LUX CMA
Luxembourg Capital Markets Association

TECHNICAL POSITION PAPER ON THE DEDUCTIBILITY OF PAYMENTS BY SECURITIZATION COMPANIES FINANCED BY DEBT

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INTRODUCTION

This paper summarizes the technical position in relation to the deductibility of payments that are typically due by debt-financed securitization companies (also referred to as “SVs”), as analyzed by the ATAD and Securitization working group of LuxCMA on the basis of the law in effect on the date of the paper’s publication (current law). It focuses specifically on the treatment of such payments under article 168bis LIR (the interest limitation rule) and article 168ter LIR (the anti-hybrid mismatch rules).

While the working group acknowledges that there is no unanimity among tax law professionals in Luxembourg, the positions taken in the paper are considered, within the group, as reasonable and defendable based on the current law. Lines of argumentation and conclusions summarized are not meant to be used in a different context than the ones analyzed in this paper.

Any changes in law or administrative statements or judgements by Luxembourg courts may require an update of the analysis.

ATAD POSITION PAPER

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1 GENERAL DEFINITION OF INTEREST

1.1 General

Under article 168bis LIR, the annual exceeding borrowing costs of a fully taxable SV shall be limited to the higher of 30% of its Tax EBITDA or EUR 3 million. The exceeding borrowing costs are defined as the amount of tax-deductible borrowing costs of the taxpayer which exceeds its taxable interest revenues and other equivalent taxable revenues.

Article 168bis (1)2) LIR defines the borrowing costs as interest expenses on all forms of debt, other costs economically equivalent to interest, and expenses in relation to financing. The provision also includes a non-exhaustive list of examples within the scope of the definition:

- payments under profit-participating loans,
- imputed interest on instruments such as convertible bonds and zero-coupon bonds,
- amounts due under alternative financing arrangements, such as Islamic finance,
- the finance cost element of finance lease payments,
- capitalized interest included in the balance sheet value of a related asset, or the amortization of capitalized interest,
- amounts measured by reference to a funding return under transfer pricing rules where applicable,
- notional interest amounts under derivative instruments or hedging arrangements related to an entity's borrowings,
- certain foreign exchange gains and losses on borrowings and instruments related to financing,
- guarantee fees for financing arrangements,
- arrangement fees and similar costs related to the borrowing of funds.

1.2 Borrowing costs

The law and the Parliamentary comments do not provide for any further details on the definition of borrowing costs and of interest in general. However, the law has transposed almost literally the definitions of Directive UE 2016/1164 (“ATAD 1”), which was largely inspired[1] by the recommendations made in the OECD-BEPS action 4 report (the “Action 4 Report”).[2] The following relevant comments provided in the Action 4 Report may therefore be considered as a source of interpretation for the definitions included in Article 168bis LIR. Under the Action 4 Report[3], “payments that are economically equivalent to interest include those which are linked to the financing of an entity and are determined by applying a fixed or variable percentage to an actual or notional principal over time. [The] rule should also apply to other expenses incurred in connection with the raising of finance, including arrangement fees and guarantee fees. [...] In deciding whether a payment is economically equivalent to interest, the focus should be on its economic substance rather than its legal form.”[4]

Thus, as a matter of principle, the substance-over-form principle should be applied to determine whether an expense must be treated as interest expense or economically equivalent to interest.

Interest expenses on all forms of debt securities issued by SVs should fall in the scope of the rule. For instance, all sums paid under profit-participating bonds, including the fixed element of the remuneration as well as any additional remuneration (for example, based on the SV's net profit or indexed to the return of a specific asset), are to be treated as interest expenses.

[1] Bill 7318, p. 23.
[2] Final report on Action 4 of the Base Erosion and Profit Shifting report “Limiting base erosion involving interest deductions and other financial payments”, 2016.
[3] Action 4 Report, paras 35-38.
[4] See also Bill 7318/01, chamber of commerce, p. 18.

With respect to the other costs economically equivalent to interest, the focus should also be on the economic substance rather than the legal form. On this basis, sums paid in respect of a bond issuance (zero-coupon bond, etc.) such as issuance premiums should be treated as equivalent to interest.

As regards the treatment of expenses, income, gains and losses in the context of specific instruments, please refer to the specific sections of this paper. Any position expressed in this paper where expenses or losses / income or gains are treated as not being economically equivalent to interest will hold true, unless 'they are used as part of an arrangement which, taken as whole, gives rise to amounts which are economically equivalent to interest'.[5]

The law further clarifies that the notion of borrowing costs includes "expenses in relation to financings" ("charges supportées dans le cadre de financements"). The wording is slightly different from the English and German versions of ATAD 1, which refers to "amounts in connection with the raising of finance"[6]. As a matter of best practice, considering the need for a uniform interpretation of European provisions[7], the terms should "be interpreted by reference to the purpose and general scheme of the rules", which have their source in the Action 4 Report (English and French versions) that refers to the terms "amounts in connection with the raising of finance" / "dépenses entraînées par la levée de capitaux".

