Thin capitalisation Q&A: Luxembourg

by Daniel Riedel and Pol Mellina, *Bonn Steichen & Partners*

Country Q&A | Law stated as at 31-Jan-2019 | Luxembourg

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This Q&A provides jurisdiction-specific commentary on *Practice note, Thin capitalisation: Cross-border*, and forms part of *Cross-border loan financing* and *Cross-border joint ventures*.

1. What are the main characteristics of thin capitalisation rules in your jurisdiction?

Luxembourg tax law does not contain any thin capitalisation rules. A company's debt financing does not need to be limited to a certain percentage of its equity, as long as it does not run afoul of the general anti-abuse or anti-simulation provisions of Luxembourg tax law (see *Question 2* for details). In practice, the Luxembourg tax authorities generally accept a debt-to-equity ratio for holding companies of up to 85%:15%. This can be considered as a type of safe harbour provision.

2. What is the main national legislation regulating thin capitalisation in your jurisdiction?

The main national legislation regulating thin-capitalisation is the general anti-abuse regulation (*section 6, Steueranpassungsgesetz*) and the anti-simulation regulation (*section 5, Steueranpassungsgesetz*). While the anti-abuse regulation aims at requalifying abusive structures that are mainly motivated by tax reasons, the anti-simulation regulation aims at requalifying situations where taxpayers simulate a certain transaction (for example, granting a loan) while in fact the real underlying transaction was a different one (for example, subscribing to capital).

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3. What is the relationship between thin capitalisation and transfer pricing rules in your jurisdiction?

No relationship exists between the thin-capitalisation restrictions and the transfer pricing rules in Luxembourg. Each provision applies independently of the other. The transfer pricing rules look only at the amount of interest expense accruing on the debt (that is, they apply a P&L test only), whereas the general anti-abuse and anti-simulation provisions look only at the debt-to-equity ratio of the taxpayer (that is, they apply a balance sheet test only).

4. Are there any additional regional / local state legislation and tax authority guidance relevant to thin capitalisation in your jurisdiction?

In the context of intra-group financing activities, which consist of providing financing to related companies by means of debt granted either by related or by third parties, the Luxembourg tax authorities issued Circular L.I.R. – n°56/1 – 56bis/1 dated 27 December 2016, which provides guidance on how the arm's length remuneration of an entity related company is to be determined.

In the context of holding activities, the 85%:15% debt-to-equity ratio has never been formally confirmed by the Luxembourg tax authorities or the Luxembourg administrative courts (see *Question 18*). The ratio is, however, generally accepted by practitioners and the Luxembourg tax doctrine. In any case, the taxpayer should, however, be free to exceed this ratio if it can evidence sound economic reasons justifying a higher indebtedness (for example, by comparison to the indebtedness ratio of comparable independent third-parties active in the same sector).

5. What type of loans do the rules apply to?

Any types of loan are, in principle, within the scope of the thin-capitalisation rules.

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6.Are any loans excluded? Are there any safe harbours?

With respect to holding activities, loans provided by third parties are generally excluded from the 85%:15% debt-to-equity ratio (see *Question 1*). This is mostly due to the fact that no base erosion or profit shifting risks are deemed to exist when dealing with unrelated parties.

7. What is the tax treatment of loans caught by the rules? Is the interest paid on the loan non-deductible in the borrower's hands?

Interest paid on the part of the debt that is deemed excessive could be requalified as hidden dividend distributions. This makes the expense non-deductible, and leads to application of a withholding tax on the dividend distribution (unless a withholding reduction or exemption applies).

Uncertainty exists as to whether such a situation could also lead to a requalification of the excessive debt (that is, the debt that generated the excessive interest expense) into equity for purposes of the Luxembourg net wealth tax.

Indeed, as the form of the payment (interest or dividend) is generally determined on the basis of the nature of the underlying instrument (that is, a debt or an equity instrument), requalifying an excessive interest payment into a hidden dividend distribution should in principle be preceded by a requalification of the excessive amount of the debt into equity. However, as detailed in *Question 3*, no formal relationship exists between the transfer pricing rules and the thin-capitalisation rules, so that a transfer pricing adjustment is in principle fully independent from a thin-capitalisation adjustment under the general anti-abuse or anti-simulation provisions.

8. How is the disallowed interest calculated? Is it by reference to a maximum amount of debt or a maximum amount of interest? If it is by reference to a maximum amount of debt, is that amount determined by an arm's length approach or a ratio approach? If it is by reference to a maximum amount of interest, is there a specific debt-to-equity ratio and are there any procedures that can be followed for a different debt-to-equity ratio to apply?

The disallowed interest is calculated by application of the Luxembourg transfer pricing provisions, which are fully aligned with the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. The disallowed interest computation is made by reference to a maximum amount of interest that can be deemed at arm's length, not by reference to a debt-to-equity ratio.

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9. Can any disallowed interest be carried forward to future years for set-off?

No carry-forward of disallowed interest is possible under Luxembourg tax law currently in force. Any disallowed interest would be requalified as a hidden dividend distribution and deemed to have been distributed in the same year as the interest payment.

Following the implementation of the ATAD 1 Directive (Directive 2016/1164 dated 12 July 2016) into domestic law as of the tax year 2019, Luxembourg will implement the mandatory interest limitation rule. This will limit the deductibility of interest expenses to 30% of the fiscal EBITDA, and will provide for a carry forward of the interest expenses that exceed the 30% threshold. It will not lead to the requalification of the disallowed interest into hidden dividend distributions.

