

Implicit substance threshold embedded within the PE concept? Lessons from Luxembourg – Part I

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The two cases discussed in this three-part blog series concern Luxembourg companies that had branch offices in foreign jurisdictions, namely the United States (“U.S.”) and Malaysia. The foreign branches were set up for the exclusive purpose of holding and administering equity investments. In each instance, a manager was allocated to the branch to undertake the day-to-day management of the relevant investment portfolio. The recognition of the foreign branches as Permanent Establishments (“PEs”) by the Luxembourg tax authorities (“LTA”) was critical for availing exemptions in respect of the annual net wealth tax (“NWT”).

In Luxembourg, resident companies are subject to an annual NWT, levied at a rate of 0.5% on the company’s worldwide net worth as determined on 1 January of each year. Where a foreign PE is recognized under Article 5 of the applicable tax treaty, Luxembourg must grant relief in respect of the income attributable to, and assets allocated to that PE. In the cases at hand, the Luxembourg companies operated branches in Malaysia and the U.S. that held substantial investments. Thus, recognition of the Malaysian and U.S. branches as PEs under the Malaysia-Luxembourg and U.S.-Luxembourg DTAAAs was critical. Absent such treaty-based PE recognition, the assets held through those branches would not qualify for the exemption from Luxembourg NWT, resulting in the value of these investments being included in the tax base for NWT in Luxembourg.

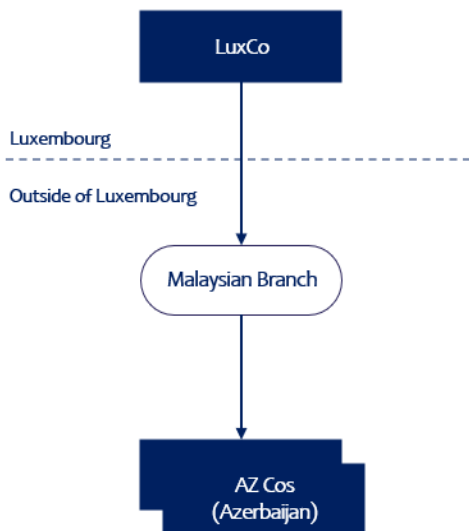
In both cases, the Luxembourg Administrative Court (“the Court”) ruled in favour of the LTA, concluding that the U.S. and Malaysian branch offices did not constitute PEs within the meaning of Article 5 of the applicable tax treaties. Although both cases deal with the issue of (foreign) PE-recognition and the impact on the Luxembourg NWT, the recognition of the (foreign) PEs by the LTA would also be relevant for exempting income from Luxembourg CIT by virtue of the Luxembourg participation exemption. It is conceivable that, had the Luxembourg taxpayer held the investments in the Azerbaijani companies (Case #1) and the Cayman Islands company (Case #2) directly, the Luxembourg companies might not have qualified for the benefits of the Luxembourg participation exemption regime.

Hence, it is plausible (but cannot be said for certain) that the branch offices in Malaysia and the U.S. were set up to allocate the equity investments (i.e., in the Azerbaijan companies and the Cayman Island company) to the respective PEs in order to (i) avail the exemption from Luxembourg NWT; and (ii), avail the benefits of the Luxembourg participation exemptions (i.e., effectively exempting dividends received and capital gains realized under Luxembourg CIT).

This blog is the first in a three-part series discussing the two Luxembourg court cases described above. This blog outlines the factual background and summarizes the Court’s reasoning in Case #1 concerning the recognition of a PE in Malaysia. It also provides our general observations and comments on the burden of proof. The second part of this series, Case #2, concerns the recognition of a PE in the U.S. In the third part of this series, we present our observations and key takeaways from the two decisions.

Background

“LuxCo”, a Luxembourg company, was established by a corporate group for the purpose of acquiring the shares of two additional companies. The acquisition was financed through an interest-free loan provided by a group company.



LuxCo acquired equity interests in two entities incorporated in Azerbaijan (“AZ Co.s”). Subsequently, LuxCo established a branch in Malaysia (“Malaysian branch”), to which it allocated its shareholdings in AZ Co.s.

The Luxembourg Tax Authorities (“LTA”) challenged the recognition of the Malaysian branch as a permanent establishment (“PE”), contending that such recognition would constitute an abuse of law. In particular, the LTA alleged that the establishment of the Malaysian branch, together with the transfer of LuxCo’s interest in AZ Co.s, was structured with the primary objective of excluding the value of those shareholdings from the Luxembourg NWT base.

The lower court denied the recognition of the Malaysian branch as a PE. It upheld the allegations of the LTA that the setup of the Malaysian branch and transfer of the AZ Co.s. shares to it constituted a circumvention of the law.

Arguments of the taxpayer before the Court

LuxCo argued that the lower court made an incorrect assessment of the facts related to the existence of the Malaysian branch. In support of its argument, it stated that the corporate group it was part of owned three commercial buildings in Malaysia, and an office space within the three towers was allocated to the Malaysian branch of LuxCo. The taxpayer alleged that, based on operational needs, the office space of the Malaysian branch changed from one tower to another. Accordingly, the taxpayer argued that the three towers should be considered as a single site. Hence, according to the taxpayer, the lower court erred in concluding that the Malaysian branch did not have a fixed place of business, despite the address being clearly identified.

In support of its position, the taxpayer presented a Service Level Agreement (“SLA”), which was entered into with another group company affiliated to LuxCo, as per which the Malaysian branch of LuxCo had access to "a fully equipped office, with office furniture, telephone, a computer and a printer, internet access and storage space" as well as “a manager in charge of its management”. The manager in charge of managing the Malaysian branch of LuxCo was thus an employee of the affiliated group company.

