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# Luxembourg Tax Authorities issue guidance on interest limitation rules

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## Executive summary

On 8 January 2021, the Luxembourg Tax Authorities published a Circular[1] clarifying certain technical aspects of the interest limitation rules introduced in the Luxembourg legislation by law in 2018 (the Law), implementing the European Union (EU) Anti-Tax Avoidance Directive 2016/1164 (2016) (ATAD).[2] These rules limit the deductibility of taxpayers' borrowing costs to the higher of 30% of taxable EBITDA (Earnings (taxable profits) before Interest, Tax, Impairments, Depreciation and Amortization) or €3 million.

The Circular notably confirms that a symmetric approach regarding the definition of relevant expenses (borrowing costs) and interest income should be applied. It also provides some clarifications on the concept of "subsequent modification" in the context of the grandfathering clause according to which interest on loans that were concluded before 17 June 2016 is excluded from the borrowing cost definition, and on the method to determine non-deductible exceeding borrowing costs in presence of grandfathered interest and interest on loans used to fund long-term public infrastructure projects.

This Alert details the various comments and clarifications provided by the Circular.

## Detailed discussion

### Scope

In line with the Law, the Circular confirms that the interest limitation rules apply to resident companies and domestic permanent establishments (PEs) of nonresident entities subject to Luxembourg corporate income tax, unless the taxpayer qualifies as stand-alone entity or financial undertaking.

### Concept of "borrowing costs"

The Circular also confirms that only such expenses that qualify as business expenses within the meaning of the Law, i.e., expenses exclusively caused by the enterprise, are targeted (as an example, hidden dividend distributions would not be considered as business expenses and would thus not fall within the definition of borrowing costs). It furthermore specifies that only deductible borrowing costs should be considered as borrowing costs, meaning that borrowing costs whose deduction is denied based on other provisions of the Income Tax Law (e.g., interest expense in relation to tax-exempt dividend income or disallowed expenses under the anti-hybrid rules) should be disregarded.

The Circular further clarifies that the interest limitation rules in principle also apply to any adjustment of profit or price of a transaction that represents "borrowing costs," whether upwards or downwards, in particular by virtue of the arm's-length principle.

The definition of borrowing costs, which is consistent with that of the ATAD, covers three categories, being: (i) interest expenses on all forms of debt; (ii) other costs economically equivalent to interest; and (iii) expenses incurred in relation with the raising of finance.

*Interest expenses* are defined as the remuneration, be it at a fixed or variable rate, owed by the borrower to the lender in return for the provision of a sum or an asset.

Other than interest expenses, the interest limitation rules also apply to other costs economically equivalent to interest. Reference is made to paragraph 35 of the final Base Erosion and Profit Shifting (BEPS) report on Action 4 for purposes of explaining the concept of *other costs economically equivalent to interest*, according to which "payments that are economically equivalent to interest include those which are linked to the financing of an entity and are determined by applying a fixed or variable percentage to an actual or notional principal over time." The interest limitation rules also apply to other expenses incurred in connection with the raising of finance, including arrangement fees and guarantee fees.

The Circular highlights that the deduction for impairment of doubtful or irrecoverable receivables does not trigger any borrowing costs for the creditor.

With respect to the non-exhaustive list of certain borrowing costs as provided for in the Law, the Circular gives further clarifications, namely:

- Any amount, fixed or variable, constituting remuneration under a *profit participating loan* falls within the scope of the definition of borrowing costs.
- Borrowing costs include interest due as well as issue and reimbursement premiums due by the issuer to the holder of instruments such as bonds with interest coupons, zero-coupon bonds, participatory bonds, exchangeable bonds, bonds convertible or redeemable in shares, bonds with subscription warrants.
- Amounts disbursed in respect of *alternative financing arrangements*, which include instruments resulting from Islamic finance such as *sukuk*, and when they are assimilated from a tax point of view to conventional financial instruments, fall within the scope of the definition of borrowing costs.
- In line with paragraph 39 of the final BEPS report on Action 4, only the finance cost element of *financial lease agreements* is caught by the definition of borrowing costs, operating lease payments fall outside the definition.
- When the option is taken to *capitalize interest in the tax balance sheet value of a related asset*, capitalized borrowing costs are only affected if they are or are likely to be deducted, which normally arises in the case of amortization, deduction for depreciation or disposal of the asset.
- Any tax adjustment made to meet the arm's-length principle under *transfer pricing rules* falls within the scope of the interest limitation rules.
- Interest calculated on the basis of a notional that has in principle not been the subject of a transaction or physical exchange *under derivative instruments* (such as forwards, futures, options and swaps) *or hedging arrangements related to an entity's borrowings* is also included in the definition of borrowing costs, particularly in the case of an interest rate swap.

