L3A Position Paper

Classification of Interest-free loans ("IFLs") for Luxembourg tax purposes

LUXEMBOURG ALTERNATIVE ADMINISTRATORS ASSOCIATION

Contents

1. Purpose of this position paper

Interest-free loans ("IFLs") are a common feature of many Luxembourg investment structures and can be used in a variety of circumstances. IFLs are characterised by their flexibility (e.g. 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.

However, in September 2022, the Tribunal in Luxembourg delivered its decision in a case concerning an IFL granted by a Luxembourg company to its wholly owned Luxembourg subsidiary. The Tribunal ruled that this IFL was an equity instrument.[1] As such, it confirmed the position of the Luxembourg tax authorities that challenged the debt classification of said IFL.

This engendered considerable legal uncertainty among investors and some tax advisors in Luxembourg. However, in November 2023, the decision of the Administrative Tribunal was overturned by the Luxembourg Administrative Court, which ruled that the IFL should be classified as a debt instrument.[2] Given the widespread use of IFLs to finance companies in Luxembourg, the significance of this decision and its contribution to legal certainty cannot be overstated.

In 2024, the Luxembourg Tribunal delivered its decision in another case involving an IFL. The court's ruling confirmed the reclassification of the IFL as an equity instrument, aligning with the position of the Luxembourg tax authorities.[3] This decision has led to a resurgence of legal uncertainty regarding the classification of IFLs.

This position paper analyses the features of financial instruments that need to be considered when classifying a financial instrument as either debt or equity and analyses specifically how IFLs should generally be classified for Luxembourg tax purposes.

The purpose of this position paper is threefold:

- to analyse key features of financing instruments;
- to consider on which basis financing instruments are classified as equity or debt for Luxembourg tax purposes; and
- to determine how IFLs should be classified for Luxembourg tax purposes.

[1] Administrative Tribunal, Decision No. 44902 of 23 September 2022.
[2] Administrative Court, Decision No. 48125C of 23 November 2023.
[3] Administrative Tribunal, Decision No. 47267 of 8 May 2024.

2. Classification of financing instruments

2.1. Overview

Luxembourg tax law does not provide for any specific rules regarding the classification of financing instruments as either equity or debt. Therefore, this determination must be based on general Luxembourg tax principles.[4]

The preparatory note of the LITL of 4 December 1967 related to Article 114 (now Article 97 of the LITL) on income from capital states that the “substance over form” principle and the economic approach (i.e. “w*irtschaftliche Betrachtungsweise*”) apply when characterising a financing instrument and the nature of income derived therefrom.

On this basis, it is necessary to analyse all relevant features of a financing instrument to determine the overall character of the instrument as either debt or equity.

2.2. Step 1: Key features to be considered

The following features should be considered when analysing financing instruments:

2.2.1. Civil law qualification and accounting treatment

The analysis of financing instruments should generally begin with a classification under Luxembourg Civil Law.[5] This classification should generally be followed under Luxembourg General Accepted Accounting Principles (“GAAP”).

Moreover, the tax treatment generally follows the accounting treatment[6], unless there are specific rules or concepts that require a different treatment for tax purposes (here, this could be the economic approach and the substance over form principle).

A loan is defined as a contract whereby one party delivers to the other one either an asset which the recipient can use with the obligation to return it after use[7] or a certain amount of fungible goods with the obligation to return the same amount or number of goods of an equal type and quality.[8]

A company contract is defined as a contract by virtue of which two or more persons (except for a “single shareholder private company”) agree to contribute funds or assets with a view to sharing the profits (and losses) that may arise therefrom.

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[4] See Oliver R. Hoor, Alternative Investments in Luxembourg, Legitech 2021, p. 97 f.

[5] Article 1 of the Commercial Law; Art. 1832 f. of the Civil Law (“*Contrat de société*”), Articles 1874 and foll. of the Civil Law (“*Contrat de prêt*”).

[6] Grundsatz der Maβgeblichkeit, Art. 40 (1) of the LITL.

[7] Article 1875 of the Civil Law – in this definition, the lender remains the owner of the asset.

[8] Article 1892 of the Civil Law – in this definition, legal title to the goods is transferred to the borrower – the contract can be interest-bearing.

