

Hidden Capital Contributions in Luxembourg – Clearing the Mist

The shifting of advantages motivated by the shareholding relationship to a company remains an obscure issue and the basis for the requalification of transactions into hidden capital contributions. Insofar as the concept of hidden capital contribution in Luxembourg is scarcely covered, this article aims at defining its main traits and clarifying its tax consequences. Consequently, descriptions of the concept and the resulting Luxembourg tax consequences are provided.

1. Introduction

Contributions to Luxembourg companies may be made in the form of regular contributions, as provided for under Luxembourg commercial law, or in the form of hidden capital contributions. Luxembourg tax law does not provide for a legal definition of regular contributions or the concept of hidden capital contributions (*verdeckte Einlagen*). Rather, the characteristics of hidden capital contributions have been shaped through the years by German case law.

Regular contributions increase a company's share capital or share premium, whilst remaining profit-neutral. These are reflected in the company's balance sheet as either an increase in assets or a reduction in liabilities. While Luxembourg Generally Accepted Accounting Practice (GAAP) solely considers regular contributions, the concept of contribution under Luxembourg tax law is broader. In particular, this includes hidden capital contributions.

Briefly, hidden capital contributions are advantages granted by a shareholder to a company that a third party would not have granted. In order to be classified as a hidden capital contribution it is essential that the contribution be reflected in the company's balance sheet, resulting in either an increase in assets or a reduction in liabilities.¹

These advantages may also be contributed within the framework of regular capital contributions (in exchange for shares or increases in the share premium of the company). Accordingly, the concept of hidden capital contributions solely relates to contributions, though not labelled as such, that remain undisclosed in agreements entered into by a shareholder and the recipient company.²

According to Luxembourg GAAP, hidden capital contributions are often treated as income in the accounting profit and loss account. An increase in the accounting

profit that is related to hidden capital contributions must, however, be deducted from the taxable basis.³

What is fundamental in understanding the dynamics of hidden capital contributions for Luxembourg tax purposes is the disconnection between the company, which is itself subject to tax,⁴ and its shareholder(s) (*Trennungsprinzip*). Thus, a clear distinction is made between the shareholding relationship and the company's business activities.⁵ Only income linked to the company's business activities should, however, be subject to Luxembourg corporate income tax and municipal business tax. Consequently, the Luxembourg tax treatment of regular contributions and that of hidden capital contributions should be the same.

2. Characteristics of Hidden Capital Contributions

2.1. Key issues

The concept of hidden capital contributions has been extensively shaped and modelled by decisions of both the German Reich Tax Court and the German Federal Tax Court. In accordance with case law, hidden capital contributions have the following characteristics:

- a shareholder or a related party of the shareholder;
- grants, motivated by the shareholding relationship;
- an advantage to a company that may be reflected in the balance sheet, i.e. either an increase in assets or a decrease in liabilities (insofar as the shareholder does not receive an arm's length compensation); and

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1. RFH, Decision of 28 July 1936, I A 83/36, RStBl 1936, p. 951; BFH, Decision of 28 February 1956, I 92/54 U, BStBl III 1956, p. 154; BFH, Decision of 19 February 1970, I R 24/67, BStBl II 1970, p. 442; BFH, Decision of 14 August 1974, I R 168/72, BStBl II 1975, p. 123; BFH, Decision of 26 November 1980, I R 52/77, BStBl II 1981, p. 181; BFH, Decision of 9 March 1983, I R 182/78, BStBl II 1983, p. 744; BFH, Decision of 11 April 1984, I R 175/79, BStBl II 1984, p. 535; BFH, Decision of 14 November 1984, I R 50/80, BStBl II 1985, p. 227; BFH, Decision of 24 March 1987, I R 202/83, BStBl II 1987, p. 705; BFH, Decision of 21 September 1989, IV R 115/88, BStBl II 1990, p. 86; and BFH, Decision of 26 October 1987, GrS 2/86, BStBl II 1988, p. 348.

2. RFH, Decision of 15 July 1925, I A 024/25, 17, p. 109.

3. Art. 18(1) LITL; BFH, Decision of 3 February 1971, I R 51/66, BStBl II 1971, p. 408; BFH, Decision of 14 August 1974, I R 168/72, BStBl II 1975, p. 123; BFH, Decision of 9 March 1983, I R 182/78, BStBl II 1983, p. 744; and BFH, Decision of 9 June 1997, GrS 1/94, BStBl II 1998, p. 307.

4. Art. 159 LITL.

5. BFH, Decision of 24 March 1987, I R 202/83, BStBl II 1987, p. 705 and BFH, Decision of 20 September 1989, BStBl II 1990, p. 368.

