

Administrative Court - Judgment on requalification of interest-free loan as hidden capital contributions

On 17 April 2025, the Luxembourg Administrative Court (Cour administrative, 17 avril 2025, n° 50602C) (the “Administrative Court” or the “Court”) was called upon to take position on the qualification of interest-free loan payables (IFLs) granted to the taxpayer by its indirect shareholder for direct tax purposes.

Summary of the case

In October 2014, the taxpayer acquired two shareholdings and planned to establish a branch in Malaysia to which the participations would be allocated. In August 2015, the taxpayer requested a tax ruling from the Luxembourg tax authorities (LTA) to confirm that the Malaysian branch would be recognized as a permanent establishment (PE) and that the exemption of these participations for Luxembourg direct tax purposes would apply. However, the LTA denied the request, stating that the structure lacked economic substance and would fall under §6 of the Luxembourg Tax Adjustment Law (*Steueranpassungsgesetz*, “StAnpG”).

In August 2020, the LTA challenged the taxpayer’s 2015 tax return, disagreeing on two main aspects related to the net wealth tax (NWT) liability for 2016:

- The IFLs financing the participations at the level of the taxpayer should be reclassified as hidden capital contributions, and thus, should not be deductible for net wealth tax purposes.
- The Malaysian branch should not be considered a PE¹⁾, and consequently the participations attributed to it should be reintegrated in the assets of the taxpayer when computing its 2016 unitary value.

The taxpayer filed an administrative claim with the Director of the LTA in January 2021. However, the Director upheld the LTA’s position. As a result, the case was further escalated to the Luxembourg Administrative Tribunal (the Tribunal), which rejected the taxpayer’s claim²⁾. The taxpayer then lodged an appeal with the Administrative Court.

Decision of the Court

In the case at stake, the Administrative Court sided with the Tribunal’s analysis, and as a result the outcome remained unchanged for the taxpayer. Both aforementioned points of disagreement were addressed in detail by the Court, namely:

- The tax qualification of the IFLs; and
- The recognition of the existence of a PE in Malaysia.

The qualification of the IFL for direct tax purposes

The judges started their reasoning by rejecting the taxpayer’s attempt to apply article 40 of the Luxembourg income tax law (LITL)³⁾ to the case. Article 40 LITL is generally presented as setting the principle according to which tax would normally follow accounting, except where the LITL specifically provides otherwise. For the Court, article 40 LITL does not concern the qualification of a financial instrument, but only the valuation of assets and liabilities for the purposes of the tax balance sheet and therefore cannot apply to justify a debt qualification of IFLs.

In the judges’ view, the same applies for §11 StAnpG that does not in itself concern the classification of a financial instrument from a tax perspective but constitutes a practical application of the principle of economic appreciation (i.e. the so-called “substance over form principle”) that should come into play in practice in the case at stake. In that regard, the judges outlined that in accordance with settled case law, the administrative jurisdictions should be entitled to interpret transactions based on economic criteria and are therefore able to disregard the legal characterizations put in place when these do not reflect the parties’ true intentions.

In this context, the judges referred to the parliamentary comment under article 114 of the draft LITL (Bill of law 571) that became article 97 LITL. Such parliamentary comment notably provides that a loan granted by shareholders to a company may, in certain circumstances, constitute a hidden capital contribution and be treated as equity. This would be the case where the analysis of the characteristics of the loan and the circumstances under which it was granted reveal that, from an economic perspective, it should be assimilated to a participation in the equity of the company concerned, and where the context makes it clear that the loan was chosen solely for tax-driven reasons.

In essence, in application of both the parliamentary commentaries and previous case law⁴⁾ rendered by the administrative jurisdictions, the judges recalled that such analysis should primarily focus on two distinct sets of elements:

- Review of the terms and conditions of the agreement, in particular its interest rate and the repayment terms

of the funds lent; and

- Examination of the facts and circumstances surrounding the transaction and the granting of the IFLs.

Having laid down these principles, the Administrative Court then turned to the main points of disagreement between the applicant and the LTA.

The allocation of the funds

The judges fully endorsed the Tribunal’s view that the IFLs were intended to finance participations that should qualify as fixed assets (i.e. long-term assets). Several case-specific elements supported this conclusion – provided below for reference:

- The IFLs were ultimately used, through the participations acquired, to finance a gas pipeline project;
- The participations were recorded as non-current assets in the taxpayer’s balance sheet, in contrast to current assets which were identified as short-term;
- The acquisition of the participations was contingent on certain conditions, including approval from government authorities, which suggests that the project was intended to be long-term;
- The entities in which the taxpayer acquired a participation were not listed companies;
- The taxpayer did not hold any other assets and was not engaged in any activities other than acquiring and managing those participations;
- The taxpayer had a “significant influence” on the entities in which it held a participation (based on the readings of notes to the annual accounts); and
- The legal denomination of the appellant and those of the companies in which it held participations were similar (showing the intention to form a group).