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

Debt obligation

- The holder is entitled to the return of its investment after a predetermined period;
- The loan carries a predetermined fixed return, which is not linked to the company's result;
- In the event of the debtor's liquidation or bankruptcy, the investor ranks above the shareholders, i.e. it has the right to be repaid before any funds are made available to them.

Equity

- Equity fully exposes the investor to the risk of the business (no assurance with respect to reimbursement of the original investment or with respect to the return);
- Vests in its holder the right to receive part of the liquidation surplus;
- Provides shareholder rights to the investor (e.g. voting rights, right of supervision, etc.).

The legal classification should be analysed based on the essential features of the contract, considering the real intention of the parties as opposed to the form or label given by the parties.

2.2.2. Maturity

The maturity of a financing instrument is an important feature. While a right of repayment after a specified period of time is a characteristic of a debt obligation, a permanent commitment of funds is an equity feature.

However, even when a financing instrument has a fixed maturity, the long-term nature of the maturity might, in accordance with the parliamentary documents[9], point to the classification as an equity instrument.

Based on German case law, a maturity of up to 29 years (i.e. less than 30 years) should be considered as a debt feature, whereas a long-term maturity of 30 years and longer is an indication of an equity instrument.[10]

2.2.3. Remuneration of the financing instrument

The remuneration of the financing instrument is another important characteristic. While a (unlimited) participation in a company's profit would be an equity feature, the mere remuneration with a fixed interest rate would be a clear-cut debt feature.

However, in practice a variety of remuneration models might be agreed upon. For example, the remuneration of a financing instrument may be linked to the income generated by the borrower in relation to a specific asset that is financed by the instrument (asset-linked or income participating instruments). Parties may also agree on a participation in the borrower's profits (which may be capped in one way or

[9] *Projet de loi concernant l'impôt sur le revenu*, parliamentary documentNr. 571[4].

[10] Some practitioners consider a 50-year (or longer) maturity as being the dividing line for a long-term financing instrument, whereas a maturity of maximum 49 years would be a debt feature.

another). While income or profit participation tends to be an equity feature, the debt character of the instrument may be reinforced through the inclusion of a (small) fixed interest rate.

When the payment of a fixed interest is limited by the amount of (accounting) profit or income derived from a certain asset, or subject to the condition that the borrower has sufficient cash for the payment of the interest, the remuneration model is still rather a debt feature.

When a financing instrument provides for a zero interest rate, the transaction is not an arm's length transaction and might require tax adjustments.[11] A zero interest rate is an equity feature.

2.2.4. Participation in liquidation proceeds and latent capital gains

Financing instruments may provide for a participation in the liquidation proceeds of the borrower or latent capital gains inherent in (certain) assets owned by the borrower. The existence of such a clause is a strong feature of an equity instrument, while the absence of such a clause is a feature of a debt instrument.

2.2.5. Loss participation

Participation in the borrower's (accounting) losses or losses incurred in relation to a specific investment (or activity) is an indication of an equity instrument. Debt instruments generally do not provide for a participation of the lender in the losses incurred by the borrower. However, this is not an absolute criterion and in specific cases, parties may agree on loss participation without jeopardising the debt classification of the financing instrument.

2.2.6. Conversion feature

Financing instruments may also include a conversion feature that provides for the possibility to convert the instrument into shares of the borrower. When the conversion can be requested by the borrower (instead of a repayment of the principal amount), this is a strong equity feature.

Likewise, a mandatory conversion clause according to which the instrument is automatically converted at a predefined date and rate is an indication of an equity instrument. If the company is liquidated before the conversion date, the instrument may either be repaid at face value or automatically be converted into shares of the borrower. In this regard, an automatic conversion clause would be a much stronger equity feature than a provision that (at least optionally) provides for a repayment at face value.

When the financing instrument may be converted upon request of the investor, this would be rather a debt feature, in particular when the instrument provides for an alternative redemption at market value.

2.2.7. Label of the financing instrument

The label of the financing instrument generally provides a first indication as to whether a financing instrument should be classified as equity or debt.

[11] Tax adjustments may be required in accordance with the concept of hidden dividend distributions (Article 164 (3) of the LITL) or based on Article 56 of the LITL.