- the contribution is not a regular contribution (pursuant to Luxembourg commercial law).⁶

Luxembourg is, of course, under no obligation to apply the concept of hidden capital contributions in all its details as defined by German case law. Most aspects, as defined in the following text are, however, widely accepted in Luxembourg tax literature and should apply as they are consistent with the spirit of the Luxembourg Income Tax Law (LITL), which is based on German income tax law.⁷

2.2. The object of hidden capital contributions

2.2.1. Overview

In principle, contributions increase the net equity reflected in the receiving company's balance sheet. The objective of a hidden capital contribution must, therefore, directly relate to balance sheet items, i.e. 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.⁸

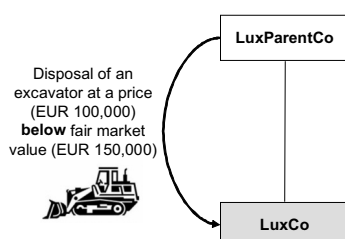
It must be emphasized that, in contrast to hidden capital contributions, any contribution, including services granted without valuable consideration, by the company to its shareholder(s) is reclassified as a hidden dividend distribution. Consequently, the scope of hidden capital contributions and that of hidden dividend distributions are not the same, though both concepts share the same objective, i.e. the separation of the realm of the company from that of its shareholders.⁹ The most relevant objects of hidden capital contributions are considered in 2.2.2. to 2.2.4.

2.2.2. Assets

With regard to hidden capital contributions of assets, either tangible or intangible, the shareholder often disposes of the assets to the company in exchange for no consideration or consideration *below* fair market value. In this scenario, the hidden capital contribution amounts to the difference between the fair market value and the sales price of the assets transferred.¹⁰ This may include a transfer of cash by the shareholder to the company with no return; i.e. not in exchange for shares in the company.

Example 1: Disposal of assets to the company

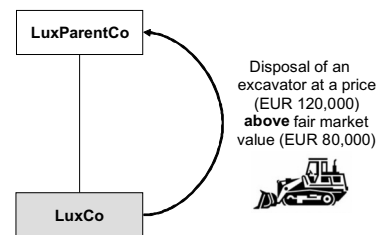
LuxParentCo disposes of an excavator worth EUR 150,000 for EUR 100,000. The difference between the fair market value and the sales price (EUR 50,000) is an advantage that is classified as a hidden capital contribution.



Equally, the company may sell assets to the shareholder at a sales price *above* fair market value. In this case, the advantage granted by the shareholder to the company that qualifies as a hidden capital contribution amounts to the difference between the sales price and the fair market value.

Example 2: Disposal of assets to the shareholder

LuxCo disposes of an excavator worth EUR 80,000 for EUR 120,000. The difference between the sales price and the fair market value (EUR 40,000) is an advantage that qualifies as a hidden capital contribution.

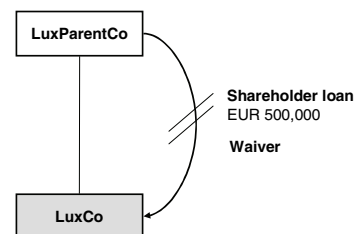


2.2.3. Liabilities

Hidden capital contributions may also be in the form of a reduction in the company's liabilities, for example, a waiver of receivables that a shareholder holds in respect of the company.¹¹ A waiver of shareholder receivables increases the company's net equity by way of a reduction in liabilities and an increase in the accounting profit. Provided that the waiver is motivated by the shareholder relationship and the receivable is of value, a hidden capital contribution may be considered, thereby resulting in a reduction of the company's taxable income.¹²

Example 3: Waiver of a shareholder receivable

LuxParentCo waives an interest-bearing shareholder loan of EUR 500,000 previously granted to LuxCo. The waiver and accrued interest should qualify as hidden capital contributions.



6. Guy Heintz, *Etudes fiscales - L'impôt sur le revenu des collectivités* (Luxembourg: Editions Saint Paul, 1999), p. 68; Jean-Pierre Winandy, *Les impôts sur le revenu et sur la fortune* (Luxembourg: Editions Promoculture, 2002), p. 831; and Charles Duro and René Faltz, "Transfer pricing in the absence of comparable market prices", Luxembourg country report, *Cahiers de droit fiscal international*, Vol. 82a (The Hague: Kluwer, 1992), p. 507.

7. Heintz, note 6, p. 30 and Jean Olinger, *Etudes fiscales - Le droit fiscal* (Luxembourg: Editions Saint Paul, 1994), p. 20.

8. Winandy, note 6, p. 831 and BFH, Decision of 26 October 1987, GrS /86, BStBl II 1988, p. 348.

9. Id. and BFH, Decision of 3 February 1971, I R 51/66, BStBl II 1971, p. 408.

10. BFH, Decision of 26 July 1967, I R 138/65, BStBl III 1967, p. 733 and BFH, Decision of 12 February 1980, VIII R 114/77, BStBl II 1980, p. 495.

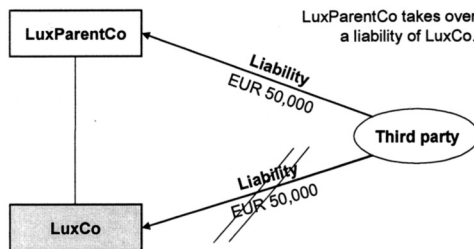
11. RFH, Decision of 28 July 1936, I A 83/36, RFHE 39, 303; RFH 22.6.1943, I 204/42, RStBl 1943, p. 587 and BFH, Decision of 29 May 1968, I 187/65, BFHE 93, 62, BStBl II 1968, p. 722.

12. BFH, Decision of 29 May 1968, I 187/65, BStBl II 1968, p. 722 and BFH, Decision of 9 June 1997, GrS 1/94, BStBl II 1998, p. 307.

