taxnotes® international

Volume 120, Number 11 ■ December 15, 2025

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Reprinted from *Tax Notes International*, December 15, 2025, p. 1803

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In this report, Hoor explores the classification of interest-free loans in Luxembourg for tax purposes following a recent Luxembourg administrative court ruling.

The views expressed in this article are solely those of the author and do not necessarily reflect the official position of ATOZ Tax Advisers.

Table of Contents

On April 17 Luxembourg's administrative court ruled on the classification and tax treatment of interest-free loans (IFL) for Luxembourg tax purposes. Although this case involved an unusual set of circumstances, the decision created a great deal of uncertainty surrounding the classification of IFLs as well as the classification of financing instruments in general. This article provides an overview of the facts of the case and the decisions of the Luxembourg courts and analyzes IFL classification for Luxembourg tax purposes.

Introduction

IFLs are a common feature of many Luxembourg investment structures and can be used in a variety of circumstances. They are characterized by their flexibility (for example, ease of implementation and repayment) and relatively light legal documentation. IFLs are generally qualified as debt instruments unless the IFL has specific equity features that result in its qualification as an equity instrument for Luxembourg tax purposes.

In the case under review, a Luxembourg company owned two participations that have been allocated to a permanent establishment in Malaysia. The participations had been financed by IFLs granted by the indirect parent company. In principle, both the participations and the IFLs should be allocated to the PE in Malaysia and not subject to tax at the level of the Luxembourg head office (application of the exemption method under the tax treaty concluded between Luxembourg and Malaysia).

However, because the taxpayer was unable to demonstrate that the PE had sufficient substance in Malaysia, the PE's existence has been challenged by the Luxembourg tax authority (LTA) — a position that has been confirmed by the administrative tribunal and the court. The participations are considered held by the Luxembourg company and financed by the IFLs.

Based on the information presented in the decisions of the Luxembourg courts, it is not clear if a PE has been constituted in Malaysia. However, this article focuses on the classification of IFLs under Luxembourg tax law and provides a technical critique of the court's decision.

Fact Pattern of the Case

The Investment Structure

On October 8, 2014, a foreign company (Company D) incorporated a Luxembourg company (LuxCo). LuxCo is part of a group of companies active in the global oil and gas industry.

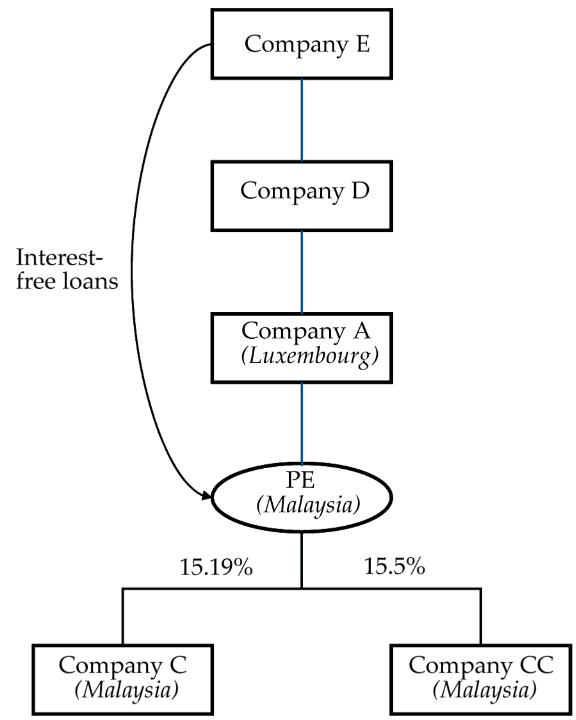
On October 13, 2014, LuxCo entered into two agreements to acquire participations of 15.19 percent and 15.5 percent, respectively, in two Malaysian companies referred to as Company (C) and Company (CC). These acquisitions became effective on April 30, 2015, once the conditions precedent established in both contracts had been fulfilled.

On December 31, 2015, LuxCo received two IFLs from its indirect parent company, referred to as Company (E), to finance two investments. These were concluded immediately after a capital reduction. Therefore, it is reasonable to assume that the investments were financed by equity between April 30 and December 30, 2015.

Figure 1 illustrates the investment structure that the taxpayer intended to implement.

On August 7, 2015, LuxCo filed a request for advance tax clearance with the LTA. The taxpayer sought advance certainty on the existence of a PE in Malaysia and the application of the exemption method for the participations that would constitute the PE's business property for

Figure 1. The Investment Structure That Was Meant to Be Implemented



Luxembourg net wealth tax purposes. The taxpayer also sought a corporate income tax exemption for the income derived from these participations and an exemption from municipal business tax.

However, on August 10, 2016, the LTA rejected the request because of alleged abuse of law[1] rather than analyzing whether the conditions for a PE were met. Further, the IFLs have been classified as equity for Luxembourg tax purposes.

Consequently, income derived from the participations was subject to Luxembourg corporate income tax and municipal business tax. Meanwhile, the fair market value of the participations was subject to net wealth tax, whereas the IFLs did not reduce LuxCo's unitary value (only debt instruments can reduce the net wealth tax base). Notably, the participations in Company C and Company CC did not benefit from the Luxembourg participation exemption regime.

[1]Section 6 of the Tax Adaptation Law.

Characteristics of the IFLs

Characteristics of the IFLs are:

- the financing instruments have been labeled "interest-free loan";
- the loans did not bear fixed or variable (participating) interest;
- the IFLs had a maturity of approximately 10 years;
- the lender did not have a right to participate in the liquidation bonus;
- the principal amount of the IFLs could not be converted into share capital;
- the IFLs did not provide for a participation in losses incurred by LuxCo;
- the principal amount of the IFLs could not be repaid through the issuance of shares by LuxCo;
- the IFLs did not provide for voting or information rights;
- the IFL agreements did not include a stapling clause;
- the IFL agreements included a change of control clause according to which the prepayment of the loans was compulsory as soon as the stake of LuxCo's parent company in LuxCo's share capital would fall below 50 percent;
- the IFLs were not subordinated to any other debt instruments;
- the IFLs have not been backed by a collateral; and
- the IFL agreements provided for an event of default clause according to which the IFLs would become interest bearing at a rate of 1 percent in the event of nonrepayment of the principal amount on the due date.

The IFLs had an aggregate nominal amount of nearly €500 million that financed about 99.998 percent of the acquisition costs of the two participations (0.002 percent equity funding).

Unfavorable Circumstances

When analyzing the decisions of the Luxembourg courts, it is important to consider the case's unique fact pattern that make it difficult to apply the decision to other cases, as well as the relevant Luxembourg and international tax developments at the time the investment was made.

LuxCo was incorporated on October 8, 2014, and entered into purchase agreements for the two participations on October 13, 2014, to take effect on April 30, 2015. On August 7, 2015, LuxCo filed a request for advance certainty, which was rejected by the LTA on August 10, 2016. The existence of the Malaysian PE was challenged on the grounds of abuse of law.

Since June 2013 the European Commission has been reviewing tax rulings of Ireland, the Netherlands, and Luxembourg to detect potential state aid concerns. In November 2014 the Lux Leaks scandal shook the European tax landscape when a group of so-called investigative journalists released numerous tax rulings filed by a Big Four organization with the LTA. Thereafter, the European Commission extended its state aid investigation into the tax ruling systems of all EU member states.

In response to this media campaign, the Luxembourg legislature on January 1, 2015, introduced formal rules regarding the country's tax ruling practice, which had not previously been formalized.

Following the introduction of the new ruling system, the number of requests for rulings dropped significantly. Further, the LTA was extremely strict in its assessments and often rejected requests on formal grounds, such as the tax return having already been filed. This was possible because the tax ruling procedure was slow when the new tax ruling commission was first established.

Despite the LTA rejection, LuxCo went ahead with the investment as planned, using a PE in Malaysia. Unfortunately, LuxCo did not provide sufficient evidence to prove beyond a doubt that a PE had been established and received allocations of participations and IFLs.

From 2013 through 2015, the OECD was working on action 7 of the base erosion and profit-shifting project, which aimed to prevent the avoidance of PE status. It is interesting to note that the aim of this BEPS action was to lower the PE threshold.[2]

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[2]*See* Oliver R. Hoor and Keith O'Donnell, "BEPS Action 7: The Attempt to Artificially Create a Taxable Nexus," *Tax Notes Int'l*, June 8, 2015, p. 929.

In 2015 the European Commission opened a state aid investigation into McDonald's. In a letter dated December 3, 2015, the commission said it had formed the preliminary view that Luxembourg had granted McDonald's a selective advantage by recognizing a PE in the United States that, according to the commission, should not have been recognized.[3] In the end, however, the European Commission accepted that the Luxembourg tax treatment was a lawful application of Luxembourg tax law and the applicable tax treaty — the only case to date in which the European Commission has not found state aid.[4]

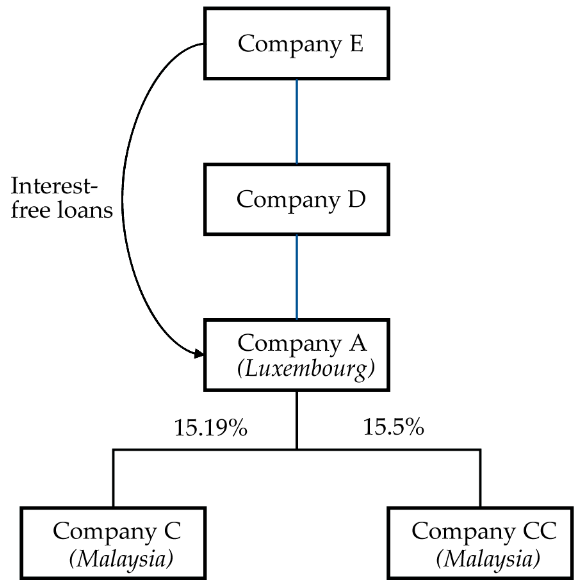
In 2019 the LTA published a circular outlining its interpretation of the PE concept under Luxembourg tax law. While this circular could not change the fundamentals of Luxembourg tax law or the interpretation of tax treaties concluded by Luxembourg, the LTA emphasized that taxpayers must demonstrate the existence of a foreign PE.[5]

Ultimately, if LuxCo had established a genuine presence in Malaysia, the PE could not have been successfully challenged by the LTA and the IFLs would not have needed to be assessed from a Luxembourg tax perspective because these instruments would have been allocated to the foreign PE. Further, Luxembourg companies usually invest in participations that are covered by the Luxembourg participation exemption regime. This makes some of the issues in this case irrelevant (for example, qualifying participations are exempt from net wealth tax).

Decision of the Luxembourg Tax Authorities

LuxCo filed its 2015 corporate tax returns with the LTA on January 3, 2017. However, the LTA rejected the existence of the PE in Malaysia on August 20, 2020, because of the abuse of law provision. Because the LTA challenged the existence of the PE in Malaysia, LuxCo was deemed to hold the participations directly. Further, LTA reclassified the two IFLs as hidden capital contributions. These decisions had a significant impact on LuxCo's tax position.

