Tax controversy series

Administrative court of appeal decision on abusive partial liquidation

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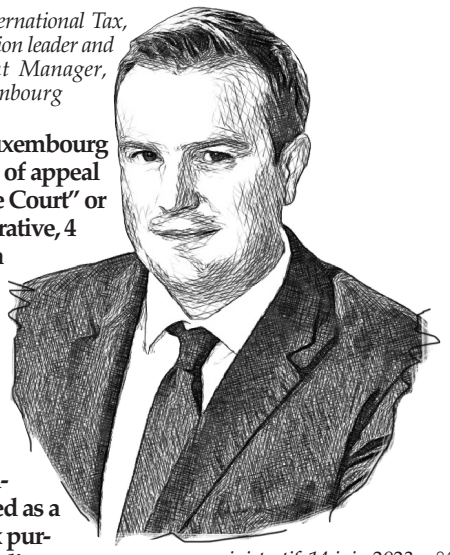

On 4 June 2024, the Luxembourg administrative court of appeal ("the Administrative Court" or "the Court") (Cour administrative, 4 juin 2024, n°49203C) issued a decision in which it took a position on whether the partial liquidation carried out by the taxpayer (or "the claimant" or "the appellant") through the redemption of classes of shares should be considered as abusive, and therefore requalified as a dividend distribution for tax purposes, i.e., subject to withholding tax ("WHT") in Luxembourg.

The recent introduction of the bill of law n°8388[1] by the Luxembourg government concerning classes of shares makes the analysis of this decision particularly relevant and interesting.

Case summary

The taxpayer in the case under review was a former Cypriot resident company which migrated to Luxembourg in 2016. The company was held by two natural persons, residents in Russia for tax purposes.

Following an audit from the Luxembourg direct tax authorities, the company's corporate tax return for the fiscal year 2017 was challenged. During that year (in November 2017), the taxpayer divided its existing share capital into classes of shares (classes of shares from A to J and from AA and JJ) shortly before receiving dividends from its subsidiaries. The taxpayer subsequently redeemed and cancelled some of its classes of shares in December 2017, treating this operation as a partial liquidation[2] exempt from WHT.

Given the circumstances surrounding the operation, and notably the fact that both shareholders of the appellant were natural persons, the tax office considered the issuance of classes of shares, almost immediately followed by their redemption and cancellation, as abusive under §6 Steueranpassungsgesetz ("**StAnpG**")[3]. As a result, profits repatriated through such a transaction were recharacterized by the tax office as income from capital, giving rise to a 15% WHT as per Luxembourg domestic tax law without any double tax treaty relief.

Following the issuance of a WHT assessment by the Luxembourg tax authorities, the claimant addressed an administrative claim to the director of the Luxembourg direct tax authorities and a request for a stay of execution (*sursis à execution*) of the WHT charge to the tax office. The latter was rejected on the grounds that the claim was not deemed to have a reasonable chance of success, and a second administrative appeal was therefore subsequently lodged with the director to contest such denial.

In December 2020, the director of the Luxembourg tax authorities took a position aligned with the tax office with respect to both claims. Unsatisfied with the outcome, the taxpayer further referred both of the director's decisions to the Luxembourg administrative court of first instance ("**the Administrative Tribunal**") in March 2021, and subsequently complemented this with a new stay of execution request in September 2021 to suspend the enforcement measure (*astreinte*) accompanying the rejection of the administrative claim. The latter was denied.

On 14 June 2023, the Administrative Tribunal confirmed the position of the tax authorities (*Tribunal administratif, 14 juin 2023, n°45759*). As a result, an appeal was lodged on 24 July 2023 with the Administrative Court.

Context of the decision

The decision under review is yet another decision where the Administrative Court has taken a position on a case involving an abuse of law. The approach followed by the Court to determine whether an abuse of law may be identified, and how this concept can coexist with what seems to be an opposite principle – the right of the taxpayer to choose the least taxed path (*choix de la voie la moins imposée*) – is now well-established.

