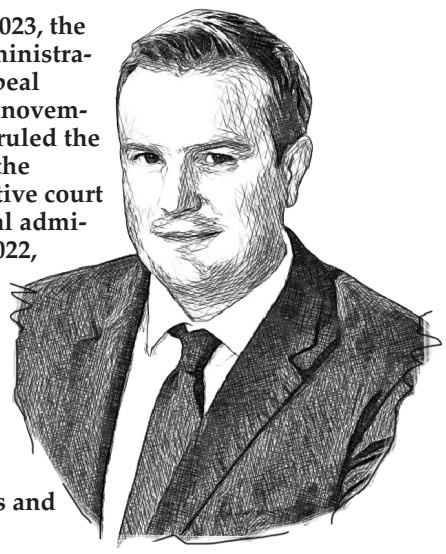
Tax controversy series

Administrative Court of Appeal - judgment on interest-free loan

On 23 November 2023, the Luxembourg administrative Court of Appeal (Cour administrative, 23 novembre 2023, n°48125C) overruled the judgement rendered by the Luxembourg administrative court of first instance (Tribunal administratif, 23 septembre 2022, n°44902) that an interest-free loan ("IFL") should be requalified as equity for Luxembourg direct tax purposes, and ruled instead that the instrument at issue should be regarded as a debt considering all facts and circumstances.



Summary of the case

In the case at hand, the Luxembourg taxpayer (or the company, or the borrower) was notified on 5 December 2018 by the tax office about its intention to challenge the company's tax return filed for the fiscal year 2016. The operation at issue was an IFL that had been granted by the sole shareholder (or the lender) of the company, tax resident in Luxembourg as well, to finance a debt portfolio. Notional interest deductions had been imputed on the IFL in the company's tax return.

The terms and conditions of the loan agreement could be summarized as follows:
- No interest;
- Maturity of 8 years;
- Does not grant the lender any rights in the profits and/or liquidation proceeds of the borrowing entity;
- Does not contain any stapling clause;
- Does not grant any voting rights to the lender;
- Provides the possibility for the lender to require the conversion of the IFL into shares of the borrower;
- Provides only for a limited recourse to the benefit of the lender;
- Is subordinated to bank debt.

It was noted separately that no guarantee had been granted in relation to the repayment of the IFL.

The Luxembourg tax authorities ("**LTA**") noted that both companies, the lender and the borrower, had joined the same fiscal unity as from 2017 and considered it could be the reason explaining why a deemed interest deriving from the IFL had been computed for the fiscal year 2016 only. The fact that the loan agreement was – from their point of view – poorly drafted and had been concluded 7 months after the actual cash injection strengthened their suspicions.

The LTA considered that based on the facts and circumstances a normal financing structure resulting from serious economic or legal considerations would have been a capital increase and, by way of consequence, that the choice of a loan agreement over a capital contribution could only have been driven by tax reasons.

Following this analysis, the tax office further concluded that the IFL had to be treated as an equity instrument and therefore recharacterized the transaction as a hidden capital contribution for tax purposes. The immediate consequence was to consider the deemed interest charge under the IFL for the fiscal year 2016 as non-deductible, leading to an upward adjustment of the taxable basis of the taxpayer (as depicted in the tax assessments issued on 30 January 2019).

Further to the issuance of the tax assessments, the taxpayer submitted on 30 April 2019 its claim to the director of the LTA, who confirmed the position of the tax office. The director's decision was then referred to the Luxembourg administrative court of first instance by the taxpayer, which rejected its claim on 23 September 2022. An appeal to the administrative Court of Appeal ("**the administrative Court of Appeal**" or simply "**the Court**") was lodged by the taxpayer the same day.

Context of the decision

The judgement of 23 November 2023 confirms first of all that the principle of economic appreciation (or substance over form principle) should be the guiding thread of the reasoning and clarifies to some extent how such principle should be applied concretely. Though this principle is arguably embedded in § 11 of the tax adaptation law of 16 October 1934 (Steueranpassungsgesetz, StAnpG), the Court based its legal reasoning on the parliamentary comments of the bill of law 571[1] (which became the Luxembourg income tax law ("**LITL**") of 4 December 1967 after its adoption by the Parliament), rather than on the § 11 StAnpG itself, considering that the matter at stake was a question of characterization of a financial instrument ruled by article 97 LITL[2].

Going beyond the mere review of the terms and conditions of the agreement to determine whether the latter includes mostly equity-like or debt-like components, the Court rules that a global analysis is required to determine whether the transaction corresponds to the normal financing route dictated by serious economic or legal considerations.

