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Luxembourg

INSIGHT: Luxembourg Tax Reform—Impact on Distressed Debt Investments

BY OLIVER R. HOOR

The Luxembourg Parliament has now adopted the 2019 tax reform implementing the Anti-Tax Avoidance Directive (''ATAD'') and other anti-base erosion and profit shifting (″BEPS″) related measures into Luxembourg tax law.

One of the main changes is the interest deduction limitation rule that put restrictions on the deductibility of interest expenses. Depending on how investments into distressed debt are made, this provision may have a significant impact.

In Luxembourg, investments into distressed debt are an important niche market which has soared over the last decade, contributing to the Grand Duchy's success as a prime location for the structuring of alternative investments in and through Europe.

Broadly speaking, investments into distressed debt rely on the acquisition of non-performing loans or other distressed debt instruments at a price below par value. Thereafter, the idea is to realize capital gains upon the disposal or repayment of the debt instrument once the financial situation of the debtor improves.

Investments into distressed debt may be structured via different Luxembourg vehicles including Luxembourg companies, securitization vehicles and fund vehicles or a combination of these.

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Luxembourg companies and securitization companies are generally subject to corporate income tax and municipal business tax at an aggregate rate of 26.01 percent (in the municipality of Luxembourg), which is expected to be reduced to 24.94 percent with retroactive effect as from January 1, 2019. (According to an announcement of the Luxembourg government, the corporate income tax rate should be reduced by 1 percent in 2019. Accordingly, the aggregate tax rate applicable in the municipality of Luxembourg in 2019 should correspond to 24.94 percent.)

Any limitation on the deductibility of interest expenses may therefore have a significant impact on the overall tax profile of these investments.

Typical Investment Structures

The Luxembourg legal framework offers a range of options when it comes to the organization of distressed debt investments. Such investments are frequently made via a Luxembourg or foreign investment fund and a Luxembourg company, or via a Luxembourg securitization company.

When investments are made via a Luxembourg company (''LuxCo''), the fund usually finances the investments largely with debt instruments that bear interest. Here, it is important that the Luxembourg company realizes an arm's length remuneration for its investment activities.

When investments are made via a Luxembourg securitization company (''Lux SV''), the latter issues securities to the investors and uses the funds received for its investments. Here, the commitments made by the secu-

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ritization vehicle to the investors may correspond to the net income derived from the investment portfolio. In other words, the securitization company does not need to realize any taxable income.

Alternatively, securitization companies that issue shares to their investors may rely on the tax deductibility of both commitments towards their shareholders and dividend distributions which should be treated as a deductible expense for Luxembourg tax purposes (Article 46 No. 14 of the Luxembourg Income Tax Law) .

The New Interest Deduction Limitation Rule

As from January 1, 2019, Article 168bis of the Luxembourg Income Tax Law (''LITL'') limits the deductibility of ''exceeding borrowing costs'' generally to a maximum of 30 percent of the corporate taxpayers' earnings before interest, taxes, depreciation and amortization (''EBITDA'').

The scope of the interest deduction limitation rule 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 3 million euros ($3,442 million) may be deducted without any limitation (a safe harbor provision).

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 (the so-called escape clause).

''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 are interest expenses on all forms of debt, other costs economically equivalent to interest and expenses incurred in connection with the raising of finance, including, without being limited to:

- payments under profit participating loans;
- imputed interest on instruments such as convertible bonds and zero-coupon bonds;
- amounts under alternative financing arrangements, such as Islamic finance;
- the finance cost element of finance lease payments;
- capitalized interest included in the balance sheet value of a related asset, or the amortization of capitalized interest;
- amounts measured by reference to a funding return under transfer pricing rules where applicable;
- notional interest amounts under derivative instruments or hedging arrangements related to an entity's borrowings;
- certain foreign exchange gains and losses on borrowings and instruments connected with the raising of finance;
- guarantee fees for financing arrangements;
- arrangement fees and similar costs related to the borrowing of funds.