Figure 2. The Investment Structure Considered by the Tax Authorities



Following the letter from the LTA, LuxCo and the LTA exchanged correspondence, including the taxpayer filing a reclamation, which the LTA rejected on January 14, 2022.

Based on the information contained within the decisions, the participations in Company (C) and Company (CC) did not fall within the scope of the Luxembourg participation exemption regime.

Therefore, the FMV of the participations are subject to Luxembourg net wealth tax at an annual rate of 0.5 percent. Although the IFLs would usually reduce the net wealth tax base (debt financing taxable assets is generally deductible for Luxembourg net wealth tax purposes), these loans have been reclassified as equity, which does not reduce LuxCo's net wealth tax base.

In addition, dividends and capital gains realized in relation to the participations would be subject to corporate income tax and municipal business tax.

Figure 2 illustrates the group structure recognized by the LTA.

[3] *See* Hoor and O'Donnell, "McDonald's State Aid Investigation: What the European Commission Got Wrong," *Tax Notes Int'l*, Sept. 12, 2016, p. 975.

[4] *See* Hoor, "European Commission Finds No Illegal State Aid," *Daily Tax Report International*, Nov. 23, 2018.

[5] Hoor, "Luxembourg's Amended Definition Of a Permanent Establishment: Is It Really Something New?" *Tax Notes Int'l*, May 20, 2019, p. 709.

Following this challenge, LuxCo sold its two participations under a contract concluded in December 2021 and effective from February 2022. These participations were therefore held for around six years.

Decision of the Administrative Tribunal

Opening Comments

On April 4, 2022, LuxCo lodged an appeal with the tribunal to reverse the LTA's January 14, 2022, decision. The tribunal had to decide whether LuxCo had a PE in Malaysia and, if not, how to classify the IFLs for Luxembourg tax purposes.

Regarding the first issue, the tribunal concurred with the LTA, confirming that the Malaysian PE represented an abuse of the law.

As the IFLs had been allocated to LuxCo, which was deemed to hold the participations in Company (C) and Company (CC), the tribunal had to analyze the IFLs to determine whether they should be classified as debt or equity. The tribunal correctly proceeded on the assumption that, for tax purposes, the classification of a financing instrument must follow the economic approach (*wirtschaftliche Betrachtungsweise*), which requires the economic reality to prevail over the legal form (substance-over-form principle).

If the IFLs are classified as a debt instrument, transfer pricing adjustments may be necessary under article 56 of the Luxembourg Income Tax Law (LITL) to restate arm's-length conditions. Alternatively, the IFLs could be reclassified as equity, in line with the concepts of hidden capital contribution (*apport caché, verdeckte Einlage*) or disguised capital (*capital caché, verdecktes Stammkapital*).

A hidden capital contribution is a contribution in cash or in kind made by a shareholder to a company that does not result in a change to the subscribed and paid-up share capital. For example, a waiver of the IFLs should be classified as a hidden capital contribution.

By contrast, disguised capital refers to a situation in which a shareholder has granted a loan to a company, directly or indirectly, whereas an independent creditor acting in accordance with market practice would not have done so (because the financing of the company by equity was mandatory).[6]

However, when it came to classifying the IFLs for Luxembourg tax purposes and applying the concepts of hidden capital contribution and disguised capital, the tribunal appeared to apply all these concepts simultaneously instead of following a step-by-step approach.

Features of the IFLs That Have Been Considered

The tribunal considered the various characteristics of the IFLs, including the existence of a maturity date of almost 10 years, the absence of a participating interest, the absence of a participation in liquidation surpluses, the inability to convert the principal amount into share capital or repay the principal amount with new shares, the absence of a stapling clause, and the absence of voting or information rights.

However, it seemed that the tribunal had focused particularly on the following features:

- **The Absence of Interest:** The IFLs did not bear interest.
- **Limited Equity Funding:** As of December 31, 2015, 99.99 percent of LuxCo's financing came from IFLs, with the remainder coming from equity. It has therefore been concluded that the company was significantly undercapitalized given the funds made available to it and that this disproportion indicates a contribution of disguised capital to LuxCo.
- **Risk of Loss/Unsecured IFLs:** Because LuxCo had no equity funding, it was exposed to the risk of losing the funds. The absence of equity funding was considered an additional factor that would prevent the IFLs from being classified as debt instruments. The tribunal also noted that the IFLs, totaling nearly $500 million, were unsecured.
- **Financing Long-Term Fixed Assets:** The IFLs financed the participations in Company (C) and Company (CC), which

[6]The concept of disguised capital does not require a debt waiver by the shareholder. Instead, an instrument that is otherwise classified as debt for tax purposes is reclassified into equity on grounds that the shareholder should have financed the company by equity rather than by debt.

were considered long-term fixed assets. Although the participations were sold about six years later following challenges by the LTA, it is reasonable to conclude that they were long-term fixed assets at the time of investment.

Tribunal Assessment

Rather than analyzing whether the conditions for a PE under the tax treaty between Luxembourg and Malaysia were met, the tribunal held that the existence of the PE in Malaysia should be rejected on the grounds of the abuse of law provision. This was somewhat surprising because one would have expected the tribunal to analyze whether the conditions for a PE were met. The scope of the abuse of law provision should generally be limited to clearly abusive cases.

In the absence of a PE in Malaysia, the participations in Company (C) and Company (CC), as well as the IFLs, were allocated to LuxCo. Consequently, the tribunal had to analyze the classification of the IFLs for Luxembourg tax purposes.

While the tribunal considered all the characteristics of the IFLs, it seemed to focus particularly on:

- the absence of interest charges;
- the limited amount of equity funding compared to LuxCo's overall funding;
- the absence of guarantees in favor of the lender; and
- the allocation of the IFLs to long-term fixed assets.

Taking these factors into account, the tribunal concluded that the characteristics of the IFLs, coupled with the circumstances in which they were granted, demonstrate that the IFLs were, in effect, a disguised capital contribution. The four features on which the tribunal focused are linked to the concept of disguised capital.

According to the tribunal, LuxCo cannot reasonably argue that a third-party lender operating under normal market conditions would make nearly $500 million available to a borrower with virtually no equity funding without providing guarantees to recover all, or at least a substantial portion, of the sums involved, or without receiving remuneration for making these sums available, or for the risk of borrower default.

On the contrary, according to the tribunal, LuxCo could only benefit from these conditions because of the shareholding link between LuxCo and the lender, its indirect parent company, if an economic approach to all circumstances were adopted. While this is correct, shareholders are free to grant advantages to their subsidiaries. Whether the interest rate does not adhere to the arm's-length standard is then a transfer pricing question that may require a transfer pricing adjustment (here, a downward adjustment).

The tribunal referred to the parliamentary works of 1955 (the commentary on article 114 of the draft 1967 LITL), stating that a loan granted by partners or shareholders to a company should be reclassified as a disguised capital contribution (in accordance with the concept of disguised capital) if the normal method of financing, dictated by serious economic or legal considerations, would have been an increase in capital, and if it is clear from the circumstances that the loan was chosen solely for tax reasons.

Features that are unusual in relation to the terms and conditions of the loan — such as interest rates and repayment terms being set, loaned funds being allocated to long-term fixed assets, a lack of collateral, a disproportion between share capital and loaned funds, and the circumstances in which the loan is granted — constitute factors that give rise to a presumption of disguised shareholding in the form of a loan.[7]

The tribunal referred to German case law on the concept of disguised capital, specifically noting that, with the 1955 guidance in the draft law commentary, the Luxembourg legislature did not intend to follow the 1953 German Federal Tax Court (Bundesfinanzhof) case law, which represented a shift towards a much stricter interpretation of the concept of disguised capital. Instead, the tribunal assumed that the Luxembourg legislature intended to rely on the previous case of the German Reich Tax Court (Reichsfinanzhof) from 1933 to 1945.

[7]The tribunal referred to the following decisions of the administrative court: n° 38357C (July 26. 2017); n° 46131C (Mar. 31, 2022); and n° 48125C (Nov. 23, 2023).

If the IFLs be reclassified, LuxCo pointed out, according to long-standing administrative practice, a debt-to-equity ratio of 85-to-15 is generally accepted for the financing of holding activities. Luxembourg companies can typically finance up to 85 percent of their participation through debt instruments that bear an arm's-length interest rate.[8] The intention was to limit the reclassification to about 15 percent of the IFLs.

However, according to this practice, interest-free loans should be deemed to be equity when calculating this ratio because they do not accrue interest. The purpose of the debt-to-equity ratio is to limit interest expenses incurred when financing participations.

While the tribunal confirmed that some Luxembourg authors take this position, it rejected the importance of this ratio for the case under review.[9] Consequently, the full amount of the IFLs has been reclassified as equity.

Decision of the Administrative Court

Opening Comments

According to the court, the classification of a financing instrument follows the economic approach. For tax purposes, this approach means that the economic reality takes precedence over the legal form, also referred to as the substance-over-form principle.[10]

The court emphasized that referring to the commentary on the previous version of today's article 97 of the LITL (article 114 of the LITL) would be useful because it provides guidance on reclassifying a loan as disguised capital.[11] This is the same guidance that had been considered by the tribunal.

The court pointed out that the principle of congruence (the principle that the tax treatment generally follows the accounting treatment, or *Massgeblichkeitsprinzip*) does not apply to the classification of financing instruments but rather to the valuation of assets and liabilities for the purposes of the tax balance sheet.

While this is consistent with previous decisions of the court, the principle of congruence should apply to both the recognition and valuation of assets and liabilities. Clearly, when specific tax rules or concepts apply, they take precedence over the principle of congruence.

Features of the IFL That Have Been Considered

According to the court, analyzing the characteristics of a loan involves examining the interest rate and the repayment terms and conditions. However, the court emphasizes that elements relating to the economics of the transaction also need to be analyzed, such as how the loaned funds are used, whether there are any guarantees, and the proportion between the share capital and the loaned funds.

In particular, the court considered the following aspects, which were also the focus of the tribunal.

Financing Long-Term Fixed Assets

The IFLs financed long-term fixed assets (ultimately funding gas pipeline projects through Company (C) and Company (CC)).

According to the court, long-term fixed assets should be financed by financial instruments that are also "long-lived." Otherwise, the debtor would be at risk of being unable to refinance its fixed assets.

The court said that the maturity of the financing instruments should not be the only consideration; an overall analysis is required given the complexity of the asset acquisition and the proximity of the corporate names of the entities concerned.

Further, the court noted that the group's strategy has been to refinance LuxCo by granting a new loan with a maturity period of at least 10 years each time. According to the court, this would mean that the IFLs have a maturity period of more than 10 years.