Furthermore, the Court reminds that the application of the principle of economic appreciation requires an economic and financial analysis and cannot be limited to highlighting the presumed intentions of the parties to the transaction, contrary to what the LTA somehow did according to the judge.

"By virtue of the principle of the preeminence of economic reality [or economic appreciation] over legal appearance, the question is to characterize the transaction based on an economic and financial analysis and not by highlighting the presumed intentions of the parties to the transaction."[3]

In the situation under review, what is particularly interesting is that the Court performed this economic and financial analysis to rule in favor of the taxpayer (we will explain below the background for this comment in light of a recent judgement of the administrative court of first instance).

Indeed, the Court went beyond the legal forms and appearances arguments as interpreted by the LTA by analyzing the economic reality of the transaction, and concluded that based on the substance over form principle as well as with the hindsight inherent in the analysis carried out at the litigation level after the end of the relevant operations, the parties executed the IFL as a debt, which should therefore not be requalified as a hidden capital contribution.

This statement is important considering the judgement of 26 July 2023 rendered by the Luxembourg administrative court of first instance (*Trib. administratif, 26 juillet 2023, n° 45706 et n°46555*) in which the latter seemed to consider that the sole purpose of § 11 StAnpG is to enable the LTA (and not the taxpayer) to go beyond legal forms and appearances by analyzing the economic reality of a given transaction behind the legal forms chosen by the parties, in order to verify whether these correspond to the parties' intentions as we commented in a previous article of this Tax controversy series[4].

As mentioned in this article, at a minimum, the judgement of 26 July 2023 indicates that for the first instance judge the principle of economic appreciation of § 11 StAnpG can only apply in exceptional situations – where the legal form and appearances are misleading – and that, when the situation is clear, and when the legal documentation is clear ("*pièces non équivoques*"), trying to argue that the economic reality is different or more complex, is worthless.

However, one could wonder if there was not more to this judgement than meets the eye. The reasoning of the Luxembourg administrative court of first instance could indeed be interpreted as suggesting that, from its point of view, the principle of economic appreciation can only play against the taxpayer but would not be valid grounds for challenging the position of the LTA.

For completeness' sake, in a judgement of 31 March 2022[5], known as the "MRPS case", the Court of Appeal already seemed to go in this direction again on the basis of the parliamentary comments of the bill of law 571, (which became the income tax law of 4 December 1967 after its adoption by the Parliament as reminder earlier on). This judgement of 31 March 2022 also concerns a case of qualification for tax purposes of financial instruments having both equity-like and debt-like type of features, this time mandatorily redeemable preference shares.

The judgement of 23 November 2023, however, suggests a more balanced interpretation of the principle of economic appreciation, potentially more favorable to the taxpayers.

Decision of the Court

The administrative Court of Appeal underscores that it emerges from the parliamentary comments of the bill of law 571 (which became the income tax law of 4 December 1967 after its adoption by the Parliament)[6] that a comprehensive analysis of the transaction is to be favored over the isolated examination of any specific feature of the loan agreement in order to understand its economic rationale. Such approach is to be followed to ascertain whether the transaction at issue is aligned with the normal course of financing, dictated by serious economic or legal considerations.

Methodically, the Court continues its reasoning by specifying that such analysis should include two distinctive elements:
1. The review of the terms and conditions of the loan agreement; and
2. The examination of the facts and circumstances surrounding the granting of the loan.

These elements were already, to some extent, analyzed by the judges of first instance; however, the courts had diverging interpretations. With respect to the terms and conditions of the loan agreement the Court disagreed with the first instance judges on the interpretation of some of the key features of the instrument:
- The administrative court of first instance deducted from the presence of a limited recourse clause, combined with the subordination to bank debt, that it should correspond in fact to an absence of repayment obligation within a specific deadline (which would be an equity characteristic). The administrative Court of Appeal disagrees with this deduction as it notes that the loan agreement did have a repayment obligation with a short-term maturity and has effectively been fully repaid since then.
- The Court also disagrees on the interpretation made by the first judges regarding the presence of a stapling clause in substance. For the administrative court of first instance the combination of 1) the clause allowing the lender to contribute the IFL to the borrower/convert it into shares of the borrower and 2) the clause providing that the approval of the lender was required for the borrower to transfer its rights and obligations, amounted to a stapling clause. In appeal, the Court rejects this reasoning and considers that an *intuitu personae* clause is normal in loan agreements.
- The Court also highlights that the absence of guarantee and the subordination to the bank debt could be considered as standard and acceptable features in certain circumstances and that there is no possibility to convert the loan at the option of the borrower.
- Based on the Court's analysis, the repayment in kind clause should be understood as repayment in kind with underlying assets. In addition, IFL cannot be repaid with shares of the borrower, unless the lender accepts such repayment and agrees on a valuation method. Therefore, this provision should not be assimilated to a unilateral conversion right at the option of the borrower.

