

[14] BFH, Decision of 9.3.1962, I 203/61 S, BStBl III 1962, p. 338; BFH, Decision of 3.2.1971, I R 51/66, BStBl II 1971, p. 408; BFH, Decision of 29.1.1975, BStBl II 1975, p. 553; BFH, Decision of 24.5.1984, I R 166/78, BStBl II 1984, p. 747; BFH, Decision of 26.10.1987, GrS 2/86, BStBl II 1988, 348; BFH, Decision of 22.11.1983, VIII R 133/82, GmbHR 1984, p. 110; BFH, Decision of 14.3.1989, I R 8/85, BStBl II 1989, p. 633.

[15] RFH, Decision of 28.7.1936, I A 83/36, I A 83/36, RFHE 39, 303; RFH, Decision of 8.6.1937, I A 378/36, RFHE 41, 274; RFH, Decision of 22.6.1943, I 204/42, RStBl 1943, p. 587; BFH, Decision of 28.2.1956, I 92/54 U, BStBl III 1956, p. 154; BFH, Decision of 3.5.1967, I 263/63, BFHE 88, 425, BStBl III 1967, p. 421; BFH, Decision of 19.2.1970, I R 24/67, BStBl II 1970, 442; BFH, Decision of 3.2.1971, I R 51/66, BStBl II 1971, p. 408; BFH, Decision of 14.8.1974, I R 168/72, BStBl II 1975, p. 123; BFH, Decision of 26.11.1980, I R 52/77, BStBl II 1981, p. 181; BFH, Decision of 9.3.1983, I R 182/78, BFHE 139, 139, BStBl II 1983, p. 744; BFH, Decision of 22.11.1983, GmbHR 1984, p. 110; BFH, Decision of 11.4.1984, I R 175/79, BStBl II 1984, p. 535; BFH, Decision of 14.11.1984, I R 50/80, BStBl II 1985, 227; BFH, Decision of 24.3.1987, I R 202/83, BStBl II 1987, p. 705; BFH, Decision of 26.10.1987, GrS 2/86, BStBl II 1988, p. 348; BFH, Decision of 27.7.1988, I R 147/83, BStBl II 1989, p. 271; BFH, Decision of 21.9.1989, IV R 115/88, BStBl II 1990, 86; BFH, Decision of 28.2.1990, I R 43/86, BStBl II, p. 615; BFH, Decision of 18.12.1990, VIII R 17/85, BStBl II 1991, p. 512; BFH, Decision of 8.5.1991, I B 30/90, BFH/NV 1992, p. 414; see Guy Heintz, "L'impôt sur le revenu des collectivités",Etudes Fiscale, Saint-Paul, Luxembourg 1999), p. 30; see Jean Olinger, "Le droit fiscal – Introduction à l'étude du droit fiscal luxembourgeois", Etudes Fiscale, Saint-Paul, Luxembourg 1994, p. 20 ; see Jean-Pierre Winandy, "Fiscalité et comptes annuels des entreprises", Portalis éditions, 2005, p. 215.

[16] See Jean-Pierre Winandy, "Fiscalité et comptes annuels des entreprises", Portalis éditions, 2005, p. 215.

An example of a hidden capital contribution that results in a reduction of a company's liabilities is the waiver of a shareholder loan.[17] The waiver of a shareholder receivable generally increases a company's net equity by way of a reduction in liabilities and an increase in accounting profit. Here, the hidden capital contribution should correspond to the valuable part of the receivable which should be excluded from the company's taxable income.[18]

It should be highlighted that the mere subordination of a shareholder loan to other liabilities of the company cannot be classified as a hidden capital contribution.[19] In this scenario, the company's liabilities remain in the balance sheet and the net equity remains unchanged.

Similarly, the granting of shareholder guarantees relating to the company's liabilities should not be classified as a hidden capital contribution.[20] Even when the guarantee is exercised, a hidden capital contribution should not be considered as the shareholder should have a claim towards the company (following the payment). A hidden capital contribution would need to be considered, however, when the shareholder waives its right to receive a refund. In this case, the amount of the company's liabilities is effectively reduced.

