Doctrine

INTEREST LIMITATION RULES

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1. INTRODUCTION

The interest limitation rules have been implemented as part of the 2019 tax reform that transposed the Anti-Tax Avoidance Directive ("ATAD")[2] and other anti-Base Erosion and Profit Shifting ("BEPS") measures into Luxembourg tax law. The interest limitation rules provided under ATAD have been largely inspired by the recommendations made in the Final Report on Action 4 of the OECD BEPS Project that aimed at developing guidance on limiting base erosion involving interest deductions and other financial payments.[3]

The interest limitation rules rely on a fixed ratio rule as the general rule and a group-wide rule as carve-out from the general rule. The fixed ratio rule limits an entity's net deductions for interest and payments that are economically equivalent to interest to a percentage of maximum 30% of its earnings before interest, taxes, depreciation and amortisation ("EBITDA").[4]

By adding a carve-out to the fixed ratio rule, the specific circumstances of capital-intensive industries and investments relying heavily on external funding should be considered. Exceeding borrowing costs up to an amount of EUR 3m may be deducted without any limitation (a safe harbour provision). The interest limitation rules further provide for several exceptions (entities and loans excluded from the scope) and carry-forward mechanisms that allow companies to carry forward both non-deductible interest and unused interest capacity.

On 8 January 2021, the Luxembourg tax authorities released a tax circular (the "Circular") on the interpretation of the interest limitation rules.[5]

2. KEY COMMERCIAL REASONS FOR DEBT FUNDING

How a business finances its operations is an important business decision that depends on a range of factors. While the deductibility of interest expenses is one factor to be considered, the decision as to whether a company should be financed by equity or debt is generally not tax driven and there are a number of good commercial reasons why intra-group loans can be preferable to a contribution of equity. Evidently, a loan receivable is very different from a participation in a company.

On the one hand, debt is easier to create and provides much more flexibility in terms of cash repatriation (i.e. repayment of principal amount and payment of interest) than equity. The cost of capital of debt is generally lower than that of equity. On the other hand, equity tends to be more formal and bureaucratic to issue and repay resulting in higher administrative costs for financing. Furthermore, dividend distributions are subject to limitations in terms of amount and timing and the repayment of capital is not a straight-forward exercise and may trigger additional tax costs.

In many circumstances, the split between equity and debt funding will be dictated by external aspects. While debt generally ranks pari passu with other creditors, equity always ranks below debt. Hence, the choice of equity or debt funding has a significant impact on the ranking between intra-group funding and external debt funding. In some countries, the decision regarding mix of debt and equity will be dictated by foreign exchange controls[6] or other local regulatory constraints and in the absence of economic and political stability there may be a strong preference for debt funding (to ease future cash repatriation). Moreover, debt funding may be preferred when minority shareholders co-invest into a company in order to not change the dynamics of an investment. Additional

1. The author wishes to thank Samantha Schmitz (Chief Knowledge Officer) for her assistance.
2. 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.
3. See http://www.oecd.org/tax/limiting-base-erosion-involving-interest-deductions-and-other-financial-payments-action-4-2015-final-report-9789264241176-en.htm.
4. EU member states were free to choose a ratio below 30% of the EBITDA.
5. Circular L.I.R. n° 168bis/1 of 8 January 2021.
6. For example, some jurisdictions, such as China, obstruct the repatriation of equity from companies located in their territory in order to keep cash from inbound investments within their country borders.

equity funding may further be subject to shareholder approval.

A key consideration is that a group will seek external finance in the country where the capital market offers the best conditions. This is, however, not necessarily the country of investment and parent companies will often be able to raise external funding at lower rates than their subsidiaries. There are significant commercial benefits from a centralized treasury function managing a group's financing. Accordingly, it is legitimate – and not BEPS motivated – to implement a central treasury function or finance companies. Last but not least, where access cash is moved around a group between entities without a direct shareholding relationship, there is reasonably no way to grant additional funding in the form of equity.

3. SCOPE OF THE INTEREST LIMITATION RULES

3.1. *Personal scope of application*

The interest limitation rules apply to all Luxembourg corporate taxpayers, including entities within the meaning of article 159 of the LITL (Luxembourg companies, cooperatives, etc.) and Luxembourg permanent establishments ("PE") of non-resident corporate entities[7].

3.2. *Financial undertakings excluded from the scope*

The following financial undertakings, regulated by European Union ("EU") directives and regulations, are explicitly excluded from the scope of the interest limitation rules[8]:

- A credit institution or an investment firm as defined in article 4 (1) of directive 2004/39/EC of the European Parliament and of the Council[9];
- An alternative investment fund manager ("AIFM") as defined in article 4 (1) b) of Directive 2011/61/EU;
- An undertaking for collective investment in transferable securities ("UCITS") management company as defined in article 2 (i) b) of directive 2009/65/EC;
- An insurance undertaking as defined in article 13 (1) of directive 2009/138/EC of the European Parliament and of the Council[10];
- A reinsurance undertaking as defined in article 13 (4) of directive 2009/138/EC;
- An institution for occupational retirement provision falling within the scope of directive 2003/41/EC of the European Parliament and of the Council[11], unless a member state has chosen not to apply that directive in whole or in part to that institution in accordance with article 5 of that directive or the delegate of an institution for occupational retirement provision as referred to in article 19 (1) of directive 2003/41/EC;
- Pension institutions operating pension schemes which are considered to be social security schemes covered by regulations (EC) No. 883/2004 and (EC) No. 987/2009 as well as any legal entity set up for the purpose of investment of such schemes;
- An alternative investment fund ("AIF") managed by an alternative investment fund manager as defined in article 4 (1) b) of directive 2011/61/EU of the European Parliament and of the Council[12] or an AIF supervised under the applicable national law;
- UCITS in the meaning of article 1 (2) of directive 2009/65/EC of the EU Parliament and of the Council[13];
- A central counterparty as defined in article 2 (1) of regulation (EU) No. 648/2012[14];
- A central securities depository as defined in article 2 (1) of regulation (EU) No. 909/2014 of the European Parliament and of the Council[15];
- Securitization vehicles within the meaning of article 2 (2) of regulation (EU) 2017/2402 of the European Parliament and of the Council[16].[17]

7. Article 160 (1) of the LITL.
8. Article 168bis (8) a) of the LITL.
9. Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC (OJ L 145, 30.4.2004, p. 1).
10. Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (OJ L 335, 17.12.2009, p. 1).
11. Directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision (OJ L 235, 23.9.2003, p. 10).
12. Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No. 1060/2009 and (EU) No. 1095/2010 (OJ L 174, 1.7.2011, p. 1).
13. Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (OJ L 302, 17.11.2009, p. 32).
14. Regulation (EU) No. 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (OJ L 201, 27.7.2012, p. 1).
15. Regulation (EU) No. 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No. 236/2012 (OJ L 257, 28.8.2014, p. 1).
16. Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 establishing a general framework for securitization and a specific framework for simple, transparent and standardised securitizations and amending Directives 2009/65/EC, 2009/138/EC and 2011/61/EU and Regulations (EC) 1060/2009 and (EU) 648/2012.
17. 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". Thus, this carve-out might be abolished.

