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LUXEMBOURG TAX AUTHORITIES RELEASE CIRCULAR PROVIDING ADMINISTRATIVE GUIDANCE ON APPLICATION OF INTEREST LIMITATION RULE

On 8 January 2021, the Luxembourg tax authorities issued Circular L.I.R. n°168*bis*/1 providing clarifications on the Interest Limitation Rule as introduced by the Anti-Tax Avoidance Directive (ATAD I) adopted in July 2016 and transposed in December 2018 by Article 168*bis* of the Luxembourg income tax law (the "**LITL**"). The new Circular, largely based on the commentaries to the bill of law implementing the ATAD I, describes the Luxembourg tax authorities' interpretation and practical approach towards the Interest Limitation Rule.

Key issues

- New Circular on interpretation and practical application of Interest Limitation Rule
- Interaction with existing tax provisions
- Definition of borrowing costs
- Clarification of the grandfathering clause
- Carry forward of unused deduction capacity

BACKGROUND

The fight against excessive interest deduction has been initiated by the OECD through its Base Erosion and Profit Shifting ("**BEPS**") Action Plan 4.

In that regard, the ATAD I contains several major actions points among which it is the Interest Limitation Rule which tackles the erosion of tax bases through excessive deduction of borrowing costs in the European Union.

Within this framework, Luxembourg implemented the Interest Limitation Rule via the law of 21 December 2018 (the "**ATAD I Law**") introducing article 168*bis* of the LITL (the "**ILR**").

Article 168*bis* of the LITL introduced a ceiling on the deduction of net financial costs, (hereinafter referred to as exceeding borrowing costs), up to a percentage of 30% of taxable earnings before interest, taxes, depreciation and amortization ("**EBITDA**"), while providing for a *de minimis* financial threshold allowing the full deduction of exceeding borrowing costs up to a maximum of EUR 3 million.

On 8 January 2021, the Luxembourg tax authorities provided some long-expected administrative guidance on the matter.

KEY ELEMENTS

The interpretation and intended practical application expressed by the Luxembourg tax authorities has shed some light on the following elements.

Possible denial of interest deductibility due to the characterisation of operating expenses and other existing tax provisions

By considering already existing tax provisions, the Circular clarifies that:

- The rules laid down in Articles 45(2) and 166(5)(1) of the LITL take priority over the ILR. In this respect, the Circular reiterates that expenses must be incurred directly by the taxpayer and must be tax deductible in order to be subject to the ILR. As such, hidden profit distributions referred to in Article 164(3) of the LITL for instance do not fall into the scope of the ILR as they cannot be qualified as operating expenses of a taxpayer.
- The hybrid mismatch rules laid down in Article 168*ter* of the LITL may result, if applicable, in a total (or partial) denial of interest deductibility even before applying the ILR.
- The ILR applies to tax related adjustments of interest required by transfer pricing rules laid down in articles 56 and 56*bis* of the LITL.
- Deductions for impairments on doubtful receivables (bad debt) do not fall within the scope of the ILR. This would mean that symmetrically the recouping of such impairments would not be seen as interest income and would therefore fall within the scope of the ILR.

Definition of borrowing costs

The Circular details the concept of borrowing costs by stating that borrowing costs encompass all costs linked to borrowed money or other financing arrangements. As such, they shall consist of interest expenses on all forms of debts, other costs economically equivalent to interest as well as expenses incurred in the context of the raising of finance.

In particular, the non-exhaustive list of Article 168*bis* of the LITL has been clarified. It is worth nothing that:

- Qualify as borrowing costs: any interest due, as well as any premium paid by the issuer to the bondholder upon issuance or redemption of various sorts of bonds (such as interest-coupon or zero-coupon bonds, exchangeable bonds, convertible bonds). In this respect, conversion premium should also be considered as economically equivalent to interest expenses and hence qualify as borrowing costs. This leaves many uncertainties depending on how broad the concept of redemption premium should be interpreted (e.g. whether it should include non-conversion premium for convertible instruments).
- Taxpayers incurring interest on borrowed funds can include such interest in the acquisition cost (*prix de revient*) when such borrowings relate to the construction of fixed assets extending over a long period of time. Such capitalised interest falls into the scope of the ILR only if it is or is likely to be deducted by the taxpayer (deduction for amortisation, depreciation or disposal of the relevant fixed asset).
- Foreign exchange gains and losses included in the tax base should be seen as interest expenses provided they are linked to interest on loans. Therefore, forex gains and losses linked to the loan principal would not be considered as borrowing costs.

Article 168*bis* of the LITL does not define interest revenue and other economically equivalent taxable income. The Circular thus provides for a symmetrical approach that should be adopted towards the borrower when applying the ILR. At least in a purely national context, if amounts incurred by the borrower are deemed to be interest expenses for the borrower, they should be considered as interest income for the lender.

Application of the grandfathering clause

For reasons of administrative coherence, compliance and non-retroactivity, ATAD I left Member States with the option to exclude from the ILR loans entered into prior to 17 June 2016. Luxembourg, along with six other Member States, has opted in by inserting the grandfathering clause into the ATAD I Law.

Keeping in mind the transitional nature of the grandfathering clause, the Circular confirms that loans concluded before 17 June 2016 are not concerned by the ILR in the absence of any subsequent modification. Hence, taxpayers can exclude interest arising from grandfathered loans when determining their exceeding borrowing costs. However, the extent of the terms "any subsequent modification" has remained unclear.

Three clarifications now brought by the Circular deserve particular attention:

- A change of one or more of the parties concerned after 17 June 2016 should be considered as a "subsequent modification" if it was not contractually agreed upon before 17 June 2016. This point raises questions about the parties targeted by the interpretation of the tax authorities. Are modifications of lenders concerned in the same manner than changes to the debtors? If so, this could be especially inconvenient in case of listed bonds which will, by nature, change hands among bondholders. This approach does not seem in line with the rationale of the ATAD I or the ATAD I Law as such change of creditor does not entail any increase of the interest charge at the level of the debtor (recital 8 of the preamble of the ATAD I refers to the modifications of the initial terms as a change of duration, amount or rate but not to a modification of the parties). Furthermore, even though a change of creditor needs to be notified to the borrower, it does not require to be contractually agreed upon, as such change is a legal right for the lender. We would therefore tend to interpret such provision of the Circular as covering only a change of debtor.
- Subsequent drawdowns made under an existing credit facility concluded before 17 June 2016 should not be considered as a subsequent modification to the extent the duration and the amount have not been modified. This statement appears welcomed and may be used to interpret similar situations like subsequent issuances in a pre-existing debt issuance program.
- Restructurings (such as mergers, divisions or migrations of corporate taxpayers to Luxembourg) are not considered as a "subsequent modification" to a loan concluded before 17 June 2016 provided the initial terms of the loan remain unchanged.

Carry forward of unused deduction capacity only if safe harbour threshold reached

The Circular reaffirms the possibility for taxpayers to carry forward the unused deduction capacity for the following five financial years. The unused deduction capacity corresponds to the unused fraction of exceeding borrowing costs representing 30% of the taxpayer's EBITDA. The Circular specifies that only taxpayers who realise exceeding borrowing costs above the EUR 3 million threshold may carry forward the amount of the unused deduction capacity.

CONCLUSION

To sum up, the circular brings some welcomed clarifications. However, uncertainty remains in some areas such as securitisation companies and the qualification as "interest income" of capital gains realised on distressed debt. While waiting for notably the jurisprudence to elaborate on the exact application of the ILR, debt (and especially distressed) financing structures should remain carefully monitored.

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