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ATOZ ALERT

Luxembourg tax authorities issue circular on interest deduction limitation rules

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On 8 January 2021, the Luxembourg tax authorities issued a new Circular n° 168bis/1 (the "**Circular**") in order to provide guidance on the interpretation of the interest deduction limitation rules ("**IDLR**") laid down in Article 168bis of the Luxembourg income tax law ("**LITL**").

Article 168bis of the LITL has transposed the Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices ("**ATAD 1**") into Luxembourg law and has been applicable since 1 January 2019. Since the Circular merely has clarifying character with regard to the interpretation of existing legal provisions and does not constitute a new legal basis itself, the IDLR shall be interpreted according to the Circular for all tax years from 2019.

This ATOZ Alert provides an overview of some selected key aspects provided by the Circular.

The IDLR limit the interest deductibility for tax purposes for Luxembourg corporate taxpayers and Luxembourg permanent establishments of foreign taxpayers, unless they qualify as financial undertakings or stand-alone entities. The limitation concerns exceeding borrowing costs (i.e. the amount by which the borrowing costs exceed the interest income in a given year) and corresponds to the higher of EUR 3mio or 30% of the tax EBITDA per fiscal year.

The notion of borrowing costs and interest income

The Circular specifies that borrowing costs are specified into three categories:

- Interest expenses on all forms of debt;
- Other costs economically equivalent to interest, and;
- Expenses incurred in connection with financing.

Borrowing costs may only concern deductible interest expenses, i.e., non-deductible interest expenses, regardless of the reason for the non-deductibility (e.g. anti-hybrid rules), do not qualify as borrowing costs.

Therefore, to apply the IDLR, one should first consider whether the relevant expenses are deductible under the other provisions of Luxembourg tax law. As a second step, the nature of the expenses will have to be checked to determine whether they fall into the scope of borrowing costs within the meaning of the IDLR.

The Circular provides a non-exhaustive list of borrowing costs, in particular:

- Fixed and variable remuneration on profit participating loans;
- Imputed interest on certain financial instruments such as convertible bonds and zero coupon bonds (including issuance and redemption premiums);
- Amounts paid on alternative financing arrangements such as Islamic finance;
- The finance cost element of finance lease payments on leasing contracts;
- Capitalised interest included in the acquisition costs of assets in the balance sheet or amortisation of capitalised interest;
- Amounts measured by reference to a funding return under transfer pricing rules (e.g. deemed interest deductions in application of transfer pricing rules);
- The notional interest element of derivatives and hedging instruments in relation to an entity's borrowings;
- Certain foreign exchange losses on borrowings and instruments connected with the raising of finance (excluding foreign exchange losses on the principal amount of borrowings);
- Guarantee fees on financing arrangements (in particular mortgage guarantees, and any other type of guarantee connected to a financing operation);
- Fees and similar charges relating to the borrowing of funds.

For the purposes of the application of Article 168bis of the LITL, the Circular further clarifies that the notion of interest income and other economically equivalent income should constitute the counterpart of the borrowing costs and should therefore be interpreted applying a symmetric and coherent approach. Hence, at least in a purely national context, expenses incurred by a borrower not considered as borrowing costs should also not be considered as interest income at the level of the lender.

Equally, when a charge is considered as a borrowing cost for a borrower under the above definition, such expense should also be considered as an interest income for the lender.

Discounted debt

The Circular specifically states that a deduction for impairment of (presumably) irrecoverable receivables does not give rise to borrowing costs on the part of the creditor. Hence, the reversal of such impairment should likewise not constitute interest income.

In this context, the question arises whether a capital gain on a discounted debt that has been acquired after the write-down would likewise not qualify as interest income. Since the Circular remains silent on this specific case, one should rely on the general principles laid down above and consider that capital gains should not be considered as interest income for the lender when they are not considered as borrowing costs for the borrower. This could lead to a tax exposure where such discounted debt has been financed, e.g. with profit participating loans since the variable interest on the profit participating loan explicitly qualifies as a borrowing cost and is therefore subject to the IDLR rules.

Real estate

The fraction of capitalised interest included in the acquisition cost, e.g. of a real estate asset, falls within the scope of the IDLR in case of amortisation, depreciation and upon sale.

Hence, even a fraction of the ordinary depreciation of real estate assets should fall within the scope of the IDLR and may therefore be subject to restrictions as to its deductibility for tax purposes. While income from foreign real estate assets is typically exempt in Luxembourg under a double tax treaty and the corresponding interest charges are therefore, in principle, non-deductible, Luxembourg real estate assets may be impacted by this rule (both on an on-going basis).