- To the extent that they are included in taxable income, *foreign exchange gains and losses* that are proportionally linked to interest on financing arrangements are included in the definition of borrowing costs, while foreign exchange gains and losses relating to the principal amount of financing are not taken into account.
- *Guarantee fees for financing arrangements* comprise, among other things, the costs of a mortgage guarantee or any other type of guarantee taken in the context of a financing transaction.
- *Arrangement fees and similar costs related to the borrowing of funds* cover all financing costs incurred in the context of a financing transaction, including opening and account maintenance fees. Fees and commissions of intermediaries such as notaries or experts involved in financing transactions are nevertheless excluded, when they are incidental expenses to the purchase price of an asset.

## Exceeding borrowing costs

The term "exceeding borrowing costs" is defined as the excess of borrowing costs (as defined) over interest income and other economically equivalent taxable revenues. While no further details regarding the definition of interest income is provided by the Law, the Circular confirms that symmetry should apply, meaning that interest income and other economically equivalent taxable revenues constitute in principle the counterpart to the borrowing costs as defined above. From this point of view, it is obvious according to the Circular that if, at least in a pure domestic context, amounts that are not considered as borrowing costs at the level of the borrower are in principle not to be considered as interest income and other economically equivalent taxable revenues for the lender either.

## Taxable EBITDA

Taxable EBITDA is defined as the total of net taxable income as per the Luxembourg Income Tax Law, increased by exceeding borrowing costs, the tax values of impairments, depreciations and amortizations that have reduced taxable income.

In determining taxable EBITDA, only taxable, i.e., non-exempt income is taken into consideration. Correlatively, exempt income, such as dividend income qualifying under the participation exemption, is not taken into account and therefore does not affect in any way the taxable EBITDA. Income that is exempt from corporate income tax, whether it be under a domestic provision or under a double taxation treaty, should therefore not be included in the calculation of taxable EBITDA. As a corollary to this, operating expenses that relate to exempt income are non-deductible.

## Computation of deductible interest in presence of truncated financial year

Exceeding borrowing costs are deductible up to the higher of 30% of taxable EBITDA or €3 million. The latter is a de minimis rule allowing the taxpayer to deduct exceeding borrowing costs up to €3 million.

The Circular specifies in this context that the deduction limit, whether it be the fraction representing 30% of taxable EBITDA or the €3 million de minimis threshold, applies to each financial year. A truncated financial year, i.e., a financial year that is shorter than 12 months, is treated as a full financial year, meaning that neither the fraction representing 30% of the taxable EBITDA nor the €3 million de minimis threshold should be prorated.

## Carry forward of exceeding borrowing costs and unused interest capacity

The Law foresees the possibility for the taxpayer to carry forward exceeding borrowing costs without limitation in time. As a result, if a taxpayer's exceeding borrowing costs during a given financial year are below 30% of its taxable EBITDA, it may still deduct, in addition to the exceeding borrowing costs of the current financial year, those exceeding borrowing costs that were not deductible in previous financial years (within the limits of the 30% EBITDA limit of the same year).

The Law also allows for a five-year carryforward of unused interest capacity, i.e., the amount by which 30% of taxable EBITDA exceeds the amount of exceeding borrowing costs. As a result, even if the amount of exceeding borrowing costs exceeds the 30% EBITDA limit in a given year, a taxpayer may still deduct this surplus amount of exceeding borrowing costs to the extent it has unused interest capacity carried forward from the five previous financial years.

## Exclusion of certain exceeding borrowing costs – grandfathering clause and public infrastructure debt

The Law contains a grandfathering clause according to which interest on loans that were concluded before 17 June 2016 is excluded from the borrowing cost definition, but the grandfathering will not apply to *any subsequent modifications of such loans*. The Circular confirms that in case of a subsequent modification grandfathering only applies to the original terms of the loan.

The Circular provides a non-exhaustive list of the changes that should be considered as subsequent modification of a loan, namely:

- Modification of the term of the loan as of 17 June 2016, when such modification was not contractually foreseen before 17 June 2016.
- Modification of the interest rate or the calculation of the interest as of 17 June 2016, when such modification was not contractually foreseen before 17 June 2016.
- Change in the amount borrowed as of 17 June 2016.
- Modification of one or more of the parties involved as of 17 June 2016, when such a change was not contractually foreseen before 17 June 2016. It should be noted that restructurings such as mergers or spin-offs do not jeopardize the benefit of the grandfathering clause, as these transactions, as such, do not result in a change in the initial terms of the loan.