3.2.2.2. Services granted without valuable consideration

It is not uncommon for shareholders to grant services to a company for partial or no consideration (*Nutzungseinlagen*).[21] Examples of free services include interest-free loans and royalty-free licenses (here, the advantage corresponds to the arm's length remuneration).

However, such advantages do not qualify as assets and may, therefore, not be reflected in the company's balance sheet. Consequently, only assets – and not their use – may be the object of a contribution although the company's net equity should be "indirectly" increased as a result of reduced business expenses.[22]

3.2.3. Motivation by the shareholding relationship

The increase of a company's net equity must be "motivated by the shareholding relationship" in order to be considered as a hidden capital contribution.

Thus, a causal link must be established between the shareholding relationship and the increase in the company's net equity with reference to the concept of the prudent business manager (*ein ordentlicher und gewissenhafter Geschäftsleiter*). In essence, if an unrelated party would not have granted the same advantage, the advantage is deemed to be motivated by the shareholder relationship as opposed to the business relationship (this should be determined based on the arm's length standard).[23]

3.2.4. Absence of compensation

A hidden capital contribution only exists to the extent that an advantage is granted by the shareholder to the company without valuable consideration; in particular, no shares must be issued to the shareholder.[24] The hidden capital contribution should correspond to the fair market value of the advantage shifted by the shareholder to the company.[25]

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[17] RFH, Decision of 28.7.1936, I A 83/36, RFHE 39, 303; RFH 22.6.1943, I 204/42, RStBl 1943, p. 587; BFH, Decision of 29.5.1968, I 187/65, BFHE 93, 62, BStBl II 1968, p. 722.

[18] BFH, Decision of 29.5.1968, I 187/65, BStBl II 1968, p. 722; BFH, Decision of 9.6.1997, GrS 1/94, BStBl II 1998, p. 307.

[19] BFH, Decision of 30.3.1993, BStBl II 1993, p. 502.

[20] BFH, Decision of 2.10.1984, VIII R 36/83, BStBl II 1985, p. 320; BFH, Decision of 16.4.1991, VIII R 100/87, BStBl II 1992, p. 234; BFH, Decision of 9.6.1997, GrS 1/94, BFHE 183, 187, BStBl II 1998, p. 307; BFH, Decision of 12.12.2000, VIII R 36/97 (NV).

[21] Typical examples include the granting of interest-free loans and letting of real estate without charging an arm's length rent.

[22] BFH, Decision of 9.3.1962, I 203/61 S, BStBl III 1962, p. 338; BFH, Decision of 16.5.1963, IV 379/60 U, BStBl III 1963, p. 400; BFH, Decision of 3.2.1971, I R 51/66, BStBl II 1971, p. 408; BFH, Decision of 29.1.1975, , I R 135/70, BStBl II 1975, p. 553; BFH, Decision of 28.1.1981, I R 10/77, BStBl II 1981, p. 612; BFH, Decision of 19.5.1982, I R 102/79, BStBl II 1982, p. 631; BFH, Decision of 22.11.1983, VIII R 133/82, GmbHR 1984, p. 110; BFH, Decision of 24.5.1984, I R 166/78, BStBl II 1984, p. 747; BFH, Decision of 26.10.1987, GrS 2/86, BStBl II 1988, p. 348; BFH, Decision of 14.3.1989, I R 8/85, BStBl II 1989, p. 633.

[23] RFH, Decision of 27.3.1928, I A 470, StuW 1928, No. 417; RFH, Decision of 28.7.1936, I A 83/36, I A 83/36, RFHE 39, 303; RFH, Decision of 8.6.1937, I A 378/36, RFHE 41, 274; RFH, Decision of 22.6.1943, I 204/42, RStBl 1943, p. 587; BFH, Decision of 29.5.1968, I 187/65, BStBl III 1968, p. 722; BFH, Decision of 19.2.1970, I R 24/67, BStBl II 1970, 442; BFH, Decision of 14.8.1974, I R 168/72, BStBl II 1975, p. 123; BFH, Decision of 9.3.1983, I R 182/78, BFHE 139,139, BStBl II 1983, p. 744; BFH, Decision of 14.11.1984, I R 50/80, BStBl II 1985, p. 227; BFH, Decision of 21.9.1989, IV R 115/88, BStBl II 1990, 86; BFH, Decision of 8.5.1991, I B 30/90 BFH/NV 1992, p. 414.

