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October 7th, 2021

Tax newsflash

Luxembourg Court Case - 13 July 2021

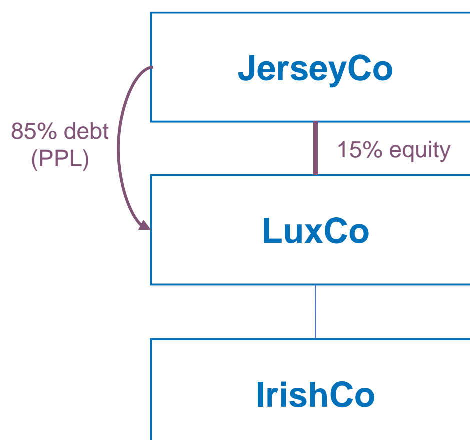
Decision on a profit participating loan from a transfer pricing and tax perspective

Foreword

Variable interest debt instruments have long been used in Luxembourg to finance equity or debt investments. Their mechanism notably allows for the repatriation of most of the income realized on an asset as variable deductible interest expense, exempt of taxes. Following years of uncertainty regarding the delimitation of eligible income to be paid as variable interest and the application of transfer pricing rules on these instruments, a recent court case brings some much needed clarity regarding their tax treatment.

Background

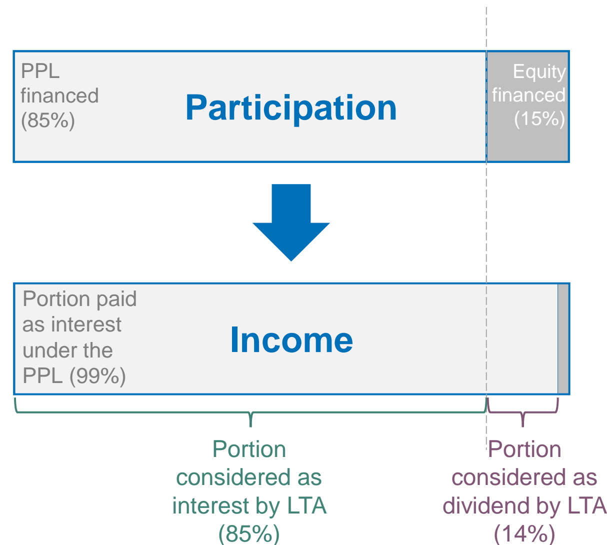
In 2013, a Luxembourg company ("**LuxCo**") acquired a participation in an Irish company ("**IrishCo**"). The acquisition was financed at 15% by equity and at 85% by a profit participating loan ("**PPL**") granted by the shareholder of LuxCo, a jersey company ("**JerseyCo**"). The terms and conditions of the PPL included a fixed interest clause of 25 bps of the financing volume and a variable interest clause which would amount to 99% of the profits derived from the participation.



To obtain certainty regarding the tax treatment of the structure and notably the PPL, LuxCo submitted a request for an advanced tax agreement ("**ATA**") to the Luxembourg Tax Authorities ("**LTA**"). The LTA approved the ATA which confirmed notably that the interest expense on the PPL should be a deductible expense for tax purposes, applicable from fiscal years 2013 to 2017. The ATA would remain applicable during this period as long as certain conditions were not breached, in particular if the effective yield on the PPL was to exceed an arm's length remuneration on an accrual basis.

In 2015, LuxCo perceived a dividend from its participation in IrishCo. Consequently, LuxCo paid to JerseyCo a variable interest amounting to 99% of the dividend perceived. Following the submission of the 2015 tax return, the LTA informed LuxCo in 2017 that it intended to deviate from the tax treatment indicated in the ATA regarding the payment performed on the variable interest of the PPL. The LTA stated that the portion of interest expense that exceeded

the portion of debt financing of the participation (i.e., 99% - 85% = 14%) should be requalified as a hidden dividend distribution for tax purposes. Furthermore, considering that JerseyCo would not benefit from the participation exemption regime, withholding tax of 15% should be levied on the portion of variable interest paid and requalified as dividends.