Disproportion Between Debt and Equity Funding

The court emphasized the criterion of disproportion between borrowed funds and

[8] *See* Hoor, *Alternative Investments in Luxembourg: A Comprehensive Tax Guide* at 55 (2021).

[9] *See* Alain Steichen, *Précis fiscal de l'entreprise*, Edition 2020, Legitech, p. 560, No. 601.

[10] *See* administrative court, n° 24061C (June 26, 2008).

[11] *See* Parliamentary document 571/04, at 295.

equity. In this regard, it considered the IFLs as debt instruments.

The significant disproportion between the amount loaned and the amount of equity "must be assessed by taking into account the debt/equity ratio at the time the funds were made available."[12]

Because the loans were granted at different times in 2015, the court deemed it appropriate to consider the situation as of December 31, 2015, when assessing the financing of LuxCo.

Regarding LuxCo's assertion that — according to administrative practice — a shareholding could be financed with up to 85 percent debt and at least 15 percent equity the court noted that such a practice was not legally binding.

While it is true that administrative practice is not legally binding, interest-free loans should be treated as equity for the purposes of the debt-to-equity ratio (because no interest is charged on these loans, and the debt-to-equity ratio aims at limiting interest charges in relation to the financing of participations). As of December 31, 2015, the IFLs that financed 99.99 percent of LuxCo should be treated as equity for computing the debt-to equity-ratio, resulting in an effective equity ratio of 100 percent (not 0 percent).[13]

LuxCo prepared a transfer pricing study that confirmed that a debt-to-equity ratio of 85-to-15 was consistent with the debt structures used by its peers in 2015. However, there appears to have been an issue with the report, because it referred to another company rather than LuxCo.

Further, it is not possible to demonstrate the arm's-length nature of the funding structure by making a comparison to other controlled transactions that are transactions between associated enterprises. Instead, a debt capacity analysis may be performed that examines if the interest payments and ultimately the repayment of the debt funding will likely be possible. As IFLs do not accrue interest, the debt capacity analysis will most likely show that the debt funding capacity is very high, potentially exceeding the 85 percent threshold.

According to the court, the question was not whether other groups financed holding activities with up to 85 percent debt funding but what the debt-to-equity ratio would have been had the financing transactions taken place between third parties rather than within entities of the same group. Here, the court seems to disregard the fact that interest-free loans are, by their very nature, non-arm's-length transactions through which an advantage was transferred to LuxCo.

While LuxCo considered that only the part of the debt funding that exceeded 85 percent should be reclassified as equity if the court applied the concept of disguised capital, the court held that the disputed loans could not be hybrid — they must be either entirely debt or entirely equity. However, this was inconsistent with the jurisprudence of the German Reich Tax Court and German Federal Tax Court, which held that only part of a loan could be reclassified as a disguised capital contribution if the concept of disguised capital applied.[14]

Risk of Loss/Unsecured IFLs

The court also confirmed the tribunal's view that the risk of loss was exclusively borne by the lender (Company E), which would constitute an additional indicator suggesting that the loans should not be classified as debt instruments.

Absence of Guarantees

The court also noted that the lender (Company (E) did not hold any guarantees, which is common in a group context. The court pointed out that Company (E), an indirect shareholder of LuxCo, could have received a pledge over the shares in Company (C) and Company (CC). Although uncommon in a group context, the absence of pledges has been considered as a criterion when classifying the IFLs.

Assessment by the Court

The court analyzed whether the conditions for a PE in Malaysia had been met and concluded that they had not. However, the court did not apply the abuse of law provision that the tribunal had applied when rejecting the existence of a PE. This

[12] *See* administrative court, n° 48125C (Nov. 23, 2023).

[13] *See* Hoor, *supra* note 8, at 57.

[14] *See* German Reich Tax Court, III 34/43, RStBl. 1943, at 765 (June 24, 1943); *see* German Federal Tax Court, I 44/57, BStBl. 1959, at 197 (Jan. 13, 1959).

is a positive aspect of the decision because the abuse of law provision should only be applied in cases of clear abuse.

Regarding the classification of the IFLs for Luxembourg tax purposes, the court reiterated the tribunal's statement that analyzing the characteristics of financing instruments is not an arithmetical calculation, whereby the disputed loans would be classified as debt if most of the indicators pointed in that direction. Rather, an overall economic analysis of the situation would be required.

While it is true that some characteristics are more important than others and that the classification of financing instruments for Luxembourg tax purposes requires an overall assessment, the tribunal and the court focused primarily on elements linked to the concept of disguised capital rather than the economic approach and the substance-over-form principle for classifying instruments as debt or equity.

According to the court, LuxCo did not provide any evidence to invalidate the tribunal's conclusion that it could only benefit from these financing conditions because of an indirect shareholding relationship with Company (E). Indeed, the conditions, particularly the interest-free nature of the loans, can only be explained by their indirect shareholding relationship.

Instead, the court agrees with the tribunal's analysis that (i) the absence of interest, (ii) the disproportion between the funds loaned by Company (E) and LuxCo's equity funding, (iii) the absence of guarantees in favor of Company (E), and (iv) the allocation of the disputed funds to long-term fixed assets, when considered as a whole together with the totality of the transactions in which the disputed loans form part, lead to the conclusion that, for tax purposes, the IFLs were disguised capital contributions.

The court rejected LuxCo's argument that the tribunal had taken a biased approach when assessing the criteria relevant to analyzing the tax classification of the disputed loans. The tribunal had allegedly disregarded the following five criteria: (i) no participating interest; (ii) no participation in the liquidation surplus; (iii) no possibility of converting the principal amount into capital; (iv) no possibility of repaying the principal by issuing shares; and (v) no voting or information rights. All these features are relevant to the classification of financial instruments for Luxembourg tax purposes. However, the court focused on features relevant to reclassifying debt instruments in accordance with the concept of disguised capital.

Regarding the classification of the IFLs as a disguised capital contribution for Luxembourg tax purposes, the court upheld the tribunal's decision. Consequently, the entire amount of the IFLs has been reclassified as equity rather than just the amount deemed excessive by the court.

Technical Analysis

Overview

Classifying financial instruments requires careful analysis from a legal, accounting, and tax perspective. It is crucial to follow the correct order of steps and to analyze which tax provisions or concepts may be applicable.

Unfortunately, in the present case, both the tribunal and the court appear to have confused the classification of financial instruments with the application of the concepts of hidden capital contributions and disguised capital.

First, the financing instrument must be characterized from a legal perspective under Luxembourg civil law. This classification generally forms the basis for the classification of financing instruments under Luxembourg's generally accepted accounting principles.

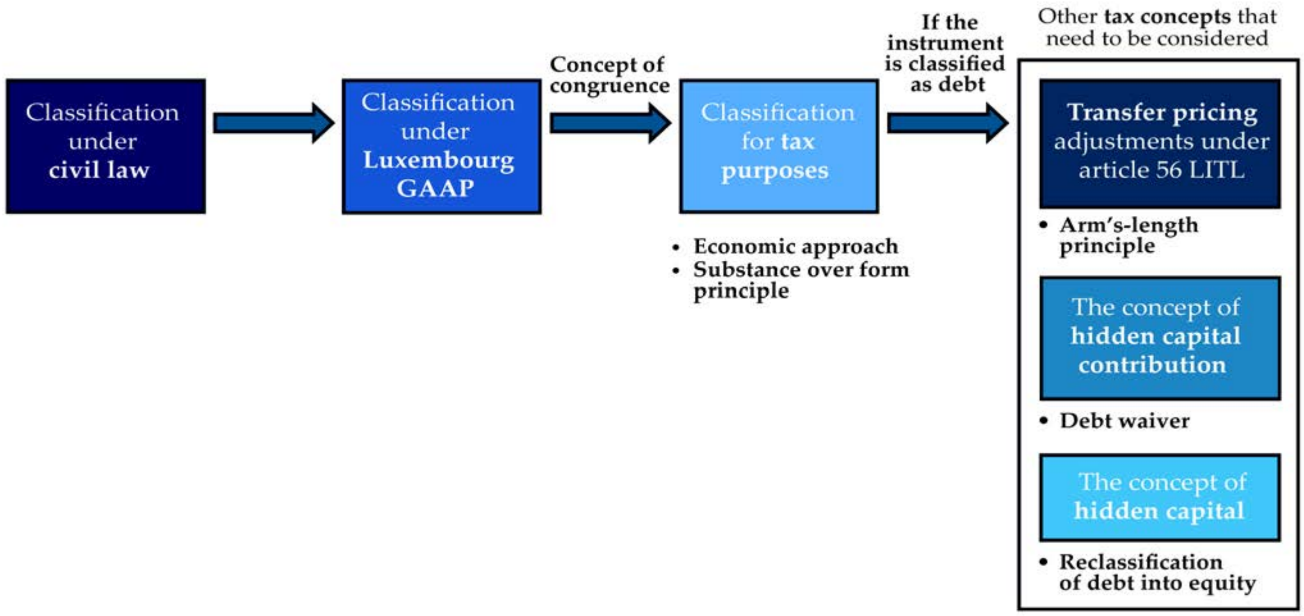
Further, the classification for Luxembourg accounting purposes is generally relevant for the classification of financing instruments for tax purposes (in accordance with the concept of congruence or *Massgeblichkeitsprinzip*).

However, if the features of the financing instrument are inconsistent with its accounting classification, the economic approach and the substance-over-form principle require a different classification for Luxembourg tax purposes.

If a financing instrument is classified as a debt instrument, article 56 of the LITL may require transfer pricing adjustments if the remuneration does not adhere to the arm's-length principle.

Further, if a shareholder (or a related party) waives a debt instrument, this waiver may be classified as a hidden capital contribution (*verdeckte Einlage*).

Figure 3. The Classification and Tax Treatment of Financing Instruments



Finally, if a Luxembourg company is financed with excessive levels of debt when it should have been financed with more equity, part of the debt instrument may be reclassified as equity for Luxembourg tax purposes in accordance with the concept of disguised capital (*verdecktes Stammkapital*).

Figure 3 illustrates the steps involved in analyzing financing instruments as well as the relevant tax rules and concepts.

Civil Law Qualification of Financing Instruments

The analysis of financial instruments should generally begin with their classification under Luxembourg civil law.[15]

A loan is defined as a contract whereby one party (the lender) provides the other (the borrower) with an asset that can be used by the latter, who is then obliged to return it after use,[16] or a specified quantity of fungible goods, which must be returned in the same quantity and quality.[17]

Equity funding is defined as an agreement between two or more persons (except in the case of a "single shareholder private company") to contribute funds or assets to share any profits (or losses) arising from the agreement.

