Revue de Droit Fiscal n° 10
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Doctrine

LUXEMBOURG SECURITISATION COMPANIES, INTEREST LIMITATION RULES AND THE STANDALONE ENTITY EXCEPTION

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Securitisation is a technique used to convert a broad range of illiquid assets or claims into tradable securities. As such, securitisation transactions may create liquidity for the original lenders (or originators) and present an attractive and diversified investment opportunity for investors. In the current COVID-19 crisis, securitisation may contribute to the efficiency of financial markets and provide businesses with much needed liquidity. In this article, the authors analyse to which extent Luxembourg securitisation companies may, or may not, be impacted by the EU-wide interest limitation rules.

1. INTRODUCTION

Securitisation vehicles established in the legal form of a Luxembourg company are subject to corporate income tax and municipal business tax at an aggregate rate of 24.94% (applicable tax rate in 2021 for companies based in Luxembourg-City). Securitisation companies are commonly financed by debt instruments that track the performance of the underlying assets. Interest expenses incurred by a securitisation company are in principle deductible for Luxembourg tax purposes.

As from 2019, Luxembourg tax law provides for interest limitation rules that have been implemented in accordance with the EU Anti-Tax Avoidance Directive ("ATAD")[1]. Accordingly, when a securitisation company realises income other than interest income (or economically equivalent revenues) the interest expenses incurred may be partially non-deductible for tax purposes in accordance with the interest limitation rules.

However, the interest limitation rules provide for certain "carve-outs" that may apply in case of securitisation companies. Firstly, certain securitisation undertakings are subject to specific EU prudential regulation (regulation 2017/2402) and these "EU-regulated" undertakings are explicitly excluded from the scope of the interest deduction limitation rules. Secondly, the interest limitation rules provide for a "standalone" entity exception that may apply if a company is not part of a consolidated group for financial accounting purposes and has no associated enterprises (or a permanent establishment), a fact pattern typical of many securitisations.

In this article, the authors examine when a securitisation company may come within the scope of the standalone entity exception, which is of particular importance for securitisation companies that are not EU-regulated. We also focus on distressed debt acquisitions which have been particularly frequent in this field.

2. INTEREST LIMITATION RULES

2.1. Overview

Article 168*bis* of the Luxembourg Income Tax Law ("LITL") limits the deductibility of "exceeding borrowing costs" generally to a maximum of 30% of the corporate taxpayers' earnings before interest, taxes, depreciation and amortisation ("EBITDA").

The scope of the interest limitation rules encompasses all interest-bearing debt instruments irrespective of whether the debt financing is obtained from a related or a third party. Exceeding borrowing costs up to an amount of EUR 3m may be deducted without any limitation (that is a safe harbour provision).

On 8 January 2021, the Luxembourg tax authorities released a tax circular (the "Circular") on the interpretation of the interest limitation rules.[2]

1. Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market.
2. Circular L.I.R. n° 168bis/1 of 8 January 2021.

2.2. Mechanism of the interest limitation rules

2.2.1. Opening comments

"Exceeding borrowing costs" correspond to the amount by which the deductible "borrowing costs" of a taxpayer exceed the amount of taxable "interest revenues and other economically equivalent taxable revenues."

2.2.2. Definition of borrowing costs

Borrowing costs within the meaning of this provision are (i) interest expenses on all forms of debt, (ii) other costs economically equivalent to interest and (iii) expenses incurred in connection with the raising of finance, including, without being limited to:

- payments under profit participating loans;
- imputed interest on instruments such as convertible bonds and zero-coupon bonds;
- amounts under alternative financing arrangements, such as Islamic finance;
- the finance cost element of finance lease payments;
- capitalised interest included in the balance sheet value of a related asset, or the amortization of capitalised interest;
- amounts measured by reference to a funding return under transfer pricing rules where applicable;
- notional interest amounts under derivative instruments or hedging arrangements related to an entity's borrowings;
- certain foreign exchange gains and losses on borrowings and instruments connected with the raising of finance;
- guarantee fees for financing arrangements; and
- arrangement fees and similar costs related to the borrowing of funds.

