

Tax controversy series

Administrative Court – Appeal decision on hidden capital contribution requalification and interest expenses tax deductibility

On 18 December 2025, the Luxembourg administrative Court of Appeal (*Cour administrative, 18 décembre 2025, n°52666C*) (the “Administrative Court” or the “Court”) had the opportunity to review the position taken earlier that year by the Luxembourg administrative Tribunal (the “Administrative Tribunal” or “Tribunal”) (*Tribunal administratif, 26 février 2025, n°47358*) concerning the non-deductibility for Luxembourg direct tax purposes of interest expenses in connection with a loan granted to a taxpayer by an affiliated undertaking.



Summary of the case

The situation at issue was quite specific and may be summarized as follows.

- On 31 July 2014, a loan (“the Loan”) was granted to a transparent company (i.e. under the legal form of an SCI, *société civile immobilière*) (the “transparent entity” or “the SCI”) by an affiliated undertaking (the “Initial Lender”) to enable the former to refund its shareholder current account. Its shareholders were natural persons tax resident in Luxembourg.

- The amount to be refunded resulted from an exchange of lands between the transparent entity/SCI and the Luxembourg State. This exchange gave rise to a capital gain on the land given in exchange. Furthermore, as the land received by the transparent entity/SCI had a higher value than the one given in exchange, a cash adjustment was paid by the transparent entity/SCI funded by its shareholder current account (refinanced with the Loan as described above).

- On 1 October 2014, a new entity, the taxpayer in the case at hand (the “taxpayer”), was established under the form of an SCS (*société en commandite simple*) by two shareholders (with one being the SCI). The Loan payable was transferred via contribution in kind as part of a business transfer by the SCI to the taxpayer upon incorporation of the latter. Shortly after, the taxpayer (initially incorporated as an SCS) was transformed into an SA (*société anonyme*). At the same time the SCI was liquidated. An addendum was signed so that the Loan could continue to be in force between the Initial Lender and the taxpayer.

- In December 2014, the remaining shareholder of the taxpayer was absorbed by a Luxembourg entity. The latter subsequently formed a fiscal unity (acting as the integrating entity) with the taxpayer.

In October 2020, the Luxembourg tax authorities (“LTA”) challenged the tax-deductible treatment of interest expenses arising from the Loan, as reported in the 2017 corporate income tax return of the SA. As the taxpayer was part of a fiscal unity, its shareholder – the integrating entity (the “Appellant”) – filed an administrative claim with the Director of the LTA, which was rejected. The Appellant subsequently filed an appeal before the Luxembourg Administrative Tribunal.

For readers seeking additional details on the facts and the decision of the first-instance judges, see our article on the case⁽¹⁾. The Tribunal took a nuanced approach, holding that, although the Loan should not be rechar-

acterized as a hidden capital contribution (“HCC”), interest expenses in relation to the Loan should nonetheless be treated as non-deductible for Luxembourg tax purposes under the circumstances. Dissatisfied with this outcome, the Appellant tried its luck by filing a second appeal, before the Administrative Court this time.

Decision of the Court

The Court confirmed the first-instance judgment in favor of the tax administration. Like the Tribunal before it, its decision was twofold, addressing the following questions:

1. Whether the Loan could be requalified into an HCC;
2. If not, whether there were still grounds to treat the interest expenses accrued on the Loan as non-deductible from a tax standpoint.

Debt characterization of the Loan

In addressing the question of whether the Loan could be recharacterized as an HCC, the Administrative Court fully endorsed the Tribunal’s approach. Relying on parliamentary comments concerning Article 97 of Luxembourg income tax law⁽²⁾ (“LITL”), the Court confirmed that an HCC treatment applies only to loans granted by a shareholder, typically when a capital increase would have been the normal financing method or where the loan was clearly structured solely for tax purposes.

The Court noted that while the Initial Lender was an affiliated undertaking and shared the same ultimate beneficiaries, it was not a shareholder of either the taxpayer or the Appellant. Following the Tribunal’s reasoning, the Loan could not be reclassified into an HCC. Economic realities of related-party operations, though potentially suspicious, should not broaden the scope of Article 97 LITL or override established administrative practice. By following the Tribunal’s narrow interpretation, the Court confirmed that the Loan remained a debt instrument. On that basis, the interest expenses should generally remain deductible, except where another legal provision would dictate otherwise.

Interest expenses tax treatment

The Court also confirmed the Tribunal’s view on this second aspect. According to the Court, although the Loan was no longer part of private assets after the taxpayer’s conversion into an SA, the mere inclusion in the balance sheet should not automati-

cally make interest payments deductible under Article 45 LITL.

In assessing the deductibility, the Administrative Court reiterated that a key test is a sufficiently close and exclusive link between the expense and the taxpayer’s actual business activity. The Court, following the Tribunal’s reasoning, looked at the origins of the Loan (which was used to repay the shareholder current account of the SCI resulting from the exchange of lands) and observed it was contracted by the SCI to let partners access unrealized capital gains, not to finance core operations. Subsequently contributing the Loan payable to the taxpayer did not create a new economic link.