The main cumulative criteria used to decide whether an instrument should be classified as debt or equity from a legal perspective are:

- **Debt Obligation**:
  - The holder is entitled to a return on investment after a set period;[18]
  - in most cases, the loan carries a fixed, predetermined return,[19] which is not linked to the company's results;[20]and
  - in the event of the debtor's liquidation or bankruptcy, the investor ranks above the shareholders — the investor has the right

[15] Luxembourg Commercial Code, art. 1; Luxembourg Civil Code, art. 1832 et seq. (*Contrat de société*) and art. 1874 et seq. (*Contrat de prêt*).

[16] Art. 1875 Civil Code. Under this definition, the lender remains the owner of the asset.

[17] Art. 1892 Civil Code. Under this definition, legal title to the goods is transferred to the borrower. The contract can be interest bearing.

[18] Administrative court, n° 50602C (Apr. 17, 2025).

[19] *Id.*

[20] Administrative court, n° 38357C (July 26, 2017).

to be repaid before any funds are made available to the shareholders.[21]

- **Equity**:
  - The investor is fully exposed to the risk of the business (there is no assurance with respect to reimbursement of the original investment or the return);[22]
  - the instrument vests the right to receive part of the liquidation surplus in its holder;[23] and
  - the instrument provides shareholder rights to the investor — voting rights and the right to supervise.[24]

The legal classification should be analyzed based on the contract's essential features and the parties' actual intentions rather than the form or label they have given it.[25]

Application to the Case at Hand

In this case, the IFLs do not accrue any fixed interest, except in the event of default. However, if the debtor were to be liquidated or declared bankrupt, the lender would take precedence over the shareholder. Consequently, the lender is not exposed to the borrower's business risk.

The IFLs do not entitle the lender to receive any portion of the liquidation surplus. Further, they do not grant the lender any shareholder rights, such as voting rights or the right to supervision.

For these reasons, the IFLs should be classified as debt instruments under Luxembourg civil law.

Accounting Treatment of Financing Instruments

The Luxembourg generally accepted accounting principles are characterized by several general principles, such as the prudence principle and the realization principle. However, there are no specific provisions regarding the classification of financing instruments as debt or equity.

In the absence of specific rules for classifying financial instruments for accounting purposes in Luxembourg, the accounting treatment is usually based on the legal terms of the contract. Consequently, the accounting treatment of financial instruments tends to be consistent with their legal classification.

Application to the Case at Hand

For Luxembourg accounting purposes, the legal classification of the IFLs should be followed. Therefore, the IFLs should be shown as debt instruments in LuxCo's financial statements (prepared in accordance with Luxembourg GAAP).

Tax Analysis of Financing Instruments

Opening Comments

Classifying financing instruments for tax purposes involves several steps. Although the tax treatment generally follows the accounting treatment, a more detailed analysis is required for Luxembourg tax purposes if the characteristics of a financing instrument are not straightforward.

Principle of Congruence

Luxembourg companies must prepare their financial statements in accordance with Luxembourg GAAP. According to the Luxembourg General Tax Code (*Abgabenordnung*), this obligation extends to tax purposes.[26] Consequently, the accounting treatment serves as the starting point for tax purposes.

The tax treatment follows the accounting treatment[27] unless specific tax rules or concepts require a different treatment for tax purposes. Examples of such concepts include the economic approach, the substance-over-form principle, and the concepts of hidden capital contributions and disguised capital.

According to article 40 (1) of the LITL, the values to be used for Luxembourg tax purposes are those in the commercial balance sheet prepared in accordance with Luxembourg's GAAP unless the valuation provisions for tax purposes do not require a specific amount.

[21] Administrative court, n° 48125C (Nov. 23, 2023); *id.*

[22] *Id.*

[23] Administrative court, *supra* note 18.

[24] Administrative court, *supra* note 21.

[25] Draft bill on income tax reform, Commentary on the articles Title II. — Income tax on legal entities, articles 118 to 223, doc. parl. 571/04, 12 J-1955-O-0054, at 293-295, 1955 (in French).

[26] General tax code, section 160(1).

[27] LITL 40(1).

In this regard, the court pointed out that article 40 (1) of the LITL would only cover valuation aspects, not the classification of financing instruments for Luxembourg tax purposes. Although the wording of article 40(1) of the LITL suggests that the principle of congruence is limited to values, the requirement to produce financial statements for Luxembourg tax purposes indicates that the accounting treatment should apparently inform the tax analysis.

Although Luxembourg companies are required to have both a commercial and a tax balance sheet, in most cases, the two are identical. This is because tax follows accounting unless a tax rule or concept requires otherwise.

Classification of Financing Instruments for Luxembourg Tax Purposes

Opening Comments

Luxembourg tax law does not provide specific rules for classifying financing instruments as debt or equity. Consequently, this classification must be guided by the general principles of Luxembourg tax law.[28]

According to the preparatory note of the LITL of December 4, 1967, which relates to article 97 (formerly article 114) on income from capital, the economic approach and the principle of substance over form applies when characterizing a financial instrument and the income it generates.

Therefore, a comprehensive analysis of all relevant features of a financing instrument is necessary to determine its overall character as either debt or equity.

Analyzing Key Features (Step One)

The following features should be considered when analyzing financing instruments:

- **Civil Law Qualification and Accounting Treatment**. The classification of financing instruments under Luxembourg civil law is generally adopted for accounting purposes. This accounting classification is then the starting point for the Luxembourg tax analysis of these instruments (principle of congruence).

- **Maturity**. The maturity date of a financing instrument is a key classification feature.[29] A right to repayment after a specified term is characteristic of a debt obligation, while a permanent commitment of funds typically indicates equity.
  However, even an instrument with a fixed maturity may be classified as equity if the term is sufficiently long. In practice, a maturity of up to 29 years is generally considered a debt feature,[30] whereas a long-term maturity of 30 years or more usually indicates an equity instrument.[31]

- **Remuneration**. The type of remuneration is another key characteristic for classification. It is generally accepted that unlimited participation in the company's profits indicates an equity feature,[32] while remuneration at a fixed interest rate is indicative of a debt feature.
  In practice, however, more complex remuneration models may be agreed on. For instance, repayment may be linked to the income generated by a specific asset funded by the instrument (known as asset-linked or income-participating instruments). In addition, parties may agree on a share of the borrower's profits, which could be capped. Although income or profit participation tends to suggest equity, the instrument's debt character may nonetheless be reinforced by including a small, fixed interest rate.
  When the payment of a fixed rate of interest is limited by the amount of (accounting) profit or income derived from a particular asset or is subject to the condition that the borrower has sufficient cash to pay the interest, the remuneration model is still more in the nature of debt.

[28] *See* Hoor, *supra* note 8, at 99f.

[29] Administrative court, *supra* note 18; administrative court, n° 46131C and 46132C (Mar. 31, 2022).

[30] Ten years is considered as a short maturity (administrative court, *supra* note 18).

[31] Sixty years is considered as long-term instrument (administrative tribunal, n° 40705 (Dec. 13, 2018)). However, based on German case law a 30-year period is considered as an equity feature.

[32] Administrative court, *supra* note 18; administrative court, *supra* note 29.

If a financing instrument carries a zero interest rate, the transaction is not considered to be at arm's length and may require tax adjustments. A zero interest rate is a strong indicator of equity.[33] However, remuneration is just one of many factors that must be taken into account.

- **Participation in Liquidation Proceeds and Latent Capital Gains**. A financing instrument may include a right to participate in the borrower's liquidation proceeds or in the latent capital gains of its specific assets. The presence of such a clause is a strong indicator of an equity instrument,[34] while its absence is characteristic of a debt instrument.
- **Loss Participation**. Participation in the borrower's accounting losses, or losses from a specific investment or activity, generally indicates an equity instrument.[35] In contrast, debt instruments typically do not involve the lender sharing in the borrower's losses.
  However, this is not a definitive criterion. In certain cases, parties may agree on loss-participation features without necessarily challenging the instrument's classification as debt.

- **Conversion Feature.** Financing instruments may also include a conversion feature, allowing the instrument to be converted into shares of the borrower. A borrower's right to request conversion of their loan instead of repayment of the principal is a strong equity feature.[36]
  Similarly, a mandatory conversion clause, which triggers an automatic conversion at a predefined date and rate, also indicates an equity instrument. In the event of the company being liquidated before the specified date, the terms may stipulate either repayment at face value or automatic conversion into shares. In this context, an automatic conversion clause represents a much stronger equity feature than a provision allowing for (at least optional) repayment at face value.[37]
  Conversely, a conversion right held solely by the investor is generally a debt feature, particularly when the instrument includes an alternative redemption option at market value.

- **Label of the Financing Instrument**. The label given to a financing instrument typically offers an initial indication of its classification as debt or equity.
  However, because the label may not align with the instrument's other characteristics, it is an ancillary feature that carries less weight than more substantive elements in the overall analysis.

- **Political and Voting Rights**. Shareholders generally have the right to participate in the company's corporate life, including voting at both ordinary and extraordinary general meetings.
  Also, shareholders possess voting rights and the right to be informed of major developments that could affect the company's situation.
  However, it should be noted that companies can issue nonvoting shares, meaning voting rights alone are not a definitive equity characteristic. Instead, voting rights are one piece of evidence that must be considered alongside other criteria to determine the overall classification.[38]

- **Modalities of the Yield Payment**. If remuneration is paid at the discretion of the board of directors, as is the case with dividend declarations, this indicates an equity instrument.
  Another equity feature arises when payment is contingent on the issuer having sufficient reserves or retained earnings.

[33] Administrative court, *supra* note 18.

