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Reclassification of Interest-Free Loans: Key Lessons from Recent Luxembourg Case Law

Contributor

Atoz Tax Advisers

Samantha Hauw

Partner | samantha.hauw@atoz.lu

Reclassification of Interest-Free Loans Key Lessons from Recent Luxembourg Case Law

In the dynamic landscape of global finance, the availability and diversity of financial instruments are essential to the competitiveness of investment funds. These financial instruments play a central role in the Luxembourg fund industry. Among these instruments, interest-free loans (“**IFLs**”) have emerged as an impactful tool due to their flexibility —particularly within the Luxembourg fund industry where IFLs are a common feature of various Luxembourg structures.

This article focuses exclusively on the IFL classification, as a debt or as an equity instrument, which has significant implications for Luxembourg tax law and corporate financing practices. Recent developments, such as the Luxembourg Administrative Court’s significant affirmation that IFLs may be reclassified as hidden capital contributions depending on their economic substance, underscore the importance of careful structuring and documentation. This decision follows a series of shifts in case law that have created some uncertainty around the tax treatment of IFLs in Luxembourg.

The question of the qualification of these instruments is crucial as it not only affects the tax treatment but also the cash repatriation strategy in the investment structure as a whole.

Legal Framework

Luxembourg tax law has embedded the concept of substance over form when reviewing, for example, facts and circumstances of a transaction. This substance over form principle allows the tax authorities / courts to requalify an operation if its qualification from a legal point of view (i.e., the legal documentation) is not aligned with its economic reality.

In parallel, the concept of hidden capital contribution/distribution is included in the Luxembourg income tax law in order to allow a reassessment of a taxpayer’s tax base. The hidden capital contribution can be defined as a cash or in-kind contribution made by a (direct or indirect) shareholder to a company outside of any formal increase in subscribed and paid-up share capital.

Through a hidden capital contribution, an advantage is granted by the shareholder to its company. This advantage would not have been granted to a third-party company, with which no relationship exists. In a nutshell, a hidden contribution involves the granting of a benefit between related parties, motivated by their relationship.

In the context of lending, the concept of ‘hidden capital’ refers to a situation in which a shareholder has, directly or indirectly, granted a loan to a company, where an independent lender, acting in accordance with market standards, would not have extended such credit. For tax purposes, Luxembourg authorities and courts may requalify a financial instrument as equity if, looking at all relevant facts, the arrangement lacks key features of debt, and exhibits features typical of equity. The effect of a reclassification might include ability to deduct interest (if any), application of withholding tax or non-deductibility of such a requalified loan for net wealth tax purposes.

A New Case Law Confirming the LTA's Approach

Facts of the case

The case involved a Luxembourg company ("**LuxCo**") that had allocated two of its participations to its Malaysian branch. The two participations were not qualifying for the Luxembourg participation exemption. They were funded by two IFLs from LuxCo's indirect shareholder. LuxCo applied for a tax ruling seeking confirmation that the branch would qualify as a permanent establishment ("**PE**") under the Luxembourg-Malaysia double tax treaty ("**DTT**") and that as a result the right to tax the assets and income of the branch would be allocated to Malaysia rather than Luxembourg.

The Luxembourg tax authorities ("**LTA**") denied the request on the grounds of the abuse of law.

Despite the decision of the LTA, LuxCo considered the branch as a PE in its 2015 tax returns. Accordingly, it allocated the two participations to said PE and sought to treat the assets and related income as tax exempt in Luxembourg in accordance with the DTT. In addition, the LuxCo treated the IFLs as debt instruments.

The LTA rejected the position taken in the tax returns, in compliance with the position taken in the tax ruling. The LTA considered that the branch did not qualify as a PE and requalified the IFLs as equity instruments. As a result, LuxCo could not apply the DTT and was considered as holding two participations not meeting the requirements of the participation exemption and could not deduct the IFLs, considered as equity, from its net wealth tax basis.

Court's analysis on the IFL qualification

Qualification of interest free loans

In the case at hand, the Court held that the IFLs in question should be requalified as equity contributions rather than debt. However, in previous rulings, the Court had also concluded that IFLs had to be classified as debt instruments following an overall assessment of all relevant criteria.

Principle of substance over form

The Court begins its analysis by clarifying the legal foundation for reclassification, reaffirming that the tax treatment of a financial instrument cannot be determined solely by its legal or accounting form. Instead, it must be assessed through the lens of economic reality, applying the substance-over-form principle.

This fundamental principle of tax law was initially described in the parliamentary work of the Luxembourg income tax law and is consistently applied by both the Luxembourg tax authorities and jurisprudence. It requires that facts and legal arrangements be interpreted based on their underlying economic substance. A holistic analysis must be performed in this respect: while the legal characterisation and formal wording of an agreement may be considered, they are only relevant to the extent that they reflect the true intent and substance of the transaction.

