Interest barrier rules under ATAD: the Luxembourg perspective

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1. The interest barrier rule in a nutshell

ATAD measures

Controlled Foreign Company rule

- **ATAD I : The Member State of a parent company will be allowed to tax certain non-distributed income of certain subsidiaries**

Exit taxation

- **ATAD I** : Member States will apply an exit tax on assets moved out of their territory

Interest limitation

- **ATAD I : There will be a limitation of the amount of net interest that a company can deduct from its taxable income, based on a fixed ratio of its earnings (EBITDA)**

Hybrids

- **ATAD I : neutralisation of hybrid mismatches between Member States resulting in a double deduction or a deduction without inclusion, by ensuring that a payment is subject to tax at least once**
- **ATAD II : Extension to third countries**

General Anti-Abuse Rule

- **ATAD I : It will allow tax authorities to disregard artificial tax arrangements and compute the tax liability in accordance with national law**
- **Point of attention: principal purpose test**

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1. The interest barrier rule in a nutshell

- Purpose of the interest limitation rule: prevent the excessive use of debt financing

- Net borrowing costs will only be deductible up to the higher of (i) **30% of the EBITDA** or (ii) **EUR 3 million**

- Net borrowing costs = interest expenses – interest revenue (as well as economically equivalent expenses and revenue)

- Intragroup and third party debt within the scope

- Applicable as from 1.1.2019

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1. The interest barrier rule in a nutshell

- RELEVANT EXCEPTIONS: Net borrowing costs will remain fully deductible under following exclusions:

Type of exclusion	Criteria

Standalone Entities	▪ entity with no consolidated accounts; and
	▪ no permanent establishment; and
	▪ no associated enterprise i.e.
	    ▪ the taxpayer is not holding directly or indirectly 25% or more of another entity's voting rights or capital ownership; and
	    ▪ no individual or entity is holding directly or indirectly 25% or more of the taxpayer's voting rights or capital ownership.

Certain Financial Undertakings	▪ AIFs managed by AIFMs; ▪ Securitisation vehicles as defined by the Regulation (EU) 2017/2402 of 12 December 2017; ▪ Credit institutions, AIFM, UCITS etc.
Grand fathering	▪ Loans issued before 17 June 2016 (to the extent no subsequent modification to the conditions of the loan).

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1. The interest barrier rule in a nutshell

- Additional Exceptions and Options

Exclusion / Options	Implementation in Luxembourg
Exclusion of loans funding long-term public infrastructure project	Loans used to fund long-term public infrastructure project under certain conditions (EU scope)
Carry forward (chosen option)	Unlimited carry-forward of disallowed borrowing costs and 5-years (max) carry-forward of unused interest capacity
Consolidated group (chosen option)	Equity ratio: net borrowing costs fully deductible if taxpayer ratio equity/total assets ≥ 98% of ratio equity/total assets of the group (provided the use of the same evaluation method)

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2. Practical impact of the interest barrier rule in Luxembourg

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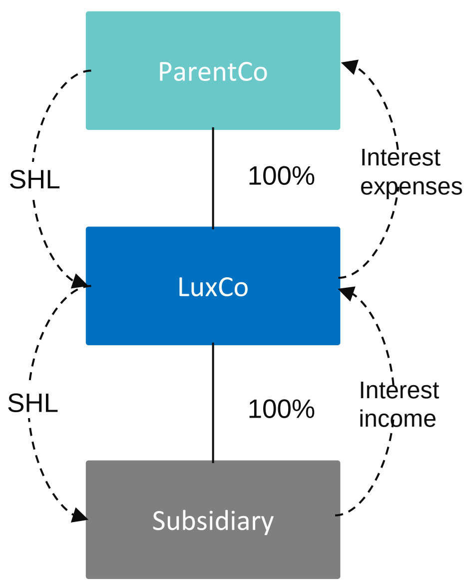
2.1. Back-to-back lending



- LuxCo finances its **participation** in its subsidiary through **equity only**. The **SHL** granted to its subsidiary is financed through **SHL**

- **In, or out of scope?**

- LuxCo incurs **interest expenses corresponding to its interest income** (less its taxable remuneration)

- Thus, deductible **borrowing costs < taxable interest** revenue so that **no excess borrowing costs** should arise at the level of LuxCo