[34] *Id.*

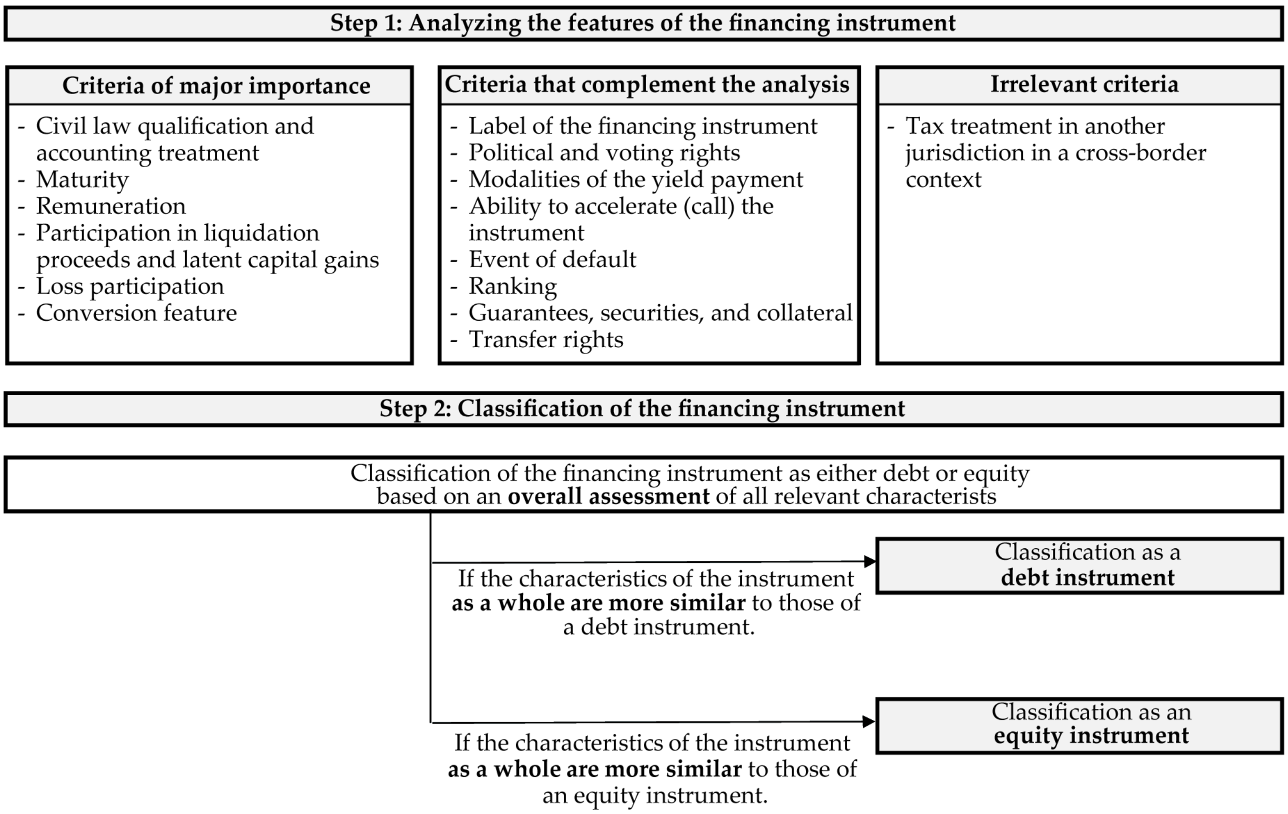
[35] *Id.*

[36] *Id.*

[37] *See* administrative court, *supra* note 18, and administrative court, *supra* note 21, about the optional conversion by unilateral decision of the company.

[38] Administrative court, *supra* note 18; administrative court, *supra* note 29.

Figure 4. Classification of Financing Instruments for Luxembourg Tax Purposes



In contrast, a debt instrument typically requires unconditional and mandatory payment.

- **Ability to Accelerate (Call) the Instrument**. The possibility of prepayment or early redemption is an indication of a debt feature, while the absence of such a provision indicates equity.
  The party entitled to demand repayment is also a key indicator. A right for the investor to request redemption points to a debt instrument, whereas a right for the borrower to do so suggests an equity instrument.

- **Event of Default Clause**. The inclusion of an "event of default" clause is a characteristic feature of a debt instrument. This clause typically allows for accelerated repayment or increased yield if the borrower fails to meet its obligations. Equity instruments, by contrast, do not contain such provisions.

- **Ranking**. The instrument's position within the entity's capital structure is a key factor in differentiating between debt and equity. In a default scenario, debt holders possess a superior right to repayment, meaning they must be paid in full before any funds are distributed to shareholders.
  However, the distinction can become less clear-cut because the gap between the most subordinated debt and equity instruments may be very narrow. In principle, subordination is an equity feature, while the absence of any subordination is a strong indicator of debt.[39]

[39] Administrative court, *supra* note 18; administrative court, *supra* note 29; administrative court, *supra* note 20.

Table 1. Analyzing the Features of the IFLs

Criteria to Be Considered	Features of the Interest-Free Loan	Indication
Civil law qualification and accounting treatment	The loan has been qualified as debt from a civil law perspective and for accoutning purposes	Debt
Maturity	The loan has a maturity of circa 10 years	Debt
Remuneration	The loan does not bear interest (i.e., the loan is interest-free)	Equity
Participation in liquidation proceeds and latent capital gains	The lender is not entitled to receive any liquidation bonus	Debt
Loss participation	The lender does not participate in potential losses of the borrower	Debt
Conversion feature	The loan does not include a conversion clause	Debt
Label of the financing instrument	The loan is labelled "interest-free loan agreement"	Debt
Political and voting rights	The loan does not provide for any voting rights	Debt
Modalities of interest payments	N/a	-
Ability to accelerate (call) the instrument	Unknown	-
Event of default	In the event of default upon maturity, the interest-free loan would become interest bearing	Debt
Ranking	The loan ranks senior to the borrower's share capital, share premium and other equity contributions	Debt
Guarantees, securities and collateral	No guarantees, securities or collateral are provided to the lender	Rather equity
Transfer rights	The loan agreement does not include any "stapling clause" (only a "change of control" clause)	Debt

- **Guarantees, Securities, and Collateral**. The provision of guarantees, security, or collateral is a common feature of debt instruments and is typically not associated with equity instruments.
  However, these protections are typically absent in intragroup debt instruments because both the lender and borrower belong to the same corporate group.
- **Transfer Rights**. Transferability is common to both shareholders and bondholders and is therefore not a clear indicator of either debt or equity classification.
  Conversely, the presence of a stapling clause — which requires the instrument to be transferred together with shares of the borrower on a pro rata basis — suggests an equity instrument.[40]
- **Tax Treatment in Another Jurisdiction in a Cross-Border Context**. In cross-border scenarios, a financing instrument must be classified separately under both Luxembourg tax law and the tax laws of the foreign jurisdiction. The classification of the instrument under foreign law is not relevant to its Luxembourg tax characterization. Consequently, an instrument may be classified as debt in Luxembourg and as

[40]Administrative court, *supra* note 18; administrative court, *supra* note 29.

equity abroad, or vice versa, resulting in a hybrid instrument.[41]

Assessment (Step Two)

The classification of a financing instrument as debt or equity requires a thorough analysis of all its relevant characteristics. It is important to note that a single feature is not necessarily decisive; rather, the assessment is dependent on the instrument's overall character.[42]

However, it should be noted that not all characteristics carry equal weight. Certain features are particularly significant as they provide clear, binary indications of debt or equity. While others may be less definitive, they nevertheless remain useful in informing the overall analysis.

The checklist in Figure 4 outlines the features that need to be considered in analyzing financing instruments.

While the classification process is often straightforward, it can become complex when an instrument exhibits a mixture of both equity and debt features. In such cases, the relevant parties may make strategic adjustments to certain features to align with the intended classification for Luxembourg tax purposes.

Application to the Case at Hand

Although the IFLs are classified as debt for accounting purposes, the economic approach and the substance-over-form principle may necessitate a different classification for tax purposes if an equity classification is warranted by an assessment of all relevant features.

The features of the IFLs are summarized in Table 1.

In this case, the interest-free element is the only equity feature. The absence of guarantees, securities, and collateral is more typically a characteristic of an equity instrument, but this is not a strong indication.

By contrast, the terms and conditions of the IFLs include several significant debt features, such as:

- the classification as debt from legal and accounting perspectives;
- a relatively short maturity;
- absence of participation in liquidation proceeds and latent capital gains;
- absence of political and voting rights; and
- ranking of the IFLs above LuxCo's equity.

While the court rightly noted that the analysis of a financial instrument is global and not arithmetical, an overall assessment of these features clearly indicates that it should be classified as a debt instrument.

The court also accounted for the fact that the IFLs financed long-term assets as well as the disproportion between debt and equity funding. While it is true that financing long-term assets with short-term debt creates a refinancing risk, this is a business decision and the world of finance is now more sophisticated than it was decades ago. Further, the disproportion between debt and equity funding cannot determine whether a financing instrument should be classified as equity or debt. This aspect is to be considered when analyzing whether the concept of disguised capital applies.

For the IFLs to be classified as equity instruments for Luxembourg tax purposes, they would require additional features that would change their fundamental nature.

Transfer Pricing Adjustments Under Article 56 of the LITL

Opening Comments

For Luxembourg tax purposes, the IFLs granted by Company (E) to LuxCo should be classified as a debt instrument.

The question arises as to whether the advantage transferred by Company (E) to LuxCo through the IFLs (the arm's-length interest) could lead to tax adjustments under article 56 of the LITL.

[41]The Luxembourg legislature transposed the Anti-Tax Avoidance Directive II (hybrid mismatch rules, Council Directive (EU) 2017/952 of May 29, 2017) in 2020 into Luxembourg tax law. Under the hybrid mismatch rules, otherwise deductible payments under hybrid financing instruments may not be deductible if certain conditions are met. Likewise, when a Luxembourg company grants a financing instrument to a subsidiary in the EU that is classified as equity from a Luxembourg tax perspective, the income would not benefit from the Luxembourg participation exemption regime if the subsidiary deducted the payment for tax purposes (article 166 (2bis) LITL).

[42]Draft bill on income tax reform, Commentary on the articles Title II. — Income tax on legal entities, articles 118 to 223, doc. parl. 571/04, 12 J-1955-O-0054, at 295, 1955; administrative court, *supra* note 18; classifying a financial instrument for Luxembourg tax purposes requires a qualitative evaluation of its features rather than an arithmetic exercise. The different characteristics may not carry the same weight in the analysis.

Scope of Article 56 of the LITL

The scope of article 56 of the LITL is limited to transactions between associated enterprises. However, it applies in both domestic and cross-border contexts.[43]

When a tax treaty applies, tax adjustments made under article 56 of the LITL are generally permitted under a provision that mirrors article 9(1) of the OECD model convention.

Tax Adjustments Under Article 56 of the LITL

Article 56 of the LITL provides the legal basis for making upward and downward adjustments in accordance with the arm's-length principle.

In other words, when a Luxembourg company transfers an advantage to another group company, the LTA may increase the company's taxable income.[44]

Conversely, when a Luxembourg company receives an advantage from an associated enterprise, its taxable income should be reduced by a downward adjustment to reflect arm's-length conditions (unless tax adjustments are already made in accordance with the concept of hidden capital contribution).

Application to the Case at Hand

The terms and conditions of the IFL do not adhere to the arm's-length standard because third parties would expect to be paid interest for providing funding.

Therefore, tax adjustments may be made at LuxCo level (downward adjustments corresponding to the arm's-length interest) regardless of whether an upward adjustment is made at the level of Company (E).

However, LuxCo did not claim a downward adjustment after the PE in Malaysia has been disregarded by the LTA.

The Concept of Hidden Capital Contribution

Opening Comments

Contributions to Luxembourg companies may be made either in the form of a regular contribution as provided for in Luxembourg commercial law or in the form of a hidden capital contribution (*verdeckte Einlage*).

While the IFLs granted by Company (E) to LuxCo should be classified as a debt instrument, the question arises whether (i) the IFLs themselves or (ii) the advantage granted through the IFL (the arm's-length interest expenses) might be the object of a hidden capital contribution.