3.3. 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 PE.[18]

With regard to the definition of associated enterprise, article 168bis of the LITL[19] 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 (directly or indirectly) or in which the Luxembourg taxpayer owns (directly or indirectly) 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 and that the Luxembourg company does not own any participation of 25% or more in terms of voting rights, capital ownership or profit entitlement. According to the Circular, the shareholding relationship must be analysed from an economic point of view.[20] Therefore, when the legal owner and economic owner of a participation are not the same person, economic ownership is decisive for the attribution of ownership for tax purposes.

3.4. Loans excluded from the scope

3.4.1. Grandfathering rule

Loans concluded before 17 June 2016 are excluded from the restrictions on interest deductibility.[21] However, this grandfathering rule does not apply to any subsequent modification of such loans.

The Circular provides for a number of examples as to which changes are (not) to be considered as a subsequent modification of a loan concluded before 17 June 2016.

A non-exhaustive list of changes that would be considered as a subsequent modification within the meaning of the grandfathering rule include:

- a modification of the term of the loan as from 17 June 2016 when such modification was not contractually provided for before that date;
- a modification of the interest rate or the calculation of interest from 17 June 2016 when such modification was not contractually provided for before that date;
- an increase of the amount borrowed after 17 June 2016 (if the loan does not provide for a credit facility that has been agreed before that date);
- a modification of one or more of the parties concerned after 17 June 2016.[22] The Circular explicitly states that restructurings such as mergers or demergers do not jeopardize the benefit of the grandfathering rule.[23]

A non-exhaustive list of changes that are not considered as a subsequent modification include:

- a modification of the term of the loan as from 17 June 2016 as long as such modification was contractually provided for before that date and does not require the agreement of the parties but merely results from the application of the terms of the loan;
- a modification of the interest rate or the calculation of interest from 17 June 2016 when such modification was contractually provided for before that date;
- a drawdown of funds under a facility agreement or a line of credit as from 17 June 2016, provided that the line of credit has been agreed upon before that date;
- a transfer to Luxembourg of the registered office or central administration of a collective undertaking which

18. Article 168bis (8) b) of the LITL.
19. Article 168bis (1) No. 6 of the LITL.
20. See No. 65 of the Circular.
21. Article 168bis (7) a) of the LITL.
22. While a change of the borrower after 17 June 2016 (resulting in additional borrowing costs for the new borrower) should jeopardize the application of the grandfathering rule, in our view, a mere change of the lender (transfer of a loan receivable) should not be treated as a modification of the loan if the terms and conditions are otherwise not amended.
23. See No. 45 of the Circular.

is a party to a loan entered into before 17 June 2016 without any change in the terms of the loan.[24]

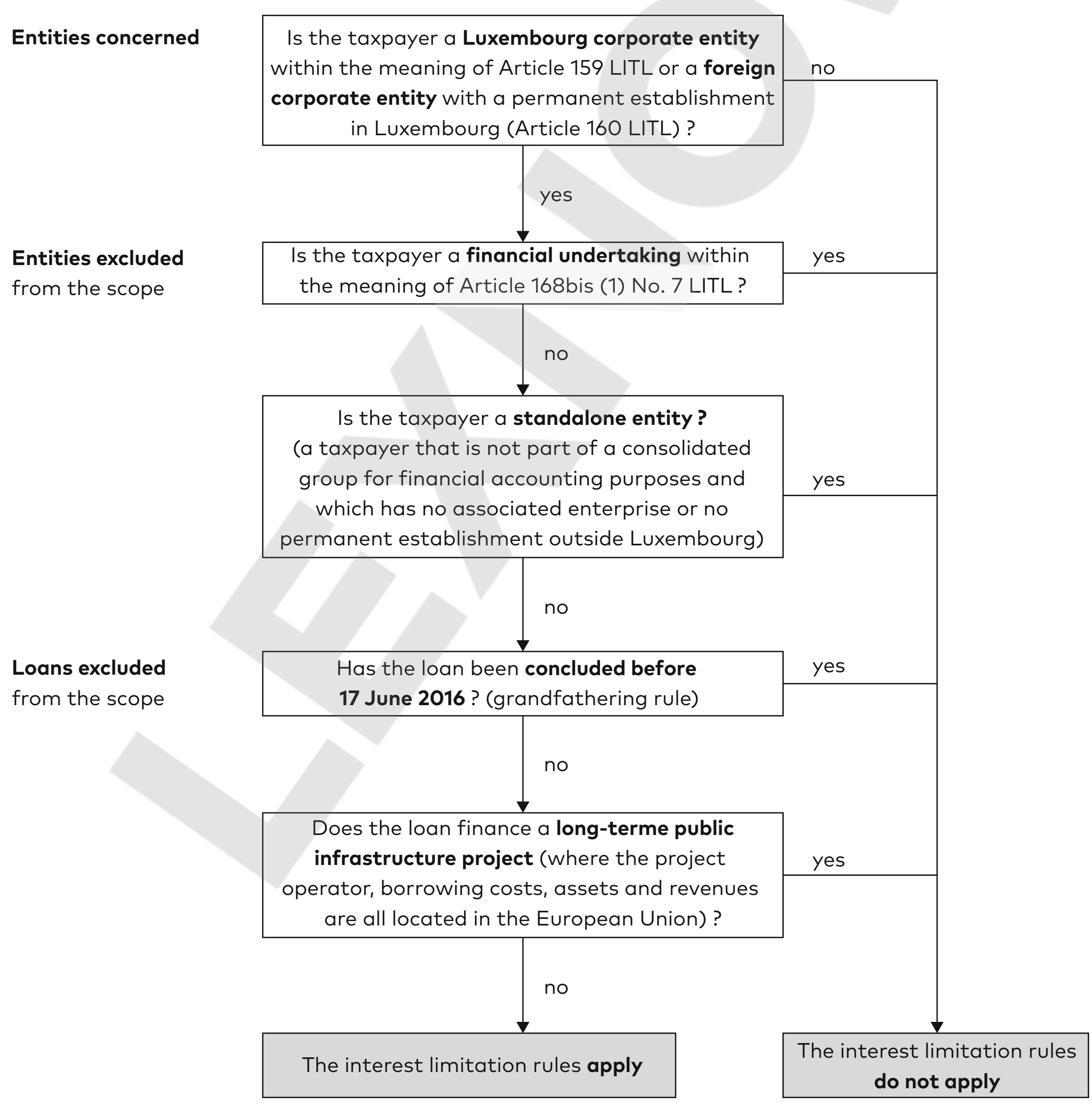
3.4.2. Long-term public infrastructure loans

Loans used to fund long-term public infrastructure projects are excluded from the scope of the interest deduction limitation rules.[25] Moreover, any income from a long-term public infrastructure project is excluded from fiscal EBITDA. Instead, the fiscal EBITDA should only take into account activities other than those linked to the long-term public infrastructure project.[26]

In this regard, a long-term public infrastructure project is defined as a project recognized as being in the public interest to provide, improve, operate or maintain a major asset.[27] In order to be eligible, the project must include an infrastructure asset which is created, modernized or renovated, managed or preserved.[28]

This exception further requires that the project operator, borrowing costs, assets and revenues are all located in the European Union.[29]

3.5. Checklist: Scope of the interest limitation rules



24. See No. 46 of the Circular.
25. Article 168bis (7) b) of the LITL.
26. See No. 58 of the Circular.
27. See No. 57 of the Circular.
28. See No. 54 of the Circular.
29. See No. 51 of the Circular.