However, as the label of the financing instrument is not necessarily consistent with the other characteristics of the instrument, this feature is ancillary to other features that are more significant in the analysis.

2.2.8. Political and voting rights

A shareholder may generally participate in the life of the company and may vote in the general meetings as well as all extraordinary shareholder' meetings. The shareholder further generally has voting rights and the right to be kept informed of major developments that may have an impact on the company's situation.

However, as companies may also issue non-voting shares, voting rights are not a strong equity feature. Rather, this feature is an equity indication that together with other criteria may result in an equity classification.

2.2.9. Modalities of the yield payment

When the payment of the remuneration due under a financing instrument is at the discretion of the board of directors under a procedure similar to the one applicable to dividend distributions, this is an indication of an equity instrument. Another equity feature would be if the payment of yield depends on the borrower having sufficient reserves or retained earnings available.

In contrast, when the payment is not subject to any procedure or condition, this would be a characteristic of a debt feature.

2.2.10. Ability to accelerate (call) the instrument

Where early repayment or redemption is possible, this would be a debt feature. Conversely, the absence of an early repayment or redemption clause is an equity indication.

The party that may request early repayment or redemption will also be an indicator. In case the repayment or redemption can be requested by the investor, this would be an indication of a debt instrument. In contrast, if early repayment or redemption can be requested by the borrower, this would be an equity indication.

2.2.11. Event of default clause

A debt instrument generally includes an "event of default" clause that may provide for an accelerated maturity or increased yield payments if the borrower fails to comply with its obligations under the instrument. In contrast, equity instruments do not include such a clause.

2.2.12. Ranking

One of the factors commonly used to distinguish debt from equity instruments is their relative ranking in the company's capital structure. In case of default, the holder of a debt obligation has the right to be repaid before any funds are made available to the shareholders.

However, there may be only a very small gap between the most subordinated debt obligation and equity instruments. As a principle, subordination is an equity feature, whereas the absence of subordination is a strong debt feature.

2.2.13. Transfer rights

Shareholders and bondholders generally have the right to freely transfer their shares or bonds to another party. Hence, a transfer right is neither a clear indication of an equity or a debt instrument.

However, should the instrument provide for a stapling clause according to which the instrument is only assignable together (on a pro-rata basis) with shares of the borrower, this is an indication of an equity instrument.

