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Global Tax Alert

Luxembourg reduces tax rates and allows interest limitation rules to apply to fiscal unities

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Executive summary

On 26 April 2019, Luxembourg's 2019 Budget Law (Budget Law) was published in the *Official Gazette*.

The Budget Law incorporates the option given by the European Union (EU) Anti-Tax Avoidance Directive¹ (ATAD) to allow companies forming a fiscal unity to apply the interest limitation rules to the fiscal unity as such (rather than the individual members of a fiscal unity). This will apply automatically to all new fiscal unities, unless the companies, in the written request to form a fiscal unity to be submitted to the tax authorities, opt to apply the interest limitation rules to each company individually. Existing fiscal unities are entitled to apply the interest limitation rule to the fiscal unity as such, provided that all the members express their choice in a common written request to be filed before a determined date.

As from tax year 2019 on, the corporate income tax rate is reduced to 17% (18.19% including the contribution to the employment fund); a lower rate will apply to taxable profits not exceeding €200,000. Furthermore, the value added tax (VAT) rate applicable to certain products will be scaled down.

Detailed discussion

Application of interest limitation to fiscal unities

The Luxembourg law implementing ATAD introduced an interest limitation rule that limits the deductibility of taxpayers' borrowing costs to 30% of taxable EBITDA (Earnings (taxable profits) before Interest, Tax, Depreciation and Amortization), applicable to financial years starting on or after 1 January 2019. The Law did not foresee that companies forming a fiscal unity would be allowed to determine exceeding borrowing costs and EBITDA for the fiscal unity as such.

The Budget Law amends the interest limitation rules to apply to fiscal unities as a whole, thereby incorporating the option given by the ATAD to allow companies forming a fiscal unity to apply the interest limitation rules to the fiscal unity as such. As a result, at the level of the fiscal unity exceeding borrowing costs will be deductible up to the higher of 30% of taxable EBITDA or €3 million.

The application of the interest limitation rules to fiscal unities will apply by default to newly formed fiscal unities, unless an "opt-out" is included in the written request to form a fiscal unity. It should be noted that the "all or nothing" principle applies, meaning that the application of the interest limitation rules on a stand-alone basis will concern all the companies belonging to the same fiscal unity, and not just some of them. Furthermore, regarding the option for the application of the interest limitation rules at the individual member's level, this choice will be binding for the entire period of belonging to the fiscal unity.

The amended fiscal unity rules contain detailed provisions on the determination of exceeding borrowing costs, taxable EBITDA and other relevant items for the application of the interest limitation rules to fiscal unities. As was the case in the past, members of a fiscal unity will have to file stand-alone tax returns. Each member will have to declare their amount of borrowing costs and interest income and economically equivalent taxable revenues.

At the level of the fiscal unity the amount of borrowing costs will correspond to the sum of borrowing costs of all members incurred during the time such member belongs to the fiscal unity. The same will apply to the determination of interest income and economically equivalent taxable revenues. Exceeding borrowing costs of the head of the fiscal unity will correspond to the excess of borrowing costs over interest

income and other economically equivalent taxable revenues of all members of the fiscal unity. Taxable EBITDA will also be determined at the level of the head of fiscal unity on the basis of an aggregation of the tax results of the members of the fiscal unity.

Only the head of the fiscal unity will be able to carry forward exceeding borrowing costs and unused interest capacity. For purposes of applying the equity escape rule, the ratio of the sum of the equity of all members over the sum of the total assets of all members is compared to the equivalent ratio of the consolidated group for financial accounting purposes. Details of the calculations must be added by the head of the fiscal unity to its tax return and the calculations must be certified in a report to be established by an independent auditor.

The new provisions will apply to financial years starting on or after 1 January 2019. The interest limitation rule will apply to fiscal unities that exist at the date of entry into force of the amendments to the fiscal unity rules, unless all the members express their wish to apply the interest limitation rules on a stand-alone basis in a common written request to be filed before the end of the first financial year to which the interest limitation rule applies for the first time. For companies whose financial year corresponds to the calendar year, the request would have to be filed by 31 December 2019.

In addition to the rules in relation to interest limitation, the Budget Law redesigns the current wording of the fiscal unity rules to incorporate certain key elements and details that were to date dealt with in the grand-ducal regulation of 18 December 2015 and in an administrative Circular. However, the basic conditions that need to be met to form a vertical or horizontal fiscal unity remain largely unchanged.

In this context, it is worth mentioning that the Luxembourg Administrative Court recently filed a request for a preliminary ruling with the Court of Justice of the European Union (CJEU) concerning the Luxembourg fiscal unity rules. In particular, the CJEU is requested to express an opinion on the strict separation, as foreseen by Luxembourg law, between a vertical fiscal unity (i.e., between a parent company and its direct or indirect subsidiaries) and a horizontal fiscal unity (between two or more resident subsidiaries of a parent company that is not itself within the fiscal unity perimeter) and on the obligation to end an existing vertical fiscal unity before being allowed to create a horizontal fiscal unity, which can lead to negative tax consequences if the minimum period of existence of the fiscal unity foreseen by the domestic

legislation is not respected. Depending on the ruling of the CJEU, the existing rules on fiscal unity may have to undergo further modifications.

Decrease of the corporate income tax rate

As from tax year 2019 on, the nominal rate of corporate income tax will be reduced from the current 18% to 17% (18.19% including the contribution to the employment fund). The global tax rate, including the municipal business tax, for a company with its statutory seat in Luxembourg-City will thus be 24.94% (compared to 26.01% for tax year 2018).

The rate of 17% will apply to taxable profits exceeding €200,000; profits not exceeding €175,000 will be taxed at a reduced rate of 15%. For profits between €175,000 and €200,000, an intermediary rate is applied, corresponding to €26,250 plus 31% of the income exceeding €175,000.

VAT measures

Authorized crop protection products will benefit from the reduced VAT rate of 8%, while the super-reduced rate of 3% will apply to books, journals and magazines, whether supplied physically or on an electronic device. Publications that are entirely or predominantly dedicated to publicity, those consisting entirely or predominantly of video content or audible music or pornographic content, are excluded.

Certain para-pharmaceutical products will also benefit from the super-reduced rate of 3%.

These provisions will apply as from 1 May 2019.

Endnote

1. Council Directive (EU) 2016/1164 of 12 July 2016 setting forth rules against tax avoidance practices that directly affect the functioning of the internal market.

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