The Court reiterates the key factors to be examined when determining whether a financial instrument should be classified as debt or equity. These include, first, contractual elements such as the presence of an interest clause and defined repayment terms; and second, economic indicators like the intended use of the funds, the existence of guarantees, and the proportion of equity relative to the total financing provided.

The Court also refers to additional criteria recognised in prior case law, such as the granting of voting rights to the lender, participation in profits and losses, entitlement to liquidation proceeds, a high level of subordination, extended maturity, convertibility into equity at the company's discretion, repayment in shares, and the inclusion of stapling clauses.

In assessing whether the interest-free loans should be reclassified as equity, the Court relied on a range of criteria traditionally used to distinguish between debt and equity instruments. These were analysed holistically, with no single factor being determinative.

<u>1) Absence of interest payments</u>

While a participation in the profit of a company is typically viewed as an equity characteristic, a fixed interest rate is clearly indicative of debt. However, in practice, the market uses a wide range of financing instruments which do not always fit neatly into either category. In the case at hand, the Court considered the absence of interest as a strong indication that the arrangement was not made on arm's-length terms, since a genuine lender would ordinarily expect to receive compensation for the use of funds. The lack of interest undermined the classification of the instrument as debt.

<u>2) Allocation of funds</u>

The IFLs were used to finance long-term equity participations in other companies, involved in a gas pipeline project, a capital-intensive and durable investment. These participations were classified as non-current assets in LuxCo's balance sheet, reinforcing their long-term nature.

LuxCo had no other significant assets or activities, and its influence over the acquired entities (e.g., board representation) further supported the view that the funds were intended for long-term strategic investment.

According to the Court, these elements are more typical of an equity investment than of a standard loan and this allocation of funds aligned the transaction more closely with a capital contribution.

The Court, however, remains silent on whether a typical private equity investment structure with a five- to seven-year investment horizon should also be considered long-term equity. It is interesting to note though that this specific feature has not been considered as crucial in past jurisprudence, which suggests a willingness by the Court to adopt a broad approach with respect to its analysis.

<u>3) Debt-to-Equity Ratio</u>

The Court observed a significant imbalance in LuxCo's capital structure.

LuxCo was significantly undercapitalized, with the loans making up nearly the entirety of its funding. This high debt-to-equity ratio (reported to be approximately 99.998% debt versus 0.002% equity) indicated tht the shareholder was assuming the financial risk typically borne by equity investors.

In its defense, LuxCo argued that it could rely on the existence of a longstanding market practice of applying an 85/15 debt-to-equity ratio, which, in its view, should be considered an acceptable benchmark for the Luxembourg tax authorities. To support its position, LuxCo submitted a transfer pricing report indicating that comparable companies in the market were applying a similar 85/15 ratio.

However, the Court rejected this argument, stating that the 85/15 ratio is merely a practice and does not constitute a binding standard for the Luxembourg tax authorities. Additionally, the Court found that the transfer pricing report lacked adequate documentation and was inadequate to demonstrate that the financing arrangement complied with the arm's length principle.

The Court also dismissed LuxCo's request for partial reclassification, affirming that instruments must be classified entirely as either debt or equity.

4) Absence of Guarantees

The IFLs lacked formal guarantees, increasing the lender's risk. There were no guarantees or security arrangements in place to protect the lender. In the absence of such protections—which are standard in arm's-length lending transactions—the Court considered the lender's position to be more reflective of an equity holder than a creditor. However, the Court adopted a more measured stance on this argument. While LuxCo's assertion that intragroup loans are generally granted with fewer securities or guarantees was not substantiated, the Court acknowledged that the argument remains plausible. This is because belonging to a corporate group inherently implies the existence of particular relationships of trust and control that do not exist between unrelated third parties.

This being said, and while the types of guarantees that may be granted in an intragroup context are potentially more limited than in third-party arrangements, the presence or absence of such guarantees remains one of the criteria to be taken into account in the overall analysis. In this case, the absence of any guarantee resulting in a higher level of risk borne by the lender tends to align the position of a company granting an IFL more closely with that of a shareholder.

5) Inclusion of stapling clause and maturity

The Court noted that, contrary to LuxCo's arguments, the loan agreement included a clause requiring early repayment in the event the lender ceased to hold a controlling shareholding in the borrower. This type of "stapling" clause effectively links the financial instrument to the shareholding structure, reinforcing its equity-like character.

