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Snapshot: what are some tax consequences of debt funding for Luxembourg?

Insights - 20/10/2022

The recent decision taken by the Luxembourg Tribunal Administratif on 23 September 2022 (decision 44902), where an interest-free loan was requalified as equity financing for tax purposes, [1] once again sheds a light on one of the most important dilemmas in corporate finance, at least from a tax perspective. Should an entity be financed with debt or equity?

Recent international (ie at OECD level), regional (ie at the level of the European Union) and unilateral initiatives have been launched and implemented to tackle a bias towards debt financing and therefore limit the risk for aggressive base erosion.

In Luxembourg, there are various legal provisions which mitigate the effects of debt financing on tax base reduction or withholding tax relief. Here is a non-exhaustive list of some of the situations covered by these Luxembourg legal provisions applicable to Luxembourg companies financed by debt (loan, bond, notes etc):

	Scenario	Possible consequences
1	Interest expense is connected with a tax-exempt income	Interest payment may not be (fully) deductible
		Interest payment may not be non- deductible and a

The debt instrument is requalified into an equity instrument

tax (WHT) of
15% may
apply—
deductibility
of such
liability for net
wealth tax
purposes may
be denied

Interest (paid to an affiliated entity) is deemed too high and/or not supported by benchmark analysis

Excessive
portion may
be nondeductible for
income tax
purposes, and
subject to 15%
WHT

Interest expense are higher than interest income

Net borrowing costs (NBCs) may not be deducted if in excess of (i) 30% of the EBITDA or (ii) €3 million

Debt instrument finances a shareholding/equity in excess of 85:15 debt-to-equity ratio

Interest on the exceeding portion are non-deductible and subject to 15% WHT

Interest payment tracks (underlying) non-exempt equity income and/or real estate income

NBCs may be not deducted if in excess of 30% of the

EBITDA or €3 million

Interest expense receives a different tax treatment in the hands of creditor (hybrid instrument)

Interest
payment may
not be
deductible

Debt instrument finances a debt funding granted by the Luxembourg company to an affiliated entity

Company
would be
subject to
intra-group
financing
compliance
rules (equity
at risk, arm's
length
remuneration,
substance)

Bonds with a return/yield contingent on profits of the issuer

Interest
payment may
be nondeductible
and subject to
15% WHT

Payee/creditor is established in a black listed jurisdiction (cf EU black list)

Interest
expense may
not be
deductible

For more information, please contact a member of our expert tax team who are ready to help you, and your clients, navigate the different angles of corporate funding and their tax treatment under Luxembourg law.

[1] Read our briefing on this decision here.

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Meet the Author



Bertrand Géradin

Partner

Luxembourg Legal Services

E: <u>bertrand.geradin@ogier.com</u>

T: +352 2712 2029

Key Contacts



Aurélie Clementz

Partner

<u>Luxembourg Legal Services</u>

E: <u>aurelie.clementz@ogier.com</u>

T: +352 691 432 024



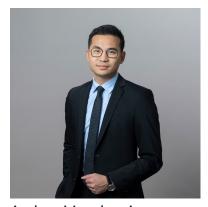
Hadrien Brémon

Counsel

Luxembourg Legal Services

E: hadrien.bremon@ogier.com

T: +352 27 12 20 71



<u>Arthur Mendegris</u>

Associate

Luxembourg Legal Services

E: <u>arthur.mendegris@ogier.com</u>

T: +352 2712 2098

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