The taxpayer also argued that the activity of the Malaysian branch would be comparable to that of a

"Luxembourg Soparfi" (*Societe de Participations Financieres*) holding shareholdings, and, therefore, there was no need for a large staff as the management of shareholdings in AZ Co.s. constituted the main activity of the Malaysian branch. Finally, the taxpayer also presented the Court with a letter from the Malaysian tax authorities, which confirmed the existence of the Malaysian branch.

Decision of the Court

The Court stated that, based on the Malaysia-Luxembourg DTAA¹ the recognition of a PE depends on the following factors (i) the existence of a place of business, (ii) the fixed nature of that business facility, (iii) the carrying out of all or part of the business of the enterprise through that establishment, and (iv) the business activities carried out from the fixed place of business not being of a preparatory or auxiliary character.

Regarding the place of business, the Court agreed that it was plausible that the office of the Malaysian branch existed within a complex consisting of three towers, and that the exact location could vary over time. However, the Court stated that such an office should be clearly identifiable at all times. According to the Court, the office address of the Malaysian branch was unclear. The management report, annual accounts, and the SLA referred to different locations as the address of the Malaysian branch, although within the three towers.

The Court agreed with the taxpayer's assertion that the Malaysian branch did not require a large staff to manage two shareholdings. However, the Court stated that someone must nevertheless carry out genuine management activities, even if these were limited, and the taxpayer had failed to provide any evidence to this effect. The Court noted that the appointed manager of the Malaysian branch had neither attended nor been mentioned among the persons who participated in the management board meeting of LuxCo.

The taxpayer had also failed to provide proof of payment of the fees due under the SLA. The Court stated that the services mentioned in the SLA may have been provided only on paper, as there was no evidence to prove the actual provision of services. The services were either not performed or not evidenced (notwithstanding the recording of revenues attributable to such services). In addition, the SLA was executed more than one year after the effective date, without a justification for this retroactive effect. The Court also noted that the bank account was opened in 2020 (whereas the services under the SLA were rendered as from 2020).

Regarding the letter provided by the Malaysian tax authorities, the Court stated that the criteria on which the Malaysian authorities based their conclusion regarding the existence of a branch office were not detailed in the letter. Moreover, the confirmation letter of the Malaysian tax authorities did not pertain to the year under consideration, i.e., 2015. No explanation was provided by the taxpayer for why the authorities had not explicitly extended their confirmation to 2015.

Based on the foregoing, the Court held that the taxpayer had failed to make it plausible that the alleged branch existed and that the shareholdings in AZ Co.s. were effectively managed from Malaysia. Hence, the taxpayers' argument regarding the existence of a PE in Malaysia was rejected.

General observations

¹ The Agreement between the Government of Malaysia and the Government of the Grand Duchy of Luxembourg for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to taxes on Income and on Capital, concluded on 21 November 2022

The Court rejected the recognition of a foreign branch office as a PE under the Malaysia-Luxembourg DTAA. In doing so, the Court has applied the following criteria for the recognition of a PE – (i) the existence of a place of business (ii) the fixed nature of that business facility, and (iii) the carrying out of all or part of the business of the foreign enterprise through that establishment and (iv) the business activities carried out from the fixed place of business not being of a preparatory or auxiliary character.

The case appears to have been lost by the taxpayer mainly due to inconsistencies and contradictions in the taxpayer's arguments. The branch office's address was inconsistent across various agreements, management reports, annual accounts, and other documents. The manager, even though appointed, was not a part of the board meetings. The Malaysian tax authorities' letter (confirming the existence of a branch office in Malaysia) related to later years. Hence, the taxpayer was unable to establish that there was a place of business in Malaysia from which its activities were carried out with some degree of permanence.

With respect to availing the exemption from Luxembourg NWT, the taxpayer bears the burden of demonstrating both the existence and the effective operation of a PE through verifiable documentation. Such evidence (also when the burden lies on the tax authorities to prove the existence of a PE) typically includes, i.e., lease agreements, registration and licensing records, bank statements (including evidence of local banking arrangements), and records substantiating the conduct of actual business activities and decision-making at the place of business. As illustrated by this case, an inability to satisfy the evidentiary expectations will likely result in the judiciary not recognizing the office/other place of business as a PE.

More broadly, this decision reaffirms that, for a foreign branch to be recognized as a PE, it must satisfy each substantive condition set out in the applicable double tax treaty. This must be demonstrated by specific evidence of (i) a fixed and identifiable place of business and (ii) genuine operational activity carried on through that place. Therefore, when trying to prove the existence of a PE, taxpayers should exercise diligence in documenting and substantiating that their cross-border arrangements meet the PE criteria under the relevant treaty framework.

Based on this case, the following indicia appear (among other elements) to be relevant:

- A specific, fixed physical establishment with a clearly identified (and consistent) branch address (including alignment between claimed facts and financial/management reports), lease agreements, registration certificates, and photographs of the furniture/office;
- intercompany agreements (including office sharing/service agreements and SLAs) with credible terms and, where relevant, a justified explanation for any retroactive effect;
- a dedicated local bank account for the branch, proof of payment of fees and expenses due under inter-company agreements (i.e., bank statements) and evidence that branch representatives have genuine authority, including signatory power for banking transactions (e.g., a proxy);
- records evidencing actual operational conduct and decision making at the branch level, such as documentation from internal meetings, records of management choices/decisions, evidence of the actual execution of concluded contracts, and corroboration of the branch manager's effective involvement (including demonstrated time commitment and participation in significant meetings).

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