Characteristics of Hidden Capital Contributions

General

In accordance with relevant case law, hidden capital contributions are characterized by:

- a shareholder or a related party of the shareholder;
- granting an advantage to a company that may be reflected in the balance sheet, either an increase in assets or a decrease in liabilities (insofar as the shareholder does not receive an arm's-length compensation);[45]
- an advantage motivated by the shareholding relationship; and
- a contribution is not a regular contribution (under Luxembourg commercial law).[46]

[43] *See* Hoor, *Hidden Dividend Distributions and Hidden Capital Contributions* 34f. (2023); *see* Hoor, *Transfer Pricing in Luxembourg* 328f. (2021).

[44] When a Luxembourg company shifts an advantage to a shareholder (or a related party), tax adjustments should generally be made in accordance with the concept of hidden dividend distributions (article 164(3) of the LITL) which takes precedence over article 56 of the LITL. This is because hidden dividend distributions have more far-reaching consequences than article 56 of the LITL, which only requires a tax adjustment at the level of the company (for example, deemed dividend payments and potential tax adjustments at the level of the company and its shareholder).

[45] Bundesfinanzhof (BFH), Decision of Mar. 5, 1962, I 203/61 S, BFH Decision of Oct. 26, 1987, GrS 2/86, *Bundessteuerblatt* (BStBl) II 1988, at 348; BFH Decision of Nov. 22, 1983, VIII R 133/82, GmbHR 1984, at 110; BFH, Decision of Mar. 14, 1989, I R 8/85, BStBl II 1989, at 633.

[46] *See* Hoor, *Hidden Dividend Distributions*, *supra* note 43, at 103f; *see* Hoor, *Transfer Pricing in Luxembourg*, *supra* note 43, at 366f; Tribunal Administratif, n° 35708 (June 13, 2016); RFH, Decision of July 28, 1936, I A 83/36, I A 83/36, RFHE 39, at 303; RFH, Decision of June 8, 1937, I A 378/36, RFHE 41, at 274; RFH, Decision of June 22, 1943, I 204/42, BStBl 1943, at 587; BFH, Decision of Feb. 28, 1956, I 92/54 U, BStBl III 1956, at 154; BFH, Decision of May 3, 1967, I 263/63, BFHE 88, 425, BStBl III 1967, at 421; BFH, Decision of Feb. 19, 1970, I R 24/67, BStBl II 1970, at 442; BFH, Decision of Feb. 3, 1971, I R 51/66, BStBl II 1971, at 408; BFH, Decision of Aug. 14, 1974, I R 168/72, BStBl II 1975, at 123; BFH, Decision of Nov. 26, 1980, I R 52/77, BStBl II 1981, at 181; BFH, Decision of Mar. 9, 1983, I R 182/78, BFHE 139, 139, BStBl II 1983, at 744; BFH, Decision of Nov. 22, 1983, GmbHR 1984, at 110; BFH, Decision of Apr. 11, 1984, I R 175/79, BStBl II 1984, at 535; BFH, Decision of Nov. 14, 1984, I R 50/80, BStBl II 1985, 227; BFH, Decision of Mar. 24, 1987, I R 202/83, BStBl II 1987, at 705; BFH, Decision of Oct. 26, 1987, GrS 2/86, BStBl II 1988, at 348; BFH, Decision of July 27, 1988, I R 147/83, BStBl II 1989, at 271; BFH, Decision of Sept. 21, 1989, IV R 115/88, BStBl II 1990, at 86; BFH, Decision of Feb. 28, 1990, I R 43/86, BStBl II, at 615; BFH, Decision of Dec. 18, 1990, VIII R 17/85, BStBl II 1991, at 512; BFH, Decision of May 8, 1991, I B 30/90, BFH/NV 1992, at 414.

The Object of a Hidden Capital Contribution

In principle, contributions increase the net equity of a company, which is then reflected in the receiving company's (tax) balance sheet. The object of a hidden capital contribution must, therefore, directly relate to balance sheet items (an increase in assets or a reduction in liabilities). Accordingly, only advantages that may be contributed within the framework of regular contributions may be classified as hidden capital contributions.[47]

An example of a hidden capital contribution that results in a reduction of a company's liabilities is the waiver of a shareholder loan.[48] The waiver of a shareholder receivable generally increases a company's net equity by way of a reduction in liabilities and an increase in accounting profit. The hidden capital contribution should correspond to the valuable part of the receivable, which should be excluded from the company's taxable income.[49]

It should be highlighted that the mere subordination of a shareholder loan to other liabilities of the company cannot be classified as a hidden capital contribution.[50] In this scenario, the company's liabilities remain in the balance sheet and the net equity remains unchanged.

Similarly, the granting of shareholder guarantees relating to the company's liabilities should not be classified as hidden capital contributions.[51] Even when the guarantee is exercised, a hidden capital contribution should not be considered because the shareholder should have a claim towards the company (following the payment). However, a hidden capital contribution would need to be considered when the shareholder waives its right to receive a refund. In this case, the amount of the company's liabilities is effectively reduced.

It is not uncommon for shareholders to grant services to a company for partial or no consideration (*Nutzungseinlagen*).[52] Examples of free services include interest-free loans and royalty-free licenses (here the advantage corresponds to the arm's-length remuneration).

However, these advantages do not qualify as assets and may not be reflected in the company's balance sheet. Consequently, only assets — and not their use — may be the object of a contribution, although the company's net equity should be indirectly increased as a result of reduced business expenses.[53]

Motivation by the Shareholding Relationship

The increase in a company's net equity must be motivated by the shareholding relationship to be considered as a hidden capital contribution.

Thus, a causal link must be established between the shareholding relationship and the increase in the company's net equity with reference to the concept of the prudent business manager (*ein ordentlicher und gewissenhafter Geschäftsleiter*).

If an unrelated party would not have granted the same advantage, the advantage is deemed to be motivated by the shareholder relationship as

[47] Administrative tribunal, n° 21466 (May 7, 2007) (confirmed by the administrative court, n° 23053C (Oct. 16, 2007)); administrative court, n° 31339C (Feb. 7, 2013); administrative tribunal, n° 35708 (June 13, 2016) (confirmed by the administrative court, n° 38221C (July 6, 2017)); BFH, Decision of Mar. 24, 1987, I R 202/83, BStBl II 1987, at 705.

[48] Administrative court, n° 31339C (Feb. 7, 2013); administrative tribunal, n° 37275 (Apr. 7, 2017); administrative tribunal, n° 46163 (June 27, 2022); RFH, Decision of July 28, 1936, I A 83/36, RFHE 39, at 303; RFH, Decision of June 22, 1943, I 204/42, RStBl 1943, at 587; BFH, Decision of May 29, 1968, I 187/65, BFHE 93, 62, BStBl II 1968, at 722.

[49] BFH, Decision of May 29, 1968, I 187/65, BStBl II 1968, at 722; BFH, Decision of June 9, 1997, GrS 1/94, BStBl II 1998, at 307.

[50] BFH, Decision of Mar. 30, 1993, BStBl II 1993, at 502.

[51] BFH, Decision of Oct. 2, 1984, VIII R 36/83, BStBl II 1985, at 320; BFH, Decision of Apr. 16, 1991, VIII R 100/87, BStBl II 1992, at 234; BFH, Decision of June 9, 1997, GrS 1/94, BFHE 183, 187, BStBl II 1998, at 307; BFH, Decision of Dec. 12, 2000, VIII R 36/97 (NV).

[52] Cour Administrative, Decision No. 36888C (July 5, 2016).

[53] BFH, Decision of Mar. 9, 1962, I 203/61 S, BStBl III 1962, at 338; BFH, Decision of May 16, 1963, IV 379/60 U, BStBl III 1963, at 400; BFH, Decision of Feb. 3, 1971, I R 51/66, BStBl II 1971, at 408; BFH, Decision of Jan. 29, 1975,, I R 135/70, BStBl II 1975, at 553; BFH, Decision of Jan. 28, 1981, I R 10/77, BStBl II 1981, at 612; BFH, Decision of May 19, 1982, I R 102/79, BStBl II 1982, at 631; BFH, Decision of Nov. 22, 1983, VIII R 133/82, GmbHR 1984, at 110; BFH, Decision of May 24, 1984, I R 166/78, BStBl II 1984, at 747; BFH, Decision of Oct. 26, 1987, GrS 2/86, BStBl II 1988, at 348; BFH, Decision of Mar. 14, 1989, I R 8/85, BStBl II 1989, at 633; however, in these circumstances a downward adjustment under article 56 of the LITL might be necessary.

opposed to the business relationship (this should be determined based on the arm's-length standard).[54]

Absence of Compensation

A hidden capital contribution only exists to the extent that an advantage is granted by the shareholder to the company without valuable consideration; in particular, no shares must be issued to the shareholder.[55]

Tax Treatment of Hidden Capital Contributions

Hidden capital contributions may require complex tax adjustments at the level of the company and the shareholder that need to be analyzed on a case-by-case basis.

At the level of the company, hidden capital contributions such as a debt waiver are often treated as income in the company's profit and loss account (under Luxembourg GAAP). An increase in the accounting profit that is related to hidden capital contributions must be excluded from the tax base because this income is not a component of a company's taxable income.[56] The value of the hidden capital contribution should correspond to the FMV of the advantage shifted by the shareholder to the company.[57]

At the shareholder level, the book value of the participation in the company should be increased on the tax balance sheet by the FMV of the contribution. In addition, deemed income corresponding to the amount of the hidden capital contribution will often need to be included in the shareholder's taxable income.

Application to the Case at Hand

Because the decisions of the tribunal and the court do not mention the waiver of the IFLs by Company (E), LuxCo's liabilities were not reduced and the net equity remained unchanged. From an accounting perspective, the IFLs were recorded as a liability at the LuxCo level.

Granting the IFLs itself cannot be classified as a hidden capital contribution. In the absence of an explicit waiver of the IFLs by Company (E), the threshold of hidden capital contribution is not met.

The question arises as to whether the absence of an arm's-length remuneration could result in hidden capital contribution classification. However, because the advantage granted through the IFLs (the zero interest rate) does not result in an increase in assets or a decrease in liabilities, the advantage transferred to LuxCo cannot be classified as a hidden capital contribution.

As detailed above, however, the advantage transferred by Company (E) to LuxCo may give rise to a transfer pricing adjustment in accordance with article 56 of the LITL.

The Concept of Disguised Capital

Opening Comments

The IFLs are debt instruments that, in the absence of a waiver by Company (E), should not be classified as a hidden capital contribution. However, for tax purposes, the question arises as to whether the IFLs could be reclassified as equity based on the concept of disguised capital. It appears that the LTA, the tribunal, and the court consider this concept to be relevant to the present case.

To determine whether the IFLs can be reclassified as disguised capital, it is crucial to conduct a thorough analysis of the origin and evolution of the concept as well as the relevant Luxembourg guidance and its application in Luxembourg over time.