Recently, the Court has issued several decisions where it also had to determine whether an abuse of law could be characterized in cases involving a delayed use of tax losses carried forward[4], applying the same reasoning.

In short, the concept of abuse of law[5] relies on the following cumulative criteria, which the Administrative Tribunal and the Court systematically analyze based on the specific facts and circumstances surrounding the case:
1. private law forms and institutions are used;
2. taxes are reduced;
3. an inadequate path is used; and
4. there are no valid non-tax reasons justifying the use of the chosen path.

It is clear from the present case that the last criterion serves as a protective measure for the tax administration. While, in principle[6], the burden of proof should primarily remain with the direct tax authorities, they only need to demonstrate the existence of elements constituting the abuse of law and to make "plausible" the absence of an economic justification for the chosen path. This relatively low threshold, when deemed satisfied by the judges, is sufficient to shift the burden of proof to the claimant, who must then substantiate and document the economic considerations justifying the litigious operations. This principle has been reiterated by the Court in the present case.

This judgment is also, and more importantly, interesting as it deals with the repurchase and immediate cancellation of classes of shares (also referred to as "Alphabet Shares"). When analyzing case n°49203C, it is striking to note that the principle of the applicability of the tax treatment of a partial liquidation to the repurchase followed by the immediate cancellation of a class of shares was not as such challenged by the tax authorities. Quite the opposite, the latter decided to challenge the contentious transactions on the grounds of the abuse of law only.

However, the legal provisions governing such a mechanism are not explicit. Due to the lack of legal clarity, uncertainties persist regarding which circumstances the Luxembourg tax authorities deem acceptable and which they do not.

This judgment therefore serves as a reminder of the current state of play and the considerations that need to be kept in mind for an operation not to be considered abusive.

The Court's decision

In the case at stake, it is important to mention that the qualification of the repurchase and immediate cancellation of classes of shares as partial liquidation was not contested. However, the Court argued that such a redemption, in the specific circumstances of the case, constituted an abuse of law.

In establishing whether there has been an abuse of law, the Court's analysis mainly[7] relies on the four cumulative criteria that we set out earlier.

The first element in the characterization of an abuse of law (i.e., the use of private law forms and institutions) was not in itself contested by the appellant. It simply refers to the operation by the taxpayer of dividing its existing share capital into classes of shares, repurchasing certain classes of shares and immediately cancelling them.

The consequences of such an operation, however, and notably whether it effectively resulted in a tax reduction, were central to the dispute and required the judges to delve deeply into the analysis of the characterization of the repurchase and immediate cancellation of classes of shares.

In this regard, the main argument held by the taxpayer was that even though the contentious operation effectively resulted in a repatriation of profits to its shareholders, no tax reduction was obtained.

The Administrative Court, however, ruled otherwise. Exploring the various means presented by the appellant, the Court observed that in 2017, when the repurchase and immediate cancellation of the classes of shares occurred, the taxpayer had available reserves resulting from profits carried forward from past fiscal years and mainly from dividend income distributed two months before, the sum of which exceeded the amount of profit that was repatriated through the repurchase and immediate cancellation of the classes of shares.

The Court then recalled, on the basis of article 97 (3) point b) LITL, that payments resulting from a capital reduction should remain taxable in cases where the operation could not be justified by sound economic reasons ("*raisons économiques sérieuses*"). The Administrative Court then clarified how the term "sound economic reasons" should be interpreted. In this respect, the Administrative Court referred among other things to parliamentary comments stating that "*sound economic reasons are generally missing when a company reduces its capital while having significant distributable reserves that it does not intend to distribute to its shareholders*"[8]. In essence, in the event that the operation constituted a share capital reduction, the profits repatriated to the individual shareholders would have been subject to a 15% WHT anyway.

