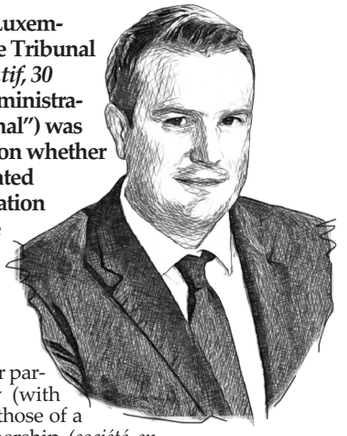
Tax controversy series

Administrative Tribunal - Judgment clarifying the treatment of debt financing foreign immovable assets for net wealth tax purposes



On 30 April 2025, the Luxembourg administrative Tribunal (*Tribunal administratif, 30 avril 2025, n° 47382*) (the "Administrative Tribunal" or the "Tribunal") was called upon to take position on whether an immovable property situated abroad, as well as debt in relation with its financing, should be taken into account for net wealth tax purposes.

Summary of the case

In the case at hand, the taxpayer partially owned at Polish entity (with legal characteristics similar to those of a Luxembourgish limited partnership (*société en commandite simple*).

The taxpayer argued for its treatment as a transparent entity from a Luxembourg direct tax perspective[1]. Relying on this premise, the taxpayer consolidated its assets and liabilities with those of the Polish entity to compute its unitary value. Notably included in this consolidation were:
- A real estate property located in Poland;
- Debt related to the financing of that real estate.

This approach and notably the net wealth tax position in relation with the above was contested by the Luxembourg tax authorities which notified the taxpayer in April 2017 of their intention to deviate from the 2013 tax return. Despite the taxpayer's submission of observations and explanations to the relevant tax office, the tax authorities upheld their decision to adjust the net wealth tax position (i.e., disregarding the asset and liability attributed to the Polish company).

In September 2017, an administrative claim (reclamation) was filed with the Director of the direct tax authorities (*Administration des Contributions Directes*). Furthermore, in early 2019, the tax office also challenged the taxpayer's tax return for 2014 on similar grounds, leading to the filing of a second administrative claim.

As the Director did not reply to either claim, the taxpayer ultimately referred the matter to the Administrative Tribunal.

Decision of the Tribunal

In the case at stake, the Administrative Tribunal affirmed the position taken by the Luxembourg tax authorities, ruling that the asset and liability attributed to the Polish entity should not be included in the calculation of the taxpayer's unitary value, based on both the *Bewertungsgesetz* ("**BewG**")[2] and the double tax treaty concluded between Luxembourg and Poland (the "**Luxembourg-Poland DTT**").

The judges start their reasoning by acknowledging what was not disputed between the parties, in particular the fact that the Polish entity owning the real estate property in Poland should be treated as transparent from a Luxembourg direct tax perspective so that the taxpayer should be treated as holding the real estate property directly, and the economic link between the property in Poland and the existing debt.

With respect to the real estate property

The judges then underscored that, in accordance with §7 of the Vermögensteuergesetz ("**VStG**")[3] the taxpayer, as a capital company resident in Luxembourg, should be subject to unlimited tax liability for the purposes of net wealth tax meaning that they should be subject to net wealth tax based on their worldwide operating wealth. Furthermore, the operating wealth should be assessed in accordance with §73 to §77 of the BewG.

The Tribunal further outlined that the assets of a resident company fall entirely under the category of operating wealth, including operating property. Economic assets that are exempt from net wealth tax under either the VStG or any other laws (such as double tax treaties) should however be excluded from the perimeter of the operating wealth, as articulated in §59 No 1 and §73 of the BewG.

In this context, the administrative judges noted that the Luxembourg-Poland DTT provides that:
- The capital represented by immovable property owned by a resident of a Contracting State and situated in the other Contracting State, may be taxed in that other State (article 23 of the Luxembourg-Poland DTT).
- Furthermore, when a Luxembourg taxpayer receives income or owns assets that are taxed in Poland (based on the mentioned DTT), these income/assets should, in order to prevent from the risk of double taxation, be exempt from corporate tax/wealth tax in Luxembourg (article 24 of the Luxembourg-Poland DTT).