Another prime example of a hidden capital contribution is the assumption of a company's liabilities by the shareholder, provided that the latter does not reclaim the amounts.¹³

Example 4: Assumption of company debt

LuxParentCo assumes a EUR 50,000 liability of LuxCo and subsequently waives its right to a refund by LuxCo. As LuxCo's liabilities will decrease, the assumption of debt qualifies as a hidden capital contribution.



It must be emphasized that the mere subordination¹⁴ of a shareholder loan to other liabilities of the company, or the granting of shareholder guarantees¹⁵ relating to company liabilities, cannot be classified as hidden capital contributions. In this scenario, the company's liabilities remain in its balance sheet and its net equity is unchanged.

2.2.4. Services granted without valuable consideration

It is not uncommon for shareholders to grant services to a company for partial or no consideration (*Nutzungseinlagen*). Typical examples include interest-free loans and rent-free lettings of real estate.

Such advantages do not qualify as assets and, in line with Luxembourg GAAP, may not be reflected in the company's balance sheet. Consequently, only assets, and not their use, may be contributed to the company. This remains the situation irrespective of the increase in the company's profit resulting from the difference between the arm's length price and that agreed to between the parties.¹⁶

In addition to the free use of assets, the shareholder may provide advisory or administrative services for partial or no consideration. Again, these advantages cannot be classified as hidden capital contributions.¹⁷

It should also be emphasized that costs incurred by the shareholder in connection with free services (interest expenses, etc.) cannot be classified as hidden capital contributions. At the level of the shareholder, these are construed as in (direct) economic relation to the income deriving from the participation.

A clear distinction must be made between the waiver of receivables in connection with previous services, for example, accrued interest, and advantages relating to services granted for the future. In the first scenario, the company records liabilities for the (unpaid) services in its accounts. The waiver increases the company's net equity and, therefore, is regularly classified as a hidden capital contribution.¹⁸

Liabilities are not recorded in the second scenario, as no expenses accrue if services are provided without valuable consideration. Such free services cannot, therefore, be classified as hidden capital contributions.¹⁹

2.3. Motivated by the shareholding relationship

2.3.1. Opening comments

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

2.3.2. Existence of a shareholding relationship

Once the existence of a relationship between the granting individual or entity, i.e. the shareholder, and the receiving company is evidenced, it is imperative to assess the moment of the conclusion of the agreement for the eventual classification of the advantage as a hidden capital contribution. Advantages granted by a future shareholder may, however, not fall within the scope of hidden capital contributions.²⁰

2.3.3. Causation and the shareholding relationship

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*). In essence, if an unrelated party would not have granted the same advantage, it is considered to be motivated less by business reasons than by the shareholding relationship.²¹

13. BFH, Decision of 12 December 2000, VIII R 36/97 (NV).

14. BFH, Decision of 30 March 1993, BStBl II 1993, p. 502.

15. BFH, Decision of 2 October 1984, VIII R 36/83, BStBl II 1985, p. 320; BFH, Decision of 16 April 1991, VIII R 100/87, BStBl II 1992, p. 234; BFH, Decision of 9 June 1997, GrS 1/94, BFHE 183, 187, BStBl II 1998, p. 307; and BFH, Decision of 12 December 2000, VIII R 36/97 (NV).

16. Heintz, note 6, p. 69; see Winandy, note 6, p. 831; Jean Schaffner, *Droit fiscal international* (Luxembourg: Editions Promoculture, 2005), p. 175; BFH, Decision of 9 March 1962, I 203/61 S, BStBl III 1962, p. 338; BFH, Decision of 16 May 1963, IV 379/60 U, BStBl III 1963, p. 400; BFH, Decision of 3 February 1971, I R 51/66, BStBl II 1971, p. 408; BFH, Decision of 29 January 1975, I R 135/70, BStBl II 1975, p. 553; BFH, Decision of 22 November 1983, VIII R 133/82, GmbHR 1984, p. 110; BFH, Decision of 24 May 1984, I R 166/78, BStBl II 1984, p. 747; BFH, Decision of 26 October 1987, GrS 2/86, BStBl II 1988, p. 348; and BFH, Decision of 14 March 1989, I R 8/85, BStBl II 1989, p. 633.

17. Winandy, note 6, p. 832 and BFH, Decision of 14 March 1989, I R 8/85, BStBl 1989 II, S. 633.

18. BFH, Decision of 22 November 1984, VIII R 133/82, BFHE 140, 69, BB 1984, p. 513 and BFH, Decision of 24 May 1984, I R 166/78, BStBl II 1984, p. 747.

19. Heintz, note 6, p. 69; BFH, Decision of 22 November 1983; VIII R 133/82, GmbHR 1984, p. 110; BFH, Decision of 24 May 1984, I R 166/78, BStBl 1984, p. 747; and BFH, Decision of 26 October 1987, GrS 2/86, BStBl II 1988, p. 348.

20. BFH, Decision of 28 February 1956, BStBl III 1956, p. 154 and BFH, Decision of 14 November 1984, I R 50/80, BStBl. 1985 II, p. 227.

