Snapshot: what are some tax consequences of debt funding for Luxembourg?

Insights - 20/10/2022

The recent decision taken by the Luxembourg Tribunal Administratif on 23 September 2022 (decision 44902), where an interest-free loan was requalified as equity financing for tax purposes, [1] once again sheds a light on one of the most important dilemmas in corporate finance, at least from a tax perspective. Should an entity be financed with debt or equity?

Recent international (ie at OECD level), regional (ie at the level of the European Union) and unilateral initiatives have been launched and implemented to tackle a bias towards debt financing and therefore limit the risk for aggressive base erosion.

In Luxembourg, there are various legal provisions which mitigate the effects of debt financing on tax base reduction or withholding tax relief. Here is a non-exhaustive list of some of the situations covered by these Luxembourg legal provisions applicable to Luxembourg companies financed by debt (loan, bond, notes etc):

Scenario	Possible consequences
Interest expense is connected with a tax-exempt income	Interest payment may not be (fully) deductible
	Interest payment may not be non-deductible and a withholding

The debt instrument is requalified into an equity instrument	withholding tax (**WHT**) of 15% may apply – deductibility of such liability for net wealth tax purposes may be denied
Interest (paid to an affiliated entity) is deemed too high and/or not supported by benchmark analysis	Excessive portion may be non-deductible for income tax purposes, and subject to 15% WHT
Interest expense are higher than interest income	Net borrowing costs (**NBCs**) may not be deducted if in excess of (i) 30% of the EBITDA or (ii) €3 million
Debt instrument finances a shareholding/equity in excess of 85:15 debt-to-equity ratio	Interest on the exceeding portion are non-deductible and subject to 15% WHT
Interest payment tracks (underlying) non-exempt equity income and/or real estate income	NBCs may be not deducted if in excess of 30% of the

	EBITDA or €3 million
Interest expense receives a different tax treatment in the hands of creditor (hybrid instrument)	Interest payment may not be deductible
Debt instrument finances a debt funding granted by the Luxembourg company to an affiliated entity	Company would be subject to intra-group financing compliance rules (equity at risk, arm's length remuneration, substance)
Bonds with a return/yield contingent on profits of the issuer	Interest payment may be non-deductible and subject to 15% WHT
Payee/creditor is established in a black listed jurisdiction (cf EU black list)	Interest expense may not be deductible

For more information, please contact a member of our expert tax team who are ready to help you, and your clients, navigate the different angles of corporate funding and their tax treatment under Luxembourg law.

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[1] Read our briefing on this decision here.

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