[24] BFH, Decision of 28.2.1956, I 92/54 U, BStBl III 1956, p. 154; BFH, Decision of 27.7.1988, I R 147/83, BStBl II 1989, p. 271; BFH, Decision of 25.10.1995, I R 104/94, BB 1996, p. 841.

[25] BFH, Decision of 24.3.1987, I R 202/83, BStBl II 1987, p. 705; BFH, Decision of 27.7.1988, I R 147/83, BStBl II 1989, p. 271; BFH, Decision of 1.8.1990, II R 17/87, BStBl II 1990, p. 879; BFH, Decision of 18.12.1990, VIII R 17/85, BStBl II 1991, p. 512; BFH, Decision of 23.2.2005, I R 44/04, DStRE 2005, p. 706.

3.3. Tax treatment of hidden capital contributions

Hidden capital contributions may require complex tax adjustments at the level of the company and the shareholder that need to be analysed on a case-by-case basis.

At the level of the company, hidden capital contributions such as a debt waiver are often treated as income in the company's accounting profit and loss account (Luxembourg GAAP). An increase in the accounting profit that is related to hidden capital contributions must, however, be excluded from the tax base as such income is not a component of a company's taxable income.[26]

At the level of the shareholder, the book value of the participation in the company should be increased in the tax balance sheet by the fair market value of the contribution. In addition, deemed income corresponding to the amount of the hidden capital contribution will often need to be included in the shareholder's taxable income.

3.4. Application to the case at hand

The decision of the Tribunal does not mention a waiver of the IFL by LuxParentCo. As such, LuxSubsidiary's liabilities were not reduced, and the net equity remained unchanged. From an accounting perspective, the transfer of funds must be recorded, respectively, as a receivable (LuxParentCo) and a liability (LuxSubsidiary).

The granting of the IFL itself cannot be classified as a hidden capital contribution. The late formalisation of the IFL on 19 December 2016 (while the funds have already been transferred on 29 April 2016) can also not be construed as a waiver declaration. Given that the granting of an IFL was market practice in these circumstances, it is further fair to assume that the intention of the parties was to implement an IFL as from the beginning.

The question arises whether the absence of an arm's length remuneration could give rise to the classification as a hidden capital contribution. However, given that the advantage granted through the IFL (i.e. the advantage of the zero interest rate) neither results in an increase of assets nor a decrease of liabilities, the advantage shifted to LuxSubsidiary cannot be classified as a hidden capital contribution.

04 HIDDEN CAPITAL ("*VERDECKTES STAMMKAPITAL*")

4.1. Opening comments

The IFL is a debt instrument that, absent a waiver by LuxParentCo, should not be classified as a hidden capital contribution.

However, the question arises whether the IFL could be reclassified for tax purposes into equity based on the concept of hidden capital ("*verdecktes Stammkapital*").

Both, the LTA and the Tribunal seem to have considered this concept to be relevant in the present case.

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[26] The tax adjustment is made in the company's corporate tax return. The legal basis for the exclusion of income relating to hidden capital contributions is Art. 18 (1) of the LITL providing that contributions should be deducted from the taxable basis; BFH, Decision of 3.2.1971, I R 51/66, BStBl II 1971, p. 408; BFH, Decision of 14.8.1974, I R 168/72, BStBl II 1975, p. 123; BFH, Decision of 9.3.1983, I R 182/78, BStBl II 1983, p. 744; BFH, Decision of 9.6.1997, GrS 1/94, BStBl II 1998, p. 307.