4. MECHANISM OF THE INTEREST LIMITATION RULES

4.1. Opening comments

Luxembourg companies are subject to corporate income tax and municipal business tax on their worldwide income. When applicable, the interest limitation rules may result in the (partial) non-deductibility of interest expenses for Luxembourg corporate income tax purposes.

The taxable basis for municipal business tax corresponds to the commercial income[30] (that is the taxable income determined in accordance with the corporate income tax law) which is adjusted in accordance with Sections 8 and 9 of the Municipal Business Tax Law. Therefore, the interest limitation rules have a direct impact on the municipal business tax base.

4.2. Determining exceeding borrowing costs

4.2.1. General

Article 168bis of the LITL limits the deductibility of "exceeding borrowing costs" generally to a maximum of 30% of the corporate taxpayers' (tax) EBITDA.

The scope of the interest deduction limitation rule encompasses all interest-bearing debt irrespective of whether the debt financing is obtained from a related party or a third party.

"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."

4.2.2. Definition of borrowing costs

Borrowing costs within the meaning of this provision are interest expenses on all forms of debt, other costs economically equivalent to interest and 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;
- capitalized interest included in the balance sheet value of a related asset, or the amortization of capitalized interest;
- amounts measured by reference to a funding return under transfer pricing rules where applicable[31];
- 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[32];
- 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.

4.2.3. 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.[33]

30. Section 6 (1) of the Municipal Business Tax Law.
31. Transfer pricing adjustments under article 56 of the LITL (or the concepts of hidden dividend distribution and hidden capital contribution) that are made to reflect (deemed) arm's length interest expenses are treated just as standard interest payments for the purposes of the interest limitation rules; see No. 14 of the Circular.
32. The Circular (see No. 16) clarifies that exchange gains and losses arising from their principal amount are not taken into account in this respect. In addition, as foreign exchange variations are only final once they are realized, unrealized foreign exchange gains and losses should not be taken into consideration for the purposes of the interest limitation rules.
33. See No. 20 of the Circular.

4.3. The 30% EBITDA limitation and the safe harbour rule

4.3.1. Determination of the (tax) EBITDA

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 amortization (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.

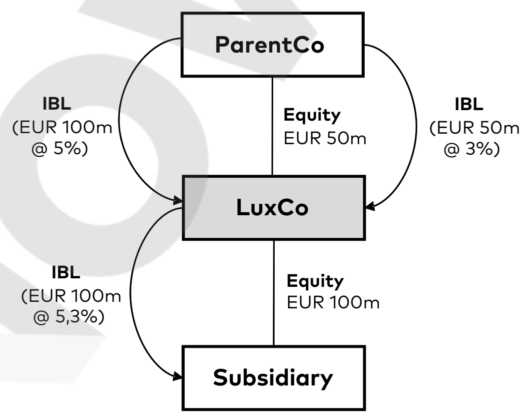
Income and capital gains may benefit from a tax exemption provided under Luxembourg tax law or in tax treaties concluded by Luxembourg. For example, income and capital gains derived from qualifying participations may benefit from a tax exemption under the participation exemption regime.[34] Moreover, income and capital gains derived from immovable properties situated in tax treaty jurisdictions are frequently tax exempt in accordance with the applicable tax treaty.[35]

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.[36] 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.[37] Tax adjustments may further be necessary in accordance with Luxembourg transfer pricing rules[38] and specific provisions such as the hybrid mismatch rules.[39]

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 amortization[40] that reduced the taxable income of the company need to be reintegrated to arrive at the relevant tax EBITDA.

CASE STUDY: DETERMINING THE TAX EBITDA

A Luxembourg company ("LuxCo") that is held by a foreign parent company ("ParentCo") invests into a subsidiary resident in another EU member state ("Subsidiary").



LuxCo finances Subsidiary with an interest-bearing loan ("IBL") of EUR 100m and equity of EUR 100m. At the level of LuxCo, the IBL granted to Subsidiary is financed by an IBL of EUR 100m granted by ParentCo. The interest rates charged on the IBLs are, respectively, 5.3% and 5% resulting in an arm's length margin of 30 bps that has been determined in a transfer pricing study. LuxCo finances the participation in Subsidiary with EUR 50m of equity and an interest-bearing loan of EUR 50m which bears interest at a rate of 3%.

In 2020, LuxCo realizes EUR 5.3m of interest income and EUR 1m of dividend income. LuxCo further incurs interest expenses of EUR 5m (in regard to the IBL of EUR 100m) and EUR 1.5m (in regard to the IBL of EUR 50m). Moreover, LuxCo incurs operational expenses of EUR 100k and tax costs of EUR 50k. As a result, LuxCo realized a loss of EUR 350k from an accounting perspective.

34. Article 166 of the LITL.
35. 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 on Income and Capital.
36. Article 45 (2) and 166 (5) No. 1 of the LITL.
37. Article 168 No. 2 of the LITL.
38. The concept of hidden dividend distributions or article 56 of the LITL.
39. Article 168ter of the LITL.
40. Article 29 to 34 of the LITL.

Determination of the accounting result:

	Interest income (IBL, EUR 100 @ 5.3%)	EUR	5,300k
+	Dividend income	EUR	1,000k
–	Interest expenses (IBL, EUR 100m @ 5%)	EUR	5,000k
–	Interest expenses (IBL, EUR 50m @ 3%)	EUR	1,500k
–	Operational expenses	EUR	100k
–	Tax costs	EUR	50k
=	**Accounting result (loss)**	**EUR**	**– 350k**

When determining the taxable income, it is necessary to perform several tax adjustments. While the dividend income of EUR 1m benefits from a tax exemption under the Luxembourg participation exemption regime[41], interest expenses incurred in relation to the financing of the participation should not be deductible up to the amount of interest expenses that are in direct economic relationship to tax exempt income.[42] Thus, interest expenses corresponding to the amount of tax exempt dividend income received in 2020 (EUR 1m) is non-deductible for tax purposes. Moreover, the tax costs of EUR 50k are non-deductible for tax purposes.[43]

Determination of the taxable income:

	Accounting result (loss)	– EUR	350k
–	Tax exempt dividend income	– EUR	1,000k
+	Non-deductible interest expenses	EUR	1,000k
+	Non-deductible tax costs	EUR	50k
=	**Taxable income (tax loss)**	**– EUR**	**300k**

Determination of the tax EBITDA:

	Taxable income	– EUR	300k
+	Interest expenses (tax deductible)	EUR	5,500k
–	Interest income (taxable)	– EUR	5,300k
+	Depreciation and amortization	EUR	-
=	**Tax EBITDA**	**– EUR**	**100k**

Based on the above, the taxable income corresponds to EUR 300k of tax losses and the relevant tax EBITDA to minus EUR 100k.

