LUXEMBOURG ADMINISTRATIVE COURT RECLASSIFIES INTEREST-FREE LOANS AS EQUITY FOR TAX PURPOSES

On 17 April 2025, the Luxembourg Administrative Court rendered a significant decision concerning the reclassification of a financial instrument—specifically, an interest-free loan—into equity for tax purposes (case n° 50602C).

Key issues

- Reclassification of interest-free loans into equity
- Substance-over-form principle
- Debt-to-equity ratio
- Arm's length principle
- Transfer pricing study

CASE LAW

The case involved a Luxembourg limited liability company ("**LuxCo**") that acquired in 2015 participations in two foreign companies, funded by two interest-free loans from its indirect shareholder. LuxCo treated these loans as debt instruments from a tax and accounting perspective. Additionally, LuxCo established a branch in Malaysia, to which its foreign participations were allocated. LuxCo sought an advance tax agreement from the Luxembourg tax authorities to recognise the existence of a permanent establishment in Malaysia, aiming to exempt its foreign participations allocated to the Malaysian branch from corporate income tax, municipal business tax, and net wealth tax.

The Luxembourg tax authorities rejected the advance tax agreement filed by LuxCo on the existence of the permanent establishment in Malaysia on the ground of the abuse of law. Moreover, they challenged the approach retained by LuxCo in its tax returns for 2015 by (i) denying the existence of the Malaysian branch, and (ii) reclassifying the shareholder loans as hidden capital contributions.

Following the questioning of its tax returns by the Luxembourg tax authorities, LuxCo lodged a claim upon the Administrative Tribunal against this decision. The Administrative Tribunal confirmed the decision of the Luxembourg tax authorities in a judgment dated 8 May 2024. LuxCo subsequently appealed the Tribunal's judgment to the Administrative Court, which affirmed this judgment.

While this case also deals with the question of the recognition of a permanent establishment in Malaysia, this alert focuses only on the tax qualification of the interest-free loans.

In that respect, the Administrative Court upheld the reclassification of the interest-free loans as hidden capital contributions (i.e., equity) on the following grounds.

1. Substance-over-form principle

The Administrative Court has reaffirmed the established principle that all intrinsic characteristics of a financial instrument (i.e. the contractual provisions as well as the circumstances under which it was granted), must be examined to determine whether it should be classified as debt or equity for tax purposes.

Accordingly, a shareholder loan can be reclassified as equity tax-wise when it results from the analysis of these characteristics that such loan is economically akin to equity and the legal arrangement is only tax-driven, based on the substance-over-form principle (i.e. irrespective of the accounting treatment of such financial instrument).

In the present case, the key equity features of the interest-free loans leading to their reclassification as equity included: (i) the absence of interest on the loans, (ii) the lack of guarantees granted to secure the repayment of the loans, (iii) the use of loan proceeds to finance fixed long-term assets (akin to equity assets), and (iv) the disproportion between debt and equity at the level of LuxCo.

2. Non-binding effect of the 85/15 debt-to-equity ratio

LuxCo notably defended its financing structure by asserting compliance with the 85/15 debt-to-equity ratio, a longstanding administrative practice usually followed by the Luxembourg tax authorities for the financing of shares.

However, the Administrative Court deemed this a non- legally binding practice and clarified that the pertinent question is not whether other groups have conducted intra-group financing according to the 85/15 debt-to-equity ratio, but rather what ratio would have been applied had the transactions occurred between third parties, rather than within the same group.

Therefore, the Administrative Court asserts that the appropriate debt-to-equity ratio should be determined through a proper and robust transfer pricing study based on the arm's length principle, rather than referring to an (informal) administrative practice. In this case, the transfer pricing study was not sufficiently robust and conclusive to support the taxpayer's declared position in its tax returns. By analogy, this implies that if a comprehensive transfer pricing study substantiates the application of an 85/15 debt-to-equity ratio, it should be deemed acceptable by the Luxembourg tax authorities.

3. Non-partial requalification of a financial instrument

The Administrative Court also dismissed the taxpayer's argument that the interest-free loans should be reclassified as equity only for the portion exceeding the arm's length debt level. The Administrative Court holds that the (re)classification of a financial instrument must be complete, categorising it entirely as either debt or equity for tax purposes.

CONCLUSION

This decision highlights the rigorous examination by the Luxembourg tax authorities and the administrative jurisdictions of all characteristics and circumstances associated with financial instruments to determine whether they should be classified as debt or equity.

The focus on the substance-over-form principle may also result in a different classification of a financial instrument (such as debt) if the context varies (refer to Administrative Court - 23 November 2023 - case no. 48125C, where the Court, adopting this holistic approach, considered that an interest-free loan should be classified as debt).

Furthermore, it underscores the necessity for a thorough review of the robustness of financing structures, particularly those relying on the non-binding 85/15 debt-to-equity ratio. This review should be grounded in a comprehensive transfer pricing study, as the Court meticulously examines such studies to assess their conclusiveness. This is also in line with the Circular L.I.R n°164/1 issued by the Luxembourg tax authorities on 29 January 2025, according to which interest rates applied on intragroup loans must be determined on a case-by-case basis and comply with the arm's length principle.

HOW CAN WE HELP?

The tax lawyers at Clifford Chance Luxembourg are at your disposal to further advise on the impact of this case law on your current and/or contemplated operations, and in particular on the documentation of your financing transactions from a general tax and transfer pricing perspective.

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