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Tax Controversy 2024

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Luxembourg: Trends & Developments

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Trends and Developments

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Loyens & Loeff is an independent European full-service business law firm providing integrated legal and tax advice with specialists in Dutch, Belgian, Luxembourg and Swiss law. The Luxembourg tax controversy team helps clients navigate an increasingly complex EU and Luxembourg tax environment and represents taxpayers in pre-litigation discussions with tax authorities and before the courts. The firm's services include developing litigation strategies, engaging in settlement negotiations, assisting with arbitration or mutual agreement procedures (MAP), assisting with information requests from tax authorities, managing tax audits and investigations, filing appeals and representing clients in proceedings at all levels, including at the Court of Justice of the European Union. The team is part of a fully integrated firm with home markets in the Benelux and Switzerland, and representative offices in all major financial centres, such as London, New York and Paris.

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Introduction

2023 was another year rich in tax controversy, with more than 160 judgments issued in direct tax litigation cases. Whilst this is less than in 2022, several high-profile cases attracted a lot of attention due to their potential broader impact on the Luxembourg financial centre. To address the increasing complexity of tax cases, the lower court (administrative tribunal) created a new chamber focusing (though not entirely dedicated to) appeals in tax matters.

After looking at some statistics, this contribution focuses on a few selected direct tax topics that shaped the Luxembourg tax controversy landscape last year. One should nevertheless not forget about cases relevant to Luxembourg at the European level, in particular the landmark wins in the Amazon and ENGIE state aid cases (case C-457/21 P and joined cases C-451/21 P and C-454/21 P, respectively) and the judgment of the Court of Justice of the European Union (CJEU) concerning the applicability of value added tax to directors' fees (case C-288/22).

Some Statistics

In 2023, once more, taxpayers have had a very low success rate before the lower court: about 15% of cases were won and 11% had a divided outcome. This lack of success spans across all subjects, with differences, however, between the topic of the liability of directors for unpaid taxes of a company (100% for the tax authorities), on the one hand, and topics such as hidden distributions (which had a divided outcome in 38% of the cases) and the application of the old regime on the taxation of income from intellectual property (37% success rate for taxpayers), on the other hand.

As part of the overall 74% success rate of the Luxembourg tax authorities, a significant part (16%) was due to the taxpayer's appeal being found inadmissible. This can be attributed in part to appeals brought by targeted taxpayers (as opposed to holders of information) against injunctions to provide information in the context of exchange of information cases. The courts consistently deny to targeted taxpayers (and also to interested third parties other than the holder of information) the right to appeal, even though the CJEU case law leaves the door open to such appeals, resulting in an unsatisfactory status quo. However, as already alluded to in last year's publication, other inadmissibility factors such as missing appeal deadlines or not being properly represented before the tribunal arise too often, resulting in lost opportunities for taxpayers.

Another factor contributing to the high success rate of the tax authorities is the fact that in the vast majority of these cases, the outcome is predictable. This raises the question of whether taxpayers are not receiving appropriate advice (if they sought any) or are too optimistic about their chances. In any case, the impact is clear: longer delays due to the congestion of the administrative tribunal.

At the administrative court level, in final instance, notwithstanding the fact that there are a few more reversals in favour of the taxpayer than in favour of the tax authorities, more than half of the cases resulted in the tax authorities' win in first instance being upheld. Also, the predictability of losses for taxpayers is lower than in first instance, which might be explained by the fact that in appeal it is mandatory for taxpayers to mandate a qualified lawyer.

Share Class Redemptions: Two Judgments but Not Much More Clarity?

In 2017, addressing the case of a repurchase of the entire participation of a shareholder without cancelling these shares shortly thereafter, the administrative court had ruled that the proceeds should be qualified as capital gains (and not as profit distribution) subject to compliance with the arm's length principle and subject to the general anti-abuse rule.

In 2023, two long-awaited judgments of the administrative tribunal dealt with the redemption (repurchase and cancellation) of a class of shares held by a shareholder not exiting the company. Traditionally these have been treated as partial liquidation proceeds which are not subject to withholding tax, contrary to regular profit distributions.

One of the judgments (case 42432) emphasised the requirement for the redemption price to be at arm's length. Having observed that there were no different economic rights between the different share classes but that virtually all the distributable reserves had been used to repurchase approximately 5% of the share capital, the tribunal concluded that the redemption price should qualify as capital gains to the extent at arm's length and be requalified as hidden profit distribution for the surplus. The tribunal referred the case back to the tax authorities to determine an arm's length redemption price.

The other judgment (case 45759) did not question the qualification of partial liquidation per se but concluded to abuse of law, in particular because the shareholders had reclassified the share capital just a few weeks before the first redemption, once distributable reserves had already become available. In addition, the judgment suggests that initially there were no different economic rights; the tribunal did not further discuss the arm's length requirement.

