THE NEW INTEREST LIMITATION RULES ON PE INVESTMENTS

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. WHEN IT COMES TO PRIVATE EQUITY (PE) INVESTMENTS, THE IMPLEMENTATION OF THE INTEREST LIMITATION RULES IS THE MOST IMPORTANT TAX LAW CHANGE GIVEN THAT DEBT FUNDING, BE IT FROM INTERNAL OR EXTERNAL SOURCES, IS AN INTEGRAL PART OF EACH AND EVERY PRIVATE EQUITY INVESTMENT.

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The interest limitation rules under ATAD have been inspired by the recommendations of the OECD on Action 4 (Limiting Base Erosion Involving Interest Deductions and Other Financial Payments) of its Base Erosion and Profit Shifting ("BEPS") Project. The objective of these rules is to discourage multinational groups from reducing their overall tax base through the financing of group companies resident in high-tax jurisdictions with debt.

This article provides a clear and concise overview of the interest limitation rules and analyses its impact on typical private equity investments

The interest deduction limitation rule

Since 1 January 2019, Article 168bis of the Luxembourg Income Tax Law 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.

The interest limitation rules also provide for carry forward mechanisms in regard to both non-deductible exceeding borrowing costs (i.e. to the extent the deductibility of interest expenses is denied) and unused interest capacity (i.e. when the exceeding borrowing costs are lower than 30% of the EBITDA).

Entities excluded from the scope of the rule

The interest limitation rules explicitly exclude financial undertakings and standalone entities from its 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 3]

Loans excluded from the scope of the rule

According to Article 168 of the ITL, 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.[4]

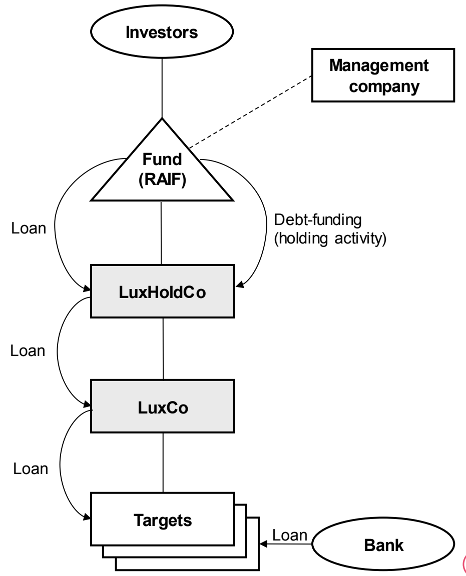
Moreover, loans used to fund long-term public infrastructure projects are excluded from the scope of the interest deduction limitation rule.

Analysing the impact on PE investments

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

The target companies are generally financed by a mixture of equity and debt instruments. Additional funding may be obtained from external sources (for example, banks).

The following chart depicts a typical PE fund structure:



When analysing the impact of the interest limitation rules on private equity 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).[5] 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.[6] 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).[7]

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 should 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.

Conclusion and outlook

While the new interest deduction limitation rule should in many cases only have a limited impact on typical private equity investments, when it comes to certain types of income (income from derivatives, capital gains realized in relation to receivables, etc.) any limitation on the deductibility of interest expenses may have a significant impact on the tax position of the Luxembourg investment platform.

Looking at the wider picture, the potential implementation of interest limitation rules in the investment jurisdictions may also have an impact on the overall tax profile of private equity investments. Therefore, tax developments in the investment jurisdictions need to be carefully monitored.

Ultimately, going forward the interest limitation rules will need to be in the focus of each and every tax analysis. ●

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. 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.
4. This should remain valid as long as the conditions of the loan facility are not amended after 17 June 2016.
5. 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.
6. Article 166 (5) No. 1 of the LITL.
7. 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.