With regard to derivative instruments, it has to be analysed on a case-by-case basis whether expenses incurred are economically equivalent to interest or not.

2.2.3. Definition of interest revenues

As far as interest income and other economically equivalent taxable revenues are concerned, neither ATAD nor Luxembourg tax law provides a clear definition of what is to be considered as "revenues which are economically equivalent to interest."

However, borrowing costs and interest income are mirroring concepts. Therefore, the interpretation of (taxable) interest income and revenues which are economically equivalent to interest should be based on the broad interpretation of the concept of borrowing costs.

This has been confirmed in the Circular. As an example, the Circular mentions the case of redemption premium relating to a bond which should be considered as borrowing costs for the issuer and, conversely, taxable interest income at the level of the bondholder.[3]

2.2.4. The 30% EBITDA limitation

The relevant EBITDA for the purposes of the 30% EBITDA rule is a tax EBITDA that is determined as follows:

  Taxable income
\+ Interest expenses (tax deductible)
– Interest income (taxable)
\+ Depreciation and amortisation (Articles 29 to 34 of the LITL)
– ---
= Tax EBITDA
  ===================================

The taxable income has to be determined in accordance with the provisions of the LITL. The determination of the taxable income starts with the accounting profit or loss that is subject to a number of tax adjustments.

Income and capital gains may benefit from a tax exemption provided under Luxembourg tax law or in tax treaties concluded by Luxembourg. For example, income and capital gains derived from qualifying participations may benefit from a tax exemption under the participation exemption regime.[4] Moreover, income and capital gains derived from immovable property situated in a tax treaty jurisdiction are frequently tax exempt in accordance with the applicable tax treaty.[5]

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3. See Section 1.3.1. of the Circular.
4. Article 166 of the LITL.
5. Article 6 (1) (Income from immovable property) and Article 13 (1) (Capital Gains) in conjunction with Article 23 A (Exemption method) of the OECD Model Tax Convention.

Expenses incurred in (direct) economic relationship to tax exempt income are not deductible for tax purposes and have to be reintegrated when determining the taxable income.[6] Moreover, the LITL provides for a number of provisions that may result in the non-deductibility of expenses. For example, corporate income tax, municipal business tax and net wealth tax expenses are not deductible for tax purposes.[7] Tax adjustments may further be necessary in accordance with Luxembourg transfer pricing rules[8] and specific provisions such as the hybrid mismatch rules.[9]

When determining the tax EBITDA, tax deductible interest expenses are to be added to the taxable income, whereas taxable interest income has to be deducted. In addition, amounts of depreciation and amortisation[10] that reduced the taxable income of the company need to be reintegrated to arrive at the relevant tax EBITDA.

2.2.5. The safe harbour rule

Exceeding borrowing costs up to an amount of EUR 3m may be deducted without any limitation (the safe harbour rule).[11] This safe harbour applies per company and tax year. When the amount of EUR 3m is not used in a given year, the unused amount cannot be carried forward to subsequent tax years.

2.2.6. Carry-forward mechanism

2.2.6.1. Non-deductible exceeding borrowing costs

When exceeding borrowing costs are non-deductible in accordance with the interest limitation rules, such non-deductible interest expenses may be carried forward without time limitation and deducted in subsequent tax years.[12]

Here, the oldest exceeding borrowing costs shall be deducted first even though this should not have any impact given that this carry-forward is not limited in time.

2.2.6.2. Unused interest capacity

When the amount corresponding to 30% of the tax EBITDA exceeds in a given year the amount of exceeding borrowing costs (provided that this amount exceeds EUR 3m), such difference is unused interest capacity. In other words, the Luxembourg taxpayer could have deducted a higher amount of interest expenses than the actual amount of exceeding borrowing costs.[13]

The unused interest capacity can be carried forward for a period of five tax years and is to be used on a first in, first out basis (i.e. the oldest amounts of unused interest capacity are to be used first).[14]

2.3. Securitisation transactions potentially concerned by the interest limitation rules

2.3.1. Opening comments

Securitisation transactions can involve a broad range of underlying assets (or rights) that may generate interest income or other types of income. When the underlying assets are interest bearing debt instruments, the interest limitation rules should not result in adverse tax consequences as the interest income should exceed (or at least correspond to) the amount of interest expenses incurred in relation to debt instruments issued to the investors.