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.

The optional provision under ATAD according to which EBITDA and exceeding borrowing costs can be determined at the level of the consolidated group (in case of tax consolidation) has not been included in the tax reform but will be introduced at a later stage with retroactive effect as from January 1, 2019 (according to a recent announcement of the Luxembourg government).

Entities Excluded from the Scope of the Rule The interest deduction limitation rule explicitly excludes financial undertakings and standalone entities from its scope.

Financial undertakings are those regulated by the EU Directives and Regulations and include financial institutions, insurance and reinsurance companies, undertakings for collective investment in transferable securities (''UCITS''), alternative investment funds (''AIFs'') and securitization 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 (''PE'').

Loans Excluded from the Scope of the Rule According to Article 168 of the LITL, loans concluded before June 17, 2016 are excluded from the restrictions on interest deductibility. However, this grandfathering rule does not apply to any subsequent modification of such loans. Accordingly, when the nominal amount of a loan granted before June 17, 2016 is increased after this date, the interest in relation to the increased amount would be subject to the interest deduction limitation rule. Likewise, when the interest rate is increased after June 17, 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 deduction limitation rule irrespective of when the drawdowns have been made. This should remain valid as long as the conditions of the loan facility are not amended after June 17, 2016.

Loans used to fund long-term public infrastructure projects (where the project operator, borrowing costs, assets and income are all in the EU) are excluded from the scope of the interest deduction limitation rule.

Carry Forward The interest deduction limitation rule also provides for a carry forward mechanism for 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

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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 percent of the EBITDA to the extent the borrowing costs exceed 3 million euros. These amounts can be carried forward for a period of five tax years.

In case of corporate reorganizations 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.

Potential Impact on Distressed Debt Investments

Whenever distressed debt investments are made via Luxembourg companies or securitization companies, the potential impact of the new interest deduction limitation rule must be carefully analyzed.

This is because often no interest payments are received over the lifetime of the investment and interest income is written off for Luxembourg accounting purposes. Instead, the focus is on the realization of capital gains upon a future exit.

When a company realizes interest income, there is no limitation on the deductibility of interest expenses up to the amount of the interest income (in this situation, there are no exceeding borrowing costs).

In contrast, capital gains realized in relation to debt instruments should in general not qualify as interest income or other economically equivalent taxable revenues. Thus, for capital gains, the 30 percent EBITDA limitation might be applicable.

Where securitization companies are concerned, this point is not yet clear, as capital gains realized by a securitization vehicle on distressed debt investments might be considered as taxable revenues that are economically equivalent to interest income. This is also the position taken by the Irish government when considering the implementation of the interest deduction limitation rule.

Another question regarding securitization companies concerns the treatment of commitments and distributions made to shareholders. From a Luxembourg tax perspective, such commitments are deductible business expenses at the level of the securitization vehicle (Article 46 No. 14 of the LITL). This is in order to achieve tax neutrality.

At the level of the investors, dividends paid by a securitization vehicle are deemed to be interest income (Article 97 (6) of the LITL in conjunction with Article 97 (1) No. 5 of the LITL).

The question arises as to whether this fiction for Luxembourg tax purposes should also have the effect of dividend payments and commitments made towards shareholders falling within the scope of the interest deduction limitation rule.

In light of the above, Luxembourg companies and securitization companies may be subject to Luxembourg corporate income tax and municipal business tax at an aggregate rate of 24.94 percent (in the municipality of Luxembourg City) on up to 70 percent of their capital gains. This may result in an effective tax rate of circa 18 percent (i.e. 70 percent taxable basis multiplied by 24.94 percent of taxes).

Going Forward

Investments into distressed debt are an important niche market of the Luxembourg fund industry. However, depending on how these investments are structured, the new interest deduction limitation rule may have a significant impact on the overall tax profile and reduce the return on investment.