Both judgments need to be read against their specific factual backgrounds, which display unsympathetic features such as false accounts or a conspicuous timing for restructuring the share capital. One may nevertheless draw some conclusions:

- It is key for each class of shares to have sufficiently different economic rights.
- Where repatriation of proceeds through share class redemptions may be contemplated, it is better to set them up from the outset, or at least well before having distributable reserves that need to be upstreamed.
- To further strengthen the position, one may consider favouring the use of tracking classes of shares if the strategy is to hold an asset

and have a sole liquidity event being the exit from the investment.

Some questions nevertheless remain open – eg, as regards the approach to approximate a market-based price. Should a discount be factored in if only a minority of the shares are redeemed? Is a redemption price defined in the articles of association upon incorporation per se at arm's length? Does the nature of the difference in economic rights influence the pricing analysis? As case 45759 has been appealed, the upcoming administrative court ruling might give further guidance.

Debt or Equity Qualification of Financial Instruments: Clarification of Some Criteria

This is another important topic, due to the multiple financial instruments that display a mix of debt and equity features: interest-free loans, (convertible) preferred equity certificates, mandatorily redeemable shares, warrants, etc. For Luxembourg issuers, a debt qualification is usually preferable because interest is deductible (subject to certain limitation rules) and in principle not subject to withholding tax, if at arm's length.

There was already a body of case law which, by leveraging on parliamentary documents of the 1960s, had listed more than a dozen criteria to appreciate on a global basis, without any single criterion being determining. A 2017 administrative court ruling followed by some administrative tribunal judgments confirmed the list of criteria.

In November 2023 (case 48125C), a landmark case confirmed the debt qualification of an interest-free loan (IFL) between two Luxembourg companies. Both the lender and the borrower had imputed for tax purposes an arm's length interest on the loan, arguing that the adjustment was required under the Luxembourg transfer pricing rules. The tax authorities, after initially denying the imputation of interest, had gone a step further and requalified the IFL into equity. This had been upheld by the administrative tribunal.

The administrative court reversed the first instance judgment. Amongst the useful clarifications, one should note the following:

- The fact that the lender is also a shareholder does not mean that the equity criteria of having voting rights and rights to participate in profits as well as in liquidation proceeds are met. Although the shareholder relationship is a relevant circumstance, these criteria need to be assessed as regards the quality of the lender (and the terms of the loan) only. In this case, the loan did not give voting rights and economic rights to the lender. Therefore, these criteria supported a debt qualification.
- A maturity of eight or ten years is not particularly long and does not support an equity requalification.
- In the presence of a loan facility, the debt/equity ratio needs to be assessed based on the actual drawdowns, not the maximum commitment. Moreover, the court found that the debt/equity ratio was not excessive in the case at hand, since the tax authorities did allow for greater leverage in the circular on intragroup financing activities applicable at the time.
- The court also confirmed that the limited recourse clause shifts risks but does not void the obligation to repay ex ante.
- Subordination of an intragroup loan to bank loans is common in the market and accordingly can also not serve as an argument to support an equity requalification.

- Documenting the loan several months after the cashflow is not ideal but, as formalities for a loan are lighter than for a share capital contribution, this fact also does not justify an equity requalification.

Minimum Net Wealth Tax: Partial Unconstitutionality of the Flat Amount

Minimum net wealth tax (NWT) is progressive in scale depending on the balance sheet total of the company. By derogation, a flat minimum NWT of EUR4,815 applies to most holding and financing companies: the criteria are that the financial fixed assets, transferable securities, receivables from affiliated undertakings, and cash deposits exceed EUR350,000 while simultaneously comprising 90% or more of their total gross assets.

A company which had a balance sheet total between EUR350,000 and EUR2 million and fell in scope of the flat minimum NWT challenged the amount payable; under the progressive scale system, it would have had to pay EUR1,605 minimum NWT.

The constitutional court sided with the taxpayer and concluded that there was no valid justification for the distinction, which resulted in discrimination between taxpayers in otherwise comparable situations in light of the general principle of contributive capacity.

The Ministry of Finance announced shortly thereafter that, pending a legislative reform, the lower minimum NWT would apply to taxpayers in that situation and that corrections would be made for those for whom it is still possible to issue a new assessment lowering the minimum NWT due.

Recognition of Foreign Permanent Establishments: a New Contentious Area?

Against the background of the McDonald's state aid investigation, and although the European Commission ultimately had to conclude that the double non-taxation arising from a mismatch between the Luxembourg and US tax systems in the recognition of a Luxembourg company's US branch as a permanent establishment was not in scope of the EU state aid rules, Luxembourg amended its rules on the recognition of a foreign permanent establishment. In some cases, if proof cannot be provided that the foreign tax authority recognises a permanent establishment, Luxembourg will deny the recognition and the usually correlative tax exemption on profits and net assets allocable to the foreign branch.