21. RFH, Decision of 27 March 1928, I A 470, StuW 1928, No. 417; RFH, Decision of 28 July 1936, I A 83/36, I A 83/36, RFHE 39, 303; RFH, Decision of 8 June 1937, I A 378/36, RFHE 41, 274; RFH, Decision of 22 June 1943, I 204/42, RStBl 1943, p. 587; BFH, Decision of 29 May 1968, I 187/65, BStBl III 1968, p. 722; BFH, Decision of 19 February 1970, I R 24/67, BStBl II 1970, p. 442; BFH, Decision of 14 November 1984, I R 50/80, BStBl II 1985, p. 227; and BFH, Decision of 21 September 1989, IV R 115/88, BStBl II 1990, p. 86.

The moment of the conclusion of the agreement, rather than the time the agreement is executed, is critical to the arm's length analysis.²² Whether the hidden capital contribution is intentional is irrelevant. Hidden capital contributions are solely demonstrated by reference to the arm's length principle.²³

If, however, for instance, a shareholder and other unrelated creditors simultaneously waive (even a fraction of) their receivables so as to save the company from insolvency, the shareholder waiver may not necessarily be "motivated by the shareholding relationship". In this event, the advantage would not be classified as a hidden capital contribution.

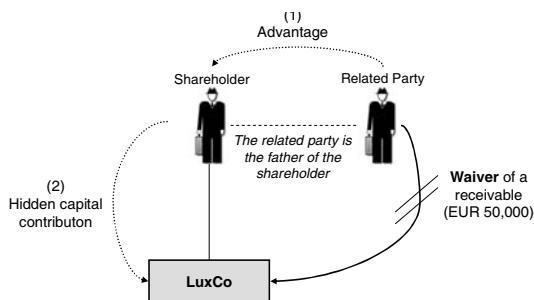
2.3.4. Related party of the shareholder

The scope of hidden capital contributions does not explicitly exclude advantages intentionally granted by a related party of the shareholder to the company.²⁴ The relationship between the shareholder and a related party can be of any nature (family, corporate, contractual, etc.). A common interest does not, however, suffice.

An analysis on a case-by-case basis must be made if the related party grants an advantage motivated by its relationship with the shareholder or for business reasons. A related party of the shareholder may, for example, waive a receivable owing by the company as a way of granting an advantage to the shareholder. Such an indirect contribution results in an increase in the company's net equity, relating to an advantage granted by the related party to the shareholder that is subsequently contributed by the shareholder to the company. As the second transfer is made in connection with the shareholding relationship, it should be considered to be a hidden capital contribution.²⁵

Example 5: Indirect (hidden capital) contribution

The shareholder's father waives a EUR 50,000 receivable owing by LuxCo. For Luxembourg tax purposes, assuming that the related party intended to grant an advantage to the shareholder, it is considered that an advantage is shifted from the related party to the shareholder and subsequently contributed to LuxCo.

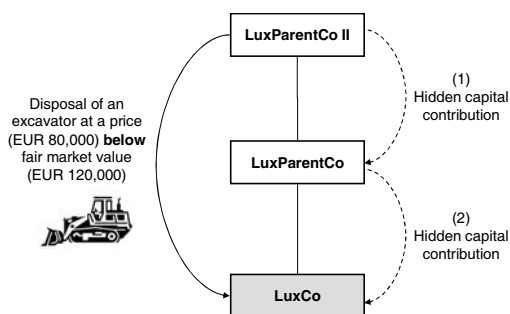


Related party transactions may, in particular, involve company groups shifting advantages through the chain or between sister companies. Whilst unrelated parties should have no interest in shifting advantages to each other, related parties may, in the absence of diverging interests, intentionally circumvent the arm's length principle so as to reduce the tax burden. As the concept of

hidden capital contributions is intended to preserve arm's length conditions in intra-group transactions (at least, for tax purposes, i.e. a "separate entity approach"), it has become a cornerstone of Luxembourg transfer pricing rules.

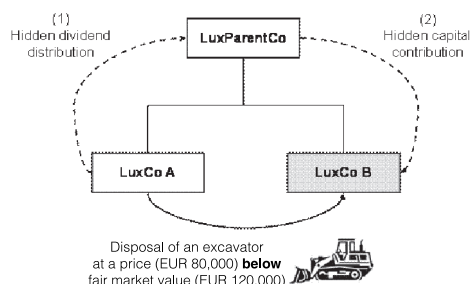
Example 6: Chain transaction

LuxParentCo II disposes of an excavator worth EUR 120,000 for EUR 80,000 to its indirect subsidiary LuxCo. Here, the advantage shifted down the chain qualifies as a hidden capital contribution via LuxParentCo. Accordingly, LuxParentCo II provides a hidden capital contribution to LuxParentCo (EUR 40,000), which itself provides a hidden capital contribution to LuxCo.²⁶



Example 7: Advantages shifted between sister companies

LuxCo A disposes of an excavator worth EUR 120,000 for EUR 80,000 to its sister company LuxCo B. Though LuxCo A grants the advantage to LuxCo B directly, the economic reason is to be found in the companies' common shareholding relationship with LuxParentCo. It is, therefore, considered that, for Luxembourg tax purposes, LuxCo A provides a hidden dividend distribution to LuxParentCo, which itself provides a hidden capital contribution to LuxCo B.²⁷



