The 2019 Luxembourg Tax Reform:

Analysing the Impact on Alternative Investments – Part 1

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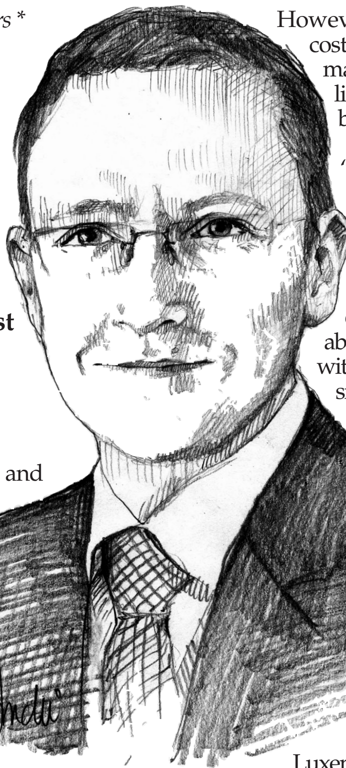


Over the last decades, Luxembourg has emerged to the location of choice for the structuring of Alternative Investments (real estate, private equity, etc.) in and through Europe. The attractiveness of Luxembourg is linked to a host of factors, which have made it an essential part of the global financial architecture.

These factors include its flexible and diverse legal, regulatory and tax framework, investor and lender familiarity with the jurisdiction, the availability of qualified, multilingual workforce, the existence of a deep pool of experienced advisers and service providers, a large tax treaty network, an investor-friendly business and legal environment, and political stability, to name a few reasons. Moreover, Luxembourg is a founder member of and sits at the heart of the European Union, one of the largest sources of capital and investment opportunities globally.

The Luxembourg Parliament has now adopted the 2019 tax reform implementing the EU Anti-Tax Avoidance Directive ("ATAD") and other anti-BEPS-related measures into Luxembourg tax law. More precisely, the 2019 tax reform includes tax law changes in the following areas:
- Interest limitation rules;
- General anti-abuse rule (GAAR);
- Controlled foreign companies (CFCs);
- Hybrid mismatch rules;
- Amendment of the exit tax rules;
- Amendment of the roll-over relief; and
- Amendment of the permanent establishment definition.

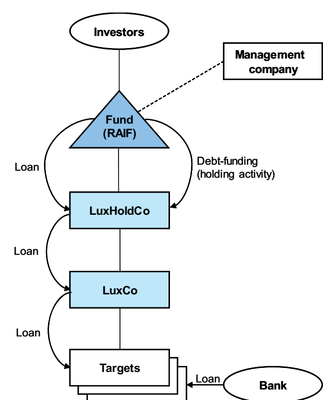
This is the first of two articles that provide a clear and concise overview of the different tax measures and analyses their impact on typical Alternative Investments (real estate, private equity, etc.) made via Luxembourg.

Alternative Investment in Luxembourg

Alternative investments are typically made via a Luxembourg or foreign fund vehicle (the "Fund") and Luxembourg companies which acquire the target (real estate, businesses, etc.). The Luxembourg investment platform of the Fund may, for example, consist of a Luxembourg master holding company ("LuxHoldCo") and separate Luxembourg companies ("LuxCo") for the different investments.

The property companies owning foreign real estate or target companies in a private equity context are generally financed by a mixture of equity and debt. Where debt funding is provided to subsidiaries, Luxembourg companies will generally finance such receivables by debt instruments (for example, shareholder loans). When investments are held via two or more Luxembourg companies, the funds granted in the form of debt to the target companies may be routed via one or more Luxembourg companies. Additional funding may be obtained from external sources (for example, banks) by the property or operational companies.

The following chart depicts a typical private equity fund structure:



Investments in real estate may be structured as follows:

Investors
Management company
Fund (RAIF)
Loan
Debt-funding (holding activity)
LuxHoldCo
Loan
Lux or local PropCo
Loan
Bank
Foreign real estate

Interest Limitation Rules

Since 1 January 2019, Article 168bis of the Luxembourg Income Tax Law ("LITL") limits the deductibility of "exceeding borrowing costs" generally to a maximum of 30% of the corporate taxpayers' earnings[1] before interest, taxes, depreciation and amortization (EBITDA). The scope of the interest limitation rules encompasses all interest-bearing debts irrespective of whether the debt financing is obtained from a related party or a third party. However, exceeding borrowing costs up to an amount of EUR 3m may be deducted without any limitation (that is a safe harbour provision).

"Exceeding borrowing costs" correspond to the amount by which the deductible "borrowing costs" of a taxpayer exceed the amount of taxable "interest revenues and other economically equivalent taxable revenues". Borrowing costs within the meaning of this provision include interest expenses on all forms of debt, other costs economically equivalent to interest and expenses incurred in connection with the raising of finance.

As far as interest income and other economically equivalent taxable revenues are concerned, neither ATAD nor Luxembourg tax law provides for a clear definition of what is to be considered as "revenues which are economically equivalent to interest". However, given that borrowing costs and interest income should be mirroring concepts, the latter should be interpreted in accordance with the broad definition of borrowing costs.