The following non-exhaustive list of changes should not be considered as subsequent modification of a loan:

- Modification of the term of the loan as of 17 June 2016, when such modification was contractually foreseen before 17 June 2016 and does not require the agreement of the parties concerned but results from the application of the loan.
- Modification of the interest rate or the calculation of interest as of 17 June 2016, when such modification was contractually foreseen before 17 June 2016.
- Draw-down of funds under a line of credit as of 17 June 2016 under a credit agreement concluded prior to 17 June 2016, in accordance with the terms and conditions of such agreement and in particular up to the credit limit provided for therein prior to 17 June 2016.
- Transfer to Luxembourg of the registered office or central administration of an entity that is a party to a loan entered into before 17 June 2016, without there being a modification of the terms and conditions of the loan.

For purposes of determining non-deductible exceeding borrowing costs in presence of interest expense on loans that were concluded before 17 June 2016, the Circular explains on the basis of an example that, in a first step, exceeding borrowing costs are to be determined based on the general rule, i.e., difference between borrowing costs (including the grandfathered interest expense) and interest income and other economically equivalent taxable revenues and that the amount of grandfathered interest is deducted from this sub-total in a second step. This amount then constitutes the exceeding borrowing costs to be used for purposes of determining the taxable EBITDA and the 30% limit.

The Law also excludes from the application of the interest limitation rule interest on loans used to fund long-term public infrastructure projects where the operator, borrowing costs, assets and income are all located in the EU. Long-term public infrastructure projects are defined as projects to provide, upgrade, operate and/or maintain a large-scale asset that is considered in the general public interest (e.g., schools, universities, libraries, etc.) by an EU Member State.

For purposes of determining non-deductible exceeding borrowing costs in presence of interest expense on loans used to fund long-term public infrastructure, the Circular explains on the basis of an example that the taxpayer must be able to identify the net income resulting from a long-term public infrastructure project and exceeding borrowing costs relating to the large-scale assets provided, upgraded, operated or maintained in the framework of a long-term public infrastructure project. The taxable EBITDA is determined by adding back the total amount of exceeding borrowing costs (including those relating to a long-term public infrastructure project) and the tax values of impairments, depreciations and amortizations that have reduced taxable income (including those related to assets provided, upgraded, operated or maintained in the framework of a long-term public infrastructure project). In a second step, the net income derived from the long-term public infrastructure project, the exceeding borrowing costs relating to the long-term public infrastructure project and the tax values of impairments, depreciations and amortizations related to assets provided, upgraded, operated or maintained in the framework of a long-term public infrastructure project are deducted. The resulting amount is then used for calculating the 30% limit.

## Exclusion of stand-alone entities and financial undertakings

The Law excludes financial undertakings as well as standalone entities from the scope of the interest limitation rule. As specified by the Circular, standalone entity means a taxpayer that cumulatively meets three conditions, being that: (i) it is not part of a consolidated group for financial accounting purposes; (ii) it has no associated enterprise (i.e., any entity or individual that is recognized as being an associated enterprise as per the definition used for purposes of applying the Controlled Foreign Company (CFC) rules); and (iii) it has no permanent establishment located in a jurisdiction other than Luxembourg. The Circular clarifies that "associated enterprise" is not limited to entities in which the taxpayer holds a participation but refers to all such entities that are covered by the relevant definition.[3] The existence of a link of association must be analyzed from an economic perspective.

## Tax transparent entities

When a taxpayer holds an interest in a tax transparent entity (e.g., partnership), whatever the nature of the activities carried out by this entity, the taxpayer realizes proportionally to the fraction held in this entity the deductible borrowing costs, the taxable interest income and other economically equivalent taxable income of the entity.

The taxpayer must provide in its tax return information on the portion of these deductible borrowing costs, taxable interest income and other economically equivalent taxable income so that they can be taken into account when determining exceeding borrowing costs.

Likewise, the taxpayer must indicate the fraction of the impairments of the tax transparent entity, as well as the deductions for impairments made by the latter.

## Endnotes

1. Circular L.I.R. n°168bis/1 of 8 January 2021.
2. See EY Global Tax Alert, *Luxembourg: A detailed review of the EU ATAD implementation law*, dated 28 December 2018.
3. "Associated enterprises" include the following: (i) resident or nonresident taxpayers subject to Luxembourg corporate income tax (CIT) or entities that are transparent under Luxembourg law (e.g., partnerships), in which the taxpayer holds directly or indirectly a participation in terms of voting rights or capital ownership of 25% or more, or are entitled to receive 25% or more of the profits of that entity; (ii) individuals or resident or nonresident taxpayers subject to Luxembourg CIT or transparent entities that hold directly or indirectly a participation in terms of voting rights or capital ownership in the taxpayer of 25% or more, or are entitled to receive 25% or more of the profits of the taxpayer; (iii) all entities, including the taxpayer, that are held directly or indirectly by an individual or a resident or nonresident corporate taxpayer or a transparent entity for 25% or more in terms of voting rights or capital ownership in the taxpayer and one or more entities.

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