Observing that the amount paid by the company upon the repurchase and immediate cancellation of the classes of shares approximatively equaled the amount of the dividends the company had received in the same fiscal year, the Administrative Court considered that the litigious operation therefore appeared as a redistribution by the appellant of almost all the dividends it had just received from its subsidiaries. The reduction of tax was then determined.

With respect to the inadequate path criterion and the absence of valid non-tax reasons justifying the chosen path, the Administrative Court reaffirmed the taxpayer's right to choose the least taxed path when carrying on its economic activities but also emphasized that such a right should be exercised within certain limits. In this regard, the judges held that even though the unusual nature of an operation should not, on its own, establish the existence of an abuse of law (though it may be an indicator), it should not enable the taxpayer to obtain any tax advantage that the legislator did not intend to grant in the given circumstances.

In the case under review, the Court, like the Administrative Tribunal, observed that all the classes of shares granted identical economic and legal rights. As, ultimately, they had not lost any rights following the capital reduction, and since the company had not received any consideration (the shares being immediately cancelled after the repurchase), the Administrative Court concluded that, from an economic standpoint, the repurchase price could be recharacterized as a dividend distribution. In addition, the taxpayer was not able to prove the existence of non-tax reasons pertaining to the operation. Arguing, as the appellant did, that the repurchase and immediate cancellation of the shares was in line with an update to the company's investment policy (i.e., no reinvestment of the funds) was not considered enough by the Court since the taxpayer did not provide any detailed explanation or documentation in this respect.

Given that (i) there were no distinct economic rights between the classes of shares, (ii) there was no change from an economic point of view from dividing the ordinary share capital of the company into classes of shares and (iii) the taxpayer repurchased its own shares less than two months after receiving a dividend distribution and the amounts of the consecutive operations were almost matching, the Administrative Court considered that the inappropriate path criterion was met. Other elements including the way the transaction had been disclosed in the notes to the appellant's financial statements were considered by the Court as confirming this view.

Considering that **all the conditions required to demonstrate the existence of an abuse of law were fulfilled**, the Administrative Court rejected the appeal.

Although the position taken by the Administrative Court in the case at stake (which was on the same page as the tax authorities and the Administrative Tribunal) does not come as a surprise, it should be kept in mind that the current framework remains subject to change considering the recent introduction of the bill of law n°8388 by the Luxembourg Government concerning partial liquidations.

It is too early to draw a final conclusion on whether a potential adoption of the bill of law n°8388 would impact the case law discussed in the present article. At this early stage, though, it seems reasonable to claim that if there is an impact, it would be expected to be rather limited.

1) Bill of law dated 23 May 2024, n°8388.
2) Article 101 of the Luxembourg Income Tax Law ("**LITL**").
3) Steueranpassungsgesetz, 16 October 1934, Mém. A / J.O.G.D.L. n° 901 dated 2 January 1934, p. 9001. To be complete it shall be remembered that the §6 StAnpG applicable at the time of the disputed transactions was the one in force before its amendment by the law of 21 December 2018 having transposed into Luxembourg domestic law the provisions of the anti-tax avoidance directive (UE) 2016/1164 related to the so-called "general anti-avoidance rule" ("**GAAR**").
4) Please refer to our previous article in this tax controversy series *(E. Lebas, V. Plateau "Tax controversy series – Administrative court of appeal judgment on the use of tax losses carried forward", AGEFI Luxembourg, June 2024 p. 38.)* in relation to the Administrative Court decision n°49336C, dated 25 April 2024.
5) As described in footnote n°3.
6) Article 59 of the Law of 21 June 1999 (*Loi modifiée du 21 juin 1999 portant règlement de procédure devant les juridictions administratives*).
7) Other arguments were invoked by the taxpayer such as a violation of the principle of legitimate expectation. However, as they were deemed non-relevant by the Administrative Court and not further elaborated on, these will not be commented on in this article for the sake of clarity.
8) Free English translation of parliamentary comments of bill of law 571 by the authors.