With regard to the facts and circumstances:
- In this respect, the Court considers that the fact that the IFL was concluded several months after the actual granting of the funds should not have an adverse impact on the qualification as the documentation of a private financing agreement should be more flexible than the one relating to a capital increase. It also emphasizes that the intention of the parties should not be assumed from this element, precisely to stick to a factual and economic analysis.
- The Court also disagrees with the assumption that the fact that the lender is the sole shareholder of the taxpayer should amount *de facto* to the loan granting a participation right in the profits/liquidation proceeds and voting rights in the borrower. In its decision, the Court therefore distinguishes what results from the shareholder status of the lender and what effect derives from the loan agreement itself.
- The Court does not elaborate on the transfer pricing aspects relating to the computation of the deemed interest as this point was not disputed by the tax office, even though it still notes that the deemed interest was also reported as income by the shareholder in its own return.
- Interestingly, the Court also takes into account the fact that the IFL has been repaid in the meantime (during a tax period not covered by the litigation) as another element showing that the execution of the transaction has been in line with a debt qualification of the instrument.

Overall, the Court judges that the debt structure, given the facts and circumstances, is consistent with the financing of short-term assets, as was the case here, and that in the case at stake the loan has been repaid fully, though some features of the IFL are equity features, starting with the absence of remuneration/yield on the instrument.

In light of these considerations, the administrative Court of Appeal rules that the judges of first instance misinterpreted certain provisions of the IFL and disagrees on the conclusion that the latter should be viewed as an equity instrument for direct tax purposes. Therefore, it decides to overrule the judgement of first instance and to refer the case back to the director of the LTA.

As mentioned above, the judgement of 23 November 2023 therefore suggests a more balanced view of the principle of economic appreciation than the one recently adopted by the Luxembourg administrative court of first instance on 26 July 2023 and by the Court of Appeal itself in the MRPS case. When we look closely at the facts and circumstances of the three cases, it appears that these judgements are in fact not contradictory.

For instance, in the MRPS case, the Court of Appeal ruled that a taxpayer cannot use the principle of economic appreciation to recharacterize for tax purposes a financial instrument treated as equity accounting wise, whereas in the judgement of 23 November 2023, the same Court ruled in favor of a taxpayer resisting an attempted recharacterization by the LTA of another financial instrument treated as debt accounting wise into an equity instrument for tax purposes.

However, the distinctions that are made by the judges are not necessarily self-explanatory or easily understandable by the taxpayers. Though the accounting treatment seems to be of paramount importance in the mind of the judges, this statement is not made that explicitly in any of these three judgements. A clarification would thus be welcome in this respect. Since an appeal (49388) has been lodged against the judgement of first instance of 26 July 2023, we should hopefully soon know more in this respect.

In any event, the importance of detailed and timely prepared documentation in order to support the economic rationale behind a financing structure should be emphasized. In the case at hand, even though the administrative Court of Appeal ultimately ruled that the poorly drafted documentation was not detrimental to the taxpayer, it certainly didn't help the taxpayer either and contributed to fuel the LTA's determination to adjust the company's tax position.

Emilien LEBAS,
Partner,
International Tax, Tax controversy & dispute resolution leader

Valentine PLATEAU,
Assistant Manager,
International Tax,

KPMG Luxembourg

1) Projet de loi 571 concernant l'impôt sur le revenu, doc. parl. 5714, commentaire des articles, ad art. 114, p. 180.
2) Article 97 LITL corresponds to article 114 of the bill of law 571.
3) Free translation by the authors of the original text in French: *"En vertu du principe de la prééminence de la réalité économique sur l'apparence juridique, il s'agit de caractériser l'opération en se fondant sur une analyse économique et financière et non pas en mettant en avant des intentions présumées des parties à la transaction. »*
4) E. Lebas and V. Plateau, "Tax controversy series – Administrative court judgment on economic appreciation", AGEFI Luxembourg, October 2023 p. 8.
5) Cour adm., 31 mars 2022, n°46131C.
6) Projet de loi 571 concernant l'impôt sur le revenu, doc. parl. 5714, commentaire des articles, ad art. 114, p. 180.