In contrast, when a securitisation company invests into assets that generate income other than interest income (or revenues which are not economically equivalent to interest) the interest limitation rules may result in the non-deductibility of a significant part of the interest expenses.

2.3.2. Distressed debt – A particular case

The interest limitation rules may, for example, apply in case of investments into distressed debt. Broadly speaking, investments into distressed debt rely on the acquisition of non-performing loans or other distressed debt instruments at a price below par value. Thereafter, the idea is to realise a return upon the disposal or repayment of the debt instrument once the financial situation of the debtor improves. When the income realised in relation to assets cannot be classified as interest income (or economically equivalent revenues) the securitisation company would incur exceeding borrowing costs which may not be fully deductible for tax purposes.

According to a position paper of the Luxembourg Capital Markets Association on the deductibility of interest payments by securitisation companies, it should be acceptable under Luxembourg Generally Accepted Accounting

6. Article 45 (2) and 166 (5) No. 1 of the LITL.
7. Article 168 No. 2 of the LITL.
8. For example, the concept of hidden dividend distributions or based on Article 56 of the LITL.
9. Article 168ter of the LITL.
10. Article 29 to 34 of the LITL.
11. Article 168bis (2) b) of the LITL.
12. Article 168bis (4) of the LITL.
13. Article 168bis (3) of the LITL.
14. Article 168bis (5) of the LITL.

Principles ("GAAP") to reflect income up to the amount of the original reasonable expectation as "interest income".[15]

Market standard for the determination of return in the field of non-performing loans is based on a valuation of the recovery that the securitisation company should expect when it acquires the debt. The difference between the expected amount of recovery and the acquisition price of the debt instruments would be the maximum amount that could be reflected as interest income for accounting purposes. Any further collection beyond the initial forecast will generally be considered as capital gains.

According to Article 40 of the LITL, the tax treatment should follow the accounting treatment, unless a specific tax provision or concept requires otherwise. In the absence of any specific tax rules, the interest income realised in regard to the non-performing loans should also be treated as interest income from a Luxembourg tax perspective. Thus, when securitisation companies adopt this accounting approach, the interest limitation rules should only be relevant with respect to income that is treated as a capital gain.

2.4. Entities excluded from the scope

The interest limitation rules provide for a number of carve-outs. For example, securitisation undertakings that are subject to EU regulation 2017/2402 are explicitly excluded from the scope of the interest deduction limitation rules. The three main conditions to fall within the scope of this regulation include (i) different tranches of securities with subordination, (ii) segmentation of the credit risk associated with the exposure of the assets and (iii) the notes need to be held by at least two different note holders.[16] However, before adopting this regulatory status, investors and originators should carefully consider the burdensome requirements of this regulatory regime (if the conditions can be met).

The EU Commission recently sent a letter of formal notice to Luxembourg requesting the abolishment of this exception as it is considered that this carve-out goes beyond the allowed exemption of "financial undertakings" provided by ATAD. Thus, this carve-out might be abolished in the future.

The interest limitation rules further provide for a carve-out for standalone entities. The potential application of the standalone entity exception in case of securitisation companies is further analysed in the following section.

3. CONSIDERATIONS REGARDING LUXEMBOURG SECURITISATION COMPANIES

3.1. Conditions of the standalone entity exception

The interest limitation rules provide for a carve-out for standalone entities. Standalone entities are entities that

(i) are not part of a consolidated group for financial accounting purposes, and

(ii) have no associated enterprise or permanent establishment ("PE").[17]

With regard to the definition of associated enterprise, Article 168bis of the LITL[18] makes reference to Article 164ter (2) of the LITL that provides for a definition of associated enterprises in the context of the controlled foreign companies ("CFC") rules. According to Article 164ter (2) of the LITL, associated enterprises are defined as individuals or entities (within the meaning of Articles 159, 160 or 175 of the LITL) that own a participation of 25% or more in terms of voting rights, capital ownership or profit entitlement.

