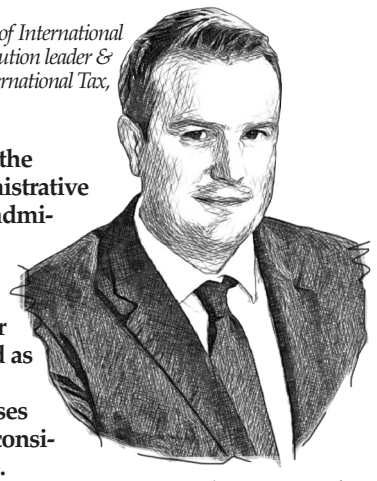
Administrative Tribunal - Judgment on hidden capital contribution requalification and interest expenses deductibility

By Emilien LEBAS, Partner, Head of International Tax, Tax controversy & dispute resolution leader & Valentine PLATEAU, Manager, International Tax, KPMG Luxembourg



On 26 February 2025, the Luxembourg administrative tribunal (Tribunal administratif, 26 février 2025, n° 47358) (the "administrative Tribunal" or the "Tribunal") had to rule on whether a loan should be requalified as hidden capital contribution and whether interest expenses deriving from it should be considered as non-tax deductible.

Summary of the case

On 20 October 2020, the Luxembourg tax authorities ("**LTA**") challenged the 2017 tax return of a taxpayer regarding a loan payable, considering that interest expenses accruing on such loan should not be tax deductible. It should be noted that in the case at stake the taxpayer is part of a fiscal unity as an integrated entity.

The situation at issue was quite specific and may be summarized as follows.
- On 31 July 2014, a loan ("**the Loan**") was granted to a transparent company (i.e. under the legal form of an SCI, *société civile immobilière*) (the "**transparent entity**" or "**the SCI**") by an affiliated undertaking (the "**Initial Lender**") to enable the former to refund its shareholder current account. Its shareholders were natural persons tax resident in Luxembourg.
- The amount to be refunded resulted from an exchange of lands between the transparent entity/SCI and the Grand Duchy of Luxembourg. This exchange gave rise to a capital gain on the land given in exchange. Furthermore, as the land received by the transparent entity/SCI had a higher value than the one given in exchange, a cash adjustment was paid by the transparent entity/SCI funded by its shareholder current account.
- On 1 October 2014, a new entity, the taxpayer in the case at hand (the "**taxpayer**"), was established under the form of an SCS (*société en commandite simple*) by two shareholders (with one being the SCI). The Loan was transferred by contribution in kind as part of a business transfer by the SCI, upon incorporation, to the taxpayer. Shortly after, the taxpayer (initially incorporated as an SCS) was transformed into an SA (*société anonyme*). At the same time the SCI was liquidated. An addendum was signed so that the Loan could continue to take effect between the Initial Lender and the taxpayer.
- In December 2014, the remaining shareholder of the taxpayer was absorbed by a Luxembourg entity (currently the integrating entity of the existing fiscal unity of which the taxpayer is part).

When challenged by the tax office, the taxpayer provided arguments to justify the tax-deductible treatment it applied to the interest charge accruing on the Loan. Unconvinced, the LTA ultimately issued a final tax assessment confirming its initial position on 8 April 2021 to the integrating parent entity (the "**appellant company**" or the "**integrating entity**") of the fiscal unity the taxpayer was part of.

On 21 June 2021, the integrating entity filed an administrative claim to the Director of the LTA, unsuccessfully. As a result, an appeal was lodged with the administrative Tribunal.

Judgment of the Tribunal

Two main points were consecutively analyzed by the administrative Tribunal:
- The qualification of the Loan that was granted by the Initial Lender, i.e. whether it should be rather regarded as a debt or an equity instrument; and
- The tax treatment of the interest expenses deriving from this loan at the level of the taxpayer, i.e. whether they should be tax deductible or not.