To justify that the totality of the variable interest paid on the PPL was as at arm's length and, in this context, in line with Luxembourg income tax law, LuxCo submitted to the LTA a transfer pricing report ("**TP report**"). In particular, the TP report included a comparability analysis performed with fixed interest debt instruments (bonds) and concluded that an arm's length fixed interest rate should fall within an interquartile range of 7.26% (minimum) and 10.71% (maximum), with a median at 8.47%. LuxCo specified that the effective yield on the PPL fell within the interquartile range. It should thus be considered at arm's length which implies that no exceeding interest deduction should be recharacterized, therefore leading to the absence of hidden dividend distribution. The LTA initially rejected the comparison established between the PPL and fixed interest instruments in the transfer pricing report, arguing that due to the profits linked nature of its variable interest, a PPL cannot be compared with fixed interest debt instruments which were used for establishing the arm's length interquartile range.

LuxCo filed a complaint to the head of LTA to point out that the yield paid on the PPL from 26 April 2013 to 31 December 2015 would correspond to a fixed interest rate of 9.81% if the PPL had been a fixed interest debt instrument, which therefore fall within the interquartile range determined in the TP report and should thus be considered at arm's length.

Following this complaint, the head of the LTA accepted the reasoning that the PPL could be compared to fixed interest debt instrument in order to justify the arm's length nature of its yield but claimed that this instrument had only been put in place to obtain a tax benefit. The LTA argued that, between third parties, both shareholders and creditors would expect a return on their investment and that, in case of profit, dividend should be paid as well as interest. In the present case, the variable interest mechanism would not permit any dividend distribution in case of profit as nearly all the income (99%) would be paid as interest expense, therefore

depriving the shareholder of a return on its equity investment. Considering that in the present case both shareholder and creditor were JerseyCo, the LTA declared that the PPL had been put in place for the sole purpose of avoiding withholding tax. As such, an amount of withholding tax would have been paid if the distribution of the profit had been performed at what the LTA considered arm's length conditions, i.e. that approximately 85% of the income would have been paid as interest expense under the PPL to the creditor and that 15% of the income would have been paid as dividend for the equity invested by the shareholder. The LTA therefore remained on their position that 14% of the interest paid should be considered as a hidden dividend distribution according to the arm's length principle.

Court decision

LuxCo deferred the case to the Tribunal of Justice of Luxembourg.

LuxCo added to its defence that it had complied with all the conditions required to maintain the validity of the ATA. By rejecting its application for another reason not stated in the ATA, LuxCo expressed that the LTA was also violating the principle of legal certainty and legitimate expectations. LuxCo furthermore drew attention on the fact that the decision of the LTA was confused between the financing ratio of the participation and the application of the arm's length principle.

The Tribunal confirmed the following:

- The yield on the PPL for the period under review is appropriately justified as amounting to a fixed interest rate of 9.81%, which falls within the interquartile range established in the TP report. It should therefore be considered at arm's length.
- An investor is free to manage its business at its best convenience and can therefore choose to be remunerated either by debt or equity. The basis of the LTA to consider that the arm's length principle is not respected because no dividend was paid on the equity invested is not valid and it does not relate to the application of the arm's length principle.
- An ATA is binding and the LTA cannot question post agreement the debt to equity financing ratio or the determination of the variable interest, considering that it had given its complete agreement by validating the ATA.

Following these statements, the Tribunal ruled that LTA had no basis to requalify the 14% portion of exceeding interest rate as a hidden dividend distribution.

Implication for taxpayers

This court decision reveals some key elements to consider for taxpayers having variable interest instruments in their structures or looking to implement some.

- Neither the LTA nor the Tribunal questioned the debt to equity financing ratio of the participation. While Luxembourg administrative approach allows for the standard 85/15

debt to equity ratio to finance participations, taxpayers should also be aware of recent developments from the OECD regarding debt financing and financial transactions.

- A transfer pricing analysis should always be produced to justify the arm's length nature of a PPL. To demonstrate that it is at arm's length, the yield of a PPL can be compared to the interest rate on a fixed rate debt instrument.
- Some transfer pricing studies would justify that paying 85% of the income on a participation as variable interest is at arm's length. Their relevance could be questioned from now on as a deduction amounting to 99% was considered as appropriate in this case.
- When determining how much can be repaid as interest under a variable interest instrument, taxpayers should also consider other tax rules that could impact such payments notably the latest Luxembourg rules which have been implemented following the Anti-Tax Avoidance Directive.

Our tax and transfer pricing teams are at your disposal should you have any questions relating thereto or should you need assistance to assess impacts on your business.

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