The negative net equity issue and the fair value option

Relocation to Luxembourg from abroad

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Due to the stable political situation and economic attractiveness of the Grand Duchy of Luxembourg, more and more multinationals and private equity firms are deciding to relocate part of their business to Luxembourg and to transfer the registered office and effective place of management of some of their group entities to Luxembourg from abroad.

The relocation is subject to legal requirements such as the continuity of the legal personality and minimum share capital. Even if not required by the law, it is common practice in Luxembourg to request companies to have a net equity equal to at least the minimum share capital required by the law (i.e. EUR 12,000.00 in the case of a SARL) upon migration.

However, most of the time, and especially when the entity owns a real estate property, the net equity is negative mainly due to the amortisation on the real estate. In order to restore the net equity of the company, the easiest solution is to proceed to a capital increase either by contribution in cash or in kind.

However, a foreign company should still be able to migrate to Luxembourg with a negative net equity if (i) a foreign counsel confirms that the company has enough hidden reserves to cover the negative net equity (Option 1) or (ii) the company opts for the fair value option (Option 2).

Option 1 can be used when the property/asset held by the migrating entity is recorded at book value and where the fair market value (FMV) of the property/asset is much higher than the value booked in the accounts. Let's take the example of a company with a negative net equity of EUR 25,000,000.00, a real estate property recorded at book value in the accounts for an amount of EUR 80,000,000.00, while its FMV is of EUR 125,000,000.00, based on the last evaluation performed by the company. Based on the above assumptions, the company would have potentially hidden reserves of c. EUR 45,000,000.00 and if they were taken into account, the company would have a positive net asset value. In a nutshell, the foreign counsel would issue a letter confirming that the company has enough hidden reserves to cover the negative net equity. The entity would be migrated to Luxembourg with a negative net equity and the real estate property would still be recorded at book value in the accounts post migration.

Option 2 could be used at the time of the migration whereby it would be decided to opt for the fair value option; the asset so far recorded at historical value would then be booked at FMV.

Luxembourg corporate considerations

On the migration date, the shareholder(s) would agree to opt for the fair value option in the migration deed to be enacted before the Luxembourg notary. Interim accounts of the company taking into account the fair value option would also be required to evidence the positive net equity of the company. Last but not least, before proceeding to the fair value option, it would be necessary to check if this accounting change is subject to any prior approval under a bank loan or joint-venture agreement.

Luxembourg accounting treatment

According to Luxembourg GAAP, assets and liabilities of Luxembourg companies should be recorded at their historical value (i.e. acquisition cost); however a company can opt (under certain specific conditions and limitations) for the fair value option, according to which certain asset classes can be measured at their fair value.

Once migrated to Luxembourg, the company can prepare its annual financial statements in Luxembourg GAAP and record the assets at FMV under the fair value option.

Insofar, the fair value option increases the net equity position of the company since no annual amortisation is recorded.

Choosing this option may also increase the distributable capacity of the company and solve some cash trap situations previously existing under historic cost accounting principles.

Upon choosing the option to book the property at FMV, the following steps should be implemented:
- A re-evaluation reserve account corresponding to the difference between the fair value and the book value of the real estate assets should be recorded (such reserve being non-available for distribution);
- Expenses for depreciation should no longer be booked in the profit and loss account (P&L) (unless in the event of a decrease further to an impairment test in the fair value of the property);
- A provision for the deferred taxes on the property should be recognised and booked in the P&L.

The change of accounting option can only be applied for the onward period, i.e. the reversal of past amortisations should be booked in a non-distributable reserve of the company.

Luxembourg tax treatment

The Luxembourg tax law determines the taxable profit of a company by comparing its net assets at the end of the relevant year with its net assets at the beginning of that year (reduced by contributions and increased by withdrawals from shareholders). Therefore, the values retained for tax purposes of the assets and liabilities of the company, rather than P&L items, have a direct impact on its taxable result.

While many jurisdictions have concluded a double tax treaty with Luxembourg which would prevent Luxembourg from effectively taxing real estate properties situated in the other contracting state, it is still interesting to look at the tax implications of the application of the fair value option under Lux GAAP.

Under Article 40 of the Luxembourg Income Tax Law (LITL), the value of the assets and liabilities of a company as recorded in its annual accounts (i.e. under Lux GAAP) would also be retained for tax purposes, unless a specific provision of the LITL imposes a different valuation.

One of those specific valuation rules is provided by Article 23 LITL, which states that amortisable fixed assets must be valued at their acquisition cost reduced by certain adjustments (e.g. normal amortisation and value adjustments).

For assets which were already present in the balance sheet of the company at the end of the previous period, the valuation of such assets for the current period cannot exceed the previous value. This rule prevents the early recognition of any latent capital gains for tax purposes on these assets prior to their actual disposal, even where Lux GAAP would allow for such recognition.

In the case of a property, the fair value option, and in particular the disclosure of an increase in fair value through P&L, would not be recognised for tax purposes, and would therefore have no impact on the taxable result in Luxembourg. As Luxembourg tax law would require the application of the cost accounting principles with regular depreciations on the real estate property, the hidden reserves showed under Lux GAAP in the annual accounts of the company should not be subject to taxation, and the company would need to prepare a tax balance sheet reflecting the amortised costs of its fixed assets. Such tax balance sheet would be the basis for the filing of its tax returns (and therefore of the tax result).

Importantly, future capital gains would be valued by comparing the tax balance sheet value of the asset to its disposal price, and, as a result, such gains may be assessed at a different value for tax purposes than the value recorded in the annual accounts of the company.

This set of rules allows for the harmonised application of the tax law to all Luxembourg taxpayers in a similar situation (i.e. owning assets latent gains are attached to) regardless of the accounting or reporting framework they choose to use.

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