Characterization of the Loan

To address the question of the recharacterization, the Tribunal relied on the parliamentary comments related to article 97 of the Luxembourg income tax law ("**LITL**"). Accordingly, there could be instances where a loan granted to a company by its shareholders could be assimilated to a hidden capital contribution. Were that to be the case, the immediate consequence would be that the interests paid on that loan should in principle not be tax deductible as an ordinary expense of the company would be.

The judges observed however that the authors of such parliamentary comments did not establish a clear method or precise rules to determine whether a loan could constitute a hidden capital contribution within the meaning of article 97 LITL, as the text only indicates the general context in which the recharacterization of a shareholder loan as hidden capital contribution may be envisaged, namely:
- When the normal financing method, dictated by serious economic or legal considerations, would have been a capital increase; and
- When it is evident from the circumstances that the loan structure was chosen solely for tax reasons.

In the case under review, the Tribunal did not follow the position of the LTA, which sustained that the Initial Lender had a shareholder relationship with either the taxpayer or the appellant company, given the absence of elements to evidence their relation, even though it agreed that the Initial Lender was a related party within the meaning of article 56 LITL[1], noting that all the entities involved (i.e. the integrating entity/appellant company, the taxpayer, the Initial Lender) shared the same beneficial owners which were either direct or indirect shareholders in all these companies.

In this decision, the judges adhered to a literal interpretation of the parliamentary comments which envisaged the recharacterization only in cases where a loan would have been granted to a company "by its shareholder". Appreciating that in the case under review the Initial Lender was not a shareholder of the taxpayer (albeit affiliated) nor the appellant, the judges concluded that a hidden capital contribution could, as a result, not be possible under article 97 LITL.

Hence, even though the Tribunal acknowledged that, considering all the circumstances surrounding the cases, i.e. a series of operations carried out within a short period of time by related entities sharing the same beneficial owners, the economic reality of the transactions legitimately raised the LTA's suspicion, it ruled that such concerns did not permit it to extensively interpret the rules as established in the parliamentary comments in relation to article 97 LITL. It further asserted its position by recalling that consistent administrative case law has ruled that for an instrument to be recharacterized from debt (loan) to equity (hidden capital contribution), it should have been granted by a shareholder of the borrower.
As a result, the judge confirmed its qualification of the recharacterization as a debt instrument. On this basis, the interest expenses deriving from it should in principle remain tax deductible in nature unless another legal provision provides otherwise.

Tax deductibility of the interest expenses

Despite this provisional conclusion, it should not be inferred that the tax deductibility of those interest charges may not be denied on other grounds.

In this respect, the Tribunal considered that there was no economic link between the Loan and the taxpayer as the Loan was initially concluded by the transparent entity to repay its shareholder current account. As such, the Loan would not have been included in its net invested assets within the meaning of article 19 (1) LITL according to which "*Assets which by their nature are intended to be used for the business shall form part of the net invested assets*"[2] as opposed to private assets (article 19 (3) LITL[3]).

To reach such a conclusion, the Tribunal relied once again on the parliamentary comments. It reaffirmed the position of the legislator regarding debt payables and receivables which is to classify those items as net invested assets when, taking into account the identity of the borrower and the rationale behind the transaction, they relate to the business activity of the company.

The judges rejected the taxpayer's arguments that sought to demonstrate that the Loan should be considered as having been historically part of the SCI's net invested assets as follows:
- The judges ruled that the mere fact that the land obtained with the Loan was part of the net invested assets of the transparent entity is not sufficient for the Loan itself to be considered included in the net invested assets as well.
- They also rejected the argument that the Loan financed the lands exchanged with the Grand- Duchy of Luxembourg, recalling that the exchange at stake was financed with other lands with a higher value and cash payment (i.e. the Loan was not directly financing the lands received, although such cash payment was made out of the Loan proceeds received). Doing so, the Tribunal favors an approach to the question of the financing of assets for direct tax purposes focusing on factual elements and cash flows as opposed to the end accounting positions and a more lump sum type of approach.
- The judges also rejected the argument according to which the internal financing (with the shareholders of the SCI, i.e. shareholder current account) was replaced by an external financing (with the Initial Lender), as the shareholder current account should not be seen as a financing as such. The current account at stake was linked to the desire for the SCI's shareholders to have access to the capital gain on the land given in exchange that was not effectively distributable due to the absence of liquidity at this time (i.e. an exchange transaction instead of a cash transaction).

