

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

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Reading time: 15 minutes

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”).

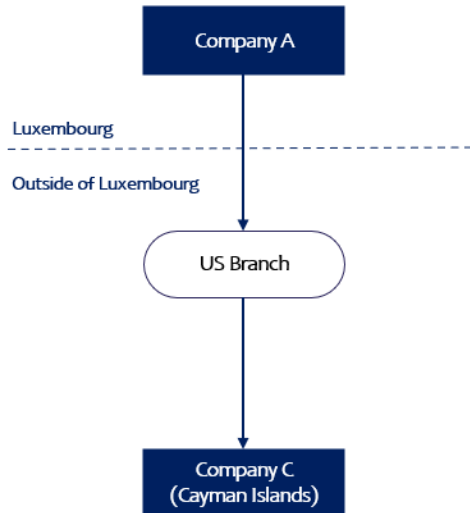
In Luxembourg, resident companies are subject to an annual NWT, levied at a rate of 0.5% on the company’s worldwide net worth as determined on 1 January of each year. Where a foreign PE is recognized under Article 5 of the applicable tax treaty, Luxembourg must grant relief in respect of the income attributable 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 second 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 #2 concerning 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



In this case, Company A was established in Luxembourg to manage the intra-group financing business.

Information regarding the finance/treasury departments and related licenses, if any, has not been provided in the judgment.

From the funding Company A received from banks and preferred equity certificates, it extended a loan to Company B, a group entity. The commitment to repay the loan was formalized through a Promissory Note.

Company A listed the Promissory Note on the Cayman Islands Stock Exchange. To facilitate this step, it created a subsidiary, Company C, in the Cayman Islands.

To hold and manage the shareholding in Company C, Company A established a branch in the United States ("the U.S. Branch"). Company A transferred the Promissory Note to Company C and allocated the shares of Company C to the U.S. Branch.

## Arguments of the taxpayer before the Court

The taxpayer contended that the activities of the U.S. Branch that consisted of owning and administering Company C, as well as receiving, controlling, and managing the income from Company C, constituted a PE in the U.S.

The taxpayer claimed that a fixed place of business existed because the U.S. Branch operated from an office space leased from a group company in the U.S. Furthermore, a manager was seconded by one of the group's companies to the U.S. Branch. According to the secondment agreement, the manager of the U.S. Branch was supposed to carry out at least the following activities: manage the investment, review and approve the monthly accounts of Company C, act as signatory to the U.S. bank account for matters relating to the activities of the U.S. Branch, and advise the taxpayer on dividends and other forms of repatriation of funds from Company C. The taxpayer further supported its case with evidence of activity, including emails approving monthly accounts, board resolutions regarding dividend distributions, and the transfer of the Promissory Note.

From a transfer pricing perspective, intercompany support services were charged to the U.S. Branch at a cost-plus 5 per cent markup. The expenses were booked in the branch's profit and loss account, and the corresponding income was recorded at the head office level. Hence, the taxpayer argued that there was sufficient evidence to prove that it had a PE in the U.S.

## Arguments of the tax authorities before the Court

The LTA argued that there was no evidence to prove that any actual and permanent activity occurred in the U.S. during the period in question. It was alleged that activities on American soil were isolated acts and did not show any degree, even limited, of regular and continuous activity. The taxpayer had provided neither invoices relating to the secondment of the manager nor any bank statements of the U.S. Branch showing that such manager had been paid. (Only two short emails had been provided as evidence of management activity).

The LTA further argued that separate branch accounts did not exist; the bank account was operated by Luxembourg directors as joint signatories, leaving no proof that the branch manager acted independently. Regarding the office space, the tax authorities stated that they were unable to determine with certainty the space allocated to the U.S. Branch's activities because the office in question was only indicated by a handwritten note on the plan in the appendix to the sublease agreement.

The LTA stated that the taxpayer had not provided any documents to justify the invoices to the U.S. Branch for support services provided during 2015. Hence, the tax authorities maintained that the U.S. Branch should not be considered a PE.

## Decision of the Court

The Court referred to Article 5 of the US-Luxembourg DTAA.<sup>1</sup> Based on the same, the Court noted that to qualify as a PE, in addition to not falling within one of the cases of exclusion expressly provided for in paragraph (4) of Article 5, three elements must be met:

- firstly, there must be a place of business, i.e. a physical place of business of some kind, such as those listed by way of illustration in Article 5, paragraph (2), of the DTAA;
- secondly, that place of business must be fixed, i.e. it must, on the one hand, have a connection with a specific geographical point and, on the other hand, be characterized by a certain permanence;
- thirdly, the business of the enterprise must have been carried on wholly or partly from or through that fixed place of business.

As regards the geographical identification of the place of business, the Court noted that the address of the U.S. Branch was identifiable in the present case. The taxpayer had, therefore, provided evidence that it has a fixed place of business in the U.S. However, it must be noted that it has not demonstrated the real and effective exercise of business activities through the U.S. Branch.

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<sup>1</sup>The Agreement between the Government of the United States of America 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 Capital, concluded on 3 April 1996.

## General observations

To provide evidence of the actual and real activity of the U.S. Branch, the taxpayer had merely submitted the secondment contract of the manager, two emails in which the manager approved the annual accounts of Company C, and a resolution authorizing the accounts of Company C.

Regarding the support services, only a transfer pricing report was produced, justifying that the invoiced amount was in accordance with the arm's length principle. However, the Court held that it did not provide proof of actual payment for services. Hence, having regard to the documents at its disposal and the explanations provided by both parties, the Court concluded that the applicant had failed to submit sufficient evidence to demonstrate the existence of a PE in the U.S.

## General observations

In contrast to the first case, in the second case, the taxpayer successfully demonstrated the existence of a place of business (via, for instance, lease agreements, secondment contracts, internal resolutions, and operational correspondence). The Court, however, concluded that there was no PE as the taxpayer was unable to demonstrate that real and effective business activity was carried out through the branch office.

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