The Court also confirmed the Tribunal’s analysis on the underlying exchange of land with the Luxembourg State: the Loan was not used to acquire the exchanged properties, which were primarily settled through the reciprocal transfer of land. The cash adjustment (*soulte*) that was made to balance the difference in value between the exchanged plots was of secondary importance, intended only to preserve economic balance and did not transform the exchange into a sale.

In this regard, the Court highlighted that, for tax purposes, Article 22 LITL provides that “the exchange of assets is treated as a disposal of the asset given in exchange followed by the acquisition of the asset received in exchange, each at its estimated market value”⁽³⁾ while Article 25 (1) LITL allows a cash adjustment to balance exchanges of unequal value to some extent⁽⁴⁾, provided that such payment remains incidental and does not convert the exchange into a sale. Applied to the case at hand, the judges observed that the values of the assets exchanged were broadly comparable, and the cash adjustment only equalized minor differences.

Finally, any attempt from the Appellant to frame the Loan as internal shareholder financing replaced by external lending was also rejected, as no prior internal financing by the shareholders had taken place.

Consequently, the Court concluded that the Appellant failed to demonstrate the required causal connection between the Loan and the company’s activity. In other words, while the Loan was now part of the company’s balance sheet, the interest charges paid on it did not qualify as tax-deductible expenses. The first-instance conclusion in favor of the LTA was therefore fully confirmed.

Key takeaways

This decision is notable as it reflects a consistent and now well-settled approach by the administrative jurisdictions towards the disputed tax issues, leaving taxpayers limited room for debate in future challenges by the LTA. On the recharacterization of loans into an HCC, the Court’s ruling largely followed the Tribunal and did not break new ground. Rather, it reinforced the strict framework that should govern the debt-versus-equity analysis. As already discussed in our first article, the classification of a financing transaction must be assessed through a combined reading of the parliamentary comments to Article 97 LITL and established case law. From a practical standpoint, the Court’s position clarifies two key points:

- **Shareholding link is decisive.** The Court, like the Tribunal, adhered to a literal interpretation: a financing operation between affiliated companies without a shareholder relationship does not suffice to trigger equity recharacterization.

- **Context matters, but within strict limits.** Only if a shareholder relationship exists should one examine, on a case-by-case basis, whether the financing would normally have been structured as a capital contribution under sound economic or legal considerations. The Court confirmed that such assessment must remain grounded in the traditional criteria established by administrative case law – i.e. the economic reality alone cannot broaden the scope of Article 97 LITL.

On the tax-deductibility of interest, the Court doubled down on the Tribunal’s economic approach: simply showing a loan on the company’s balance sheet does not make related interest automatically deductible. The decisive test remains a sufficiently close and exclusive link between the expense and the company’s business activity. A loan originally contracted by a transparent entity to let partners access unrealized capital gains cannot later be treated as business financing merely because it was contributed to a corporate successor.

The decision also underscores that the LTA and administrative judges focus on cash flow and actual use of funds, not on accounting labels or balance sheet entries. In this context, a purely technical inclusion in the accounts will not necessarily satisfy Article 45 LITL.

The economic reasoning of the Court is not always easy to understand for the reader, potentially due to a lack of detail about certain facts and circumstances as well as about some of the arguments of the Appellant. It would have been useful to see the Court’s thinking regarding the potential economic link between the piece of land initially owned by the SCI (that would later be exchanged with the Luxembourg State) and the internal shareholder financing (that would subsequently be replaced by the Loan). This piece of the puzzle, that would allow us to make full sense of the conclusion that the piece of land received in exchange and the Loan were not economically related, is missing.

In any event, the decision stands as a useful reminder that, in tax matters, facts and circumstances prevail and that accounting entries alone are not necessarily sufficient to evidence the true economic reality.

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1) E. Lebas and V. Plateau, “Administrative Tribunal: Judgment on hidden capital contribution requalification and interest expenses deductibility”, AGEFI Luxembourg, April 2025, Page 38.

2) Loi modifiée du 4 décembre 1967 concernant l’impôt sur le revenu.

3) Unofficial English translation by the authors. Article 22 (4) LITL: « L’échange de biens est à considérer comme cession à titre onéreux du bien donné en échange, suivie de l’acquisition à titre onéreux du bien reçu en échange. Le prix de cession du bien donné en échange correspond à sa valeur estimée de réalisation. »

4) Unofficial English translation by the authors. Article 25 (1) LITL: « En cas d’échange de biens, le prix d’acquisition du bien reçu en échange correspond à la valeur estimée de réalisation du bien donné en échange, diminuée ou augmentée d’une soulte lorsque les biens échangés n’ont pas la même valeur. »