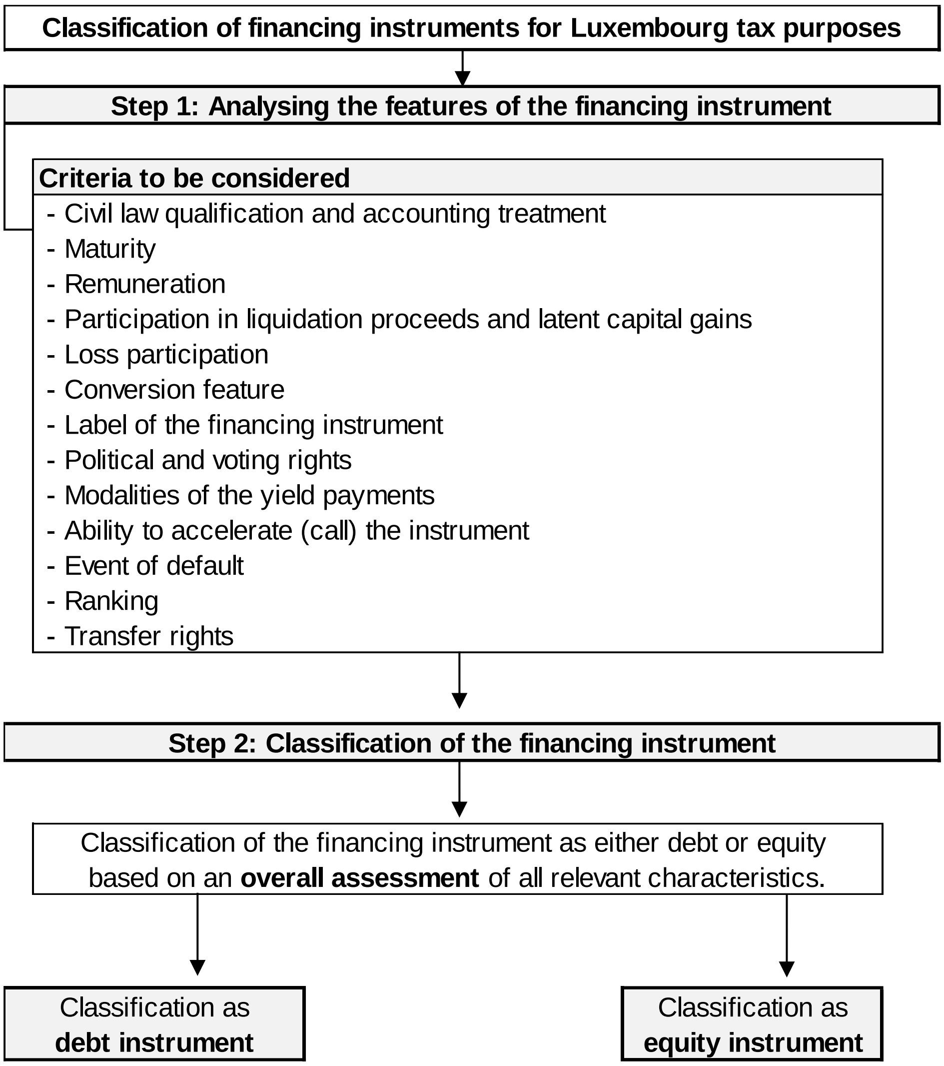
2.3. Step 2: Assessment

The classification of a financing instrument as either debt or equity follows an in-depth analysis of all relevant characteristics of the financing instrument. There is no single criterion that would be decisive for the assessment. Rather, the assessment is based on the overall character of the financing instrument.

However, not all the characteristics are equally important. Some characteristics are of more important as they provide clear-cut debt and equity indications, whereas other characteristics may be less relevant as they are less binary. These characteristics may, nonetheless, be useful to inform the analysis.

While in most cases the assessment is straight forward, in some cases, the presence of both equity and debt features may make the classification of financing instruments a more intricate exercise. In the latter case, it might be considered by the parties to align some of the features with the desired classification for Luxembourg tax purposes.

The following checklist depicts the features that need to be considered when analysing financing instruments.



3. Classification of interest-free loans

3.1. Overview

IFLs are a common feature of many Luxembourg investment structures and a flexible financial instrument that can be used for both short-term and long-term funding.

IFL agreements tend to be less complex than agreements for other financial instruments, given that the IFL does not include some of the features of other financial instruments by virtue of its nature.

In this section, the terms and conditions of typical IFLs are examined. When it comes to classifying an IFL in practice, it is necessary to analyse the terms and conditions of the specific IFL in question.

3.2. Common characteristics of IFLs

While IFLs may be equipped with a variety of features, in practice they are often less complex. It is important that the IFL agreement is formalised when the loan is granted.

The IFL is labelled as an interest-free loan. It should be noted that a loan is generally considered to be a debt instrument.

The IFL does not accrue interest (i.e. it is interest-free). Consequently, it is not necessary to define modalities of interest payments. This is an equity feature.

The maturity of the IFL should be consistent with the financing horizon. If it is unclear how long the IFL should be in place, it may be advisable to consider a slightly longer maturity (in order to avoid the potential need to amend the legal documentation at a later stage). If no longer maturity is necessary, a maturity of 10 years can often be witnessed in practice. A short maturity indicates a debt instrument, whereas a very long maturity (above 30 years) indicates an equity instrument.

An IFL generally does not provide the lender with the right to participate in the liquidation proceeds or latent capital gains. In cases where such a right is included in a financial instrument, this indicates an equity instrument.

Similarly, the IFL should not generally provide for participation in the borrower's losses. This is an indication of a debt instrument.

An IFL generally does not provide the lender with political or voting rights. Such rights would be considered equity features.

An IFL is generally unsecured but should rank higher than share capital, share premium and other equity contributions (contributions into account 115 – equity contributions without the issuance of shares). This is an indication of a debt instrument.

In case of an event of default upon maturity, IFLs often stipulate that the IFL would become interest-bearing. This can be regarded as a debt feature.

