

## **EU COMMISSION'S LATEST LETTER OF FORMAL NOTICE TO LUXEMBOURG: LUXEMBOURG TO REVISIT THE TRANSPOSITION OF THE INTEREST BARRIER RULE FOR SECURITISATION ENTITIES**

On 14 May 2020, the EU Commission issued two letters of formal notice to Luxembourg regarding (i) the application of the EU interest barrier rule to Luxembourg securitisation entities and (ii) the tax treatment of certain securitisation transactions carried out in Luxembourg. The present briefing will focus on the former.

### **EU COMMISSION'S LETTER OF FORMAL NOTICE**

According to article 258 of the Treaty on the Functioning of the European Union, the EU Commission has the power to take legal action against a Member State that is not respecting its obligations under EU law. Accordingly, the EU Commission can initiate infringement proceedings when it considers that a Member State has breached EU law. The infringement procedure starts with a request for information (or "letter of formal notice"), by which the EU Commission allows the Member State to present its views regarding the breach observed.

If no reply to the letter of formal notice is received, or if the observations presented by the Member State in reply to that notice cannot be considered satisfactory, the EU Commission will move to the next stage of the infringement procedure and send a formal request (or "reasoned opinion") to comply with EU law. If the Member State still fails to ensure compliance with EU law, despite the reasoned opinion, the EU Commission may then refer the case to the Court of Justice of the European Union.

In this context, the EU Commission recently decided to initiate an infringement procedure against Luxembourg, by issuing a letter of formal notice on 14 May 2020. This letter of formal notice relates to the transposition of the EU interest barrier rule in Luxembourg law (in particular, regarding the application of this rule to Luxembourg securitisation entities). The EU Commission has indeed requested Luxembourg to amend the way it has implemented the interest barrier rule laid down in Article 4 of the Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market (the "ATAD").

## **TRANSPPOSITION OF THE INTEREST BARRIER RULE IN LUXEMBOURG AND APPLICATION TO SECURITISATION ENTITIES**

According to the interest barrier rule included in the ATAD and in order to tackle base erosion schemes, taxpayers are precluded from deducting exceeding borrowing costs (corresponding to, broadly speaking, tax-deductible interest expenses in excess of taxable interest income) from their annual taxable base, if those exceeding borrowing costs are higher than EUR 3 million and 30% of their adjusted EBITDA.

In order to acknowledge the special features of financial institutions and insurance undertakings, however, the ATAD indicated that a more customised approach should be adopted for the financial and insurance sectors, although it was not yet possible to provide specific rules in these sectors, given the absence of sufficiently conclusive discussions in this field. Consequently, Article 4(7) of the ATAD offered the option for EU Member States to exclude certain financial undertakings from the scope of the interest barrier rule.

Luxembourg transposed the provisions of the ATAD in its domestic legislation via a law dated 21 December 2018 (the "**Luxembourg ATAD Law**"), most of the provisions of which applied as from 1 January 2019. Because of the importance of the financial sector, Luxembourg decided to exercise the option offered by Article 4(7) of the ATAD and thus excluded the financial undertakings listed in the ATAD from the application of this particular rule. Luxembourg also decided to include in the financial undertakings carve-out securitisation entities governed by Article 2 (2) of Regulation (EU) N° 2017/2402 EU of 12 December 2017 (or "**SSPE**"), even though such entities were not listed in the ATAD.

Interestingly, this addition was strictly limited to SSPE and did not refer to securitisation companies governed by the Luxembourg law dated 22 March 2004 (which do not necessarily qualify as SSPE within the meaning of the aforementioned EU regulation). One may therefore assume that Luxembourg considered that securitisation entities are sufficiently captured in the financial sector to fall within the ambit of the financial undertakings exclusion, but decided in the meantime to limit this exclusion to SSPE only so as not to expand this exclusion too broadly (and, presumably, to be EU compliant while doing so). In addition, taking into account the fact that SSPE are governed by an EU regulation adopted after the ATAD, including these entities in the financial undertakings exclusion could be viewed as quite an opportune measure, which does not necessarily contradict the very aim of the ATAD.

Nonetheless, the EU Commission is of the view that the Luxembourg ATAD Law went beyond the financial undertakings exclusion offered by the ATAD, because of the addition of SSPE to this exclusion.

Against this background, the EU Commission decided to send a letter of formal notice to Luxembourg on 14 May 2020 (and, in relation to the same matter, to Portugal) requesting it to transpose in its domestic legislation a version of the interest limitation rule that is fully compliant with the ATAD provisions. If Luxembourg does not act within the next four months to adapt its domestic legislation, the EU Commission may send a reasoned opinion to the Luxembourg authorities.

As mentioned above, most of the Luxembourg securitisation companies are likely not to qualify as SSPE within the meaning of the EU Regulation N° 2017/2402, so that the SSPE carve-out added by the Luxembourg legislator would, presumably, not have had a significant impact in practice.

Nevertheless, taxpayers who are expected to rely on this specific exclusion for certain of their Luxembourg securitisation entities are strongly urged to reconsider their initial position (in particular, when they file their tax returns for the fiscal year 2019 – which is the first fiscal year for which the Luxembourg interest barrier rule kicks in). This would have a particular impact on SSPE deriving non-interest income which, after this change, could no longer be fully offset by interest expenses due to the interest barrier rule.

This also sends a clear message to various Member States (especially Ireland, which is still in the process of implementing ATAD rules) that the interest barrier rule has to be properly implemented and no room will be given to Member States to include additional exemptions.

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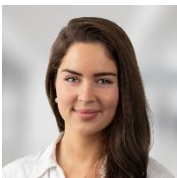
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