Finally, although the taxpayer argued that long-term assets should be financed through long-term instruments – which was allegedly not the case here, as the IFLs at issue had only a 10-year maturity – the Court ruled that such strict correlation should not be required. Furthermore, it emphasized that the transaction should be analyzed globally, noting that, in the case at hand, the group’s strategy had consistently been to finance the taxpayer through successive short-term loans, which, in substance, was equivalent to providing financing to the taxpayer for a maturity longer than 10 years.

The disproportion between the borrowed funds and the taxpayer’s equity

The Administrative Court further confirmed the disproportion between the taxpayer’s borrowed funds and equity highlighted by the Tribunal.

- While the taxpayer tried to challenge the Tribunal’s reasoning, arguing that the relevant moment for assessing the debt-to-equity ratio should be the point in time where the funds were made available (as opposed to when the participations were acquired), the Court found the Tribunal’s choice reasonable.
- In addition, the appellant’s argument that, based on market practice, participations could be financed 85% by debt and 15% by equity (85:15 ratio) was dismissed by the judges according to whom this practice was neither legally binding nor sufficiently evidenced.
- Furthermore, the Court rejected the appellant’s argument that the re-characterization of the IFLs as equity should be limited to the part exceeding the amount of the debt considered to be at arm’s length. For the judge, a partial re-characterization of the IFLs is not possible. According to the Court’s decision, financial instruments must be fully characterized either as debt or hidden capital contributions, though the judge did not fully explain or justify the reasoning leading to this conclusion.

Finally, the risk exclusively borne by the lender was also seen as a strong indication that the financing should not be treated as genuine debt.

The absence of guarantees

The Court rejected the appellant’s arguments concerning the absence of guarantees on the IFLs as the latter failed to demonstrate the effective impact of the absence of a limited recourse clause provision in the contract. Indeed, the Court observed, based on the management report and the taxpayer’s annual accounts, that repayment was subject to available

funds. The taxpayer’s claim that a pledge over its shares was neither possible nor relevant because the lender was its shareholder was dismissed as well. For the Court, the lender was an indirect shareholder (and not a direct one), and therefore a pledge was possible. Moreover, for the Administrative Court, the taxpayer did not substantiate why no other form of security could have been considered. The absence of any guarantees was therefore upheld and seen as an additional indicator that the IFLs should be requalified as hidden capital contributions.

Other criteria taken into account by the Court

The Administrative Court reviewed the appellant’s argument that other criteria for the characterization of the IFLs had been dismissed arbitrarily and without justification by the Tribunal. However, the Court followed the reasoning of the Tribunal, mentioning that these criteria had been taken into consideration, but the situation should be assessed globally (and a majority of debt features (terms and conditions) would not be sufficient in the case at stake as the various criteria (terms and conditions as well as economic circumstances) should not necessarily be given equal weight). The following criteria helped inform this decision:

- The absence of any participating interest;
- The absence of any participation in the liquidation proceeds;
- The absence of the possibility of converting the principal amount into equity;
- The absence of the possibility of repaying the principal through the issuance of shares; and
- The absence of voting or information rights.

For the Court, even though these undisputed characteristics of the IFLs pointed to a debt qualification for Luxembourg direct tax purposes, the global picture led to an equity characterization. The Court followed the reasoning of the Tribunal and concluded on the re-characterization of the IFLs as equity for direct tax purposes.

The existence of a PE

The Administrative Court also agreed with the conclusions of both the Director of the LTA and the Tribunal regarding the non-recognition of a PE in Malaysia.

Based on the double tax treaty between Luxembourg and Malaysia (DTT) which, for the most part, provides a PE definition in line with the Organisation for Economic Co-operation and Development’s (OECD) Model Convention⁵⁾, the judges reaffirmed that a PE must be a physical place of business, characterized by its fixed and relatively permanent nature. In that sense, even though the judges acknowledged that an office location could occasionally change, they nonetheless emphasized that an alleged PE must remain easily identified. Observing that the documentation provided by the taxpayer was inconsistent in that regard, the judges considered this as a serious indication casting doubt on the actual existence of the alleged PE.

This was further confirmed by other elements, notably:

- The intragroup rental contract for the office was signed more than one year after the alleged creation date of the PE and was made retroactively effective. The judges found that such retroactive effect was not justified in this context;
- The transfer pricing study submitted by the appellant indicated that the taxpayer was supposed to provide certain services its branch, which it ultimately never did;
- The taxpayer did not provide any proof evidencing it had actually paid for the alleged office;
- A bank account in Malaysia was only opened several years after the formation of the branch;
- The manager of the branch could not be clearly identified; and
- There were inconsistencies in the documents provided by the taxpayer regarding the address of the manager of the branch.