The question is whether the IFL provides for an early repayment clause that would allow the borrower to repay the loan before maturity (or the lender to call the repayment of the IFL). This is an indication of a debt instrument.

An IFL generally does not provide for a conversion clause. However, an IFL may be contributed (as any debt instrument) into share capital, share premium or into account 115. The presence of a conversion clause is an indication of an equity instrument, unless it is the right of the investor to claim a conversion into equity.

In the event of an IFL being granted by a shareholder to a subsidiary, the question arises as to whether the IFL provides for a stapling clause (i.e. the IFL can only be transferred together with (part of) the shares in the subsidiary). However, it is not standard practice for a standard IFL to include a stapling clause. A stapling clause would be an indication of an equity instrument.

3.3. Classification of an IFL for Luxembourg tax purposes: A case study

A foreign parent company has granted a loan to its subsidiary in Luxembourg. The loan has the following features:

- The loan is labelled "interest-free loan".
- The loan does not bear interest (i.e. the loan is interest-free).
- The loan has a maturity of 10 years.
- The lender is not entitled to receive a liquidation bonus.
- The lender does not participate in potential losses of the borrower (i.e. the loan does not include a limited or non-recourse clause).
- The terms and conditions of the loan do not include a conversion clause.
- The loan does not provide the lender with political or voting rights.
- The borrower has a right to make an early repayment at any time.
- In an event of default upon maturity, the loan will start to bear interest at a rate of 5%.
- The loan ranks *pari passu* with other intra-group debt funding, junior to third party debt and senior to the borrower's share capital, share premium and other equity contributions.
- The terms and conditions of the loan do not include a stapling clause.
- It is assumed that the loan is qualified as a debt instrument from a civil law perspective and for accounting purposes.

The features of the loan are summarised in the following table:

Criteria to be considered	Features of the IFL	Indication
Civil law qualification and accounting treatment	The loan is qualified as debt from a civil law perspective and for accounting purposes	debt
Maturity	The loan has a term of 10 years	debt
Remuneration	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 loan does not provide for a limited recourse clause (i.e. no participation in the company's losses)	debt
Conversion feature	The loan does not include any conversion clause	debt
Label of the financing instrument	The loan has been 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	The borrower has a right to make an early repayment.	debt
Event of default	In case of an event of default upon maturity, the interest-free loan would become interest bearing	debt
Ranking	The loan is unsecured but ranks higher than share capital, share premium or other equity contributions	debt
Transfer rights	The loan did not include any "stapling clause"	debt

In this particular instance, the loan has only one equity feature (i.e. the interest-free element). All other loan terms and conditions are (strong) debt features. These include: (i) the debt classification from a legal and accounting perspective; (ii) a relatively short maturity of 10 years; (iii) the absence of participation in liquidation proceeds and latent capital gains; (iv) the absence of political and voting rights; and (v) the ranking of the loan above the equity.

The tax treatment should generally follow the accounting treatment unless a provision of the Luxembourg tax law or a specific tax concept requires a different treatment for tax purposes ("*Massgeblichkeitsprinzip*").[12] Thus, while the classification of the IFL as debt for accounting purposes is the starting point of the tax analysis, the economic approach and the substance over form principle may require a different classification for tax purposes if the overall assessment of all relevant features points to a classification as an equity instrument.

In this instance, the categorisation of the interest-free loan is relatively straightforward. Among the numerous features that must be taken into account, only one is an equity feature. Consequently, the loan should be classified as a debt instrument for tax purposes in Luxembourg.

[12] See Article 40 of the LITL.

4. Conclusion

The classification of financial instruments for Luxembourg tax purposes is determined by an overall assessment of various features that may indicate whether a particular instrument is a debt or equity instrument. It is important to note that a single feature alone is not sufficient to determine the classification of a financial instrument as either debt or equity.

An IFL's key equity feature is its interest-free nature. However, there are a number of other factors to be taken into consideration, the result of which may be a strong debt classification. The content of this position paper should help practitioners with the classification of IFLs for Luxembourg tax purposes.