The Scope of the Disguised Capital Concept

General

The concept of disguised capital was developed by the German Reich Tax Court

[54] RFH, Decision of Mar. 27, 1928, I A 470, StuW 1928, No. 417; RFH, Decision of July 28, 1936, I A 83/36, I A 83/36, RFHE 39, at 303; RFH, Decision of June 8, 1937, I A 378/36, RFHE 41, at 274; RFH, Decision of June 22, 1943, I 204/42, RStBl 1943, at 587; BFH, Decision of May 29, 1968, I 187/65, BStBl III 1968, at 722; BFH, Decision of Feb. 19, 1970, I R 24/67, BStBl II 1970, at 442; BFH, Decision of Aug. 14, 1974, I R 168/72, BStBl II 1975, at 123; BFH, Decision of Mar. 9, 1983, I R 182/78, BFHE 139,139, BStBl II 1983, at 744; BFH, Decision of Nov. 14, 1984, I R 50/80, BStBl II 1985, at 227; BFH, Decision of Sept. 21, 1989, IV R 115/88, BStBl II 1990, at 86; BFH, Decision of May 8, 1991, I B 30/90 BFH/NV 1992, at 414.

[55] BFH, Decision of Feb. 28, 1956, I 92/54 U, BStBl III 1956, at 154; BFH, Decision of July 27, 1988, I R 147/83, BStBl II 1989, at 271; BFH, Decision of Oct. 25, 1995, I R 104/94, BB 1996, at 841.

[56] The tax adjustment is made in the company's corporate tax return. The legal basis for the exclusion of income relating to hidden capital contributions is article 18(1) of the LITL, providing that contributions should be deducted from the taxable basis; BFH, Decision of Feb. 3, 1971, I R 51/66, BStBl II 1971, at 408; BFH, Decision of Aug. 14, 1974, I R 168/72, BStBl II 1975, at 123; BFH, Decision of Mar. 9, 1983, I R 182/78, BStBl II 1983, at 744; BFH, Decision of June 9, 1997, GrS 1/94, BStBl II 1998, at 307.

[57] BFH, Decision of Mar. 24, 1987, I R 202/83, BStBl II 1987, at 705; BFH, Decision of July 27, 1988, I R 147/83, BStBl II 1989, at 271; BFH, Decision of Aug. 1, 1990, II R 17/87, BStBl II 1990, at 879; BFH, Decision of Dec. 18, 1990, VIII R 17/85, BStBl II 1991, at 512; BFH, Decision of Feb. 23, 2005, I R 44/04, DStRE 2005, at 706.

(Reichsfinanzhof), which ruled that debt instruments granted by a shareholder could, in exceptional circumstances, be partially reclassified as disguised capital.

The German Federal Tax Court (Bundesfinanzhof) significantly narrowed the scope of the concept of disguised capital through an interpretation that the civil law form must be respected unless it was mandatory for the shareholder to finance the company through equity.

The commentary on the 1967 draft LITL, published in 1955, also provides some guidance on the concept of disguised capital, which has been at the heart of decisions by the tribunal and the court.

Jurisprudence of the German Reich Tax Court

The German Reich Tax Court confirmed that taxpayers are not restricted in how they run their business. In particular, taxpayers should not be limited in their choice of financing options. Consequently, taxpayers are free to choose the most tax-efficient option available. Shareholder loans may only be regarded as disguised capital in special circumstances.[58]

According to case law of the German Reich Tax Court, a loan may be reclassified for tax purposes as equity (disguised capital) if special circumstances indicate that the loan is merely a misleading designation for a capital contribution, in which a capital increase would be the only viable option.[59] In other words, the shareholder did not intend to grant a loan, but rather to make a contribution.[60]

The decision to reclassify a loan as disguised capital must be made with particular caution. This is especially true when it comes to corporate income tax because it is not a decision relating to a one-off tax adjustment, but rather a decision that usually has tax implications over a longer period — often the entire duration of the company.[61]

The German Reich Tax Court has identified the following characteristics and circumstances of loans that may indicate disguised capital:

- the nonterminability of the loan;[62]
- the purpose of financing is to compensate for considerable losses;[63]
- the articles of association and the loan agreement were concluded at the same time;[64]
- the amount of the loan was significant compared to the relatively low share capital;[65]
- there was no agreement on maturity, collateral (security), or interest rates;[66]
- adjustment of the interest rate to the distribution of profits;[67]
- the interest rate depended on the annual operating results;[68]
- the loan was interest free;[69]
- interest was not paid regularly;[70] and
- conversion of equity into debt instruments (equity to debt swap).[71]

It should be noted that, in each case, the German Reich Tax Court considered not just one element to be decisive, but rather the presence of several features at the same time. Further, these cases involved both interest-free and interest-bearing loans.

The argument that the company would not have received the same amount of loans from

[58] *See* RFH, Decision of Aug. 30, 1938, I 271/38, RStBl. 1938, at 901.

[59] *See* RFH, Decision of Dec. 7, 1932, III A 159/32, RStBl. 1933, at 50; RFH, Decision of Aug. 30, 1938, I 272/38, RStBl. 1938, at 902; RFH, Decision of Nov. 21, 1940, III 34/40, RStBl. 1941, at 269; RFH, Decision of June 24, 1943, III 34/43, RStBl. 1943, at 765.

[60] *See* RFH, Decision of Aug. 30, 1938, I 271/38, RStBl. 1938, at 901; a lender wants to invest funds securely and at interest with the idea to be repaid (including interest) regardless of the performance of the borrowers business, whereas a shareholder that makes a contribution would like to participate in the assets and income of the business, see RFH, Decision of May 14, 1936, RStBl. 1936, at 692.

[61] *See* RFH, Decision of Aug. 30, 1938, I 272/38, RStBl. 1938, at 902.

[62] *See* RFH, Decision of Dec. 7, 1932, III A 159/32, RStBl. 1933, at 50.

[63] *See* RFH, Decision of Dec. 7. 1932, III A 159/32, RStBl. 1933, at 50.

[64] *See* RFH, Decision of May 26, 1933, III A 355/32, RStBl. 1933, at 1167.

[65] *See* RFH, Decision of May 26, 1933, III A 355/32, RStBl. 1933, at 1167; however, the RFH acknowledged that from an economical perspective there is no universal debt-to-equity ratio that would need to be respected. Rather, this depends entirely on the individual case and varies from one industry to another, RFH, Decision of June 24, 1943, III 34/43, RStBl. 1943, at 765.

[66] *See* RFH, Decision of Aug. 30, 1938, I 271/38, RStBl. 1938, at 901.

[67] *See* RFH, Decision of Dec. 7, 1932, III A 159/32, RStBl. 1933, at 50.

[68] *See* RFH, Decision of Aug. 30, 1938, I 271/38, RStBl. 1938, at 901.

[69] *See* RFH, Decision of Aug. 30, 1938, I 272/38, RStBl. 1938, at 902.

[70] *See* RFH, Decision of Aug. 30, 1938, I 272/38, RStBl. 1938, at 902.

[71] *See* RFH, Decision of Oct. 31, 1939, I 77/37, RStBl. 1940, at 35.

anyone other than the shareholders has not been deemed a valid justification for reclassifying it as disguised capital. Instead, the RFH pointed out that, as shareholders have the opportunity to inspect and influence the management of the company, they might be willing to grant loans even in cases in which other individuals might refuse.[72] Overall, the German court treated loans as disguised capital with caution and restraint.

Jurisprudence of the German Federal Tax Court

In 1953 the German Federal Tax Court significantly narrowed the scope of the concept of disguised capital. According to the court, apart from cases of obvious abuse, a shareholder loan could only be treated as disguised capital if additional equity was objectively necessary, meaning the intervention of the shareholder was mandatory because the required capital could not have been raised through external loans given the circumstances of the case in question.[73]

The German Federal Tax Court emphasized the principle that taxpayers can arrange their affairs as they see fit, including how shareholders finance a company, even if tax savings are a consideration. According to the economic approach, the legal form chosen by the taxpayer is assessed, and economic reality takes precedence over the legal form if the two are inconsistent. Regarding company financing, the German Federal Tax Court ruled that tax authorities are generally obliged to recognize the legal form of the financing instrument and that only formal equity should be considered as such.[74]

Loans granted by shareholders to their company do not constitute disguised capital simply because it was not possible to obtain loans on equally favorable terms in the capital market. Instead, loans may only be reclassified as disguised capital if the contribution of share capital in this form was the only legally and economically possible option. Whether it was mandatory to provide the company with share capital must be examined on a case-by-case basis, taking into account all the circumstances.[75]

It should be noted that the applicability of a low interest rate alone does not justify the treatment of loans as disguised capital. Instead, a shareholder may grant their company loans on more favorable terms than those offered by third-party creditors. In their capacity as a shareholder, they may even waive, depending on the market situation, part of the interest to which they are entitled.[76]

In economic terms, it cannot be regarded as unusual for a shareholder to finance their company in the long term in the form of an interest-free loan.[77] In this way, the loan retains its economic character and does not become a contribution or (disguised) capital of the company.[78]

Regarding the burden of proof, it is the responsibility of the tax authorities to demonstrate that a different form was mandatory under the circumstances of the case. However, if a company can conduct its business operations without difficulty based on the chosen civil law structure, it will be hard to prove that this structure is unnatural and that a different one is necessary. Apart from exceptional cases, the civil law structure must generally be followed. The taxpayer is not obliged to provide evidence that the tax authorities' assumption that the funds should necessarily have been given as a contribution is incorrect.[79]

The German Federal Tax Court emphasized that it attaches much greater importance to the civil law structure than was the case in the jurisprudence of the German Reich Tax Court. This change in approach increased legal certainty,

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[72] *See* RFH, Decision of Aug. 30, 1938, I 272/38, RStBl. 1938, at 902.

[73] *See* BFH, Decision of May 15, 1953, III 103/52, BStBl. 1953, Part III, at 208; BFH, Decision of Mar. 21, 1969, III R 18/68, BStBl. 1969, Part III, at 430.

[74] *See* BFH, Decision of May 15, 1953, III 103/52, BStBl. 1953, Part III, at 208; BFH, Decision of Mar. 20, 1956, I 178/55 U, BStBl. 1956, Part III, at 179; BFH, Decision of Jan. 13, 1959, I 44/57, BStBl. 1959, Part III, at 197.

[75] *See* BFH, Decision of Mar. 20, 1956, I 178/55 U, BStBl. 1956, Part III, at 179; BFH, Decision of Jan. 13, 1959, I 44/57, BStBl. 1959, Part III, at 197; BFH, Decision of Mar. 18, 1966, IV 218/65, BStBl. 1966, Part III, at 197.

[76] *See* BFH, Decision of Mar. 20, 1956, I 178/55 U, BStBl. 1956, Part III, at 179; BFH, Decision of Jan. 13, 1959, I 44/57, BStBl. 1959, Part III, at 197.

