

REDEMPTION OF "ALPHABET" CLASSES OF SHARES – GUIDANCE ON THE LUXEMBOURG TAX TREATMENT FROM THE ADMINISTRATIVE TRIBUNAL

On 27 January 2023, the Administrative Tribunal of Luxembourg ruled in case n°42432 on the Luxembourg tax treatment of the redemption and cancellation of an entire class of shares. Whilst the Administrative Tribunal confirmed that the proceeds derived by the shareholder from the redemption of a class of shares qualify as capital gains, it also held that the repurchase could nevertheless be recharacterised as a hidden dividend distribution, subject to Luxembourg withholding tax, for the amount exceeding the fair market value of the shares redeemed if this amount cannot be supported by valid economic reasons.

FACTS

The case at hand concerned a Luxembourg limited liability company (*société à responsabilité limitée* – "**LuxCo**") which had one sole shareholder located in the Cayman Islands (the "**Shareholder**") and whose share capital had been divided into one class of ordinary shares and ten classes of "alphabet" shares (from A to J – the "**Alphabet Shares**"), each class of Alphabet Shares representing circa. 5% of the share capital of LuxCo.

The Alphabet Shares had been put in place after the incorporation of LuxCo and had all the same economic features. The Alphabet Shares could be redeemed in reverse alphabetical order (i.e., starting from J to A).

In 2014, the class J Alphabet Shares was redeemed, cancelled and subsequently followed by a share capital reduction for an amount corresponding to the nominal value of the class J Alphabet Shares.

LuxCo treated the redemption followed by the cancellation of the class J Alphabet Shares as a partial liquidation (i.e., this should be viewed as the allocation of the proceeds derived from the redemption of a participation, rather than a distribution of profits), therefore not subject to withholding tax in Luxembourg.

The Luxembourg tax authorities considered that such redemption could not be viewed as a partial liquidation, notably due to (i) the absence of different economic rights between the various Alphabet Shares, (ii) the timing of their

Key issues

- Redemption of classes of "alphabet" shares qualifies as capital gains up to the amount corresponding to the fair market value of the shares redeemed
- Recharacterisation into hidden dividend distribution for the portion exceeding the fair market value, subject to Luxembourg withholding tax
- Valuation of a class of shares referred to the Luxembourg tax authorities
- Status of "alphabet" shares compared to tracking shares

implementation (i.e., after the incorporation of LuxCo), and (iii) the fact that they were entirely held by one sole shareholder. Therefore, the Luxembourg tax authorities denied the qualification of the transaction as a withholding tax-free partial liquidation but considered that it should be viewed as a distribution of dividend, subject to a 15% withholding tax.

After considering the various arguments laid down by the parties, the Administrative Tribunal concluded that the Luxembourg tax authorities have validly characterised the redemption of the class J Alphabet Shares as a hidden dividend distribution, to the extent that LuxCo could not provide any justification explaining the price of the shares redeemed. However, the Administrative Tribunal considered that such characterisation (and, therefore, the related withholding tax consequences) should not apply to the entire amount of the shares redeemed, but only to the portion of the price that exceeds the fair market value of the shares.

The Administrative Tribunal referred to the relevant tax office of the Luxembourg tax authorities to determine such valuation.

THE "ALPHABET" SHARES AT THE HEART OF THE CASE

In its decision, the Administrative Tribunal emphasised a few specific characteristics of the classes of shares that had been repurchased by the Shareholder. In that sense, the Administrative Tribunal notably underlined that (i) the Alphabet Shares had only been implemented after the incorporation of LuxCo, and (ii) the difference between the economic and legal rights attached to each class of Alphabet Shares were not sufficiently salient.

Regarding the economic difference of each class of Alphabet Shares in particular, the Administrative Tribunal stressed that the redemption price of the shares included all the dividend previously received by LuxCo and was almost equal to the entire cash that LuxCo held at the time, although the nominal value of the shares repurchased represented only circa. 5% of its share capital. Therefore, the judges rejected LuxCo's argument according to which the purchase price of the class of shares was justified by the reverse alphabetical order in which the classes of shares had to be repurchased according to the articles of association. Indeed, LuxCo argued that the last class (i.e., class J Alphabet Shares) had a preferential and priority right to collect all the available net asset of the company, including the distributable reserve at the time of the redemption, in such a way that the value of this last class for a potential investor would be higher than for later classes. It should be noted that the Administrative Tribunal does not seem to have followed this line of argument, or at least ignored it. This is something we can regret as this may have an impact on the valorisation of the shares that the Luxembourg tax authorities would have to perform.