Conclusion: interest deduction limitation rule should not apply to LuxCo

NO IMPACT

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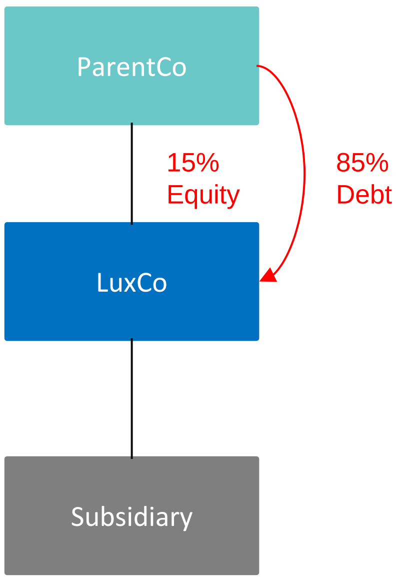
2.2. Debt financed exempt participation



- LuxCo finances its participation in its subsidiary through equity (15%) and debt (85%)
- LuxCo has interest expenses on the debt financing its participation in the subsidiary, but no interest income. Thus deductible interest expenses **are exceeding** its interest income

Conclusion: interest deduction limitation rule should apply

BUT: to the extend the subsidiary is covered by the participation exemption, any interest is not deductible up to the amount of the exempt dividend and any exceeding deductible interest is subject to the so-called recapture rule

NO IMPACT

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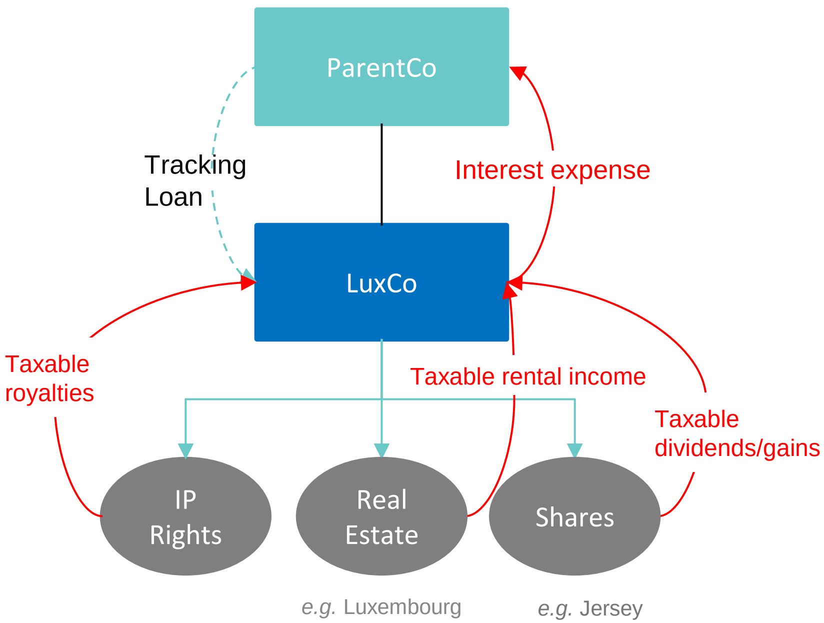
2.3. Debt financing of taxable assets



- LuxCo finances taxable assets (IP rights, real estate, shares…) by a tracking loan
- LuxCo realises taxable income that generate a variable interest expense up to such income
- LuxCo's **deductible interest expenses are higher** than its interest **income** → LuxCo has **exceeding borrowing costs**

