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Luxembourg Tax Alert

Tax authorities release guidance on interest limitation rules

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The Luxembourg tax authorities issued guidance (Circular n°168bis/1, in French only) on 8 January 2021 clarifying certain aspects of the interest expense deduction limitation rules in article 168bis of the Income Tax Law (ITL).

The interest limitation rules were introduced following the transposition of the EU Anti-Tax Avoidance Directive (ATAD1) into Luxembourg domestic tax law. They are applicable as from fiscal years starting on or after 1 January 2019.

Broadly speaking, any excess borrowing costs (EBC) are generally restricted to 30% of the taxpayer's tax-based earnings before interest, tax, depreciation, and amortization (EBITDA). The rules apply to the borrower regardless of the jurisdiction of the lender (located in Luxembourg, in an EU member state, or in a third country) and of its link with the latter (related entity or third party).

The circular only focuses on the rules applicable at the level of a concerned taxpayer (article 168bis ITL)—Luxembourg companies as well as permanent establishments of nonresident companies—but does not provide any additional guidance on how to apply the rules in the context of a fiscal tax consolidation (article 164bis (9) ITL). The main points of the circular are summarized below. Each concerned taxpayer should continue to analyze its own situation on a case-by-case basis.

It should be noted that the circular solely reflects the interpretation of the Luxembourg tax authorities.

Borrowing costs and interest revenue

Borrowing costs

A taxpayer's borrowing costs are defined as interest expenses on all forms of debt, other costs economically equivalent to interest, and expenses economically incurred in connection with the raising of finance. Only deductible borrowing costs are taken into consideration in determining EBC.

The circular mentions that only borrowing costs incurred exclusively by the taxpayer (article 45 ITL) or directly for the purpose of acquiring, securing, and retaining revenue (article 105 ITL) are in principle tax deductible and can be subject to the interest expense deduction limitation rules, to the extent that their total or partial deduction is not denied.

Following the ordering rules of the ITL and the above rule, the circular indicates, for illustrative purposes, that:

- Hidden dividend distributions cannot be characterized as operating expenses or costs of obtaining funding;
- The rules on hybrid mismatches (article 168ter ITL), as well as the provisions of articles 45 (2) and 166 (5) (1) ITL, apply before article 168bis ITL; and
- Transfer pricing rules (articles 56 and 56bis ITL) should apply first. Article 168bis ITL should apply on the tax-adjusted (up or down) amount of interest where an adjustment is required.

The circular provides further analysis on the non-exhaustive list of borrowing costs included in article 168bis (1) 2) ITL. However, these concepts remain unclear in many instances, hence leaving certain transactions or structures in the same uncertain position as they were before the circular was issued. The list includes more particularly the following:

- Issuance of, and redemption premium on, financial instruments.
- Derivatives, including contracts commonly known as forwards, futures, options, and swaps. Interest expenses that are calculated on the basis of a notional amount are also covered, in particular in the context of a swap where the notional amount (in principle) has not been the subject of a transaction or a physical exchange.
- Capitalized interest included in the balance sheet value of a related asset, or the amortization of capitalized interest. The circular specifies that, where the option for incorporating the interest on borrowed capital to the acquisition cost of a new asset is retained for tax purposes, the regime only applies to capitalized interest or borrowing costs when they are or are likely to be deducted (notably for amortization, depreciation deduction, or disposal of the asset).
- The circular also clarifies that foreign exchange gains and losses that are included in taxable income and that relate to interest on loans and financing-related instruments are included in the definition of borrowing costs. Foreign exchange gains and losses resulting from the loan principal are not taken into account by the current rules.

