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Luxembourg Tax Alert

Tax authorities update guidance on interest expense deduction limitation rules

8 June 2021

The Luxembourg tax authorities updated their guidance on the interest expense deduction limitation rules of article 168bis of the Income Tax Law (ITL) by commenting on the equity escape provision for members of a consolidated group for financial accounting purposes in a circular dated 2 June 2021 (Circular n°168bis/1, in French only).

The new circular replaces the one issued on 8 January 2021 (n° 168bis/1 dated 8 January 2021) and includes the earlier provisions which still all apply. The new circular introduces a new section 6 focusing on the equity escape provision for a member of a consolidated group for financial accounting purposes.

Where the taxpayer is part of a group that files statutory consolidated accounts, the worldwide indebtedness of the overall group may be taken into account to allow taxpayers to deduct higher amounts of exceeding borrowing costs. In this respect, the interest limitation rule does not apply if a company can demonstrate that its ratio of equity over total assets is equal to or higher than the equivalent group ratio.

The circular explains how a member of a consolidated group for financial accounting purposes may benefit from the equity escape clause and addresses the following:

- The nature of the consolidated accounts (optional consolidation, level of consolidation);
- The accounting system that may be used. In this respect, the circular clarifies that consolidated financial statements prepared under US, Canadian, Chinese, Korean, and Japanese GAAP (generally accepted accounting principles) are acceptable and multinationals should not be required to convert their consolidated accounts into IFRS or EU GAAP;
- Adjustments to consolidated accounts (only the full line-by-line integration is accepted and equivalent or proportional method should be adjusted and neutralized) and to stand-alone accounts (to be prepared under the same method as the consolidated accounts) may be needed for Luxembourg tax purposes;
- The requirement for independent control of the statutory and consolidated account;
- The date to be used for the financial statements. The equity ratio should be calculated as at the closing date of the consolidated and stand-alone financial statements; and

- The procedures to opt for this mechanism, which should be renewed annually and require the enclosure of relevant documentation with the taxpayer's direct tax returns.

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

We strongly recommend that taxpayers assess their position in order to benefit from the equity escape clause in light of the clarifications provided by the circular.

The circular only provides guidance regarding the application of article 168bis ITL to stand-alone taxpayers, be they Luxembourg companies or permanent establishments of nonresident companies, and does not unfortunately provide any guidance on how to apply the rules in the context of a fiscal consolidation (article 164bis(9) ITL).

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