10. How is the lender taxed on receipt of the interest?

Regular (that is, arm's length and non-profit participating) interest income is not subject to withholding tax in Luxembourg. Luxembourg resident taxpayers receiving regular interest income are, in principle, fully taxable on it. For corporate taxpayers, the applicable aggregate corporate income tax, municipal business tax and solidarity surcharge rate amounts to 26.01% for corporations established in the municipality of Luxembourg-City.

Disallowed interest is considered as a hidden dividend distribution. Hidden dividend distributions are subject to a 15% withholding tax (save for the application of the Luxembourg withholding tax exemption regime or double tax treaties entered into by Luxembourg that provide for a reduced withholding tax rate).

If both the lender and the borrower are fully taxable Luxembourg resident companies, the (hidden) dividends received are in principle taxed at the level of the lender, subject to the application either of the participation exemption regime (full exemption) or of a partial exemption regime (50% exemption). Any withholding tax paid by the borrower may be credited against the tax due from the lender. If the lender is a non-resident taxpayer, Luxembourg's taxation powers may be limited under an applicable double tax treaty.

11. How are the rules applied to hybrid instruments?

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Under Luxembourg tax law, and according to the substance over form principle, hybrid instruments should be classified either as debt instruments or as equity instruments, depending on their main characteristics. The general Luxembourg tax rules applicable to interest or dividend payments described above would then apply.

12. Is it possible to obtain any clearances from the revenue authorities in respect of transactions?

It is possible to request and obtain advance tax clearance from the Luxembourg tax authorities. This is subject to certain conditions, such as the payment of an administrative handling fee and that clearance is requested before setting up the intended transaction.

Obtaining an advance tax clearance will lead to automatic exchange of information with EU member states and affected third countries.

13. What are the main international treaties and agreements that apply in your jurisdiction?

As an EU member state, Luxembourg is bound by the Treaty on European Union and the Treaty on the Functioning of the European Union, which notably enact the fundamental freedom of movement. Luxembourg also applies EU secondary legislation, such as directly applicable EU regulations and EU directives implemented into Luxembourg domestic law. Luxembourg currently has 83 double tax treaties in force (which generally follow the OECD Model Tax Treaty).

Luxemburg has not entered into any legally binding treaties or agreements in the field of thin capitalisation rules.

14. What impact do international treaties and agreements have in your jurisdiction? Do double tax treaties apply?

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Duly ratified (and therefore legally binding) international treaties and agreements take precedence over Luxembourg domestic laws and regulations. No treaty override can occur in Luxembourg. Luxembourg has an extensive double tax treaty network (83 double tax treaties are currently in force) and has also signed the OECD multilateral agreement.

15. What are the reporting and other administrative obligations that apply to help authorities evaluate thin capitalisation?

Taxpayers must, on request, provide the Luxembourg tax authorities with any documentary evidence that supports the positions taken in their tax returns (*section 171, Abgabenordnung*). These obligations apply to intragroup transactions in particular.

16. Where the revenue authorities make an adjustment of the deductibility of interest for tax purposes due to thin capitalisation rules, can other penalties also be imposed?

There are no specific penalties under Luxembourg tax law for abuse of law or simulation, including in thin-capitalisation matters. Non-fraudulent tax avoidance can be sanctioned by an administrative penalty of up to EUR125,000, without however exceeding 25% of the amount of evaded taxes, nor going below 5% of the amount of evaded taxes (*section 402, Abgabenordnung*).

17. What are the relevant national courts and what dispute resolution mechanisms exist for thin capitalisation issues in your jurisdiction? Can thin capitalisation rulings be appealed?

Decisions on thin capitalisation are dealt with in Luxembourg following the ordinary procedure for taxation matters. Tax assessments issued by the Luxembourg tax authorities can be appealed to the Director of the Luxembourg tax authorities. If the Director of the Luxembourg tax authorities rejects the appeal or does not take any formal position within six months of the date on which the appeal was filed, the matter may be brought before the Luxembourg administrative courts (*Tribunal administratif* in the first instance, and *Cour administrative* on appeal: the decision of the *Cour administrative* will be final).

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18. What are the most significant case law developments on thin capitalisation in your jurisdiction?

To the best of our knowledge, there is only one relevant case. In 2007, the Luxembourg administrative courts confirmed, on the basis of the factual circumstances, that a taxpayer was sufficiently capitalised with a debt-to-equity ratio of 70%:30% (*Tribunal Administratif, 7 Mai 2007, N°21466 du rôle*). No formal decision on the 85%:15% debt-to-equity ratio has yet been taken by the Luxembourg administrative courts.

19. Does your jurisdiction place any further restrictions on the deductibility of interest?

Following the transposition of the ATAD 1 Directive (*Directive 2016/1164 dated 12 July 2016*) into domestic law, Luxembourg must implement, effective as of 1 January 2019, the mandatory interest limitation rule, which will limit the deductibility of interest expenses to 30% of the fiscal EBITDA of the taxpayer (subject to exceptions applying, among other things, to certain financial institutions and certain securitisation vehicles, as well as to standalone entities). A *de minimis* rule will also be implemented, under which excess borrowing costs not exceeding EUR3 million in a given tax year will remain entirely deductible. Loans concluded before 17 June 2016 will be grandfathered to the extent that there has been no subsequent modification of those loans.

20. Are there any current trends, developments or reform proposals that have or will affect the area of thin capitalisation in your jurisdiction?

To the best of our knowledge, there are currently no reform proposals that will affect the area of thin capitalisation in Luxembourg. As Luxembourg is an active member of the OECD, the outcome of the discussion draft on financial transactions published by the OECD in July 2018 should be monitored carefully.

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