Finally, although the loans formally had a ten-year maturity, the Court considered the broader context. The shareholder had previously and repeatedly refinanced LuxCo through new long-term interest-free loans, suggesting that repayment was not genuinely expected within the stated term. This reinforced the impression that the arrangement lacked the commercial features of true debt.

Conclusions of the Court

Taken together, these factors led the Court to conclude that the IFLs, while formally labelled as loans, in substance functioned as capital contributions. Their features reflected a willingness by the shareholder to absorb risk and support LuxCo with the profile of an equity investor, rather than that of a third-party creditor.

It is worth mentioning that, based on the doctrine and past jurisprudence, other features could also be taken into consideration when determining the nature of financial instruments. In this respect, the Court rejected LuxCo's criticism that the first-instance Tribunal had arbitrarily and unjustifiably disregarded five criteria: the absence of a participating interest, the absence of participation in liquidation proceeds, the absence of a conversion right into capital, the absence of repayment through share issuance, and the absence of voting or information rights.

Indeed, the Court confirmed that the analysis is not a matter of simple arithmetic, where a majority of indicators would automatically lead to a debt qualification. Rather, it requires a comprehensive economic assessment of the overall situation. In this case, according to the Court, the Tribunal laid out its reasoning in detail, and LuxCo failed to provide any evidence capable of overturning the conclusion that such favorable financing conditions could only be explained by the indirect shareholder relationship.

Furthermore, the Court concurred with the Tribunal's assessment that the following indicators:

- the absence of interest payments,
- the significant disproportion between the funds provided by the indirect shareholder and LuxCo's equity,
- the absence of guarantees in favor of the indirect shareholder, and
- the use of the funds to finance long-term fixed assets,

when considered collectively and in light of the overall structure of the transactions in which the IFLs were embedded, support the conclusion that, from a tax perspective and based on the economic reality these loans must be recharacterized as hidden capital contributions from LuxCo's indirect shareholder.

Finally, it is worth noting that the Court rejected the idea of *partial reclassification* (i.e. that only that part of the loan exceeding some arm's length amount should be reclassified). In this case, the entire loan instrument was recharacterized due to its complex nature. From a Luxembourg tax perspective, because the IFLs were requalified as equity contributions, they were therefore not deductible for the purpose of Luxembourg Net Wealth Tax.

Furthermore, the Court held that, insofar as the right to tax was allocated to Luxembourg as a result of the recharacterisation, the issue of abuse of law was no longer relevant.

Expected consequences on the market going-forward

This jurisprudence tends to be consistent with the trend toward greater scrutiny of IFLs. The case appears to be less a shift in legal doctrine than a reaffirmation and reinforcement of existing principles detailed earlier. This case however provides explicit clarifications especially with respect to the acceptable benchmarks and the circumstances under which reclassification may occur.

It is anticipated that the Luxembourg courts and tax authorities will continue to focus on the underlying economic substance of a transaction rather than relying merely on its formal documentation, and take a global approach when reviewing and assessing a taxpayer's position. Additionally, the Court confirmed that the LTA are entitled to review a specific group pattern in order to assess the intention of a taxpayer.

This decision also suggests that taxpayers cannot rely purely on "market practices" or previous administrative thresholds (e.g. debt/equity ratio norms) without solid evidence of arm's length character of a transaction. The evidence of the arm's length character will inevitably go through the lens of transfer pricing and more particularly debt capacity analysis.

Historically, many taxpayers, especially holding companies, have followed an informal 85:15 debt-to-equity ratio, as a non-binding but commonly accepted administrative practice; However, this decision has jeopardized the perceived certainty associated with this ratio. Tax authorities are now expected to place greater emphasis on whether intercompany financing arrangements reflect realistic economic behaviour and whether the borrower could have secured similar terms from an independent lender under comparable circumstances.

This decision highlights the increasing importance of conducting both a debt capacity analysis and a commercial rationale assessment at the time financing is arranged. These elements—along with an evaluation of repayment ability, lender risk exposure, and the presence or absence of guarantees—will likely be subject to increased scrutiny. This trend further enhances the importance of robust transfer pricing governance and documentation standards.

While this decision confirms the long-standing approach of substance over form, it is expected that the clarification of the Court regarding the 85/15 ratio as well as the holistic review in its broad sense will inevitably create an additional layer of complexity and compliance work in order to make sure that any challenges from the tax authorities in the next years will be appropriately documented.

Going forward, it is expected that taxpayers will adopt a more cautious and diligent approach in determining appropriate financing structures and with increased attention to economic rationale, and compliance in the management of their holding and financing arrangements. This ensures that any intra-group financing structures are supported by robust and contemporaneous documentation.

Contributors

Samantha Hauw
Partner

samantha.hauw@atoz.lu