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LUXEMBOURG ADMINISTRATIVE COURT RECLASSIFIES INTEREST-FREE SHAREHOLDER LOANS AS EQUITY: A REINFORCEMENT OF SUBSTANCE-OVER-FORM AND ARM'S LENGTH PRINCIPLES

Decision of 17 April 2025 – Key Clarifications on the Tax Characterization of Shareholder Funding

On 17 April 2025, the Luxembourg Administrative Court (the “Court”) issued a significant judgment regarding the requalification of interest-free loans (“IFLs”) granted by shareholders, concluding that such instruments should be treated as hidden equity contributions for Luxembourg tax purposes.

This decision provides important guidance on the delineation between debt and equity in the context of intra-group financing and underscores the centrality of both the substance-over-form and the arm’s length principles under Luxembourg tax law.

Although the case also addressed the refusal to recognize a permanent establishment in a treaty jurisdiction, this summary focuses mainly on the Court’s legal and factual analysis concerning the tax treatment of the IFLs.

I. Factual Background

The dispute involved a Luxembourg holding company that **had received two interest-free shareholder loans from an indirect shareholder**. The company used the funds to acquire shareholdings (i.e., participations), which were subsequently allocated to its Malaysian branch. **This restructuring aimed to access tax treaty benefits through the Malaysian branch, since the participations did not meet the conditions of the Luxembourg participation exemption regime when held directly.**



Before implementing the structure, the taxpayer submitted a ruling request to the Luxembourg tax authorities (“LTA”) seeking confirmation that the Malaysian branch qualified as a permanent establishment entitled to treaty protection. The request was denied by the LTA on the basis that the arrangement constituted tax abuse based on the following factors:

- Lack of fixed place of business (no proof of physical or business presence provided by the taxpayer)
- No documents evidencing ongoing business activities
- No human or technical resources (no staff and no infrastructure were available in Malaysia)

Despite this, the taxpayer unilaterally applied the treaty in its 2015 tax return, allocating the assets and related income to the Malaysian branch and claiming an exemption accordingly.

Concurrently, the taxpayer treated the IFLs as debt instruments, thus deducting them from its net wealth tax base. The LTA rejected this treatment, reclassifying the loans as equity contributions, thereby denying both the treaty-based exemption and the wealth tax deduction. This position was upheld by the Administrative Tribunal. The taxpayer appealed to the Administrative Court.

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II. The Court's Legal Analysis: Debt vs. Equity

The Court confirmed the tax authorities' recharacterisation of the IFLs as hidden equity contributions rather than debt instruments. **It ruled that the classification of a financial instrument for tax purposes must be grounded in its economic substance, rather than its legal form, contractual terms, or accounting treatment.**

Key points from the Court's reasoning include:

1. Primacy of Economic Substance over Legal Form

- The Court reaffirmed the substance-over-form doctrine as codified in §11 of the Luxembourg Tax Adaptation Law (StAnpG). For tax purposes, it is the economic reality of a financial instrument—not its label or legal documentation—that governs its classification.
- The Court clarified that Article 40 of the Luxembourg Income Tax Law (LIR), which links tax treatment to commercial balance sheets, is relevant only to valuation issues, not to determining whether an instrument qualifies as debt or equity.

2. Rejection of Administrative Guidelines as Legal Authority

- The taxpayer relied on the 85/15 debt-to-equity ratio (a non-binding administrative guideline applicable to holding companies). The Court unequivocally rejected this argument, noting that such guidelines do not have the force of law. Instead, the arm's length principle enshrined in Articles 56 and 56bis LIR is the decisive test.
- The Court emphasized that a robust transfer pricing (TP) analysis is essential to support intra-group loans.

3. No partial requalification is possible

- The Court stressed that **partial reclassification of shareholder loans is impermissible. An instrument must be fully classified either as debt or equity.**
- The taxpayer's proposal to recharacterise only the "excess" portion of the IFLs above an arm's length amount as equity was dismissed. The Court focused instead on the overall nature and economic context of the instrument.

III. Equity-Like Features Identified by the Court

In reaching its conclusion, the Court identified several features of the IFLs that aligned more closely with an equity contribution than a genuine loan:

- **Lack of Remuneration: The complete absence of interest payments was fundamentally inconsistent with arm's length lending. No independent lender would provide funding without compensation.**
- **Extreme Undercapitalisation :** The borrower's capital structure was almost entirely composed of shareholder IFL loans (**debt-to-equity ratio of 99.998/0.002**), suggesting that the lender bore virtually all the economic risk.
- **Absence of Security or Guarantees provided by the borrower to secure the loan :** There were no financial guarantees or contractual provisions ensuring loan repayment; which deviating from typical creditors protections. Based on the management report and financial statements of the taxpayer, the repayment of the loan was dependent on the available funds, strengthening the equity characterization.
- **Unreliable Maturity Terms :** Although the IFLs had a nominal 10-year maturity, **they had been repeatedly rolled over, undermining the existence of a genuine fixed repayment obligation.**

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IV. Practical Takeaways for Luxembourg Taxpayers

This ruling has broad implications for the tax treatment of intra-group financing arrangements in Luxembourg.

It underscores several key principles and practical recommendations:

- **Legal form is not determinative: Taxpayers cannot rely solely on documentation or balance sheet presentation to classify financing instruments. Substance will prevail.**
- **Non-binding administrative practices (like the 85/15 rule) offer no legal protection : Each case must be analysed individually in light of the arm's length principle.**
- **Transfer Pricing documentation must be comprehensive :** TP studies must rigorously analyse comparability, risk allocation, and economic substance.
- **Interest-free loans are inherently suspect:** Funding provided by shareholders without remuneration and without creditor-like protections will likely be reclassified as equity, particularly when used to finance non qualifying investments.
- **Reclassification impacts on both income tax and net wealth tax:** If shareholder IFL loans are deemed hidden capital contributions, taxpayers may lose deductions and exemptions, and be exposed to increased tax liabilities, particularly in the context of cross-border structuring and repatriation.

Conclusion

The 17 April 2025 decision of the Luxembourg Administrative Court reaffirms and deepens :

- **The application of the substance-over-form and arm's length principles in the classification of shareholder funding. It places a clear responsibility on taxpayers to substantiate the economic rationale of intra-group financing through rigorous documentation and structuring. Interest-free shareholder loans—especially those granted under thinly capitalised structures—now face a high risk of requalification as equity, with potentially significant tax consequences (especially when financing non-qualifying assets).**
- The importance of conducting of permanent establishment diagnostics (the importance of re-assessing regularly foreign operations to ensure a correct application of the permanent establishment treaty criteria).
- The necessity of having physical and operational evidence (documentation, infrastructure, bank account) to prove the existence of a permanent establishment.