Luxembourg Administrative Court Confirms Reclassification of Interest-Free Loans as Equity for Tax Purposes - Decision of 17 April 2025 – Case No. 50602C

In brief

On 17 April 2025, the Luxembourg Administrative Court issued a significant ruling in a case involving the reclassification of interest-free shareholder loans into equity (hidden capital contributions) for Luxembourg tax purposes.

Background

A Luxembourg limited liability company (the LuxCo) acquired participations in two foreign companies in 2015. The acquisition was financed through two interest-free loans provided by the LuxCo's indirect shareholder. The LuxCo accounted for the loans as debt instruments and allocated the acquired participations to a Malaysian branch. An advance tax agreement was requested from the Luxembourg tax authorities to confirm the existence of a Malaysian permanent establishment (the PE), which would have allowed the related income and assets to be exempt from Luxembourg corporate income tax, municipal business tax, and net wealth tax.

The tax authorities challenged the request based on the structure the LuxCo presented, denying the PE's existence.

Despite the refusal, the LuxCo, in its 2015 tax returns considered the Malaysian branch as a PE, allocated the two participations to the said PE and sought to treat the assets and related income as tax exempt in Luxembourg under the Luxembourg–Malaysia Double Tax Treaty (the DTT). Furthermore, the LuxCo treated the interest free loans (the IFLs) as debt instruments.

The Luxembourg Tax Authority rejected this position presented in the tax return considering that the branch does not qualify as a PE and requalified the IFLs as equity instruments. The LuxCo challenged this before the Administrative Tribunal, which upheld the tax authorities' position. The LuxCo then appealed to the Administrative Court, which confirmed the Tribunal's decision.

Key Findings of the Administrative Court

The Court's analysis focused not only on the classification of the interest-free loans but also with the question of recognition of a permanent establishment. This ultimately supported interest-free loans' reclassification into equity. The main legal and factual grounds included:

1. Denial of Permanent Establishment Status in Malaysia

As part of its tax position and as mentioned above, the LuxCo asserted that its Malaysian branch constituted a permanent establishment under the DTT, and that the participations allocated to the branch should accordingly be exempt from Luxembourg corporate income tax, municipal tax and net wealth tax.

The Luxembourg Administrative Court rejected this argument, concluding that no PE existed within the meaning of the DTT. The following elements were decisive in its assessment:

- **Absence of a Fixed Place of Business**: The LuxCo failed to demonstrate the existence of a verifiable physical office or any form of fixed business premises in Malaysia.

- **Lack of Operational Substance**: There was no supporting documentation indicating that the Malaysian branch carried out any real or continuous economic activities.

- **No Human or Technical Resources**: The taxpayer did not provide evidence of personnel, infrastructure, or other resources that would enable the branch to perform business functions independently in Malaysia.

This reinforces the requirement for tangible substance and actual business operations when claiming treaty-based exemptions linked to permanent establishments. Simply allocating assets to a foreign branch—absent supporting infrastructure and activities—will not suffice under treaty standards.

2. Tax qualification of the interest-free loans

The Luxembourg Administrative Court confirmed the reclassification of the interest-free loans as hidden capital contributions on the following grounds:

Substance-over-Form Principle

The Court reaffirmed that tax classification depends on the economic substance of a transaction, not merely its legal form or accounting treatment. Where a shareholder loan exhibits characteristics more consistent with equity—such as:

- no interest charged;
- no repayment guarantees;
- use of proceeds for long-term fixed investments; and
- a significant imbalance in the LuxCo's debt-to-equity ratio;

the loan may be treated as equity.

Limitations of the 85/15 Debt-to-Equity Ratio

The LuxCo invoked the widely referenced 85/15 debt-to-equity ratio (i.e., 85% debt to 15% equity) as compliant with Luxembourg tax practices. The Court clarified that:

The 85/15 ratio is an administrative practice, not legally binding.

What matters is not conformity with administrative norms but whether the terms reflect what independent third parties would have agreed (the arm's length standard).

Therefore, reliance solely on administrative practice is insufficient. A proper and robust transfer pricing study is essential to justify intra-group financing terms.

All-or-Nothing Reclassification

The taxpayer argued for partial reclassification—only amounts exceeding an arm's length threshold to be considered equity. The Court rejected this argument, stating that financial instruments must be reclassified in full—either as debt or as equity-not split.

3. Key Takeaways

The recent judgment offers important insights for taxpayers engaged in cross-border structuring and financing:

- **Permanent establishment requires genuine presence**: Merely registering a branch or office abroad does not constitute a PE. A PE must be supported by tangible business activities, physical infrastructure, and local personnel capable of carrying out operations.

- **Substance over form remains paramount**: Tax authorities and courts will prioritise the economic reality of a transaction over its legal or accounting classification. Formal arrangements lacking genuine substance are at risk of recharacterization.

- **Robust financing documentation is essential**: Transfer pricing documentation must go beyond general benchmarks. It should include a comprehensive debt capacity analysis, demonstrate comparability, and clearly assess risk allocation within the group.

- **Administrative practices are not legally binding**: The long-standing 85/15 debt-to-equity ratio commonly referenced in Luxembourg is an administrative guideline, not a legal safe harbour. Taxpayers must instead demonstrate that their financing structure is consistent with the arm's length principle.

4. Steps to Follow

The April 2025 judgment serves as a reminder that structuring and documenting shareholder loans—particularly those that are interest-free or have unusual terms—requires rigorous economic and legal analysis. Taxpayers should review their financing structures, especially those relying on informal administrative ratios, and ensure that they are supported by comprehensive transfer pricing documentation.

In light of this decision, taxpayers should consider the following steps to mitigate tax risk and ensure compliance:

- **Reassess intercompany loan structures**: Review the economic rationale and documentation supporting shareholder and intragroup loans. Where applicable, update or strengthen the debt capacity analysis to reflect current risk profiles and comparables.

- **Evaluate PE exposure abroad**: Conduct periodic reviews of foreign branches to assess whether they meet the threshold for permanent establishment under the relevant tax treaties, based on actual substance and activity.

- **Enhance internal governance and documentation**: Maintain clear and contemporaneous evidence of business functions, physical presence, staffing, and decision-making processes in foreign jurisdictions to substantiate both financing and PE positions.

Contact us

For further information, do not hesitate to contact one of our team members, who will be glad to assist you at any time:

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