4.3.2. The safe harbour rule

Exceeding borrowing costs up to an amount of EUR 3m may be deducted without any limitation (the safe harbour rule).[44] This safe harbour rule 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.

4.3.3. Non-deductibility of interest expenses

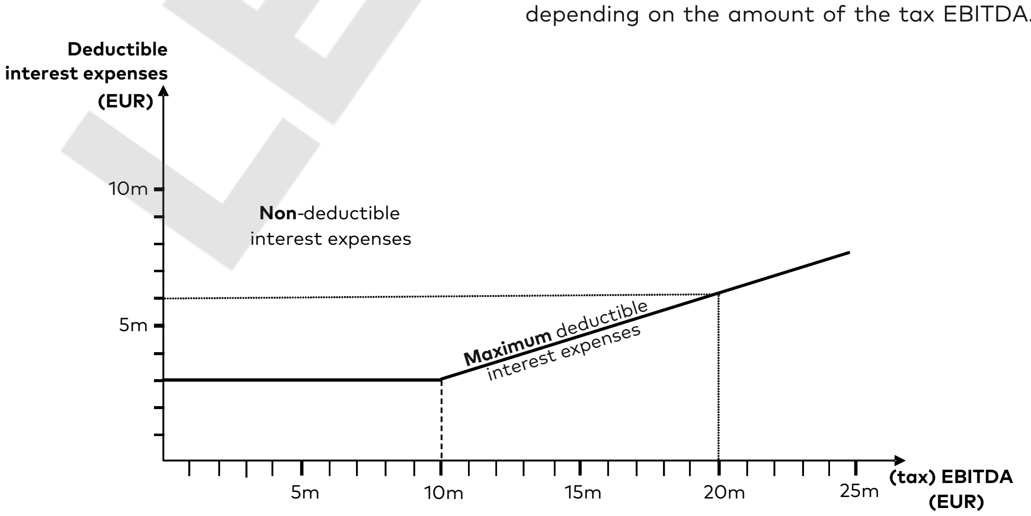
Under the interest limitation rules, exceeding borrowing costs up to the higher of

(i) 30% of the tax EBITDA, and

(ii) the EUR 3m safe harbour

are deductible for tax purposes.[45] Conversely, exceeding amounts are non-deductible for tax purposes.

The following chart depicts the maximum amount of deductible interest expenses (exceeding borrowing costs) depending on the amount of the tax EBITDA.



41. Article 166 (1) of the LITL.
42. Article 166 (5) No. 1 of the LITL.
43. Article 168 No. 2 of the LITL.
44. Article 168bis (2) b) of the LITL.
45. Article 168bis (2) of the LITL.

Exceeding borrowing costs up to an amount of EUR 3m may be deducted without any limitations. When the exceeding borrowing costs exceed the amount of the safe harbour, Luxembourg companies may deduct additional interest expenses in accordance with the 30% EBITDA rule once the amount of the tax EBITDA exceeds EUR 10m.

When the 30% EBITDA rule applies, 70% of the exceeding borrowing costs are non-deductible for Luxembourg tax purposes. This may result in an effective tax rate of ca. 17.45% (i.e. 70% * 24.94% aggregate tax rate in Luxembourg-City).

4.4. The escape clause

4.4.1. General

The interest limitation rules also provide for an escape clause for corporate taxpayers that are part of a consolidated group for financial accounting purposes. This is a group of companies consisting of all entities which are fully included in consolidated financial statements drawn up in accordance with the International Financial Reporting Standards or Luxembourg GAAP.

4.4.2. Mechanism of the escape clause

According to the escape clause, corporate taxpayers who can demonstrate that the ratio of their equity over their total assets is equal to or higher than the equivalent ratio of the group can fully deduct their exceeding borrowing costs.[46]

This requirement is deemed to be fulfilled if the ratio of the taxpayer's equity over the amount of total assets is no more than 2% lower than that of the consolidated group.[47]

This escape clause should allow capital-intensive industries that rely heavily on external funding to deduct higher levels of interest expenses.

4.4.3. Equity ratio comparison

When comparing the equity ratio of a Luxembourg company with that of the entire group, it is crucial to make sure that the assets and liabilities are treated similarly in the different accounting systems.[48] Accordingly, the same valuation principles and options (for example, fair value option) should be applied consistently in the annual accounts of the Luxembourg company and the consolidated accounts.

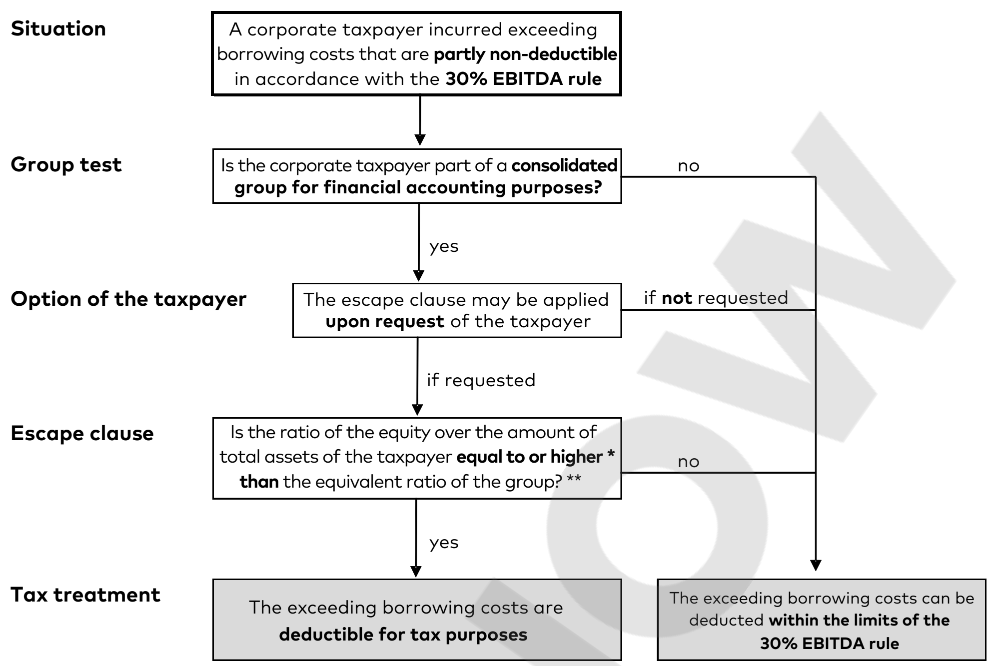
Should the accounting treatment in the annual accounts of the Luxembourg companies deviate from the principles applied in the consolidated accounts, it might be necessary to prepare a reconciliation with a view to determine comparable equity ratios.

In practice, the comparability of the annual accounts of individual entities and the consolidated accounts of the group may give rise to intricate issues that may require a time consuming reconciliation exercise.