2.4. Absence of compensation for shareholders

In order for an advantage by a shareholder to be a hidden capital contribution, it must be granted without valuable consideration. In particular, no shares should be issued

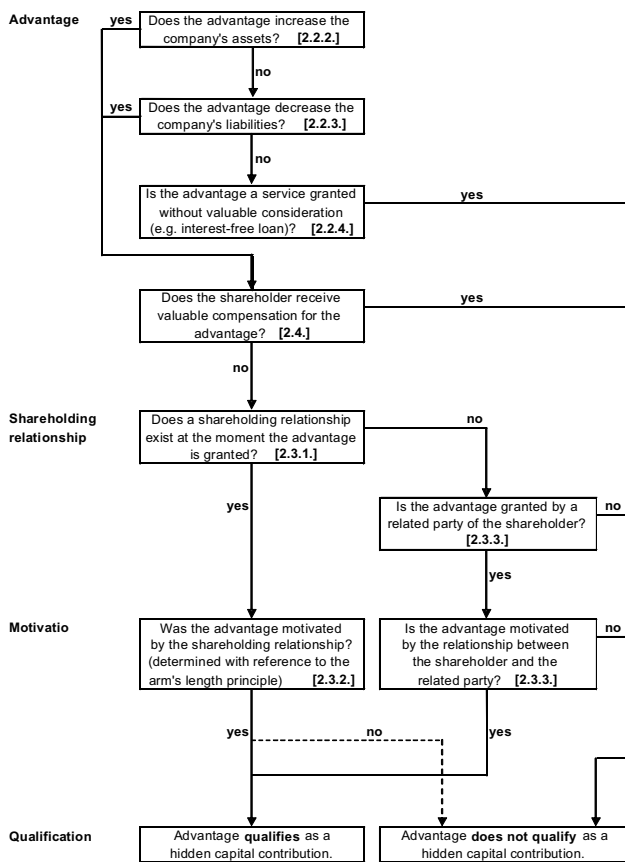
22. BFH, Decision of 15 July 1997, I R 80/96, BFH/NV 1998, p. 624.
 23. BFH, Decision of 14 August 1974, I R 168/72, BStBl II 1975, p. 123 and BFH, Decision of 8 May 1991, BFH/NV 1992, p. 414.
 24. RFH, Decision of 28 July 1936, RStG 1936, p. 951; RFH, Decision of 8 June 1937, I A 378/36, RFHE 41, 274; and BFH, Decision of 8 May 1991, I B 30/90, BFH/NV 1992, p. 414.
 25. BFH, Decision of 9 June 1997, GrS 1/94, BStBl 1998 II, S. 307 and BFH, Decision of 12 December 2000, VIII R 22/92, BStBl II 2001, p. 385.
 26. BFH, Decision of 29 January 1975, I R 135/70, BStBl II 1975, p. 553; BFH, Decision of 23 October 1985, I R 247/81, BStBl II 1986, p. 195; and BFH, Decision of 9 September 1986, VIII R 159/85, BStBl II 1987, p. 257.
 27. Heintz, note 6, p. 69 and BFH, Decision of 22 October 1986, I R 107/82, BStBl II 1987, p. 293.

to the shareholder.²⁸ Such a hidden capital contribution is limited to the fair market value of the advantage shifted by the shareholder to the company. What is significant is that the increase in the fair market value of the participation in the company cannot be classified as consideration for the advantage granted; rather, a mere reaction to the hidden capital contribution.²⁹

2.5. Checklist of characteristics of hidden capital contributions

The following checklist may be used to identify hidden capital contributions under Luxembourg law.

Table: Checklist



3. Luxembourg Tax Treatment of Hidden Capital Contributions

3.1. Introductory remarks

The primary purpose of the hidden capital contribution concept is the separation of the company, itself subject to tax,³⁰ from its shareholders. Consequently, a clear analysis of the tax treatment of both the company and its shareholder(s) is vital in understanding the dynamics of this separation.

3.2. Tax treatment of the company

3.2.1. Valuation of hidden capital contributions

Regular contributions in exchange for shares or to the share premium of a Luxembourg company must be val-

ued at their fair market value.³¹ The timing of the contribution, i.e. when the net equity of the company increases, is vital to this valuation. These principles also apply to hidden capital contributions.

A few exceptions from the general rule may apply in respect of individual shareholders who hold a participation in their private property (*Privatvermögen*) and who dispose of specific assets to the company at a price below fair market value.³² Only “realized” capital gains should be taxed as private property. In these cases, latent capital gains may be (partially) transferred to the company.

3.2.2. Correction of hidden capital contributions

3.2.2.1. Opening comments

Hidden capital contributions are not a component of the taxable income of the company. Tax adjustments may, therefore, be required on the execution of these transactions and in the following fiscal years.

3.2.2.2. Tax adjustments when making hidden capital contributions

In practice, transactions classified as hidden capital contributions must first be analysed from a Luxembourg accounting perspective. As hidden capital contributions are advantages in the form of agreements concluded with the shareholder, they are, for accounting purposes, generally reflected as income. Considering the variety of potential transactions, the Luxembourg accounting treatment may vary from case to case and provide for different alternatives.