Derivatives and hedging instruments

Within the scope of the IDLR are, in particular, interest rate swaps and similar derivative or hedging instruments where the interest charges are calculated on the basis of a notional amount and are in relation to an entity's borrowings. Conversely, derivatives in relation to the assets of a company should, in principle, not be in the scope of the IDLR.

Tax EBITDA

The Circular provides for certain clarifications on the tax EBITDA computation. Amongst other things, the deductible fraction of foreign taxes, as well as interest expenses which benefit from the grandfathering rules, shall not be added back on to the tax EBITDA. Further, income and interest expenses from infrastructure projects which qualify for the carve-out from the IDLR should be excluded from the tax EBITDA computation.

Tax neutral reorganisations

The Circular clarifies that unused interest capacity and the carry forward of exceeding borrowing costs which could not be deducted in a given tax year may be transferred in case of tax neutral reorganisations. Conversely, reorganisations performed at market value or at an intermediate value (i.e. between book value and market value) should not benefit from this transfer.

Grandfathering and material modifications

The IDLR provide for a grandfathering clause which covers existing loans to the extent that their terms are not subsequently modified, i.e. in case of a modification on or after 17 June 2016, the grandfathering would be limited to the original terms of the loan. Such material modifications include, in particular, an extension of the maturity of a loan, a modification of the interest rate or the interest rate computation method or the modification of one or several of the contracting parties if such modifications were not contractually foreseen before 17 June 2016, or a modification of the principal amount.

Restructurings such as mergers and demergers are not considered as a material modification since the initial conditions of the loan should not be impacted.

In light of the above, it seems ambiguous whether the mere change of the lender (e.g. within the same group) would cause a loss of the grandfathering privilege if the terms and conditions of the loan remain unchanged. However, if the borrower pays exactly the same amount of interest on the same loan principal amount before and after the change of lender, the loan should continue to benefit from the grand-fathering rule.

A mere drawdown under a loan facility granted before 17 June 2016 falls within the scope of the grandfathering rule (provided that the maximum amount has not been subsequently increased).

Stand-alone entity exception

The IDLR provide for a number of carve-outs. For example, securitisation undertakings subject to EU Regulation 2017/2402 are explicitly excluded from the scope of Article 168bis of the LITL. However, many securitisation vehicles do not fall within the scope of this EU Regulation and may therefore only benefit from the general carve-out rule applicable to all Luxembourg corporate taxpayers/Luxembourg permanent establishments of foreign entities, i.e. if they

1. are not part of a consolidated group for financial accounting purposes;
2. do not have an associated undertaking as defined in Article 164ter, paragraph 2 of the LITL; and
3. do not have a permanent establishment situated in a state other than Luxembourg.

For point 2, the Circular states that it is therefore necessary to verify the existence of a direct or indirect link of association existing between the taxpayer and an undertaking within the meaning of articles 159, 160 or 175 of the LITL or a natural person. This link of association must be analysed from an economic point of view.

The above guidance, especially the fact that the link of association has to be analysed from an economic point of view, seems to support the argument that so-called orphan structures may benefit from the stand-alone entity exception. However, this is subject to a case-by-case analysis.

Implications

While the long-awaited Circular clarifies a number of points and provides useful guidance, some other aspects unfortunately remain unclear.

In particular, in regard to derivatives and hedging instruments, additional guidance would have been welcome to determine under which circumstances exactly a connection with the raising of funding may be assumed (e.g. a contractual and/or temporal link).

Further, a more concrete clarification with regard to the qualification of capital gains on discounted debt would have been desirable. In light of the Circular, taxpayers which finance discounted debt with profit participating instruments or other loan instruments (e.g., debt funds) may therefore need to review their current structure set-up to identify potential tax exposures and take the necessary steps, if needed.

In addition, investments in Luxembourg real estate will require additional compliance monitoring if interest expenses are intended to be capitalised to anticipate the potential impact of the IDLR.

Finally, the developments made in the Circular regarding the stand-alone entity exception seem to suggest that orphan structures, such as those often used in securitisation transactions, could in certain cases benefit from the carve-out.

Do you have further questions?

ANTOINE DUPUIS
Partner, International & Corporate Tax
antoine.dupuis@atoz.lu
T + 352 26 940 207

ANDREAS MEDLER
Principal, International & Corporate Tax
andreas.medler@atoz.lu
T +352 26 940 237