The computations necessary for the determination of the ratio of the equity over total assets of the Luxembourg company and that of the group should be certified by an auditor.[49]

46. Article 168bis (6) of the LITL.
47. Article 168bis (6) a) of the LITL.
48. Article 168bis (6) b) of the LITL.
49. While article 168bis of the LITL does not explicitly provide such requirement, article 164bis (9) No. 10 of the LITL (Implementation of the interest limitation rules in case of fiscal consolidation) explicitly sets out this requirement.

4.4.4. Checklist: Application of the escape clause



* This requirement is deemed to be fulfilled if the ratio of the taxpayer's equity over the amount of total assets is no more than 2% lower than that of the consolidated group.

** The accounting treatment of assets and liabilities (valuation principles and options) have to be similar in the annual accounts of the Luxembourg corporate taxpayer and the consolidated accounts.

4.5. *Carry forward mechanisms*

4.5.1. 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.[50]

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.

4.5.2. 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 higher interest expenses than the actual amount of exceeding borrowing costs.[51]

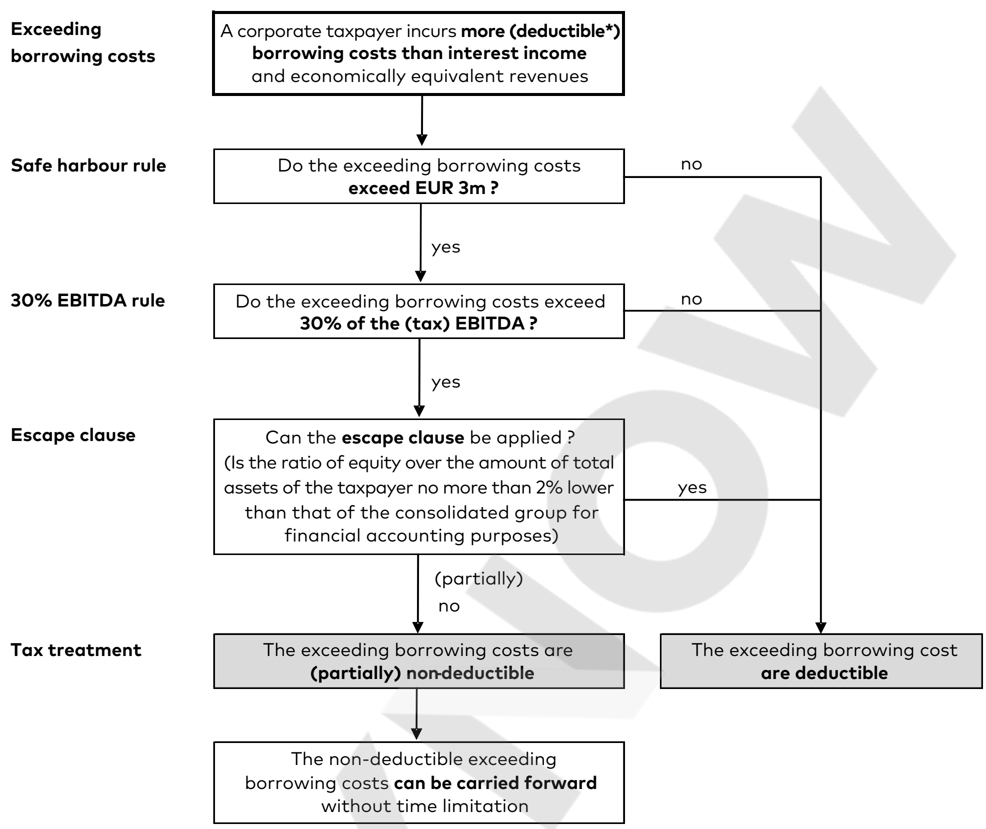
These amounts can be carried forward for a period of five tax years and are to be used on a first in, first out basis (i.e. the oldest amounts of unused interest capacity are to be used first).[52]

4.5.3. Corporate reorganisations

For corporate reorganizations that fall within the scope of article 170 (2) of the LITL (for example, mergers), exceeding borrowing costs and unused interest capacity are continued at the level of the remaining entity.

50. Article 168bis (4) of the LITL.
51. Article 168bis (3) of the LITL.
52. Article 168bis (5) of the LITL.

4.6. Checklist: Mechanism of the interest limitation rules



* Interest expenses on all forms of debt (and economically equivalent charges incurred in relation to financing) that
- are business expenses (Article 45 (1) LITL),
- not incurred in economic relationship to tax exempt income (Article 45 (2) and Article 166 (5) No. 1 LITL),
- adhere to the arm's length standard (Article 56 and 164 (3) (hidden dividend distributions) LITL), and
- do not fall within the scope of the hybrid mismatch rules (Article 168ter LITL).

4.7. Tax consolidation

4.7.1. General

Luxembourg companies are subject to corporate income tax and municipal business tax that is levied on the taxable income of each individual company. However, Luxembourg companies that are members of the same group may be taxed on a consolidated basis if certain conditions are met.[53]

When the tax consolidation regime applies, the taxable income of each member of the fiscal unity is determined separately and aggregated at the level of the integrating company. Here, the positive taxable income of some members of the fiscal unity may be offset by tax losses incurred by other members of the fiscal unity.

Article 164bis (9) of the LITL provides for specific rules regarding the application of the interest limitation rules. However, while the application of the interest limitation rules at the level of the fiscal unity is the rule, taxpayers are free to opt out of this default option. In this case, the interest limitation rules are applied at the level of each member of the fiscal unity separately.[54]

53. Article 164bis of the LITL.

54. Article 164bis (17), (20) of the LITL.

4.7.2. Determining exceeding borrowing costs

When determining the exceeding borrowing costs of the fiscal unity, the borrowing costs and interest revenues (and economically equivalent revenues) of all members of the fiscal unity have to be aggregated.[55]

Should the aggregate amount of borrowing costs exceed the aggregate amount of tax revenues, the difference would be the exceeding borrowing costs of the fiscal unity.[56]

4.7.3. The 30% EBITDA limitation and the safe harbour rule

The deductibility of exceeding borrowing costs incurred by the members of the fiscal unity is limited to the higher of:

(i) 30% of the (tax) EBITDA realized by the integrating company and the integrated companies; and

(ii) EUR 3m (safe harbour rule).[57]

The safe harbour of EUR 3m applies to all the members of the fiscal unity. In contrast, when the members of the fiscal unity opt for the application of the interest limitation rules at the level of each individual entity, the EUR 3m safe harbour applies to each of the members of the fiscal unity.

Thus, the availability of the EUR 3m safe harbour for each of the companies may be a reason to opt for the application of the interest limitation rules at the level of each individual company.

