

Luxembourg**INSIGHT: Are Verbal Confirmations Binding on the Luxembourg Tax Authorities?**

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Do verbal confirmations have any binding effect on the Luxembourg tax authorities? A recent judgment provides the answer.

The Luxembourg Administrative Tribunal, in a decision of December 13, 2018, ruled on the potential binding effect of verbal comments of the Luxembourg tax authorities regarding the tax qualification (as equity vs. debt) of equity tainted loans ("ETL"s) granted by a Luxembourg corporate taxpayer to its Luxembourg subsidiaries.

**No Binding Effect on the Tax Authorities**

In 2011, the taxpayer had two meetings with the tax authorities during which a planned investment and the related tax consequences were discussed. It is worth noting that, at the time, the advance tax clearance procedure had not yet been formalized (it was introduced as from 2015).

Seven months after the two meetings, the tax adviser of the taxpayer sent a letter ("statement of tax consequences") to the Luxembourg tax authorities seeking to confirm that the ETLs qualified as equity for Luxembourg tax purposes.

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The letter ended with the following statement: "We agreed that we can consider the above-described tax treatments to be fully in line with the interpretation of the Luxembourg tax law by Office VI (as of today), if we do not receive within six weeks a letter from your side outlining a different view."

The Luxembourg tax authorities did not reply or react in any other form to the letter, so the taxpayer considered that an agreement had been reached on the ETL equity treatment.

In the course of 2012, a tax inspector of the tax office in charge sent an email to the tax adviser of the taxpayer according to which there would be no reason for not considering the ETL as equity.

However, in the 2014 net wealth tax assessment of the taxpayer, the tax authorities did not follow the tax treatment described in the statement of tax consequences and qualified the ETLs as loans fully subject to net wealth tax.

**Four Conditions Required** The tribunal referred to the four cumulative conditions required by previous case law in order to analyze whether a statement made by the tax authorities is binding on them in accordance with the principle of legitimate expectations and legal certainty:

- a written request including all relevant facts so as to enable the tax authorities to analyze the situation properly;
- feedback of the tax authorities provided by a duly qualified officer or an officer the taxpayer may reasonably consider as competent;

- a clear intention of the tax authorities to issue a binding opinion;

- feedback provided by the tax authorities which influenced significantly the decision of the taxpayer.

In the case at hand, the tribunal concluded that these cumulative conditions were not met. The statement of tax consequences is a unilateral document prepared by the tax adviser on behalf of the taxpayer, so that no agreement was reached with the tax authorities. In addition, given that the ETLs were granted prior to the statement of tax consequences and before the tax adviser received the email of the tax inspector, it was quite clear that the position of the tax authorities did not influence significantly the decision of the taxpayer to grant the ETLs.

As a result, the taxpayer could not rely on any agreement reached with the tax authorities in order to qualify the ETLs as equity for Luxembourg tax purposes.

**Equity Qualification of Equity Tainted Loans** The tribunal analyzed whether the ETLs, based on their terms and conditions, had to be considered as either an equity investment in the subsidiary or as a debt (i.e. a loan granted to the subsidiary).

The ETLs had the following characteristics:

- no interest rate during a six-month period—afterwards review of the interest rate;

- conversion of the ETL into shares at the option of the borrower;

- fixed term of 60 years;

- subordination.

According to the taxpayer and its tax adviser, as mentioned in the statement of tax consequences, the following tax qualification was to be given to the ETLs:

- the ETLs qualify as equity for income and net wealth tax purposes;

- the ETLs are considered as a participation within the meaning of the participation exemption regime (Article 166 of the Income Tax Law and Grand-Ducal Regulation of December 21, 2001 and section 60 of the Valuation Law) so that potential remuneration or capital gains on the ETL (if any) would be tax-exempt income and the principal amount of the loan would be exempt from net wealth tax;

- the ETLs qualify as equity for debt/equity ratio purposes.

To motivate the equity qualification of the ETLs, the taxpayer mainly argued that:

- in line with the well-established administrative practice (based on numerous tax rulings granted in the

past), loans with similar features as the ETL (interest-free, maturity exceeding 50 years, convertible, stapling clause) are to be considered as equity for Luxembourg tax purposes: adopting a different approach would go against the principle of equality in tax matters;

- the ETLs have to be considered as a participation based on the economic approach.

The tribunal rejected the argument based on the principle of equality in tax matters since the taxpayer did not provide any evidence of such administrative practice.

However, referring to the parliamentary documents on the Income Tax Law, after having performed an economic analysis of the ETL, the tribunal confirmed the position of the taxpayer according to which the ETLs had to be re-qualified into hidden capital contributions and thus into equity for Luxembourg tax purposes. As a consequence, the ETLs were to be considered as an additional participation in the subsidiary which could benefit from the participation exemption regime for both corporate income tax and net wealth tax purposes.

## Lessons to be Learned

The decision of the tribunal is in line with previous case law on “pre-2015 tax rulings” which made very clear under which conditions one may consider that a binding agreement has been reached with the tax authorities.

Since 2015, the advance tax clearance procedure has been formalized by means of a new law provision and a Grand-Ducal Regulation and verbal confirmations received in the course of discussions with the tax authorities can now obviously not be invoked before courts.

Finally, the decision clarifies the well-established economic/substance over form approach in tax matters.

## Planning Point

While it is clear that exchanges with the tax authorities can be very useful for taxpayers, especially in the current context of repeated tax changes with limited guidance on how to apply these changes, it is also clear that taxpayers cannot only rely on discussions with the tax authorities and should either seek a tax opinion from their tax adviser or send an advance tax clearance request in order to clarify the tax consequences and the transactions and operations they envisage.

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