Nevertheless, the elusive wording of the decision raises the question whether a different fact pattern would have led to a different outcome. For instance, it remains unclear whether a differentiation of the economic rights attached to each class of shares (e.g., via a degressive profit entitlement or a specific asset allocation per class) would have influenced the judges' decision. Moreover, the Administrative Tribunal's decision does not consider whether a class of shares could be viewed as an independent shareholding whose redemption would be considered as a partial liquidation (i.e., outside of the scope of the Luxembourg withholding tax provisions).

THE CRUCIAL VALUATION OF THE CLASSES OF SHARES

The decision reached by the Administrative Tribunal follows a prior ruling issued by the Administrative Court of Luxembourg on 23 November 2017 (case n°39193C) to the extent that it confirms the capital gain treatment of the redemption proceeds at the level of the recipient. Nevertheless, by ruling that a redemption of a class of shares is to be recharacterised as a hidden dividend distribution up to the amount that exceeds the fair market value of the shares redeemed (absent any valid economic reasons), the present case puts the spotlight on the question of valuation of the classes of shares and its methodology.

Accordingly, taxpayers will have to be able to substantiate the value of the shares redeemed (whether structured as different classes of shares or not) to mitigate the risk of successful recharacterization as a hidden dividend distribution. It is thus regretful that the judges did not provide any guidance on the methods to be applied to determine the value of a specific class of shares and merely deferred to the tax office in charge to determine the adequate value of the class repurchased by the Shareholder.

In contrast to the above, this case law seems to comfort the tax treatment of classes of shares whose value is closely related to the performance of a specific investment (i.e., tracking shares) - which was not the case at hand. Indeed, the repurchase of a class of tracking shares following a divestment should be more difficult to challenge on the grounds of this recent decision, given that the fair market value of the shares repurchased should by essence reflect the value of the investment tracked by these shares.

HOW CAN WE HELP?

The tax lawyers at Clifford Chance Luxembourg are at your disposal to further advise on the potential impact of this decision on your operations, in particular to review the robustness of the corporate documentation and identify any risk of challenge.

CONTACTS



Geoffrey Scardoni
Partner

T +352 48 50 50 410
E Geoffrey.Scardoni
@cliffordchance.com



Maxime Budzin
Counsel

T +352 48 50 50 456
E Maxime.Budzin
@cliffordchance.com



Josselin Badoc
Counsel

T +352 48 50 50 291
E Josselin.Badoc
@cliffordchance.com



Aude Tusamba
Senior Knowledge
Lawyer

T +352 48 50 50 411
E Aude.Tusamba
@cliffordchance.com



**Antoine-David
Freymann**
Senior Associate

T +352 48 50 50 420
E Antoine-
David.Freymann
@cliffordchance.com



Caroline Poiret
Senior Associate

T +352 48 50 50 429
E Caroline.Poiret
@cliffordchance.com



Kim Ngo
Senior Tax Adviser

T +352 48 50 50 423
E Kim.Ngo
@cliffordchance.com



Katharina Creutz
Senior Associate

T +352 48 50 50 214
E Katharina.Creutz
@cliffordchance.com



Simon Paran
Senior Associate

T +352 48 50 50 278
E Simon.Paran
@cliffordchance.com

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Clifford Chance, 10 boulevard G.D. Charlotte,
B.P. 1147, L-1011 Luxembourg, Grand-Duché
de Luxembourg

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Katharina Schwarzkopf
Associate

T +352 48 50 50 265
E Katharina.Schwarzkopf
@cliffordchance.com



Tom Bleser
Associate

T +352 48 50 50 451
E Tom.Bleser
@cliffordchance.com



Mathieu Moulin
Associate

T +352 48 50 50 350
E Mathieu.Moulin
@cliffordchance.com