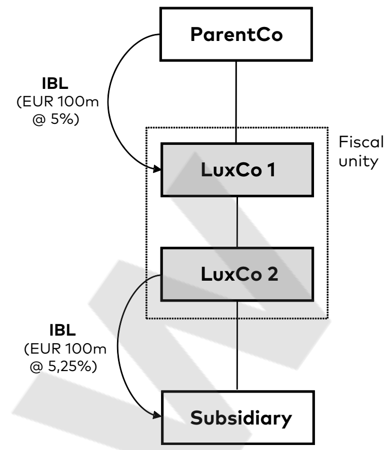
CASE STUDY: EXCEEDING BORROWING COSTS IN A FISCAL UNITY

A Luxembourg company ("LuxCo 1") is financed by a mix of equity and debt, including a EUR 100m shareholder loan that bears interest at a rate of 5%.

LuxCo 1 holds a participation in another Luxembourg company ("LuxCo 2") that is fully financed by equity.

LuxCo 2 finances its subsidiary with equity and a loan of EUR 100m that bears interest at a rate of 5.25%.

LuxCo 1 and LuxCo 2 formed a fiscal unity in accordance with article 164bis of the LITL.



LuxCo 2 realizes annual interest income amounting to EUR 5.25m and does not incur any interest expenses. In contrast, LuxCo 1 does not realize any interest income but incurs interest expenses of EUR 5m.

When applying the interest limitation rules on a standalone basis, LuxCo 1 would have exceeding borrowing costs amounting to EUR 5m that could, in view of a zero tax EBITDA, only be deducted up to the safe harbour amount of EUR 3m.

However, when the interest limitation rules are applied at the level of the fiscal unity, both LuxCo 1 and LuxCo 2 did not incur exceeding borrowing costs as the interest income of LuxCo 2 (EUR 5.25m) exceeds the interest expenses of LuxCo 1 (EUR 5m). Hence, the interest limitation rules would not limit the deductibility of interest expenses at the level of LuxCo 1, heading the fiscal unity.

4.7.4. Carry forward mechanisms

Article 164bis of the LITL provides for some specific rules regarding the carry-forward of non-deductible exceeding borrowing costs and unused interest capacity.

When exceeding borrowing costs incurred by the fiscal unity 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. 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.[58]

Non-deductible exceeding borrowing costs that a Luxembourg company incurred before joining the fiscal

55. Article 164bis (9) No. 1, 2 of the LITL.
56. Article 164bis (9) No. 3 of the LITL.
57. Article 164bis (9) No. 4 of the LITL.
58. Article 168bis (4) of the LITL.

unity may not be deducted during fiscal years that the company is a member of the fiscal unity. Such carry forward may be used again once the company leaves the fiscal unity.[59]

When the amount corresponding to 30% of the tax EBITDA realized by the members of the fiscal unity exceeds in a given year the amount of exceeding borrowing costs (provided that this amount exceeds EUR 3m), such difference is unused interest capacity.[60]

Exceeding borrowing costs incurred by the members of the fiscal unity that exceed the maximum deduction (i.e. the 30% EBITDA limit) may be deducted up to the amount of the unused interest capacity.[61] These amounts can be carried forward for a period of five tax years and are to be used on a first in, first out basis (i.e. the oldest amounts of unused interest capacity are to be used first).[62]

Unused interest capacity that a Luxembourg company realised before joining the fiscal unity cannot be used during the period the company forms part of the fiscal unity. Instead, the unused interest capacity is locked in until the company leaves the fiscal unity in the future. The 5-year time limitation is suspended for the period that the company is part of the fiscal unity.[63]

4.7.5. The escape clause

When all the members of a fiscal unity are also members of a consolidated group for financial accounting purposes[64], the exceeding borrowing costs of the integrating parent company and the integrated subsidiaries can, upon request, be fully deducted to the extent that it can be demonstrated that the ratio of equity over the total assets of all the members of the fiscal unity is equal to or higher than the equivalent ratio of the group.[65]

The escape clause applies if the taxpayer can demonstrate that the ratio of its equity over the amount of total assets is equal to or higher than the equivalent ratio of the group. This requirement is deemed to be fulfilled if the ratio of the taxpayer's equity over the amount of total assets is no more than 2% lower than that of the consolidated group.[66]

When comparing the equity ratio of the fiscal unity with that of the entire group, it is crucial to make sure that the assets and liabilities are treated similarly in the different accounting systems.[67] Accordingly, the same valuation principles and options (for example, fair value option) should be applied consistently in the annual accounts of the Luxembourg companies that are members of the fiscal unity and the consolidated accounts.

Should the accounting treatment in the annual accounts of the Luxembourg companies deviate from the principles applied in the consolidated accounts, it might be necessary to prepare a reconciliation with a view to determine comparable equity ratios.

The application of the escape clause requires that the taxpayer attaches details of the calculations regarding the determination of the equity ratio of the fiscal unity and the consolidated group which have to be certified in a report to be drawn up by a certified auditor. This is obviously a costly exercise.

4.7.6. Loans excluded from the scope

Loans concluded before 17 June 2016 are excluded from the restrictions on interest deductibility.[68] However, this grandfathering rule does not apply to any subsequent modification of such loans.[69]

Moreover, loans used to fund long-term public infrastructure projects are excluded from the scope of the interest deduction limitation rule.[70] A long-term public infrastructure project is defined as a project recognized as being in the public interest to provide, improve, operate or maintain a major asset.

4.7.7. Financial undertakings excluded from the scope

Article 164bis of the LITL clarifies that the interest limitation rules do not apply in case of financial undertakings, regulated by EU Directives and Regulations, which are listed in article 168bis (1) No. 7 a) – j) of the LITL.

59. Article 164bis (9) No. 10 of the LITL.
60. Article 164bis (9) No. 6 of the LITL.
61. Article 164bis (9) No. 8 of the LITL.
62. Article 164bis (9) No. 7 of the LITL.
63. Article 164bis (9) No. 11 of the LITL.
64. A consolidated group for financial accounting purposes means a group of companies consisting of all entities which are fully included in consolidated financial statements drawn up in accordance with the International Financial Reporting Standards or Luxembourg GAAP.
65. Article 164bis (9) No. 9 of the LITL.
66. Article 168bis (6) a) of the LITL.
67. Article 168bis (6) b) of the LITL.
68. Article 164bis (9) No. 12 a) of the LITL.
69. See section 3.4.1. above.
70. Article 164bis (9) No. 12 b) of the LITL, see section 3.4.2. above.

4.8. Checklist: Deductibility of interest

The analysis as to whether or not interest expenses are deductible for Luxembourg tax purposes is a multi-layer exercise that requires much more than a mere analysis of the interest limitation rules.

Interest expenses incurred by corporate taxpayers are deductible for Luxembourg tax purposes if certain conditions are met. Interest expenses are generally business expenses[71] that are tax deductible to the extent that they are not incurred in economic relationship with tax exempt income.[72] Tax exemptions may apply under Luxembourg tax law[73] and tax treaty law[74].