Finally, the judges sustained that while managing two participations should not in itself require a large number of branch staff, some real management activity should still take place. However, no evidence of such activity being performed in Malaysia was provided by the taxpayer.

In light of the above elements, the Administrative Court concluded that no PE could be recognized in Malaysia and therefore confirmed the reintegration of the participations to the taxpayer in Luxembourg for the computation of its unitary value.

Takeaways

This decision is of particular significance as it addresses two complex direct tax issues that have increasingly

been the subject of scrutiny and challenges for Luxembourg taxpayers in recent years – the qualification of loans as either a debt or an equity instrument, and the documentation to evidence the existence of a PE abroad. Regarding the second element (i.e. the PE qualification), the decision is not surprising, even though it did relate to a tax year in which the new provisions for the recognition of a foreign PE under domestic tax law had not yet been implemented. In line with previous decisions of the Court, it clearly emphasizes the critical importance of documentation evidencing a PE’s existence.

The LTA are generally cautious when it comes to allowing the relocation of assets or income abroad. Consequently, any documents presented to substantiate the existence of a fixed place of business will be subject to rigorous scrutiny. It seems that ultimately, in this case, it was the inconsistencies and gaps in the documentation provided by the taxpayer that led to the rejection of its claim.

However, the decision rendered by the Court is more interesting on the first of the two points, i.e. the re-characterization of the IFLs. The decision of 17 April 2025 is not surprising as it is in line with the Tribunal’s findings, but it was also in line with several other decisions rendered recently on the same topic⁶⁾. The approach taken by the administrative jurisdictions is therefore consistent and, in the case at hand, the outcome was to be expected.

With respect to the assessment whether an instrument should be considered as debt or equity, this decision illustrates well the importance given to the substance over form principle, which at the end of the day allows the LTA and the judges to disregard legal qualifications when they come to the conclusion that such instruments were primarily employed for tax-driven reasons. Furthermore, it should be emphasized that, despite a list of criteria (terms and conditions as well as economic circumstances) being established through various pieces of case law that have enabled the classification of instruments as either debt or as equity, the judges remain at liberty, on a case-by-case basis, to decide whether they should be placed on equal footing. In the case at hand, several elements were therefore considered irrelevant for the purpose of the assessment.

That being said, the topics explored in the decision of 17 April 2025 remain tricky as they are heavily dependent on the facts and circumstances surrounding the situation being challenged. The decision clearly illustrates this fact. Indeed, a comparison between this decision and another Administrative Court decision dated 23 November 2023⁷⁾ shows that, dealing with financial instruments with quite similar characteristics, the Court took opposite decisions (debt characterization in 2023 and equity characterization in 2025) without contradicting itself, simply on the grounds that the two cases have differences in their applicable facts and circumstances. This shows that between the two key elements we mentioned before, i.e. review of the terms and conditions of the agreement on the one hand, and examination of the facts and circumstances surrounding the transaction and the granting of the financial instrument on the other, the second one appears to be decisive.

Finally, it should be noted that even though the Court concluded in the case at stake that further to the re-characterization of the IFLs into equity for direct tax purposes and the absence of a PE in Malaysia, the question of the existence of an abuse of law was no longer relevant, this remains an important potential argument for the LTA that taxpayers should keep in mind when establishing their activities.

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1) We understand that the taxpayer attempted to assert the existence of a permanent establishment in Malaysia, despite being denied a tax ruling on this matter.

2) Tribunal adm., 8 May 2024, n°47267.

3) Unofficial English translation by the authors of Article 40 (1) LITL: “(1) Where the regulations governing valuation for tax purposes do not require valuation at a specific amount, the values to be used in the tax balance sheet must be those of the commercial balance sheet, or as close as possible to these values within the limits of the applicable requirements, depending on whether or not the commercial balance sheet values meet the same requirements.”

4) Cour adm., 26 July 2017, n° 38357C; Cour adm., 31 March 2022, n° 46131C et 46132C.

5) The minor differences between the DTT and the OECD’s Model Convention were deemed not relevant by the judges in the case under review and will therefore not be detailed in the present article.

6) On the same topic, please refer to our other articles:

- E. Lebas and V. Plateau, “Administrative court judgement on tax ruling and permanent establishment”, AGEFI Luxembourg, October 2023, Page 8.

- E. Lebas and V. Plateau, “Administrative court of appeal decision on the economic appreciation”, AGEFI Luxembourg, December 2024, Page 39.

7) Cour adm., 23 November 2023, n°48125C.