The circular also refers to the personal exclusions allowing the full deduction of borrowing costs if the taxpayer is a financial enterprise or a stand-alone entity:

- For purposes of the financial enterprise exclusion, the definition of “financial enterprise” covers entities regulated by an EU directive or regulation. Companies not regulated under an EU directive or regulation are not covered by this definition, except alternative investment funds (AIFs) supervised under applicable national law. The circular further clarifies that, under Luxembourg law, this exception applies to AIFs/SICARs (investment companies in risk capital) under the supervision of the CSSF (*Commission de Surveillance du Secteur Financier*).
- For purposes of the stand-alone entity exclusion, the circular mentions the three parts of the definition of a “stand-alone entity,” including the absence of associated enterprises. The circular then clarifies that the term “associated enterprises” is not limited to organizations in which the taxpayer holds a stake; the concept of associated enterprises applies to all organizations and individuals recognized as constituting an associated enterprise of the taxpayer in the meaning of the definition provided by the Luxembourg CFC regime. The existence of a direct or indirect association between the taxpayer and an entity or a natural person should be analyzed from an economic perspective.

Interest revenue and other economically equivalent revenue

The circular confirms the application of a horizontal symmetric approach whereby the concept of "borrowing costs" and "interest revenue and other economically equivalent income" should be defined or interpreted similarly whether it is arising from a debt receivable or a debt payable. This was highly discussed during the legislative process and hence expected by Luxembourg taxpayers.

The Luxembourg tax authorities also formalized the economic approach as a possible way to qualify income as equivalent to interest. This is, however, without any further details or background.

We also note that the circular proposes to consider the tax treatment in the hands of the creditor and the debtor (vertical symmetry) for the purpose of qualifying an income or an expense in a domestic context. It remains however unclear how such a vertical symmetry would apply in a cross-border context.

How to calculate the interest expense deduction limitation

The rule limits the deduction of EBC incurred to an amount equivalent to 30% of the taxpayer's tax EBITDA.

The circular clarifies that the rule applies to each financial year as defined in the ITL, i.e., if a tax year contains less than 12 months, it is treated as an entire financial year. The circular provides an example where a taxpayer has EBC related to an exempt participation. Unfortunately, the circular does not provide any example illustrating the calculation where a capital gain is realized on the participation.

EBC carryforward

A taxpayer may carry forward indefinitely EBC that is not deducted in a given financial year. The EBC carryforward is an attribute that is retained in a tax-free transformation qualifying under articles 170 al. 2, 172 al. 5, as mentioned in article 172bis al. 4 ITL.

Unfortunately, the concept of the maximum allowable deduction of article 168bis (4) ITL is not defined. It should be also noted that the rule is silent on whether the use of carryforward EBC is conditional on the existence of EBC during a subsequent financial year where the EBITDA limit will not be reached. This might be clarified in the 2020 tax forms.

Unused capacity to deduct interest and right to carry forward unused capacity

The circular states that the unused capacity to deduct interest expenses is the amount representing 30% of tax EBITDA that is not absorbed by the (insufficient) amount of EBC deducted during the same financial year. It is interesting to note that the circular refers to the concept of the maximum deduction allowed of article 168bis (4) ITL but does not define it.

The circular confirms that only taxpayers incurring borrowing costs in an amount greater than EUR 3 million are allowed to carry forward the unused capacity.

The unused capacity attribute may only be carried forward to the next five financial years.

The circular reminds taxpayers that unused capacity should be used in a chronological order, i.e., the unused capacity from the earliest of the five financial years should be used first, and this mechanism is illustrated in the circular.

Finally, the right to carry forward unused capacity is retained in a tax-free transformation qualifying under articles 170 al. 2, 172 al. 5, as mentioned in article 172bis al. 4 ITL.

Loans used to fund EU long-term public infrastructure and grandfathering clause

Article 168bis (7) ITL excludes from the scope of the interest limitation rules EBC incurred on loans used to fund EU long-term public infrastructure projects, subject to certain conditions.

This exclusion also applies to EBC incurred on loans concluded before 17 June 2016 but it does not extend to any subsequent amendments to the loans (grandfathering rule). The circular confirms that the application of the grandfathering rules is mainly based on a legal analysis of the terms and conditions of the debt instruments concluded before 17 June 2016..

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