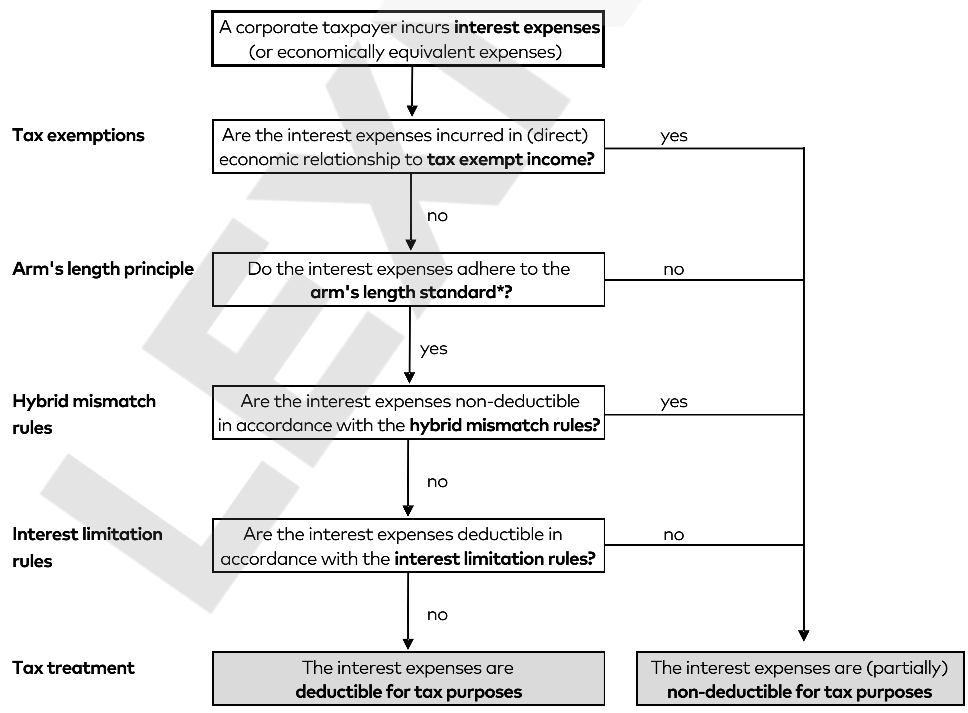
A specific tax exemption provided under Luxembourg tax law is the participation exemption regime. While income derived from qualifying participations (dividends, capital gains, liquidation proceeds) may benefit from a tax exemption, (interest) expenses incurred in relation to qualifying participations may be tax deductible to the extent that no tax exempt dividend income is realized in a given year. Here, a specific rule applies according to which only those expenses are non-deductible that have been incurred in direct economic relationship to tax exempt income.[75] The word "direct" limits the non-deductibility to the amount of tax exempt dividend income realised in the same fiscal years.

The deductibility of interest expenses further requires that the interest expenses adhere to the arm's length principle. Otherwise, the excessive part of the interest payments is non-deductible in accordance with article 56 of the LITL or the concept of hidden dividend distributions.[76]

The deductibility of interest expenses may further be denied on grounds of the hybrid mismatch rules.[77] This might, for example, be the case when interest payments are made under a (hybrid) financial instrument that is classified as debt under Luxembourg tax law and as equity under the law of the recipient of the interest income (to the extent that such income is tax exempt at the level of the recipient).

Finally, it has to be analysed whether the otherwise deductible interest expenses are (partially) non-deductible under the interest limitation rules.

The following checklist reflects the sequence of steps to be followed when analysing the deductibility of interest expenses for Luxembourg tax purposes:



* The non -deductibility in accordance with Article 56 LITL or Article 164 (3) LITL (hidden dividend distributions) is limited to excessive interest payments.

71. Article 45 (1) of the LITL.
72. Article 45 (2) of the LITL.
73. For example, the Luxembourg IP tax regime (article 50ter of the LITL) or a 50% exemption which applies to qualifying dividend payments (article 115 No. 15 a) of the LITL).
74. For example, an exemption of income from immovable property (article 6 of the OECD Model Tax Convention on Income and Capital) and income derived through a foreign permanent establishment (article 7 of the OECD Model Tax Convention on Income and Capital, Business expenses).
75. Article 166 (5) No. 1 of the LITL.
76. Article 164 (3) of the LITL.
77. Article 168ter of the LITL.

5. CRITICAL REVIEW OF THE INTEREST LIMITATION RULES

5.1. Opening comments

The interest limitation rules may result in the non-deductibility of interest expenses for tax purposes. However, while limiting the deductibility of interest expenses may seem to be a good idea in order to tackle perceived abuse, the effect of the interest limitation rules is not uncontroversial.

The most important concerns relate to unpredictable outcomes, potential double taxation, undesired impact on business decisions and potential constitutional issues.

5.2. Uncertain outcomes

The interest limitation rules essentially limit exceeding borrowing costs to 30% of a company's (tax) EBITDA. The key weakness of this fixed ratio rule is that it proposes a "one size fits all" approach which does not take into account the significant differences among businesses in different sectors with different profit margins and different debt ratios; some businesses require more gearing than others.

As such, the deductibility of interest expenses may be restricted due to the mere fact that a company is not profitable during certain periods or a recession. The COVID-19 crisis is a good example for extraordinary circumstances where some businesses severely suffer through no fault of their own.

However, when the (tax) EBITDA drops, the quantum of deductible borrowing costs automatically decreases which further exacerbates the financial difficulties of businesses that are already hit by the crisis. The existing carry-forward mechanism does not mitigate the adverse consequences of the interest limitation rules since carried forward borrowing costs may never be deductible.

The interest limitation rules further induce uncertainty since the deductible borrowing costs may only be determined at the end of the fiscal year based on the (tax) EBITDA.

The escape clause also contributes to uncertainty. While it is positive to have an escape clause for highly indebted groups, the escape clause has a number of flaws. First, the escape clause is difficult to apply in practice as it may require complex reconciliation exercise that may become costly to taxpayers. Second, taxpayers will not know the amount of deductible interest expenses until all the financial statements are prepared. Third, a group of companies may be involved in a number of completely different businesses with different capital structure. In these circumstances, the reliance on one average capital structure that is accidently reflected in the consolidated accounts does not make sense from an economic perspective.

5.3. Risk of double taxation

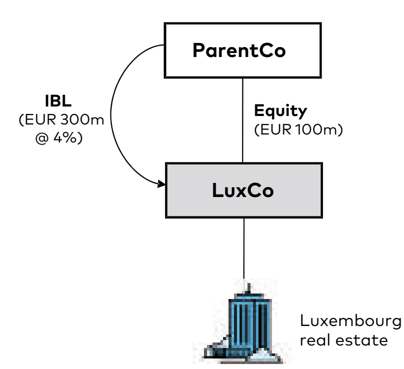
When interest expenses are not deductible, double taxation will likely arise as the lender should be taxable on the corresponding income. To deal with this obstacle, a carry-forward mechanism should be implemented in regard to both the non-deductible interest and unused capacity so as to mitigate the effect arising from the volatility in a company's earnings over time. Nonetheless, even such carry-forward would not eliminate the problem of double taxation as companies may never be in a position to use the amounts carried forward (for example, banks, real estate property companies or finance companies).