The Administrative Tribunal therefore concludes that, the immovable property held by the taxpayer (through the transparent Poland entity) should be taxed in Poland (country where the property is located). The above should apply notwithstanding that the asset is held via a transparent entity as the Luxembourg-Poland DTT does not contain any specific provision in this respect. The Tribunal concludes that based on §59 No 1 and §73 of the BewG the asset under discussion should be excluded from the operating wealth of the taxpayer (as such excluded from the overall wealth of the taxpayer).

Based on the above, the argument of the taxpayer according to which the current Luxembourg valuation law constitutes an infringement of the taxpayer's freedom of establishment or the free movement of capital, as the property in Poland should be valued in accordance with the provisions applicable to property in Luxembourg (i.e. at its value on 1 January 1941) instead of the fair market value (used for properties located abroad under the BewG) for net wealth tax purposes, is therefore considered not relevant by the Tribunal, since the property in question should not be included in the taxable wealth of the taxpayer.

With respect to the loan financing the real estate

As mentioned above, in the case at stake, the economic link between the property in Poland and the existing debt is not contested.

The Tribunal acknowledges that the Luxembourg-Poland DTT does not explicitly exclude debts related to real estate located in Poland (solely taxable in that country) from taxpayer's operating wealth and as such, the judges agree that this cannot serve as a legal basis for excluding those debts from their operating wealth. However, the lack of exclusion for these items under the Luxembourg-Poland DTT does not automatically imply that the loan at issue should be included in the determination of the operating wealth of the taxpayer according to the Tribunal.

In that regard, the judges are of the view that the combination of §62 and §74 BewG provides that debts should not be deductible if they are economically related to assets that are not included in the operating wealth for the purposes of the net wealth tax computation. Having already concluded that the real estate property was to be exempt for net wealth tax purposes, the Tribunal logically ruled that, based on the BewG, the loan financing it should also be excluded (i.e., not deducted from the unitary value).

Finally, for completeness, the Tribunal clarified that since the loan had been contracted exclusively to finance the real estate in Poland, it should be excluded fully for the computation of the unitary value, irrespective of whether its amount exceeded the alleged value of the asset for net wealth tax purposes: *"(…) This is fundamentally different from the case in which the amount of a loan is, at the outset, in excess of the property it is intended to finance, regardless of the valuation of this property for wealth tax purposes, which may be different. Strictly speaking, there is no excess of the loan in question over the tax-exempt value of the property in Poland, since the "Negative Balance" is in fact the result of a lower valuation of the property in Poland than its market value, carried out by the plaintiff company on the basis of national provisions which are not, however, automatically applicable to property located abroad. According to the plaintiff's explanations, the loan at issue was taken out to fully finance the real estate located in Poland the full amount of the disputed loan, which is economically related to the property in Poland."*[4]

Takeaways

In recent months, the administrative judges have rendered several decisions with respect to the tax treatment of debt financing. These decisions underscore the uncertainties that taxpayers encounter in this area, which is frequently scrutinized by the Luxembourg tax authorities.

Adding to its complexity, the case under review involved a transparent (partially owned) entity in Poland. The point regarding whether the transparent entity under Polish tax law was also to be deemed tax transparent from a Luxembourg direct tax perspective was not contested. However, the Tribunal clarified that for net wealth tax purposes, all the wealth (i.e., net asset value) of the entity should not necessarily be consolidated with that of the resident taxpayer. Although in principle capital companies in Luxembourg should be taxed on their worldwide income, some items may be exempt when they are covered notably by a double tax treaty providing for their taxation in the other contracting state.

Consistent with its previous decisions[5], the judges recalled that the qualification and tax treatment of debt instruments should depend on the underlying asset such instruments are meant to finance. In the case under review, insofar as the debt was economically related to an immovable property in Poland which the Tribunal ruled should be exempt from net wealth tax, the loan was also to be disregarded from the unitary value of the taxpayer according to the Tribunal.

The decision ultimately emphasizes that particular attention is given to the link of the instrument with the asset funded. Since the loan was solely intended for the financing of the property, the judges considered that it is not relevant that the amount exceeds the alleged value of the asset for net wealth tax purposes.

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1) The tax transparency of the Polish company was not contested in the case at stake.
2) Valuation Law of 16 October 1934.
3) Luxembourg Net Wealth Tax Law of 16 October 1934
4) Unofficial English translation of the original French text by the authors.
5) Tribunal administratif, 26 février 2025, n° 47358