Further to the above, it was concluded that the Loan was to be considered as part of the private assets of the transparent entity.

Finally, the Tribunal ruled that the fact that the SCI transferred the Loan as part of a contribution in kind of its business to the taxpayer does not establish or create an economic link between the Loan and the activity of the taxpayer (i.e. such contribution is not sufficient to establish that the Loan is part of the net invested assets of the taxpayer).

For the judge, even though there is no such concept as private assets for capital companies (as opposed to transparent entities), operating expenses tax treatment is governed by article 45 LITL which essentially provides that only expenses incurred by the company may in principle be considered tax deductible. In other words, this provision allows the categorization as operating expense only if:
- there is a sufficiently close causal link between the expense and the taxpayer's income, and if
- this link is exclusive enough to rule out that the expense was actually incurred for the personal needs of other persons.

In the case at hand, the Tribunal observed that the Loan had not been concluded for the purpose of generating income at the SCI's level but rather to allow the distribution of capital gain income to its shareholders. Concluding that such Loan could not be considered as economically linked to the activity of the transparent entity (nor with the activity of the taxpayer when passed on), the Tribunal ultimately rejected the deductibility of the interest incurred by the taxpayer in relation to the Loan.

Takeaways

This decision is interesting on several grounds as it addresses various recurring tax topics on which some uncertainties remain.

Regarding the recharacterization of a loan as a hidden capital contribution, this decision is not particularly innovative, but it serves as a useful reminder. In an instructive manner, the Tribunal reiterates that the choice for the characterization of a transaction between a debt instrument and an equity instrument should be based on a combined analysis of the parliamentary comments related to article 97 LITL and past case law. Based on this case law, the reasoning to adopt when assessing a financing operation should be as follows:
- As a prerequisite, one should check whether the financing transaction is carried between parties having a shareholding link with each other – it seems clear from this decision that the Tribunal decided to follow a literal interpretation of the parliamentary proceedings and does not consider the fact that the operation was concluded by two entities belonging to the same group sufficient for equity qualification purposes.
- If that first circumstance is present, one should follow a case-by-case approach, bearing in mind all the facts and circumstances of the specific case, to assess what the normal financing structure resulting from sound economic/legal considerations would be. Such assessment should be performed in light of the criteria established by administrative jurisdiction case law (non-exhaustively listed above).

Regarding the non-deductibility of the interest expenses, this decision underscores the importance of the taxpayer's ability to demonstrate that the loan was undertaken for economic reasons linked to its business activity. The repayment of funds made available to the company through shareholder current accounts cannot be equated with external financing, as the formalities, particularly those concerning repayment, differ—regardless of the reasons why those funds were originally provided. This judgment also evidences the fact that the Tribunal favors an approach to the question of the financing of assets for direct tax purposes focusing on factual elements and cash flows as opposed to the end accounting positions and a more lump sum type of approach. As this judgment is a first instance judgment, we should however remain prudent at this stage when dealing with refinancing.

Considering the case is recent as we submit this article, we do not know whether the taxpayer will lodge an appeal on this judgment in front of the administrative Court of Appeal.

1) Article 56 LITL is the legal basis of the arm's length principle and provides that two enterprises should be considered related parties when:
- an enterprise participates directly or indirectly in the management, control or capital of another enterprise, or
- the same persons participate directly or indirectly in the management, control or capital of two enterprises
2) Unofficial English translation by the authors
3) Unofficial English translation by the authors: article 19 (3) LITL: "*Assets that cannot be used for the business because of their purpose may not form part of the net invested assets*".