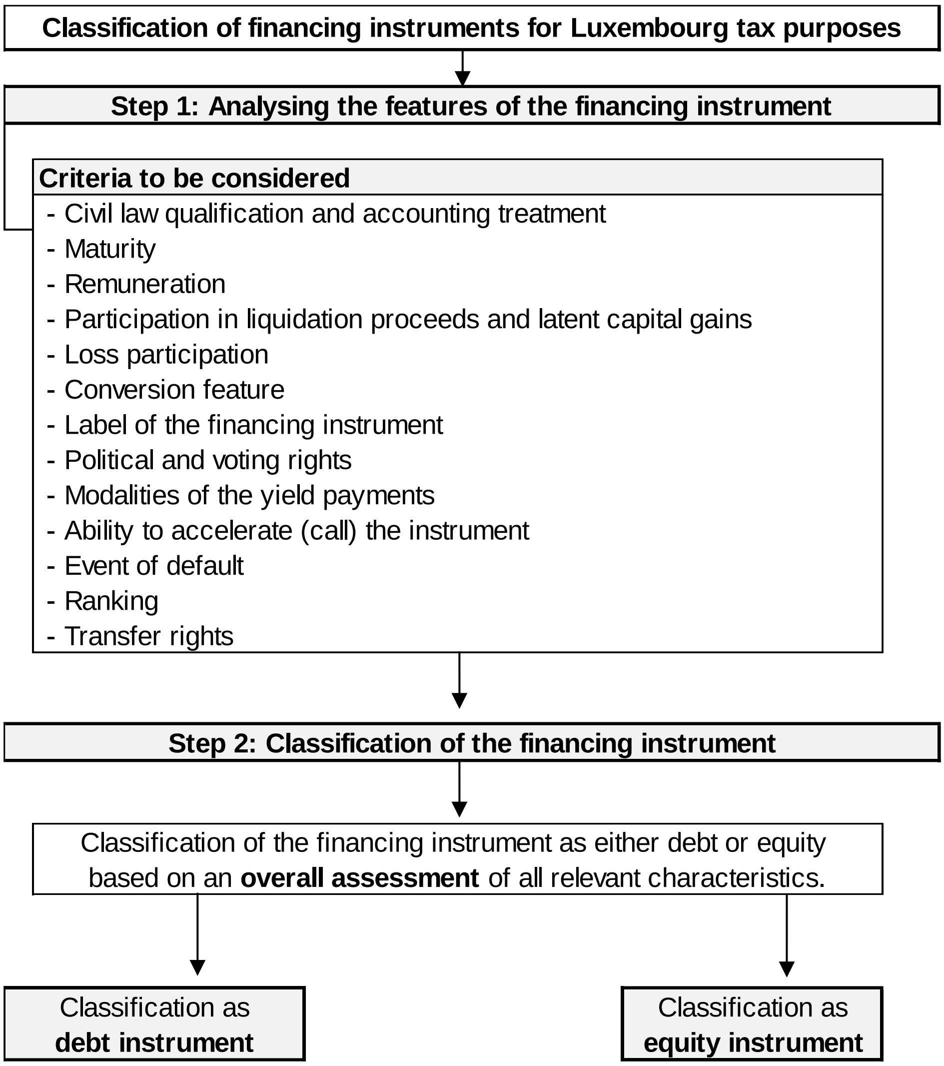
While a decision of the Administrative Tribunal in September 2022 created some legal uncertainty regarding the classification of interest-free loans, the Administrative Court restored legal certainty in November 2023 (despite a subsequent decision of the Administrative Tribunal again finding an IFL to be an equity instrument).

Ultimately, the classification of IFLs as either debt or equity instruments must be determined on a case-by-case basis.

5. Appendix

5.1. Checklist: Classification of financial instruments

The following checklist sets out the features of financial instruments to be analysed, and the process of classifying a financial instrument as either debt or equity.



5.2. Relevant features of financing instruments

The following table may be used for the analysis of the features of a financial instrument:

Criteria of major importance	Features of the financial instrument	Indication
Civil law qualification and accounting treatment		
Maturity		
Remuneration		
Participation in liquidation proceeds and latent capital gains		
Loss participation		
Conversion feature		
Label of the financing instrument		
Political and voting rights		
Modalities of interest payments		
Ability to accelerate (call) the instrument		
Event of default		
Ranking		
Transfer rights		