In particular, the accounting treatment may differ if assets are transferred by the shareholder(s) to the company (partly) without valuable consideration. In general, the sales price should be considered for Luxembourg accounting purposes, but the fair market value should be recorded in a diverging tax balance sheet (the taxable income of the company would remain unaffected). Such assets may, however, and under certain conditions, be recorded at fair market value, whilst also increasing the company’s profit or reserves. In the latter case (i.e. an increase in the reserves), the accounting profit would not increase and, therefore, no tax adjustment would be necessary.

28. BFH, Decision of 27 July 1988, I R 147/83, BStBl II 1989, p. 271 and BFH, Decision of 25 October 1995, I R 104/94, BB 1996, p. 841.

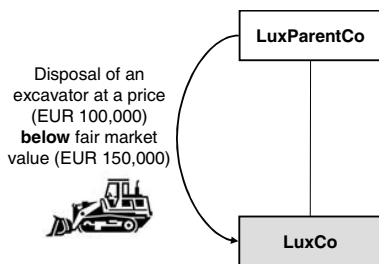
29. BFH, Decision of 24 March 1987, I R 202/83, BStBl II 1987, p. 705; BFH, Decision of 27 July 1988, I R 147/83, BStBl II 1989, p. 271; BFH, Decision of 1 August 1990, II R 17/87, BStBl II 1990, p. 879; BFH, Decision of 18 December 1990, VIII R 17/85, BStBl II 1991, p. 512; and BFH, Decision of 23 February 2005, I R 44/04, DStRE 2005, p. 706.

30. Art. 159 LITL.

31. Art. 27(1) of the LITL in connection with Art. 162(1) and Art. 43(1) of the LITL.

32. Art. 43(2) of the LITL in connection with Art. 100(2), Art. 99ter or Art. 99bis of the LITL.

Example 8: Disposal of assets to a company (see Example 1)



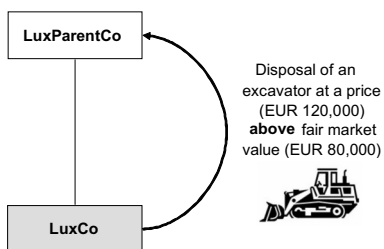
Alternative 1: if LuxCo recorded the excavator for accounting purposes at its sales price (EUR 100,000), its fair market value (EUR 150,000) would, nonetheless, have to be recognized for Luxembourg tax purposes in a diverging tax balance sheet. The increase in the acquisition cost of the excavator would not increase LuxCo's taxable income. The higher acquisition cost is relevant for the calculation of depreciation and capital gains for Luxembourg tax purposes.

Alternative 2: if LuxCo recorded the excavator for accounting purposes at its fair market value (EUR 150,000) and treated the EUR 50,000 difference as income, the taxable income would have to be reduced by the hidden capital contribution.

Notwithstanding the accounting treatment, income linked to a hidden capital contribution must be deducted from the taxable income, as it is connected with the shareholding relationship and not with the business activity of the company.³³ It should be noted that contributions are not tax exempt, but, rather, are excluded from the taxable basis, as they do not form part of taxable income.³⁴

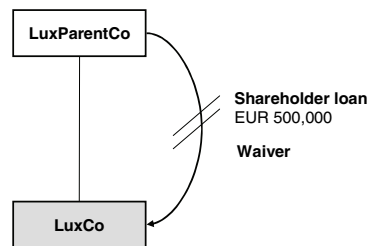
The broad understanding of contributions, including hidden capital contributions, from a Luxembourg tax perspective, does not affect the legal independence of the company, which may freely conclude agreements with its shareholders. Increases in profit and net equity are unchanged in the balance sheet and the profit and loss account, respectively. Only a reduction of income in connection with hidden capital contributions is recorded in the corporate tax returns.³⁵ Consequently, the Luxembourg tax treatment of regular and hidden contributions is identical.

Example 9: Disposal of assets to a shareholder (see Example 2)



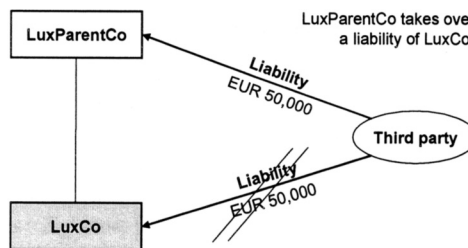
Assuming that the book value of the excavator corresponds to its fair market value, LuxCo realizes capital gains amounting to EUR 40,000, which must be deducted from LuxCo's taxable income.

Example 10: Waiver of a shareholder receivable (see Example 3)



The waiver of the shareholder loan reduces the company's liabilities and should be treated as income from an accounting perspective. Assuming that the waiver qualifies as a hidden capital contribution, income corresponding to the waiver amount must be deducted from LuxCo's taxable income in its corporate tax returns.

Example 11: Takeover of company debt (see Example 4)



Similar to a waiver of shareholder loans, the takeover of LuxCo's debt (simultaneous with LuxParentCo's waiver of its right to repayment) reduces the company's liabilities and should be treated as income from an accounting perspective. Income in connection with a hidden capital contribution must be deducted from LuxCo's taxable income.