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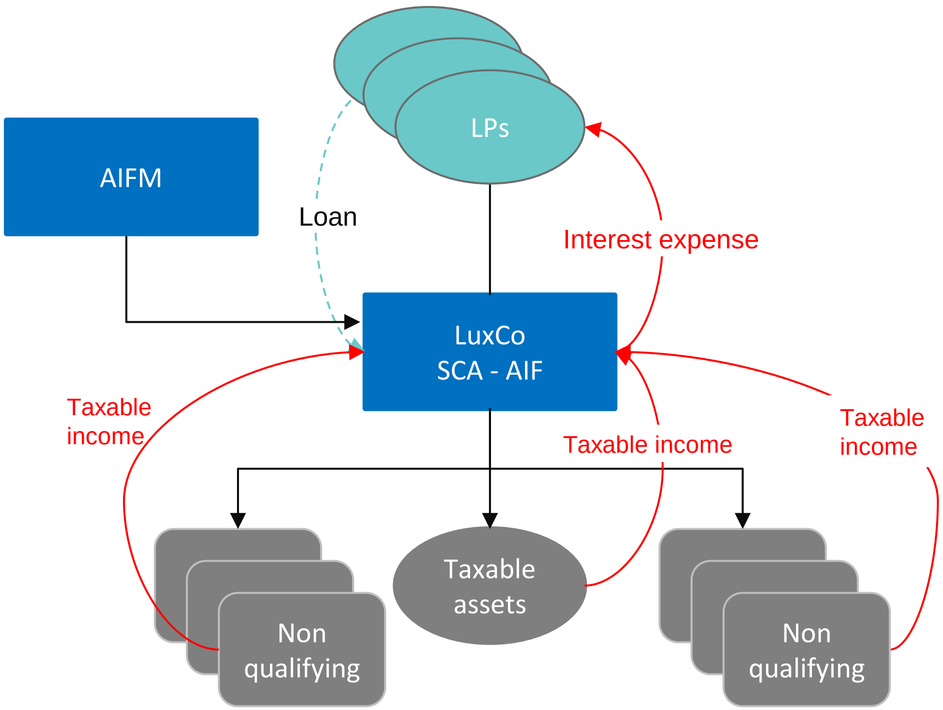
2.3. Debt financing of taxable assets

Possible alternative: AIF solution



- AIFs managed by AIFMs (and AIFMs themselves) are excluded from the scope of application of the interest limitation rule

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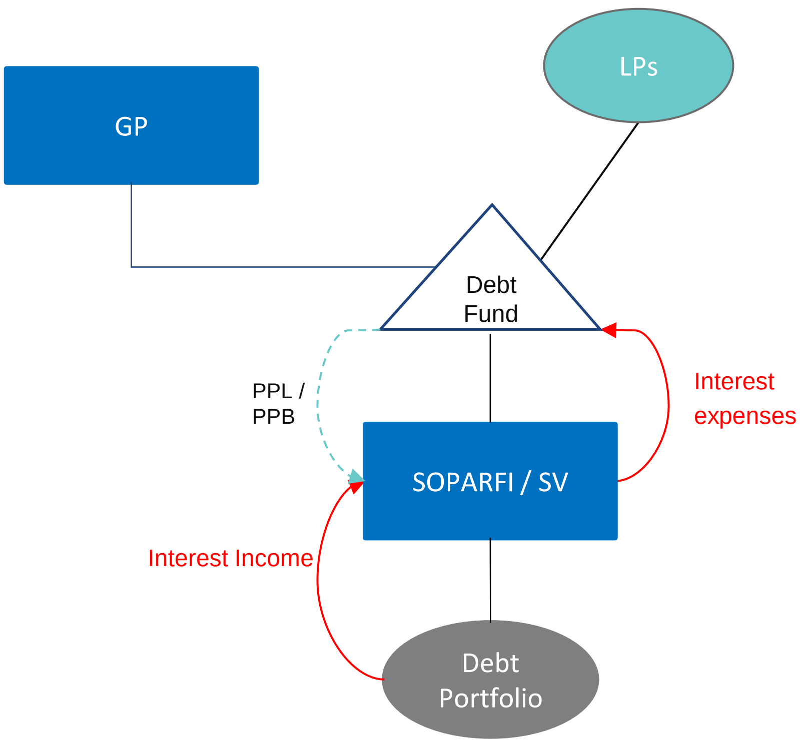
2.4. Debt funds



- LuxCo is established by the debt fund as SOPARFI or securitisation company and financed by profit participating debt instruments (PPL, PPB…)
- Interest expenses lower than interest income