[77] *See* BFH, Decision of Oct. 9, 1956, I 207/55 U, BStBl. 1956, Part III, at 382.

[78] *See* BFH, Decision of Jan. 13, 1959, I 44/57, BStBl. 1959, Part III, at 197.

[79] *See* BFH, Decision of Mar. 20, 1956, I 178/55 U, BStBl. 1956, Part III, at 179; BFH, Decision of Jan. 13, 1959, I 44/57, BStBl. 1959, Part III, at 197; BFH, Decision of Mar. 21, 1969, III R 18/68, BStBl. 1969, Part III, at 430.

enabling taxpayers to reliably determine their tax liabilities.[80]

Luxembourg's 1955 Guidance Regarding Disguised Capital

On November 1, 1955, the Luxembourg legislature published its commentary on the 1967 draft LITL, which included the following guidance on the concept of disguised capital:

> It is possible that members who participate in the capital in the manner provided by law may also grant a loan to the company. In this case, the loan may be a disguised way of providing the company with the capital it needs to pursue its purpose. Under certain conditions, such a loan is considered to be hidden share capital of the company for corporate income tax purposes. In this case, the interest paid on the loan is not deductible as a company expense. Consequently, the loan must be considered by the member as an additional shareholding and the interest as dividends from this shareholding. It is difficult to lay down general and precise rules that would make it possible to determine, in a particular case, whether the loan constitutes a shareholding within the meaning of article 114. In general, a loan is to be regarded as a holding where the normal method of financing, dictated by serious economic or legal considerations, would have been an increase in capital and where it is clear from the circumstances that the form of the loan can only have been chosen for the purpose of tax avoidance. The absence of the usual legal forms of loan, i.e. the fixing of interest rates and repayment terms, the allocation of the loaned funds to long-term fixed assets, the absence of guarantees, and the disproportion between the share capital and the loaned funds all point to the existence of a disguised shareholding in the form of a loan. It is also important to take into account the circumstances in which the loan is granted. Where the loan is, for example, immediately subsequent to a repayment of capital, there can be no doubt as to the economic nature of the loan.[81]

This guidance was reproduced in both the tribunal's and the court's decisions and was a crucial factor in classifying the IFLs as disguised capital.

According to this guidance: "In general, a loan is to be regarded as a holding where the normal method of financing, dictated by serious economic or legal considerations, would have been an increase in capital and where it is clear from the circumstances that the form of the loan can only have been chosen for the purpose of tax avoidance."

However, the commentary explicitly states that it is difficult to establish general and precise rules that could be used to determine whether a loan constitutes disguised capital in a particular case. Further, it has been said that consideration must be given to the circumstances in which the loan was granted.

The commentary provides the following examples of indicators that a loan may be disguised capital, which the tribunal and the court put at the heart of their tax analysis:

- the absence of interest charges and repayment terms;
- the allocation of the loaned funds to long-term fixed assets;
- the absence of guarantees; and
- the disproportion between the share capital and the loaned funds.

The tribunal explicitly stated that, in its 1955 commentary, the Luxembourg legislature did not intend to adopt the stricter interpretation of the concept of disguised capital adopted by the German Federal Tax Court in 1953, but rather to adhere to previous case law of the Federal Reich Tax Court.

[80]*See* BFH, Decision of Jan. 13, 1959, I 44/57, BStBl. 1959, Part III, at 197.

[81]Draft bill on income tax reform, Commentary on the articles Title II. — Income tax on legal entities, articles 118 to 223, doc. parl. 571/04, 12 J-1955-O-0054, at 295, 1955.].

The Concept of Disguised Capital Over Time

The concept of disguised capital was developed by the German Reich Tax Court about 80 to 90 years ago at a time when financing was much more basic. Today, companies can be financed through a variety of equity and debt instruments, which can be tailored to the specific requirements of the parties involved.

According to administrative practice, Luxembourg companies can finance their holding activities through a mix of equity and debt. More precisely, a debt-to-equity ratio of 85-to-15, in which up to 85 percent of the acquisition costs are financed by interest-bearing debt,[82] has frequently been considered acceptable from a Luxembourg tax perspective.

However, interest-free debt instruments, such as interest-free loans, should be treated as equity for the purposes of this ratio because it is intended to limit interest expenses relating to holding activities. Therefore, the financing of participations through interest-free loans should not be restricted by this ratio.

This raises the question of whether this long-standing administrative practice might affect the legislature's intention. After all, if the Luxembourg legislature disagreed with the LTA's administrative practice, there was ample opportunity to amend the legal framework.

Considering that the Luxembourg transfer pricing landscape has become much more technically oriented over the last 15 years, a debt capacity analysis could be conducted for holding activities to support the appropriateness of the 85-15 debt-to-equity ratio in a specific case.

While the tribunal noted that the Luxembourg legislature intended to align with the jurisprudence of the German Reich Tax Court in its 1955 commentary (on the 1967 draft LITL), the Luxembourg tax system has long been aligned with the more restrictive interpretation adhered to by the German Federal Tax Court since 1953.

Therefore, it is reasonable to question whether the legislature's intention, as expressed in the commentary, may have changed implicitly over time. At the very least, taxpayers can reasonably expect the LTA to continue its administrative practice of the principle of legitimate expectations unless they are informed otherwise.

Tax Treatment of Disguised Capital

For Luxembourg tax purposes, reclassifying loans as disguised capital may have implications for corporate income tax, municipal business tax, and net wealth tax.

However, according to the interpretations of the German Reich Tax Court and the German Federal Tax Court, it is not the entire loan amount that needs to be reclassified as disguised capital.[83] Instead, loans can be partially reclassified as disguised capital. Conversely, the tribunal and the court have both ruled that the IFLs must be reclassified as disguised capital in their entirety.

Any interest payments made on loans that have been reclassified as disguised capital must be treated as hidden dividend distributions. Hidden dividend distributions cannot reduce a company's taxable income. If they have already been deducted, they must be added back to the taxable income.[84]

From a net wealth tax perspective, (the part of the) loans reclassified as disguised capital should not be deductible for Luxembourg net wealth tax purposes (when financing assets taxable for net wealth tax purposes).[85]

The LTA bears the burden of proof that a debt instrument should be classified as equity in accordance with the concept of disguised capital.[86] However, the Luxembourg tax authorities should not easily conclude that the concept of disguised capital applies.

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[82] The interest rate charged for debt financing of shareholdings should generally adhere to the arm's-length principle.

[83] *See* German Reich Tax Court, June 24, 1943, III 34/43, RStBl. 1943, at 765; *see* German Federal Tax Court, Jan. 13, 1959, I 44/57, BStBl. 1959, at 197.

[84] Article 164 (3) of the LITL; *see* RFH, Decision of Aug. 30, 1938, I 271/38, RStBl. 1938, at 901.

[85] BFH, Decision of May 15, 1953, III 103/52 S, BStBl III 1953, at 208.

[86] RFH, Decision of Sept. 19, 1933, I A 272/31, RStBl 1933, at 1220; RFH, Decision of Aug. 30, 1938, I 271/38, RStBl 1938, p. 901; RFH, Decision of Sept. 29, 1942, I 129/42, RStBl 1942, at 1075; BFH, Decision of Nov. 7, 1950, I 20/50 U, BStBl III 1951, at 12; BFH, Decision of Aug. 20, 1954, I 130/53 U, BStBl III 1954, at 336; BFH, Decision of Oct. 11, 1955, I 117/54 U, BStBl III 1956, at 11; BFH, Decision of Mar. 20, 1956, I 178/55 U, BStBl III 1956, at 179, BFH, Decision of Jan. 13, 1959, I 44/57 U, BStBl III 1959, at 197; BFH, Decision of Oct. 28, 1964, I 198/62 U, BStBl III 1965, at 119; BFH, Decision of Dec. 10, 1975, I R 135/74, BStBl II 1976, at 226.

Application to the Case at Hand

LuxCo financed two investments in Malaysian companies almost entirely through two IFLs, totaling around €500 million. Although LuxCo allocated these investments and the IFLs to a Malaysian PE, both courts disregarded its existence for different reasons. Consequently, the investments and IFLs were recognized at the level of the Luxembourg head office.

According to the jurisprudence of the German Federal Tax Court since 1953, the IFLs should not be reclassified as disguised capital. Similarly, participations may be largely financed by interest-free loans, which are deemed to be equity for debt-to-equity ratio purposes in line with administrative practice. Based on this, the IFLs should not be reclassified as disguised capital.

A more detailed analysis of the IFLs would be necessary if the case law of the German Reich Tax Court were to be considered. For Luxembourg tax purposes, the IFLs should be categorized as debt when applying the economic approach and the substance-over-form principle. Otherwise, there would be no scope for the disguised capital concept to apply because only debt instruments can be reclassified as equity. In addition, it would be necessary to analyze whether the IFLs could be reclassified (in part) as disguised capital.

Once the court has concluded that the concept of disguised capital should apply, the next logical step is to determine which part of the loans should be reclassified. Although the court said that IFLs cannot be hybrid — they must be either entirely debt or entirely equity — this is inconsistent with the jurisprudence of the German Reich Tax Court and the German Federal Tax Court.

The acceptable level of debt funding for holding activities could be determined using a debt capacity analysis. This would establish whether the debt funding in a given case can be served. In other words, it must be analyzed if a company will likely be able to cover the arm's-length remuneration and to repay its debt. However, because there is no interest charge on IFLs, the debt analysis should very likely support a high debt capacity. After all, investors only invest if they expect a positive return.

Conclusion

On April 17 the court issued a ruling on the classification of IFLs for Luxembourg tax purposes. This ruling upheld the tribunal's decision to reclassify these loans as disguised capital.

In their decisions, the tribunal and the court appear to have applied the concept of disguised capital when classifying the loans for Luxembourg tax purposes. However, under this concept, financing instruments can only be reclassified as equity if they are first classified as debt for Luxembourg tax purposes.

Considering that the financial world is much more sophisticated today than in the past and that the Luxembourg legislature did not address the long-standing administrative practice of debt funding for holding activities, one could argue that the legislature has implicitly shifted towards a stricter interpretation of the concept of disguised capital.

According to the interpretation of the concept of disguised capital by the German Reich Tax Court and the German Federal Tax Court, only the excessive part of the financing instrument should be reclassified rather than the entire instrument. In this case, a debt capacity analysis could be conducted to support the level of debt funding. For interest-free debt instruments in which no interest is charged, the analysis is expected to result in a very high debt capacity percentage.

Ultimately, this decision shocked many because IFLs are commonly used to provide funding to companies in Luxembourg. It has resulted in significant legal uncertainty, with some tax advisers interpreting the decision literally rather than considering the specific circumstances of the case. Notably, this decision could affect the classification of all debt instruments financing shareholdings — both interest-free and interest-bearing instruments. Hopefully, this publication will contribute to greater legal certainty in this area. ■