Corporate taxpayers who can demonstrate that the ratio of their equity over their total assets is equal to or higher than the equivalent ratio of the group can fully deduct their exceeding borrowing costs (that is the so-called "escape clause" that should protect multinational groups that are highly leveraged).

Moreover, according to a recent announcement of the Luxembourg Government, the optional provision under ATAD according to which EBITDA and exceeding borrowing costs can be determined at the level of the consolidated group (i.e. when several companies form a fiscal unity) will be introduced within the upcoming six months with retroactive effect as from 1 January 2019.

• Entities excluded from the scope of the rules

The interest limitation rules explicitly exclude financial undertakings and standalone entities from their scope.

Financial undertakings are the ones regulated by the EU Directives and Regulations and include among others financial institutions, insurance and reinsurance companies, undertakings for collective investment in transferable securities ("UCITS"), alternative investment funds ("AIF") as well as securitisation undertakings that are subject to EU Regulation 2017/2402.

Standalone entities are entities that (i) are not part of a consolidated group for financial accounting purposes and (ii) have no associated enterprise or permanent establishment. Thus, in order for a Luxembourg company to benefit from the standalone entity exception, it is necessary that none of the associated enterprises has directly or indirectly a participation of 25% or more.[2] It is interesting to note that the definition of associated enterprise for the purpose of the newly introduced provisions is defined very broadly including individuals, companies and transparent entities such as partnerships.

• Loans excluded from the scope of the rules

According to Article 168 of the LITL, loans concluded before 17 June 2016 are excluded from the restrictions on interest deductibility. However, this grandfathering rule does not apply to any subsequent modification of such loans. Therefore, when the nominal amount of a loan granted before 17 June 2016 is increased after this date, the interest in relation to the increased amount would be subject to the interest limitation rules. Likewise, when the interest rate is increased after 17 June 2016, only the original interest rate would benefit from the grandfathering rule.

Nevertheless, when companies are financed by a loan facility that determines a maximum loan amount and an interest rate, the entire loan amount should be excluded from the scope of the interest limitation rules irrespective of when the drawdowns have been made.[3]

Moreover, loans used to fund long-term public infrastructure projects are excluded from the scope of the interest deduction limitation rules.

• Carry forward mechanisms

The interest deduction limitation rules also provide for a carry forward mechanism in regard to both non-deductible exceeding borrowing costs and unused interest capacity.

Non-deductible exceeding borrowing costs are interest expenses which cannot be deducted because they exceed the limits set in article 168bis of the LITL. Such exceeding borrowing costs may be carried forward without time limitation and deducted in subsequent tax years.

Unused interest capacity arises in a situation in which the exceeding borrowing costs of the corporate taxpayer are lower than 30% of the EBITDA to the extent they exceed EUR 3m. These amounts can be carried forward for a period of 5 tax years.

In case of corporate reorganisations that fall within the scope of article 170 (2) of the LITL (for example, mergers), exceeding borrowing costs and unused interest capacity will be continued at the level of the remaining entity.

Analysing the Impact on Alternative Investments

When analysing the impact of the interest limitation rules on Alternative Investment Funds, it is crucial to distinguish the different activities performed by the Luxembourg companies involved.

• Financing activities

When Luxembourg companies perform financing activities or on-lend funds, the receivables owed by other group companies are generally financed by debt instruments (for example, LuxCo grants a loan to its subsidiary that is financed by a loan from LuxHoldCo).[4] In this regard, the Luxembourg company has to realize an arm's length remuneration which should be reflected in the interest rates applied. In other words, Luxembourg companies should realize more interest income than interest expenses. It follows that in case of financing activities the interest limitation rules should not apply in the absence of exceeding borrowing costs.

• Holding activities

With regard to holding activities, the potential impact of the interest limitation rules depends on how the participations are financed. Here, the investors have the choice between a range of equity and debt instruments. In many cases, Luxembourg companies will not incur deductible interest expenses in relation to the holding of participations. This might be because of the instrument used (not creating any tax-deductible expenses) or the fact that interest expenses incurred in direct economic relationship to tax exempt income are not deductible for tax purposes.[5] Nevertheless, the interest limitation rules only apply in case of tax-deductible interest expenses.

When a Luxembourg company finances a participation by a debt instrument that bears fixed interest, the interest expenses incurred should be deductible to the extent the interest expenses exceed tax exempt dividend income in a given year. In these circumstances, the amount of deductible interest expenses should be limited to EUR 3m (i.e. the safe harbour).[6]

• Other activities

When Luxembourg companies realize other financial income such as capital gains in regard to loan receivables or income from derivatives, the new rules may limit the deductibility of interest expenses if it is not possible to rely on the EUR 3m safe harbour. Hence, whenever it is expected that a Luxembourg company may realize significant amounts of income of these categories, it is crucial to consider potential tax implications beforehand.