4.2. The concept of hidden capital and related tax treatment

The freedom of shareholders in the financing of companies is limited by the concept of hidden capital under which shareholder loans may be reclassified into equity based on their economic substance. The hidden capital concept has been shaped by German case law and is based on the principles laid down in § 5 Steueranpassungsgesetz (sham transactions) and § 6 Steueranpassungsgesetz (abuse of law).

However, the scope of the concept has been limited by German jurisprudence to exceptional cases in which additional equity financing was imperative considering the legal and economic circumstances of the case. This could, for example, be the case if the company does not comply with minimum equity requirements from a legal or a regulatory perspective and the company has been financed by debt anyway. The LTA should not lightly conclude that the concept of hidden capital applies though.

When the concept of hidden capital applies, interest payments on the shareholder loans is reclassified into hidden dividend distributions that are not deductible for tax purposes and, in principle, subject to Luxembourg dividend withholding tax. Moreover, the concept of hidden capital would result in a requalification of debt into equity. This may, for example, affect the NWT position of the company.[27]

The burden of proof that a debt instrument is to be classified as equity in accordance with the concept of hidden capital lies with the LTA.[28]

4.3. Application to the case at hand

The IFL might be reclassified into hidden capital if it was necessary for LuxParentCo to finance LuxSubsidiary with additional equity rather than by means of a debt instrument.

However, Luxembourg companies investing into debt instruments do not have to respect any specific debt-to-equity ratio and the financing of debt instruments generally does not require a significant amount of equity funding at arm's length. Under the former transfer pricing regime applicable to Luxembourg finance companies until the end of 2016, Luxembourg finance companies had to be financed by an amount of equity corresponding to the lower of 1% of the financing volume or EUR 2 million. However, the equity did not have to be used to finance the debt instruments but could be invested into other assets (for example, participations qualifying for the Luxembourg participation exemption regime).[29]

The Decision mentions that LuxSubsidiary has been financed by circa 10% of equity and circa 90% of IFL. Based on experience, this percentage of equity financing is very high even for investments into distressed debt that are at the riskier end of the spectrum.

On this basis, it seems to be quite a stretch to conclude that it was imperative for LuxParentCo to finance LuxSubsidiary with equity rather than an IFL. On the contrary, the investment structure was consistent with market practice and all applicable tax rules.

[27] See Winandy, Jean-Pierre: „Fiscalité et comptes annuels des entreprises", Portalis Editions 2005, p. 535; BFH, Decision of 15.5.1953, III 103/52 S, BStBl III 1953, p. 208; Döllerer, Georg: „Verdeckte Gewinnausschüttungen und verdeckte Einlagen bei Kapitalgesellschaften", 2nd Edition, Verlag Recht und Wirtschaft GmbH, Heidelberg 1990.

[28] RFH, Decision of 19.9.1933, I A 272/31, RStBl 1933, p. 1220; RFH, Decision of 30.8.1938, I 271/38, RStBl 1938, p. 901; RFH, Decision of 30.8.1938, I 272/38, RStBl 1938, p. 902; RFH, Decision of 29.9.1942, I 129/42, RStBl 1942, p. 1075; BFH, Decision of 7.11.1950, I 20/50 U, BStBl III 1951, p. 12; BFH, Decision of 20.8.1954, I 130/53 U, BStBl III 1954, p. 336; BFH, Decision of 11.10.1955, I 117/54 U, BStBl III 1956, p. 11; BFH, Decision of 20.3.1956, I 178/55 U, BStBl III 1956, p. 179, BFH, Decision of 13.1.1959, I 44/57 U, BStBl III 1959, p. 197; BFH, Decision of 28.10.1964, I 198/62 U, BStBl III 1965, p. 119; BFH, Decision of 10.12.1975, I R 135/74, BStBl II 1976, p. 226.

[29] The equity funding merely had to be available in case the risk in relation to the financing activities materialises.

05 TAX ADJUSTMENTS UNDER ARTICLE 56 OF THE LITL

5.1. Opening comments

The IFL granted by LuxParentCo to LuxSubsidiary should be classified as a debt instrument and not be reclassified into equity based on the concepts of hidden capital contribution or hidden capital.