Entities within the meaning of Articles 159 and 160 of the LITL comprise Luxembourg and certain foreign entities that are treated as Luxembourg corporate taxpayers. Article 175 of the LITL covers entities that are viewed as transparent from a Luxembourg tax perspective (in particular, partnerships). In essence, Article 175 of the LITL replicates the wording of Section 11bis of the Tax Adaptation Law according to which general partnerships, limited partnerships, special limited partnerships, economic interest groupings, European economic interest groupings and other types of partnerships are deemed not to have a legal personality distinct from that of their partners.

Thus, for a Luxembourg company to benefit from the standalone entity exception, it is necessary that none of the associated enterprises has directly or indirectly a participation of 25% or more in terms of voting rights, capital ownership or profit entitlement.

15. See Technical Position Paper on the Deductibility of Payments by Securitisation Companies Financed by Debt, LuxCMA (Task Force – Securitisation & ATAD), October 2020, p. 21 f.
16. Given that these requirements may not be fulfilled in many cases, this regulatory status is not an option in each and every case.
17. Article 168bis (8) b) of the LITL.
18. Article 168bis (1) No. 6 of the LITL.

3.2. Orphan structures

Securitisation transactions are often organised via so-called "orphan" vehicles where the shares of the Luxembourg securitisation company are held by a third party disconnected from both the originator of the securitisation and the investors. These orphan arrangements are industry standard in many parts of the securitisation sector and respond to commercial and regulatory imperatives (independence of governance, deconsolidation for regulatory purposes, notably).

The third parties used are often charitable trusts or foundations such as Dutch Stichtings. The question then arises as to whether securitisation companies held in such orphan structures may fall within the scope of the standalone entity exception. In substance, it may seem obvious that they should be within scope of the exception as the fundamental purpose of orphan arrangements is to create a vehicle that is standalone for a host of non-tax reasons.

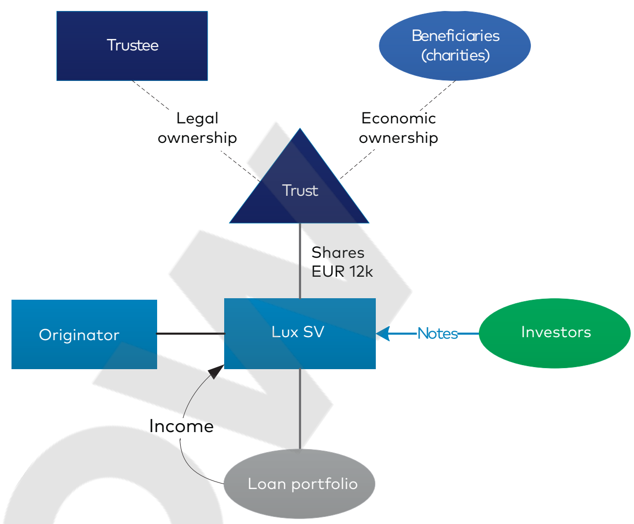
Securitisation companies in orphan structures are generally not part of a consolidated group for financial accounting purposes, nor do they have a PE in another jurisdiction. Therefore, the standalone entity exception should apply as long as the securitisation company has no associated enterprise.

In an orphan structure, a securitisation company is typically established with minimum share capital (i.e. EUR 12,000 in case of a Luxembourg limited liability company). Thereafter, the shares are transferred to, for example, a charitable trust that operates as a share trustee on behalf of an identified class of beneficiaries.