With regard to securitization companies, the Luxembourg legislator should clarify that capital gains realized upon the sale of debt instruments are treated as taxable revenues economically equivalent to interest income. Likewise, the qualification of commitments and distributions to shareholders should be clarified, excluding such commitments from the scope of borrowing costs. Clarifications by the Luxembourg government on the impact of the new interest limitation rules on securitization companies are expected in the coming months.

As the tax law changes entered into force on January 1, 2019, taxpayers should urgently review their investment structures, assess the impact of the new rules and, where necessary, develop strategies to mitigate any adverse tax implications. Ultimately, although the structuring of investments is becoming more complex in the post-BEPS era, investments may still be made in a tax efficient manner.

Planning Points

The potential impact of the interest deduction limitation rule may be managed in different ways:

- Relying on the grandfathering rule

For existing investment structures, taxpayers may rely on the grandfathering rule applicable to loans concluded before June 17, 2016.

As these loans are excluded from the scope of the interest deduction limitation rules, related interest expenses should remain fully deductible for tax purposes. However, when taxpayers rely on the grandfathering rule, it will be important to ensure that the loans are not amended until the end of the investment period.

- Relying on the safe harbor

Given that the Luxembourg legislator adopted a 3 million euro safe harbor, taxpayers with smaller investments may rely on this safe harbor rule.

If the amount of capital gains in a given year exceeds the amount of 3 million euros, the effective tax rate of the investment vehicle may increase significantly due to the non-deductibility of interest expenses.

- Relying on the standalone entity exception

Investors may further rely on the standalone entity exception as long as the company (i) does not form part of a consolidated group for financial accounting purposes, and (ii) has no associated enterprise or PE.

However, it is interesting to note that the definition of associated enterprise for the purpose of the newly introduced interest deduction limitation rule is very broad, including individuals, companies and transparent entities such as partnerships. 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 percent or more.

In this regard, participation means a participation in terms of voting rights or capital ownership of 25 percent or more or the entitlement to receive 25 percent or more of the profits of that entity.

It remains to be seen whether the Luxembourg tax authorities will apply a different understanding in case of Luxembourg securitization vehicles. After all, owning a Luxembourg securitization company via five trusts instead of one seems to be artificial, runs counter the intention of the EU to foster securitization transactions and results in unnecessary costs for investors.

■ Implementing securitization vehicle subject to EU regulation

Securitization undertakings that are subject to EU Regulation 2017/2402 are explicitly excluded from the scope of the interest deduction limitation rules. The three main conditions falling within the scope of this regulation include (i) different tranches with subordination, (ii) segmentation of the credit risk associated with the exposure of the assets, and (iii) the notes need to be held by at least two different noteholders. However, before adopting this regulatory status, investors should consider its potentially burdensome requirements.

■ Investments via a Luxembourg fund

It might be considered to use a Luxembourg fund vehicle (for example, a Reserved Alternative Investment Fund) for investments into distressed debt. Nevertheless, from a commercial perspective, there will generally be a preference to implement investments via a Luxembourg company or securitization company, to protect the fund from potential commitments, obligations and other liabilities relating to the investments.

Alternatively, it might be considered to structure investments via a Luxembourg securitization fund in contractual form, i.e. a fonds commun de placement (''FCP''), which is exempt from corporate income tax and municipal business tax and thus not subject to the interest deduction limitation.

■ Using derivatives

Where investments of a Luxembourg or foreign fund are made via a Luxembourg company, it might be considered to separate the interest income from the potential capital gains. With regard to the interest income, the distressed debt portfolio may be largely financed by debt instruments that bear interest. Since the Luxembourg company has to realize an arm's length remuneration in regard to its investment activities, the company should realize a positive margin and related interest expenses should be fully deductible.

Regarding potential variations in value, the Luxembourg company may enter into derivative transactions with the fund (for example, options) that protect the company against the downside risks in relation to the investment portfolio in exchange for the upside potential and an arm's length remuneration. Potential expenses incurred in relation with the derivative transactions should not come within the definition of borrowing costs.

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