Therefore, in order to reduce the negative impact on the financing of investments (for example, investments in capital-intensive industries and real estate or infrastructure projects), a recommendation regarding the fixed ratio must not be set too low. It is also important to remember that the current interest rates are at historic lows. Hence, data on interest expense levels in the current environment is not at all representative and cannot be the basis for benchmarking an appropriate fixed ratio.

CASE STUDY: NON-DEDUCTION/INCLUSION OUTCOME

A Luxembourg company ("LuxCo") invests into Luxembourg real estate assets. The acquisition price of the real estate corresponds to EUR 400m. LuxCo is financed by a mixture of equity (EUR 100m) and an interest-bearing loan ("IBL", EUR 300m) granted by the foreign parent company ("ParentCo").

LuxCo realizes annual rental income of EUR 20m and incurs operational costs of EUR 1m. In addition, LuxCo books depreciation amounting to EUR 8.75m. The annual interest expenses incurred in relation to the IBL amount to EUR 12m.



Determination of the accounting profit:

	Rental income	EUR	20m
–	Operational costs	EUR	1m
–	Depreciation	EUR	8.75m
–	Interest expenses	EUR	12m
=	Accounting profit (loss)	EUR	– 1.75m

Determination of the (tax) EBITDA

	Accounting profit (loss)	EUR	– 1.75m
+	Depreciation	EUR	8.75m
+	Interest expenses	EUR	12m
=	(tax) EBITDA	EUR	19m

The maximum amount of interest that LuxCo can deduct in accordance with the interest limitation rules amounts to EUR 5.7m (= 30% of EUR 19m). Hence, EUR 6.3m of interest expenses are non-deductible for tax purposes.

While the non-deductible borrowing costs can be carried forward without limitation in time, they will likely never be deductible given that the interest expenses exceed the 30% (tax) EBITDA limitation.[78]

At the level of ParentCo, however, the full amount of interest income is subject to tax at a rate of 25%.

Consequently, while EUR 6.3m (of EUR 12m) of interest payments are non-deductible for tax purposes at the level of LuxCo, the full amount of interest income is taxable at the level of ParentCo, resulting in double taxation or a non-deduction/inclusion outcome (using the language established during the BEPS Project).

5.4. Impact on business decision making and international trade

The interest limitation rules (as implemented across Europe) have a significant impact on business decisions as these increase the effective cost of capital for businesses. This may force multinationals to raise the level of target return required on investments with the consequence that investments may be rejected that otherwise would have been approved. Apart from the negative impact on global growth and employment opportunities, the ultimate long-term effect of this could be increased costs being passed onto consumers and reduced earnings realized by the shareholders.

A group-wide rule presents a particular issue to MNEs engaged in completely different sectors with different debt requirements. Here, multinational groups may be constrained to structure their financing in a way that is most favourable from a tax perspective but which might be completely opposite to how the financing would be structured from a commercial perspective. However, even within the same corporate group, individual companies may be financed in different ways. The mechanical application of a group-wide rule would significantly restrict the freedom of businesses to structure their financing which would also affect sound business activities and financial market transactions.

The Final Report on BEPS Action 4 states that MNEs may restructure the financing of their group companies in order to more closely align net interest expense with economic activity and to maximise deductions for interest paid across the group. While this seems not to be a viable option for groups with hundreds of entities, it would mean that intra-group debt would have to be implemented in cases where there is no commercial requirement for additional funding.

Moreover, it is questionable whether reported earnings alone are a reliable indicator for an entity's economic activity. A company that realises temporarily losses may nonetheless be very active and generally profitable. An earnings-based ratio is not appropriate in these circumstances as it denies the deductibility of interest expense and increases a company's tax base irrespective of the economic loss position. Thus, it would exacerbate the situation of the company and may even lead to default when tax is due irrespective of the profitability.

In a group of companies, there may be capital intense businesses with high level of leverage (that is because debt funding represents the lowest cost of capital) and businesses which are not capital intense (for example, service companies). In these circumstances, the escape clause disallows the deductibility of interest expense of the capital intense business, whereas other companies would not be able to use their allowable interest deductions. Likewise, for institutional funds investing into a range of Alternative Investment classes such as real estate, private equity and infrastructure with different debt, asset and earnings profiles, a 'blended rate' is unlikely to be representative.

The group-wide rule would further create a competitive disadvantage for pension funds and sovereign wealth funds that usually have no third part debt compared to

78. The interest expenses may be deductible upon a future sale of the real estate assets if the capital gains are high enough.

other types of investors with significant gearing. This could act as a barrier to investment in the real estate and infrastructure sector where significant investments are needed.

A disturbing feature of a group-wide rule is that it would be an incentive to increase external debt funding for tax purposes, contrary to the lessons learned from the financial crisis. This is because highly leveraged groups are treated more favourably if a group-wide rule is applied as group companies would be allowed to deduct higher amounts of interest expenses. Should the group-wide rule only apply to cross-border financing transactions, it may further create an uneven playing field between multinational and purely domestic groups (in favour of domestic businesses).

5.5. *Constitutional issues*

The interest limitation rules further raise concerns from a constitutional perspective. While the Constitution gives broad discretionary powers to legislators in the realm of tax law, the general principle of equality provided in article 10bis (1) of the Luxembourg Constitution places limits to this discretionary leeway.

This principle requires legislators to treat similarly those things that are substantially alike and treat differently those things that are substantially different. The structure of the tax system is required to take into account the ability-to-pay principle and the consistency requirement.

In the area of income tax law, the financial ability to pay is assessed based on the objective net principle. According to this principle, only the net income (that is the income after deduction of (business) expenses) should be subject to income taxation. Thus, limiting the deductibility of borrowing costs incurred by Luxembourg companies might be a violation of the legislator's fundamental, systematic decision to apply the objective net principle.

The question arises whether the violation of the objective net principle could be justified, for example, based on the purpose of controlling economic policy, the coverage of the state's financing needs or the fight against abuse. However, in the author's view it seems doubtful that there is a valid justification for the violation of the objective net principle.

The same kind of constitutional concerns have been raised in other EU member states. Back in 2015, a decision of the German Federal Fiscal Court raised serious doubts that the German interest barrier rules (which have been the blue print of the interest limitation rules in ATAD) are constitutional.[79] The case has been referred to the German Constitutional Court that still needs to deliver its decision. However, even if the Constitutional Court confirmed the decision of the German Federal Fiscal Court, the hierarchy of the Constitution and EU Law (ATAD, etc.) would not be self-evident.

6. CONCLUSION

Debt funding is a common phenomenon of investment and business activities. While interest expenses are generally deductible for Luxembourg direct tax purposes, the interest limitation rules add yet another potential restriction on interest deductibility.

The interest limitation rules should have a limited impact on Luxembourg companies that perform holding and financing activities although this has to be analysed on a case-by-case basis.

The interest limitation rules are, however, not free from criticism: as these may result in uncertain outcomes that can also impact business decisions, there is a risk of double taxation and there are concerns from a constitutional perspective. Ultimately, the interest limitation rules are an important part of each and every tax analysis.

79. German Federal Tax Court, Decision I R 20/15 of 14 October 2015.