



New tax administrative guidance on interest deduction limitation rule

On 25 March 2022, the Luxembourg Tax Authority updated for the third time the circular issued on 8 January 2021 ("Circular") providing additional clarification on certain aspects of the interest deduction limitation rule ("IDLR") laid down in Article 168bis of the Luxembourg income tax law ("LITL").

To gain insight into the previous updates, please refer to our article of [14 September 2021](#).

The grandfathering rule and the end of LIBOR

According to the grandfathering rule (Article 168bis (7) of the LITL), borrowing costs related to loans concluded before 17 June 2016 are excluded from the application of the IDLR. However, borrowing costs related to subsequent modifications to such loans are not covered by the grandfathering rule. In the second update of the Circular, the Luxembourg Tax Authority already provides for examples of what would be considered as a "subsequent modification" and what would not.

With this third update, the Luxembourg Tax Authority clarifies that an amendment to the interest rate or the computation of interest return of a loan concluded before 17 June 2016 due to the phasing out of the "London Interbank Offered Rate" ("LIBOR") is not considered as a "subsequent modification" for the purposes of the application of the grandfathering rule, provided the following three cumulative conditions are met:

- The modification is strictly necessary to take into account the end of LIBOR or its non-representativeness;
- The modification does not alter the economic substance of the loan; and
- The modification does not include other modifications that could be qualified as "subsequent modifications" within the meaning of Article 168bis (7) of the LITL.

Interplay between the recapture rule and the IDLR

As a reminder, expenses incurred in relation to exempt participations (under the

participation exemption regime) may be deducted to the extent that they exceed tax-exempt dividend income realised in a given tax year. However, such expenses are then subject to recapture. This means that exempt capital gain realised on the disposal of the participation will remain subject to tax up to the sum of all related expenses and write-downs that were previously deducted (during the year of disposal or in previous financial years).

In the first version of the Circular issued on January 2021, the Luxembourg Tax Authority confirmed that only the borrowing costs that remain deductible after the application of the IDLR must be accounted for the recapture rule without providing any further details.

In this third update, the Luxembourg Tax Authority brings further clarification regarding the interaction between the recapture rule and the IDLR.

In particular, the Luxembourg Tax Authority provides for an allocation method (along with an illustrative example) to determine the part of exceeding borrowing cost in relation to an exempt participation that is disallowed as a deduction under the IDLR (and correlative, the amount of recapture).

This allocation method also has to take into account the retrospective impact of potential carry-forward of the exceeding borrowing costs (Article 168bis(4) of the LITL). Under the IDLR, the amount of exceeding borrowing cost disallowed as a deduction in the current year could be carried forward without limitation of time ("**Disallowed Interest Expense Carry-forward**"). Where in a subsequent tax year, the company decides to make use of its interest deduction capacity, the Disallowed Interest Expense Carry-forward part in relation to the exempt participation will need to be recalculated (as will be the amount of recapture).

Holding companies financing their participations with a mix of debt and equity should monitor this aspect carefully.

Definition of tax EBITDA

According to Article 168bis al.1 number 4 of the LITL, the tax EBITDA corresponds to the total net taxable income determined according to the LITL, increased by the amount of net borrowings costs as well as impairments, depreciation and amortisation having decreased the basis.

The Luxembourg Tax Authority specifies in this latest update that no further increase or correction is required to determine the tax EBITDA (for instance, in the case of reversal of an impairment booked in a previous year).

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We undertake no responsibility to notify any change in law or practice after the date of this newsletter.