

# Luxembourg tax authorities' guidance on interest deduction limitation rule

On 8 January 2021, the Luxembourg tax authorities issued the long-awaited administrative circular (the "Circular") providing guidance on certain aspects of the interest deduction limitation rule ("IDLR") laid down in Article 168bis of the Luxembourg tax law ("LITL")

Back in 2018, the Luxembourg law transposing ATAD 1<sup>1</sup> into domestic tax law ("ATAD1 Law") introduced a new rule that limits the deductibility of the taxpayers' exceeding borrowing costs to 30% of its taxable EBITDA or EUR 3 million. The exceeding borrowing costs are defined as the deductible borrowing costs that are in excess of the taxable interest income and other taxable economically equivalent income realised by the taxpayer.

The IDLR applies to Luxembourg companies and Luxembourg permanent establishments of non-resident entities subject to Luxembourg corporate income tax with respect to financial years starting on or after 1 January 2019.

For further background, please see our previous articles on this topic

- [Implementation of Anti-Tax Avoidance Directive \(ATAD 1\)](#)
- [Luxembourg Tax Unity Regime](#)

The Circular sets out the Luxembourg tax authorities' interpretation on the IDLR rules and related concepts. Some of the points covered in the Circular are summarised below:

## DEFINITION OF "BORROWING COSTS"

- The Circular specifies that only (i) operating expenses that are caused exclusively by the taxpayer pursuant to Article 45 LITL and (ii) expenditures incurred directly for the purpose of acquiring, securing or preserving income pursuant to Article 105 of the LITL, could be qualified as "borrowing costs" for purposes of the IDLR. As such, the Circular points out that hidden dividend distributions could not qualify as borrowing costs and that other rules that may limit the deductibility of borrowing

costs (such as the Luxembourg anti-hybrid mismatch rules, anti-abuse rules, transfer pricing rules and participation exemption regime) should apply before the IDLR.

- The Circular recalls that "borrowing costs" encompass three categories of costs (i) interest expenses on all forms of debt, (ii) other costs economically equivalent to interest and (iii) expenses in relation to financings and provides some clarifications on the non-exhaustive list of borrowing costs included in Article 168bis LITL, in particular:
  - Deductions for impairment of irrecoverable receivables do not give rise to borrowing costs in the hands of the creditor;
  - For profit participating loans, the borrowing costs encompass the fixed and variable remuneration;
  - Interest along with issuance and redemption premiums due by the issuer of financial instruments such as zero-coupon bonds or convertible bonds qualify as borrowing costs;
  - For capitalised interest included in the acquisition cost of assets in the balance sheet of the taxpayer, the IDLR only applies to capitalised interest that is deducted or likely to be deducted;
  - Interest calculated on the basis of a notional amount in the context of interest rate swaps or other derivative/hedging instruments in relation to an entity's borrowings are also covered by the IDLR;
  - Foreign exchange gains and losses related to interest on loans and financing-related instruments and included in the taxable income are treated as "borrowing costs" for the purposes of the IDLR. Conversely, foreign exchange gains and losses resulting from the loan principal are not "borrowing costs".
  - Guarantee fees for financing arrangements includes, inter alia, mortgage-related fees and any other forms of guarantees on financing operations. Fees and commissions charged by intermediaries such as notaries or experts involved in financing transactions are, however, excluded, when they are incidental to the purchase price of an asset.

## SYMMETRICAL APPROACH

Unlike the notion of "exceeding borrowing costs", Article 168bis LITL does not provide a definition or examples of the notion of "interest income" or "other economically equivalent taxable revenues" despite their importance in the context of the IDLR.

According to the Circular, a symmetric approach should be adopted. Therefore, for the purposes of the IDLR, when a cost should be considered as interest or economically equivalent to interest, the corresponding revenue should accordingly be considered as interest or economically equivalent to interest.

## GRANDFATHERING RULE

The application of the grandfathering rule is another main aspect of the guidance. Under ATAD1 Law, borrowing costs related to loans concluded before 17 June 2016 are excluded from the application of the IDLR provided that no subsequent modifications to the loans

are made.

According to the Circular, the following changes, amongst others, are considered as “subsequent modifications” for the purpose of the grandfathering rule:

- Amendment to the term of the loan on or after 17 June 2016, when amendment was not contractually foreseen before 17 June 2016;
- Amendment to the interest rate or the calculation of interest on or after 17 June 2016, when such an amendment was not contractually foreseen before 17 June 2016;
- Amendment to the amount borrowed on or after June 17, 2016;
- Amendment to one or more of the parties concerned on or after 17 June 2016, when such an amendment was not contractually foreseen before 17 June 2016.

Conversely, the following changes, amongst others, are not considered as “subsequent modifications” for the purpose of the grandfathering rule:

- Drawdowns under an existing loan facility after 17 June 2016 in accordance with the terms and conditions contractually agreed before 17 June 2016;
- Transfer of a company’s registered office or central administration to Luxembourg that is a party to a loan concluded before 17 June 2016, insofar as the terms and conditions of the loan are not modified.

In this context, it is worth noting that the IDLR only applies to the exceeding borrowing costs arising as a result of the “subsequent modification”.

## STAND-ALONE ENTITIES

Under ATAD 1 Law, a stand-alone entity is exempt from the IDLR. The ATAD 1 Law defines a stand-alone entity as a taxpayer that is not part of a consolidated group for financial accounting purposes and has no associated enterprises or permanent establishment in a state other than Luxembourg.

The Circular confirms that the term “associated enterprises” is not limited to the organisations in which the taxpayer holds a participation but also includes all organisations and individuals recognised as associated enterprises under the Luxembourg CFC rules (see Article 164ter (2) LITL). Furthermore, it is stated that the association link should be analysed from an economic perspective.


The Circular also brings clarifications on some other items such as the carry-forward of exceeding borrowing costs and the unused interest capacity, the specific exemption applicable to long-term infrastructure projects and the computation of the EBITDA.

## CONCLUSION

The guidance provided by the Circular is most welcome although some issues remain outstanding (especially the qualification of capital gains realised on distressed or non-

performing debts which is a major concern for debt funds and securitisation companies in particular).

Please contact our specialists who could assist you on any concern you may have.

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- 1. Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market

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