3.2.2.3. Tax adjustments following a hidden capital contribution

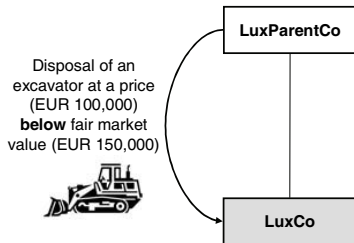
In addition to tax adjustments at the time of the hidden capital contribution, further tax adjustments may be necessary in the future as a result of the different accounting and tax treatments at the time of the contribution. Two important examples arise with regard to such subsequent tax adjustments and both are linked to the disposal of assets by the shareholder to the company for partial or no consideration, provided that, for accounting purposes, the sales price is recognized (in contrast to the fair market value, for tax purposes).

First, the depreciation of these assets for Luxembourg tax purposes is based on their fair market value as recorded in the company's tax balance sheet. In this instance, the principle that the tax treatment follows the accounting treatment³⁶ does not apply and, therefore, tax depreciation will generally differ from accounting depreciation.

33. BFH, Decision of 14 August 1974, I R 168/72, BStBl II 1975, p. 123.
 34. BFH, Decision of 21 December 1977, I R 20/76, BStBl II 1978, p. 346.
 35. BFH, Decision of 19 July 1994, VIII R 58/92, BStBl II 1995, p. 362; BFH, Decision of 29 May 1996, I R 118/93, BStBl II 1997, p. 92; and BFH, Decision of 9 June 1997, GrS 1/94, BStBl II 1998, p. 307.
 36. Art. 40(1) LITL, Maßgeblichkeitsprinzip.

Second, future capital gains are, for Luxembourg tax purposes, computed on the basis of their book values recorded in the company's tax balance sheet. As the tax book value is higher than the accounting book value, capital gains realized for tax purposes should be less.

Example 12: Tax adjustments following a hidden capital contribution (see Example 8)



In Alternative 1, LuxCo records the excavator for accounting purposes at its sales price (EUR 100,000), whereas, in its tax balance sheet, the fair market value (EUR 150,000) was considered.

From a Luxembourg tax perspective, the (higher) tax acquisition costs form the basis for future depreciation. The accounting depreciation should be increased accordingly. If LuxCo disposes of its excavator, taxable capital gains would be determined on the basis of the tax acquisition cost.

3.2.3. Municipal business tax treatment

Under Sec. 2(2) of the Municipal Business Tax Law (MBTL), Luxembourg resident companies are deemed to be commercial enterprises and, therefore, subject to municipal business tax (*Gewerbebetrieb kraft Rechtsform*). The taxable basis for municipal business tax is the commercial income,³⁷ i.e. the taxable income under the LITL as modified by specific tax adjustments set out in Secs. 8 and 9 of the MBTL.³⁸

Accordingly, the provisions of the LITL have a direct effect on the taxable basis for municipal business tax purposes and the concept of hidden capital contribution is no exception to the rule. Consequently, income relating to hidden capital contributions is not subject to municipal business tax.

3.3. Tax treatment of shareholders

3.3.1. Opening comments

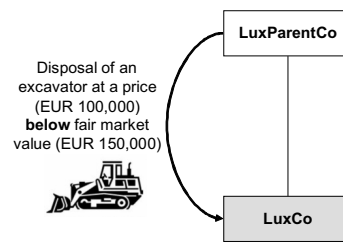
With regard to the tax treatment of shareholders, a clear distinction must be made between shareholders that hold the participation as business property (*Betriebsvermögen*) and those that hold the participation as private property (*Privatvermögen*).

3.3.2. Participation held as business property

In general, hidden capital contributions are valued at their fair market value³⁹ and increase the acquisition cost of the participation in the company in a diverging shareholder's tax balance sheet; the shareholder's taxable income is increased accordingly. Though hidden capital contributions must be valued separately, at the level of both the company and the shareholder, their valuation should, in principle, be the same.

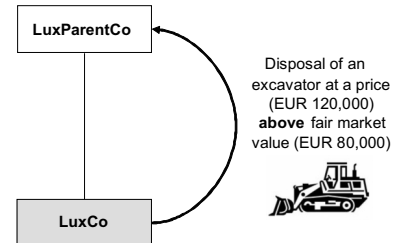
It should be noted that hidden capital contributions are often recorded as expenses for accounting purposes, but never for tax purposes.⁴⁰ Accordingly, the adjustment of the taxable income linked to the increase in the acquisition cost of the participation should solely neutralize the accounting expenses relating to hidden capital contributions, for example, expenses in connection with the waiver of a shareholder loan. Only where the shareholder disposes of assets for partial or no consideration to the company, will latent capital gains (*stille Reserven*) be realized and hidden capital contributions effectively increase the shareholder's taxable income.⁴¹

Example 13: Disposal of assets to a company (see Examples 8 and 12)



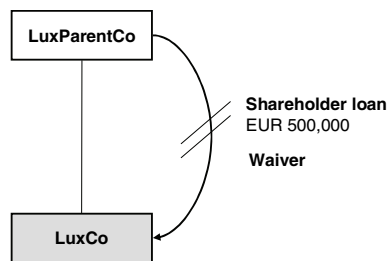
Assuming that the excavator's sales price corresponds to its accounting book value (EUR 100,000), LuxParentCo realizes latent capital gains of EUR 50,000. Technically, the taxable income is adjusted via an increase in the participation's acquisition costs in LuxParentCo's tax balance sheet.