However, the question arises whether the advantage shifted by LuxParentCo to LuxSubsidiary through the IFL (i.e. the arm's length interest) may result in tax adjustments under Article 56 of the LITL.

5.2. Scope of Article 56 of the LITL

The scope of Article 56 of the LITL is limited to transactions between associated enterprises and does not apply to transactions between individual shareholders and a Luxembourg company.

Notably, Article 56 of the LITL applies to cross-border transactions and transactions between Luxembourg companies alike.

In a tax treaty context, tax adjustments made under Article 56 of the LITL are generally permitted under a provision that replicates Article 9 (1) of the OECD Model Convention.

5.3. Tax adjustments under Article 56 of the LITL

Article 56 of the LITL serves as a legal basis for performing upward and downward adjustments in accordance with the arm's length principle.

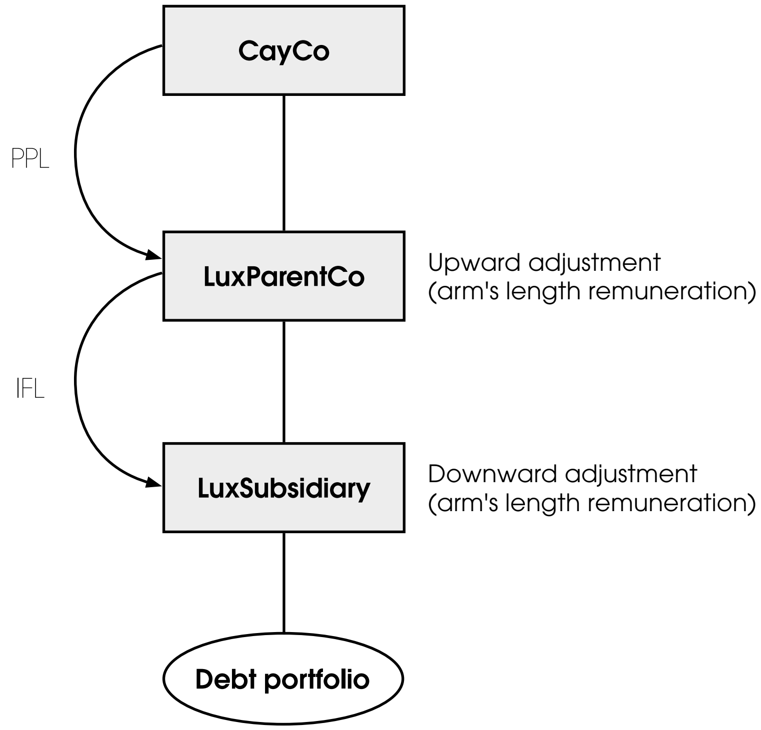
In other words, when a Luxembourg company shifts an advantage to another group company, the LTA may increase the company's taxable income (that is an upward adjustment).

Conversely, when a Luxembourg company receives an advantage from an associated enterprise, the taxable income of the Luxembourg company should be reduced by a downward adjustment to reflect arm's length conditions (to the extent such tax adjustment is not made in application of the concept of hidden capital contribution).

5.4. Application to the case at hand

The terms and conditions of the IFL do not adhere to the arm's length standard. Therefore, tax adjustments should generally be performed at the level of LuxParentCo (upward adjustment) and LuxSubsidiary (downward adjustment). The arm's length remuneration of the IFL should be documented in a transfer pricing study (as it has been done by the taxpayer).

The necessary tax adjustments are depicted in the following chart:



In the fiscal year 2016, both companies have been taxed separately. Therefore, the tax adjustments have a direct impact on the companies' taxable income.

As from fiscal year 2017, both companies formed a fiscal unity. Thus, the downward adjustment and the upward adjustment offsetted each other in the tax base to be reported for the fiscal unity. While the LTA may perform tax adjustments for consistency purposes, overall, these tax adjustments would not change the tax base of the fiscal unity and merely be a theoretical exercise.

Prior results do not guarantee similar outcome. This publication was not designed to provide tax or legal advice and it does not substitute for the consultation with a tax or legal expert.

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