The securitisation company issues notes or other debt instruments to the investors and uses the funds received to acquire a portfolio of assets such as distressed debt. The interest paid under the debt instruments issued by the securitisation company generally corresponds to the income derived from the investments (minus costs incurred by the securitisation vehicle).[19]

Given that the income derived from the underlying assets is largely transferred to the investors (for example, in the form of interest paid under notes), the only payments made by the securitisation company to the charitable trust are (limited) profit distributions and capital repayments at the end of the lifetime of the investment.

The following chart depicts a typical orphan structure:



3.3. Application of the standalone entity exception

The ownership of the shares in the Luxembourg securitisation company has to be attributed in accordance with the concept of economic ownership regardless of the classification of a trust or a foundation from a Luxembourg tax perspective.

The concept of economic ownership is an expression of the economic approach (that is broadly speaking substance over form) according to which the economic reality should take precedence over the mere legal form. With regard to the ownership of assets for tax purposes, economic ownership takes precedence over legal ownership when the legal owner and the economic owner are not the same person. This approach, of general application and enshrined in certain specific provisions (see discussion of Section 11 below) has also been confirmed in the Circular.[20]

Section 11 of the Tax Adaptation Law provides for some examples as to how the concept of economic ownership applies in practice. Paragraph 2 and 3 of Section 11 of the Tax Adaptation Law provide that assets held in a fiduciary relationship should be attributed to the beneficiary thereof (depending on the circumstances, either the founder or the beneficiaries). While the typical fiduciary relationship referred to in Section 11 is a civil law concept slightly different from that of the typical common law trust, it is generally acknowledged that Section 11 of the Tax Adaptation Law also applies to common law trusts.

19. Securitisation companies fall outside the scope of Luxembourg transfer pricing rules.

20. See Section 7.2. of the Circular.

So what of a trust? A trust is a three-party fiduciary relationship in which the trust or settlor transfers assets to the trustee for the benefit of a third party (i.e. one or more beneficiaries). In the case of an orphan structure, the beneficiaries of a trust may be charities (often in the form of trusts, at least in the Anglo Saxon world) or the trust itself may be a charity with a defined class of beneficiaries. Thus, the legal ownership rests with the trust, whereas the beneficial or economic ownership belongs to the beneficiaries.

However, the trust is not specifically mentioned in either the list of entities that are liable to corporate tax (Article 159 of the LITL) nor in the list of entities that are transparent for tax purposes (Article 175 of the LITL).

As a consequence, the individual beneficiaries of a charitable trust should be considered as the owner of the shares in the securitisation companies from a Luxembourg tax perspective and, provided that these beneficiaries do not constitute an associated enterprise (having a right to more than 25% for example), the securitisation company should not have an associated enterprise within the meaning of Article 164ter (2) of the LITL.

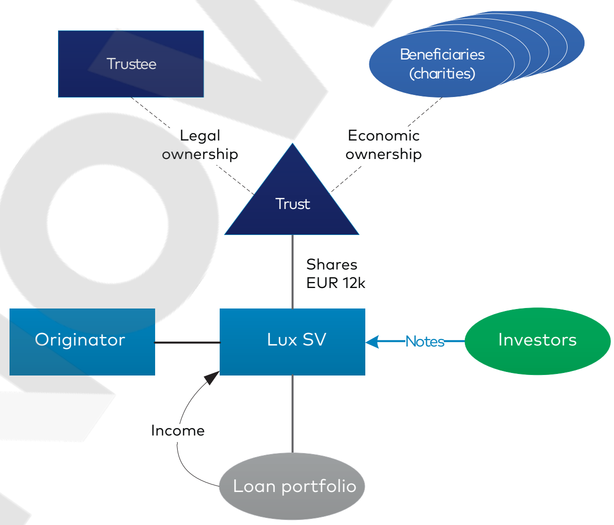
If the immediate owner of the shares were a trust with other trusts as beneficiaries, then the same analysis would apply, effectively looking through to the ultimate beneficiaries of these other trusts.