Example 14: Disposal of assets to a shareholder (see Example 9)

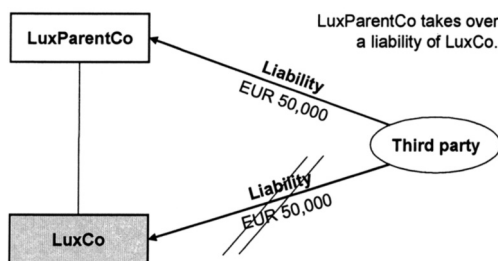


As the excavator's fair market value (EUR 80,000) is less than its sales price (EUR 120,000), LuxParentCo may, for accounting purposes, record extraordinary depreciation upon acquisition or at financial year-end. Such depreciation reduces the accounting profit accordingly. This transaction is, however, classified as a hidden capital contribution. Accordingly, LuxParentCo must increase the acquisition cost of its participation in LuxCo in its tax balance sheet. Whilst the accounting profit should be reduced by EUR 40,000, additional income recognized for tax purposes should offset the expenses.

37. Sec. 6(1) MBTL, *Gewerbeertrag*.
 38. Sec. 7 MBTL, "Gewerbeertrag ist der Gewinn aus dem Gewerbebetrieb, der nach den Vorschriften des Einkommensteuergesetzes oder des Körperschaftsteuergesetzes zu ermitteln ist, vermehrt und vermindert um die in den §§ 8 und 9 bezeichneten Beträge".
 39. Art. 27(1) LITL.
 40. BFH, Decision of 9 June 1997, GrS 1/94, BStBl II 1998, p. 307.
 41. Art. 22(5) LITL and BFH Decision of 26 July 1967, I R 138/65, BStBl III 1967, p. 733.

Example 15: Waiver of a shareholder receivable (see Example 10)

LuxParentCo generally realizes extraordinary expenses upon the waiver of its shareholder loan, thereby reducing its accounting profit. Such expenses are, however, neutralized by the additional income (EUR 500,000) relating to the increase in the acquisition cost of its participation in LuxCo.

Example 16: Takeover of company debt (see Example 11)

For accounting purposes, LuxParentCo increases both its liabilities and expenses by EUR 50,000. The expenses are, however, neutralized by the additional income considered for Luxembourg tax purposes when increasing the acquisition cost of its participation in LuxCo.

3.3.3. A participation held as private property

Hidden capital contributions made by an individual holding a participation as private property (*Privatvermögen*) are valued at their fair market value⁴² and increase the participation's acquisition cost. Though hidden capital contributions must be valued separately at the level of the company and the shareholder, the valuation of the hidden capital contribution should, in principle, be the same.

It should be noted that hidden capital contributions are not treated as deductible expenses within the meaning of Art. 105(1) of the LITL; rather, they should increase the acquisition cost of the participation.⁴³

If the shareholder disposes of assets for partial or no consideration, latent capital gains (*stille Reserven*) are generally tax exempt at the level of the shareholder,

whilst the receiving company recognizes the asset's fair market value.⁴⁴

In certain circumstances, however, where the private individual would exceptionally be taxable on realized capital gains, assets may have to be recorded by the company at a value below their fair market value.⁴⁵ Nevertheless, according to Luxembourg tax principles, only "realized" capital gains should be taxed as private property (*Privatvermögen*).⁴⁶ In these circumstances, latent capital gains may (partly) be transferred to the company.

3.4. Cross-border scenarios

Whilst the concept of hidden capital contribution applies in purely domestic transactions, it may also apply if non-Luxembourg resident parties are involved, i.e. in cross-border transactions. In these situations, the Luxembourg tax treatment of the Luxembourg parties involved does not differ from the general tax consequences analysed in sections 3.2. and 3.3. The tax consequences arising in Luxembourg, either at the level of a Luxembourg resident shareholder or a Luxembourg resident company, do not depend on the foreign tax treatment of the other parties involved.

4. Conclusions

The possibilities for shareholders to transfer advantages to a company are virtually limitless and the Luxembourg tax consequences extend beyond those of regular contributions. The fact that the Luxembourg tax treatment of hidden capital contributions mirrors that of regular contributions is critical to a sound understanding of the concept. Further, the concept of hidden capital contribution as a means of preserving arm's length conditions is undisputed. The importance of this is reflected in its pre-eminence as a cornerstone of Luxembourg's transfer pricing rules.

42. Art. 27(2) LITL.

43. RFH, Decision of 14 March 1928, VI A 214/28, RStBl 1928, p. 183.

44. BFH, Decision of 26 October 1987, GrS 2/86, BStBl II 1988, p. 348. See Paul Lauterbour, *Régime d'imposition des plus-values générales par la réalisation des biens du patrimoine privé* (Luxembourg: Etudes fiscales, 1999), p. 103.

45. Art. 43(2) of the LITL in connection with Art. 100 (2), Art. 99ter or Art. 99bis of the LITL.

46. Lauterbour, note 44, Winandy, note 6, p. 582; and Parliamentary document No. 2078, p. 14.