The interest free loan: a financial instrument prone to recharacterisation by the Luxembourg judge?

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Associate Arthur Mendegris from our Luxembourg Tax team provide a critical analysis of the reasoning behind a recent decision made by the Administrative Tribunal of Luxembourg regarding the recharacterisation of a financial transaction.

Background of the case

On 23 September 2022 (decision 44902), the Administrative Tribunal of Luxembourg (the **Tribunal**) took a position regarding the recharacterisation of a financial transaction on the grounds of the "normal way of financing dictated by serious economic and legal considerations" that should have been followed by the taxpayer. The decision is in line with the approach taken by the Luxembourg Administrative Court (the **Court**) in a ruling dated 26 July 2017 (decision 38357C).

The Tribunal confirmed the approach taken by the tax authorities regarding the tax reclassification of the financing received by a Luxembourg company (the **Company**) via an interest free loan (the **IFL**) and then refused the deduction of a notional interest on such IFL. The choice of financing was considered by the Tribunal as "made solely for tax purposes".

The funds were initially granted by the sole shareholder of the Company's mother, a Cayman Islands company, under the form of a profit participating loan on 29 April 2016 to the Company's mother company which, in turn, has transferred the funds to the Company, such transfer later documented as an IFL dated 19 December 2016 with retroactive effect as of 29 April 2016.

Context

The financing of corporate structures via debt or via equity is a strategic choice leading, amongst others, to different tax implications. Indeed the debt financing triggers deductions from the tax base of the debtor of the accrued interest whereas under equity financing dividend payments will be made and may be taxed at the level of both the company from which the income is derived and of the recipient of those dividends.

In order to determine whether the funds contributed to the Company are to be considered as equity and not as debt, the Tribunal undertook the analysis of the IFL under the "substance over form" principle, deriving from paragraphs 5, 6 and 11 of the Adaptative Tax Law (Steueranpassungsgesetz) which considers, on a case-by-case basis, the economic reality of a financial instrument rather than its purely legal qualification and features.

Such reclassification of an instrument is possible in principle and is performed by establishing a set of indicators within the framework of an economic and financial analysis, following an *in concreto* examination of the disputed agreement and the circumstances of the case.

The "substance over form" approach

This "substance over form" approach is now deeply rooted in the analysis process of Luxembourg direct taxes by the Luxembourg judges. This approach derogates from the alignment of the tax classification of a financial instrument to its legal classification under civil and commercial law, and to its accounting perspective under the principle of linking the tax balance sheet to the commercial balance sheet, which is laid down in article 40, paragraph 1, of the Luxembourg Income Tax Law (the **LITL**).

Therefore, the Luxembourg Tax Authorities (the **LTA**) have the power to reclassify a financial instrument as equity or debt under such core principle. A loan granted by a shareholder to a subsidiary could then be requalified as a capital contribution when the "normal way of financing dictated by serious economic and legal considerations" would have been a capital increase and that it clearly results from the circumstances that opting for a debt instrument was dictated by tax reasons only.

This approach is in line with the above mentioned decision of the Court dated 26 July 2017 in which loans granted to Luxembourg companies were characterized as "disguised capital contributions". According to the Court, in view of the conditions under which they had been granted, the normal way of making these funds available would, in principle, have been a capital increase.

Decisions by Luxembourg Courts

The Court based its decision on the parliamentary work in relation to the LITL which support the intention by the Luxembourg legislator to follow an approach based on the economic and financial analysis of the operation which can lead to the reclassification of a transaction for tax purposes.

The Court stated as a principle that elements to be taken into account for the requalification of a loan in a capital contribution are the following: (i) interest rate, (ii) conditions of repayment, (iii) allocation of the funding to long term asset, (iv) the lack of guarantees, (v) excessive debt to equity ratio and (vi) the circumstances in which the loan is granted.

In the decision of 26 July 2017, the Court concluded that the following elements of the case were characteristics of financing that should have been made as a capital contribution under "normal way of financing": a 75% participating interest on gains realised on the financed assets, no fixed date of repayment of the loans, a right of consent granted to the lender regarding the disposal of the assets financed by the loans.

In the decision dated 23 September 2022, the Tribunal also qualified the IFL as a disguised capital contribution by identifying, amongst others, two different maturity dates (ie, 8 and 10 years), a limited recourse clause, the absence of any interest due to the nature of the IFL and the possibility for the lender to demand the issuance of shares of the debtor for a portion or the entirety of the IFL.

The Tribunal concluded that the intention of the Company was mainly to make funds available to its subsidiary rather than to act as a lender seeking remuneration and recovery of the funds within a reasonable period of time. This is corroborated by the circumstances of the case at hand, as noted by the government delegate, according to whom the IFL agreement was only concluded on 19 December 2016, ie, more than seven months after the supply of funds following the incorporation of the subsidiary.

Conclusion

This decision should also be put in perspective with the expected implementation of the debt-equity bias reduction allowance (DEBRA) directive proposed by the European Commission. Indeed, in its decision the Tribunal clearly denies the application under current Luxembourg law of a notional interest deduction on equity instruments, emphasising that the financing instrument must first be qualified as a debt instrument before the question of allowing any deduction of a notional interest can be addressed.

Conversely, the aim of DEBRA is to place the taxation of debt and equity on an equal footing in order to encourage equity investments and reduce debt accumulation by non-financial companies, providing a comprehensive anti-abuse framework or removing distortions in the single market. To achieve that goal, one of the new features brought forward by the directive would be to allow a notional deduction on corporate equity.

An appeal is possible on the decision taken by the Tribunal, leaving to the Cour Administrative the duty to confirm or not the position taken by the lower court.

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