Luxembourg tax authorities issue a circular on interest deduction limitation

Insights - 19/01/2021

On 8 January 2021, the Luxembourg tax authorities (**LTA**) issued highly anticipated guidance with respect to the application of article 168 bis of Luxembourg income tax law (**LITL**), which was introduced in 2018 through the implementation in Luxembourg law of the EU Directive 2016/1164 *Anti-Tax Avoidance Directive 1*.

According to article 168 bis LITL, Luxembourg taxpayers are subject to limitations with respect to deduction of interest from their taxable basis. The purpose of the LTA's administrative circular 168bis/1 (the **Circular**) is to clarify some of the concepts and key aspects of this piece of legislation, through numerical examples.

As a reminder, in a nutshell article 168 bis LITL provides that Luxembourg fully taxable companies[1] and Luxembourg permanent establishments of non-Luxembourg resident companies cannot deduct from their taxable basis net borrowing costs which exceed either 30% of their earnings before interest, tax, depreciation and amortization (**EBITDA**) or EUR3million. The Circular explains key points with respect to article 168 bis LITL (carry forward of exceeding borrowing costs, unused interest capacity, exclusion of borrowings taken up to finance public infrastructure projects, exclusion of stand-alone entities and financial entities). Below is an analysis of some of the most salient topics addressed by the Circular.

Determination of the "net borrowing costs"

First the relevant taxpayer needs to determine its borrowing costs, which covers interest expenses derived on all kind of debt, other economically equivalent cost and expenses incurred in relation with borrowings (**Item A**).

Then, the amount of taxable income or other economically equivalent, realised by the taxpayer should be computed (**Item B**).

The next step consists of calculating the net borrowing costs, which are the positive result of:

Item A – Item B. This positive result will then be subject to the above mentioned limits, i.e. these net borrowing costs will be deductible from the company's taxable result, but only up the higher of either EUR 3million or 30% of its EBITDA.

And this is where this administrative circular 168bis/1 (the **Circular**) comes into play: clarifying the method.

To start with, with respect to Item A, the LTA confirms that the amount eventually determined should exclude expenses or costs which are not deductible pursuant to other provisions of the LITL or the application of a double tax treaty. As illustrated by the Circular, the following items would not be taken into account to determine the "borrowing costs":

- Expenses requalified as hidden dividend distribution
- Expenses economically linked to an exempt dividend received
- Expenses for which deductibility is denied pursuant to the application of the anti-hybrid rules
- Expenses for which deductibility has to be claimed in another jurisdiction as per a double tax treaty signed by Luxembourg

The rule is that an expense cannot be considered for Item A if its deductibility is not allowed irrespective of and disregarding the application of article 168bis LITL.

On the other hand any expense revealed by a transfer pricing adjustment would be considered for the determination of Items A.

Regarding Item B, the Circular confirms that the determination of the relevant income follows a symmetrical approach, in the sense that if an expense qualifies for Item A in the hands of a payer, the corresponding income will qualify as Item B in the hand of a payee[2]. Therefore there has to be consistency for the qualification of any sum paid by one entity to another, with respect to the determination of what constitutes the scope of Item A and Item B.

The limitation thresholds

As indicated in the law (see above), the tax deduction of the positive difference between Item A and Item B is then limited to two thresholds: the higher of either 30% of the EBITDA (**Limit 1**) or EUR 3million (**Limit 2**).

For the purposes of Limit 1, the EBITDA corresponds to the total net income, determined for tax purposes, increased by the amount of net borrowings costs (i.e. the positive amount resulting from: Item A – Item B), and other costs or expenses having decreased the basis.

Therefore, when establishing the amount of "earnings", an income which (i) taxing right is not attributed to Luxembourg as per a relevant double tax treaty or (ii) is exempt as per a domestic

provision (for instance, dividends falling in the scope of the participation exemption regime) should be disregarded and deducted from the tax EBITDA. Correlatively, expenses which are connected to such exempt "earnings" will have to be added to total net income. All other income and expenses will in principle be in the scope of such tax EBITDA.

Limit 1 and Limit 2 apply each for a given year, and the Circular clarifies that they would fully apply, without any adjustment or pro-rata, to a fiscal year shorter than 12 months.

The grandfathering clause

A key element of article 168bis is its temporal scope. According to the grandfathering clause, borrowings concluded before 17 June 2016 are not prejudiced by the provisions of article 168 bis LITL to the extent that they have not been subject to any "subsequent modification". Interestingly, the Circular provides explanation thereof and gives a non-exhaustive list of relevant modifications:

- **maturity of the borrowing**: such event would not be deemed a "subsequent modification" provided that it was foreseen by contract before the 17 June 2016 and that no agreement of any party is needed
- **interest rate and method of determination of such interest**: such event would not be deemed a "subsequent modification" provided that it was foreseen by contract before the 17 June 2016
- **principal amount**: a change in the borrowed amount after 17 June 2016 would be a "subsequent modification"
- **drawdown of funds under the borrowing:** such event would not be deemed a "subsequent modification" provided that it was foreseen by contract before the 17 June 2016 and within limit of the facility amount
- **identity of the borrower or lender**: such event would not be deemed a "subsequent modification" provided that (i) it was foreseen by contract before the 17 June 2016 or (ii) it results from a restructuring (merger, demerger,...)
- **inbound transfer of registered seat or central administration of one of the parties to the borrowing, after 17 June 2016**: such event would not be a "subsequent modification" provided that the other conditions of the borrowing are modified (*see above*)

The Circular indicates that in case of a "modified" borrowing (after the 17 June 2016), the interest limitation rules of article 168 bis LITL would only apply to provisions of the borrowing having been modified, and not to the original features (and relevant financial consequences) of the borrowing as they were before 17 June 2016.

[1] Other than financial undertakings or stand-alone entities as defined in article 168bis LITL.

[2] This would explain why deduction of provision for bad debts are not covered by the limitation provided by article 168 bis LTIL

About Ogier

Ogier is a professional services firm with the knowledge and expertise to handle the most demanding and complex transactions and provide expert, efficient and cost-effective services to all our clients. We regularly win awards for the quality of our client service, our work and our people.

Disclaimer

This client briefing has been prepared for clients and professional associates of Ogier. The information and expressions of opinion which it contains are not intended to be a comprehensive study or to provide legal advice and should not be treated as a substitute for specific advice concerning individual situations.

Regulatory information can be found under Legal Notice

Key Contacts

Aurélie Clementz

Partner

Luxembourg Legal Services

E: aurelie.clementz@ogier.com

T: +352 691 432 024

Bertrand Géradin

Partner

Luxembourg Legal Services

E: bertrand.geradin@ogier.com

T: +352 2712 2029

Hadrien Brémon

Counsel

Luxembourg Legal Services

E: hadrien.bremon@ogier.com

T: +352 27 12 20 71

Related Services

Tax

Corporate

Legal