In addition to a number of taxpayers receiving questions from the tax authorities about foreign branches, two judgments of the administrative tribunal attracted attention during 2023. Both cases show amongst others the need for properly drafted and sufficiently detailed documentation.

In the first case (45030, upheld on appeal in early 2024 – case 49145C), the tax authorities denied the recognition of a US permanent establishment. The administrative tribunal (and then the administrative court) sided with the tax authorities:

- It is for the taxpayer to substantiate its claim for a tax exemption – ie, in that case to substantiate the existence of a permanent establishment.
- The question of whether a single loan was sufficient to constitute a business activity conducted in a fixed place in the United States was not clearly addressed; the jurisdictions relied mainly on the fact that the legal

documentation contained contradictions as regards the address of the branch, leading to questions about whether a "fixed place" existed.

- In addition, the fact that the branch manager was also a director of the Luxembourg company led especially the administrative tribunal to question the management of the branch as that person was – in the tribunal's view – supposed to manage the company out of Luxembourg (and therefore not in the United States). This last element seems questionable, as it is common to have Luxembourg companies with a mix of resident and non-resident managers or directors.
- Finally, the taxpayer's claims that rent and other operating expenses were charged to the branch by an associated group company were dismissed, as there was no effective payment. The taxpayer claimed a lack of liquidity, but the court rejected this argument, observing that there was interest income on the loan and that the costs charged by the associated US entity were low.

In the second case (46470), the tax authorities also prevailed. This case concerned the allocation of dividend income to a foreign branch instead of the Luxembourg head office. The administrative tribunal did not question the qualification of the branch as a permanent establishment but agreed with the tax authorities that, based on the legal documentation (which referred to the company as a whole and not to the branch specifically), there was nothing suggesting that the dividend should not be allocated to the head office. The existence of a tax ruling did not change the outcome, as the actual facts diverged from those described in the ruling request, so that the ruling was not binding on the tax authorities in this case.

More cases dealing with the recognition of foreign permanent establishments are expected in the course of 2024.

Transfer Pricing: Some Attention Points to Manage Exposure to Hidden Dividends

Various cases dealt with the recognition of hidden distributions of profits in case of non-arm's length transactions between Luxembourg companies and their shareholders.

In the first case (48127C), the administrative court confirmed that an upstream loan without charging interest to the shareholder could justifiably result in the tax authorities claiming withholding tax on a hidden distribution equal to the amount of arm's length interest that should have been charged. This case is relevant, as upstream loans have been used for many years as a tool to quickly move cash without the need for additional formalities. In an era of very low or even negative interest rates, not applying any interest could still possibly be sustained. In the current market environment, except for very low amounts or very short maturities, it appears advisable to charge some interest on upstream loans remaining in place for more than a few weeks.

In the same case, as well as in case 47754C, the administrative court also stressed that it is for the tax authorities to substantiate not only the existence of a hidden distribution but also its amount. Merely referring to a 1998 circular which mentions a 5% rate is not sufficient, especially as circulars are binding on the tax authorities but not on taxpayers. In case 48127C, the administrative court examined in detail the transfer pricing argumentation raised by the taxpayer and accepted a rate lower than 5%, thereby reducing the amount of the hidden distribution subject to withholding tax. In case 47754C, the court ruled that, in the absence of substantiated arguments of the tax authorities to challenge the 3.5% rate charged by the taxpayer to its shareholder, there was no hidden distribution (confirming again that the 1998 circular could not serve as a basis to impose a 5% rate on the taxpayer without assessing the actual facts and circumstances).

A third case (48281C) dealt with a total return swap: because of the material imbalances between what the Luxembourg company had to pay to its shareholder (a material amount of income) and the consideration paid in return (the coverage of some limited costs), the court considered that this total return swap was not at arm's length and caused a hidden distribution of profits to the shareholder. Total return swaps are regularly considered in certain types of structures and this court ruling shows the importance of respecting the commercial purpose of the swap (as a true risk hedging mechanism) instead of tweaking its terms such that – while it is denominated and looks like a swap – the economic reality is actually a transfer of profits.

Looking Ahead

The beginning of 2024 has not brought significant improvements for taxpayers in terms of success rates. Several interesting administrative court rulings, which deal with the concept of economic ownership, have already been issued and at first sight appear to take a more legalistic approach, narrowing down the possibilities of economic ownership diverging from legal ownership. Moreover, the court ruling in the appeal case on share class redemptions is expected in the coming months, and further clarity on the application of the general anti-abuse rule is also anticipated. Therefore, case law is likely to continue informing the choices of taxpayers and practitioners in an increasingly complex environment in which many rules are subject to a sometimes significant margin of interpretation.

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