General Anti-Abuse Rule (GAAR)

The Luxembourg abuse of law concept as defined in §6 of the Tax Adaptation Law ("*Steueranpassungsgesetz*") has been replaced by a new GAAR that keeps the key aspects of the previous abuse of law concept (according to which "the tax law cannot be circumvented by an abuse of forms and legal constructions") whilst introducing the concepts of the GAAR provided under ATAD. According to the new provision, non-genuine arrangements or a series of non-genuine arrangements put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the applicable tax law shall be disregarded. Arrangements are considered as non-genuine to the extent that they are not put into place for valid commercial reasons which reflect economic reality.

When the Luxembourg tax authorities can evidence an abuse in accordance with the new GAAR, the amount of taxes will be determined based on the legal route that is considered as the genuine route (i.e. based on the legal route which would have been put into place for valid commercial reasons which reflect economic reality). In terms of scope, the new GAAR is broader than the GAAR provided under ATAD. While the latter only applies to corporate income taxes and taxpayers, the Luxembourg GAAR applies to all taxpayers and is not limited to corporate income tax. However, in practice the scope of the new GAAR should be limited to clearly abusive situations and, in an EU context, to wholly artificial arrangements considering relevant jurisprudence of the Court of Justice of the European Union ("CJEU").

Analysing the Impact on Alternative Investments

The GAAR is generally targeted at abusive transactions that are tax driven. However, Alternative Investments are frequently made for legitimate commercial reasons such as the generation of ongoing income and the realization of capital gains upon a future exit. Moreover, the CJEU confirmed on numerous occasions the right of taxpayers to arrange their affairs in a way that results in the lowest tax liability. In light of the above, when private equity, real estate and investments are properly managed (good corporate governance, proper legal documentation, appropriate substance in Luxembourg, etc.), Luxembourg companies should be out of reach of the new GAAR.

Amendment of the Luxembourg Roll-over Relief

Article 22bis of the LITL provides for exceptions to the general rule that Luxembourg taxpayers have to realize the latent capital gains linked to assets that are exchanged for other assets. As from 2019, the provision applicable to a specific category of exchange operations involving the conversion of a loan or other debt instruments into shares of the borrower has been abolished. Hence, the conversion of debt instruments into shares of the borrowers will no longer be possible in a tax neutral manner. Instead, the conversion will be treated as a sale of the debt instrument followed by a subsequent acquisition of shares. Accordingly, any latent gain on the debt instrument will become fully taxable upon the conversion.

The amendment of article 22bis of the LITL follows the State Aid investigations of the EU Commission in the Engie case. However, while the aim of this amendment is to ensure that double non-taxation outcomes can no longer arise from this provision, it would have been wise to implement more targeted measures to avoid collateral damage.

Analysing the Impact on Alternative Investments

As a matter of principle, whenever a debt instrument should be contributed by a Luxembourg company, consideration should be given to the question as to whether the fair market value of the receivable exceeds its book value. Where the amendment of the roll-over relief would result in adverse tax consequences, alternative restructuring options should be explored.

Conclusion

The 2019 tax reform introduces a number of new anti-avoidance rules into Luxembourg tax law. With regard to Alternative Investments, the interest limitation rules have to be in the focus of each and every tax analysis, whereas the other tax measures should in many cases have a limited effect. Nevertheless, the impact of the tax reform on a particular investment structure has to be determined on a case-by-case basis. Anticipating the next tax reform in 2020, taxpayers should analyse whether the adoption of the comprehensive anti-hybrid mismatch rules provided under ATAD 2 may have an impact on investments and implement structure alignments where necessary.

Ultimately, the attractiveness of Luxembourg as a prime location for the structuring of investments should not be undermined by the current tax developments. To the contrary, Luxembourg offers an ideal framework for private equity investments in the post-BEPS era. The other tax measures will be analysed in a second article that will be published in the March edition of AGEFI.

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1) Tax exempt income such as dividends benefiting from the Luxembourg participation exemption regime are to be excluded when determining the EBITDA.
2) In this regard, participation means a participation in terms of voting rights or capital ownership of 25% or more or the entitlement to receive 25% or more of the profits of that entity.
3) This should remain valid as long as the conditions of the loan facility are not amended after 17 June 2016.
4) When a Luxembourg company bears the risks in relation to the granting of loans (in particular, the credit risk), it will be considered as a finance company from a Luxembourg transfer pricing perspective and required to realize an arm's length finance margin. In contrast, when a Luxembourg company merely on-lends funds without bearing any risks in relation to the on-lending of funds, it should be considered as a financial intermediary that needs to realize an arm's length remuneration for the services rendered. The arm's length remuneration for financial intermediation should be significantly lower than that of a Luxembourg finance company.
5) Article 166 (5) No. 1 of the LITL.
6) Should the Luxembourg company perform financing activities and realize a finance margin, the amount of deductible interest expenses should be limited to EUR 3m plus the amount of the finance margin. Other interest income would further increase the amount of deductible interest expenses.