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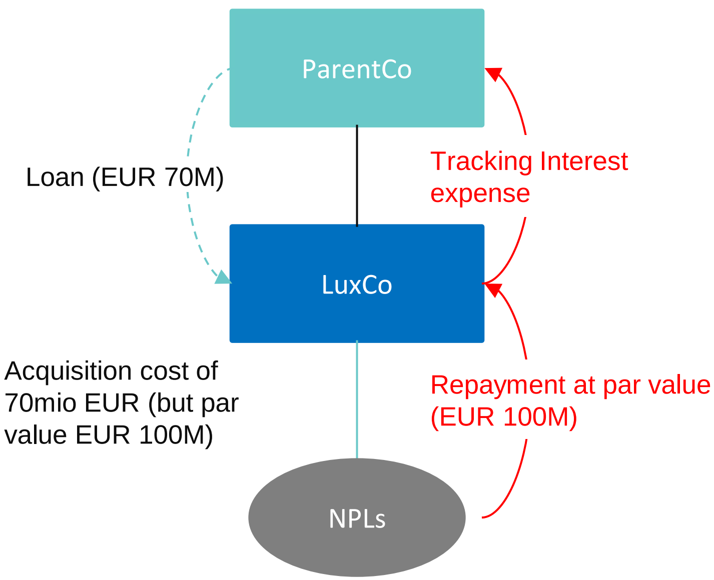
2.5. Distressed debt



- LuxCo finances the acquisition of a non-performing loan portfolio (distressed debt) valued below par value
- LuxCo, through a tracking loan carrying an interest equal to the income derived from the NPLs.
- Debt (and interest thereon) is entirely **repaid** up to its **original value**, so that LuxCo realises a **gain of EUR 30 Million.** Interest payments made by LuxCo track the interest received on the distressed debt **plus the gain** realised thereon.

  Interest **expenses are higher** than its interest **income?**

  LuxCo has **exceeding borrowing costs?**
- Economically equivalent revenues?
- Accounting treatment?

Conclusion: most likely no impact.

NO IMPACT…?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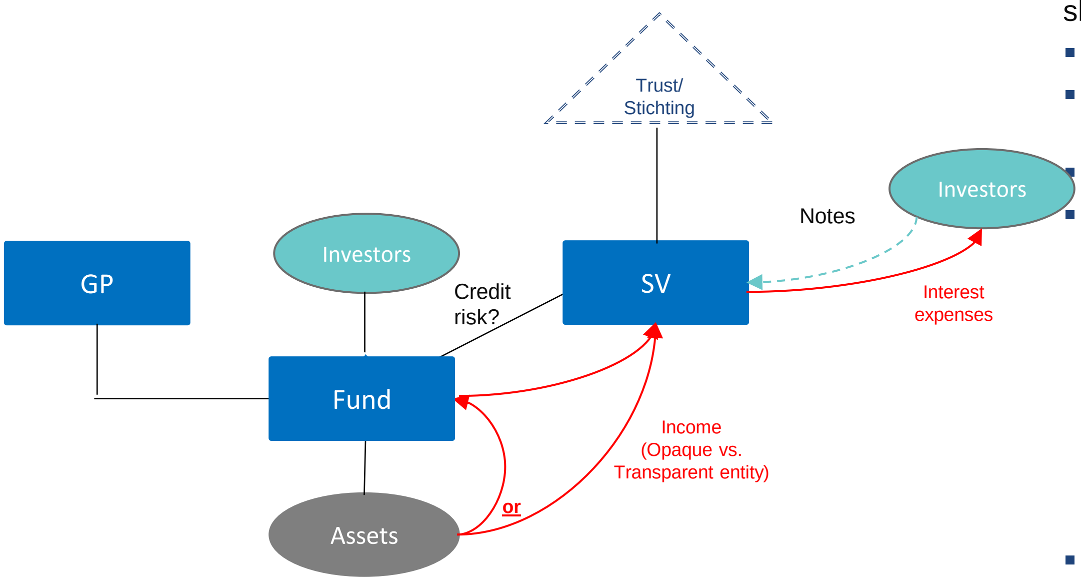
2.6. Securitisation Vehicles



- SV acquires a portfolio of assets, credits, fund interest, etc…
- SV is financed through a tracking note carrying an interest equal to the income derived from the underlying assets.

If taxable income arises, available exclusions should be assessed:

- **Standalone entity**: likely no
- **SV in the meaning of the Regulation n°2017/2402**
- **AIF**: likely no
- **Grandfathering**:
  - yes to the extent the relevant drawdowns are signed prior to 17 June 2016 (and no ulterior modification)
  - notes deriving from ulterior drawdowns will not be covered by the grandfathering rule

- **Special Attention: Fund Equity SVs**

IMPACT…

Questions / Answers

Contact us

Please do not hesitate to send your questions to BusinessDevelopment@arendt.com

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