In many cases, Luxembourg securitisation companies are also held by foundations such as a Dutch Stichting. Here, it has to be analysed on a case-by-case basis whether the foundation is an entity within the meaning of Article 159 or 160 of the LITL (corporate taxpayer) or Article 175 of the LITL (transparent entity). This requires a detailed analysis of the precise constitution and operating rules of the foundation. In addition, a separate although linked analysis of whether the Foundation is the beneficial owner of the shares may be required.

CASE STUDY: THE LUXEMBOURG SECURITISATION COMPANY

A Luxembourg securitisation company ("LuxSV") is established by the originator (the "Originator"), a Luxembourg bank, LuxSV having minimum share capital of EUR 12,000 that is legally owned by a Trust ("Trust"). The immediate beneficiaries of the Trust are one or more charitable organisations that enjoy equal rights in the Trust. The charitable organisations in turn, in trust or similar form, are not the economic beneficiaries of the rights in the Trust but have multiple "ultimate" beneficiaries, with no individual ultimate beneficiary having more than 20% of the shares in LuxSV on a "look through" basis.

LuxSV issues bonds to investors with an aggregate principal amount of EUR 100,000,000 and uses the funds received to acquire non-performing loans of the Originator. The bonds bear variable yield corresponding to the income derived LuxSV from its loan portfolio minus the costs incurred by LuxSV in regard to corporate governance and management of the investments and any residual profit generated by LuxSV.



In the present case, the shares of LuxSV are held by the Trust. However, while the Trust is the legal owner of the participation in LuxSV, all economic rights in the shares rest with the ultimate beneficiaries of the charities that are the economic owners of the participation in LuxSV.

When the legal owner and the economic owner are not the same, it is the economic ownership which is relevant for Luxembourg tax purposes. Accordingly, the relevant shareholders of LuxSV are, for tax purposes, the beneficiaries of the charities.

As LuxSV is a standalone entity (none of the shareholders owns 25% or more in LuxSV), the interest limitation rules do not apply to LuxSV. Hence, variable interest expenses incurred in relation to the bonds are fully deductible at the level of LuxSV.

The question has been raised on occasion whether interest on variable rate notes could create a associated enterprise relationship with a significant bondholder, if that bondholder were entitled to 25% or more of the variable rate interest. The authors are of the view that this question should be answered in the negative (absent any obvious avoidance motive). This for at least 2 reasons:

- firstly, on a straightforward reading, the law refers to a right to receive 25% or more of the profits of the entity, whereas the commercial essence of a securitisation is that the yield will depend on cash flows, irrespective of accounting profits that may vary depending on the unrealised changes in valuation of the underlying assets; and
- secondly, as the variable interest payments are classified as borrowing costs (so prima facie subject to limitation), it would seem to be contradictory to classify these for the purposes of the same provisions as profits.

4. CONCLUSION

The implementation of the interest limitation rules has created quite some legal uncertainty for Luxembourg securitisation companies. In particular, the exact scope of the standalone entity exception and the interpretation of concepts such as interest and economically equivalent expenses (or revenues) give rise to a lack of clarity.

When securitisation companies invest into distressed debt assets, it should be possible to reflect income up to the amount of the original reasonable expectation as "interest income", whereas any exceeding income should be treated as capital gains. This accounting treatment should mitigate the scope of application of the interest limitation rules significantly as only exceeding borrowing costs might be restricted in terms of deductibility.

However, when it can be established that the standalone entity exception applies, the interest limitation rules do not apply at all. Therefore, originators should look carefully at existing or planned structures as, in the experience of the authors, a significant proportion of the orphaned securitisation vehicles should in fact benefit from the standalone entity exception set out in the law.

Securitisation is an important niche market of the Luxembourg financial centre that may also play its role in overcoming the economic effects of the current COVID-19 crisis. In particular, investments into distressed debt are expected to become a flourishing asset class which may also contribute to businesses obtaining much needed liquidity. Ultimately, securitisation needs to function without unexpected tax charges due to non-deductibility of interest paid on notes.

The authors wish to thank Samantha Schmitz (Chief Knowledge Officer) for her assistance.