In addition, as those terms are not further defined in the law, the following general guidelines may be followed: Fees related to the financing of an SV (i.e. the sums put at the disposal of the SV by an investor under the form of debt) should be

[5] Action 4 Report, para 40.
[6] „Aufwendungen im Zusammenhang mit der Beschaffung von Kapital" in the German version. The English and German versions could be translated as « dépenses entraînées par la levée de capitaux ».
[7] CJEU Judgement of 3 April 2008, Criminal proceedings against Dirk Endendijk, C-187/07, ECLI:EU:C:2008:197, paragraphs 22 and 24.

treated as borrowing cost, unless these fees remunerate additional services[8]. Thus, expenses such as arrangement or commitment fees should fall into the scope of the definition of borrowing costs if they are related to debt incurred by the SV. Conversely domiciliation and management fees as well as calculation agent, paying agent, clearing and listing fees and any other expenses that do not directly relate to the financing of an SV (i.e. that are paid to third parties to the financing arrangements) should fall out of the scope of the definition.

1.3 Interest revenues and other equivalent revenues

The exceeding borrowing costs are determined by reference to the taxable interest revenues and other equivalent taxable revenues of the taxpayer.

Based on the symmetrical approach detailed in section 2, any item that is treated as interest expenses and other costs economically equivalent to interest should similarly be treated as interest revenues and other equivalent revenues. The comments mentioned in section 1.1 therefore similarly apply, in particular, the substance-over-form approach.

The law does not refer to the type of revenue that would be the symmetrical counterpart to "expenses in relation to financing". As a result, a restrictive approach would be to consider that fees (income) such as commitment or arrangement fees or equivalent fees should in principle not be considered when determining the amount of exceeding borrowing costs. However, as those fees are often a mere recharge of fees incurred by the SVs in relation to their financing, one

[8] A similar approach was taken recently in one of the first decisions (FG Münster on 12 April 2019 - 10 K 2859/15 K) dealing with fees under the German interest limitation rules. Contrary to the ATAD, there is neither a reference to "economically equivalent" nor to "expenses in relation to financing" under the German implementation of the interest limitation rules, which only refers to interest expenses. The court in such case held however that even in the absence of such reference, fees can be deemed interest for the purposes of the interest limitation rule, to the extent that they are granted in the context of the raising of financing and not to remunerate additional services. *("[… danach zu differenzieren, ob mit den in Rede stehenden Gebühren besondere, über die eigentliche Kreditüberlassung hinausgehenden Leistungen vergütet werden oder ob das nicht der Fall ist*".].

may question the appropriateness of this approach (since the law implementing ATAD 1 aims at tackling base erosion, which is clearly not the case where there is a mere recharge of fees). In addition, this approach would lead to results that would be contrary to the basic principle of neutrality of a securitization vehicle, which passes on all risks and rewards to its investors. Finally, a number of EU Member States have not followed such restrictive approach. The Luxembourg tax authorities seem to have taken a similar view by considering (at least in the complement to the Luxembourg tax returns for 2019 regarding the determination of the exceeding borrowing costs of a taxpayer) that guarantee fees and arrangement fees received in the context of money lending are also to be considered as economically equivalent interest income. As such, the symmetric approach seems indirectly to be considered as an appropriate methodology by the Luxembourg direct tax authorities as well.

1.4 Foreign exchange gains and losses

The law lists as an example of exceeding borrowing costs “certain foreign exchange gains and losses on borrowings and instruments related to financing”. As the law refers to certain foreign exchange gains and losses, it remains to be determined which foreign exchange gains and losses should fall in the scope of the rule[9], but the law does not provide for any explanations.

Under the Action 4 Report (which similarly refers to “certain foreign exchange gains and losses on borrowings and instruments connected with the raising of finance”), “it is recognized that foreign exchange gains and losses on instruments to hedge or take on a currency exposure connected with the raising of finance are not generally economically equivalent to interest. A country may however wish to treat some or all foreign exchange gains and losses on these instruments as economically equivalent to interest, in line with local tax rules and to reflect the economics of the currency exposure.”

[9] Bill 7318/02, State Council opinion, p.13.

The law does not take a clear position on this aspect. A possible approach in relation to debt instruments issued by a SV is to consider that all foreign exchange gains and losses on borrowings and instruments related to financing should fall in the scope of the interest definition. These foreign exchange gains and losses would be considered realized when reflected in the commercial accounts of the SV, subject to the application of specific tax valuation rules (where applicable). This is further discussed in section 4. in relation to foreign exchange swaps.

With respect to foreign exchange gains and losses on the remuneration itself (interest expenses or economically equivalent), the law does not provide for any specific treatment. It is also proposed to follow the above approach[10].

The law is also silent on the treatment of foreign exchange gains and losses derived from financing assets and their remuneration. By applying a symmetrical approach, all foreign exchange gains and losses derived from those assets and their remuneration should be taken into consideration when computing the exceeding borrowing costs in case the above approach in relation to debt instruments would be taken. Similar to foreign exchange results on borrowings of the SV, these foreign exchange gains and losses would be considered realized when realized in the commercial accounts of the SV, subject to the application of specific tax valuation rules (where applicable).

[10] It may be noted that in practice foreign exchange gains and losses related to the remuneration are directly taken into consideration in the accounting of the interest expenses or income, and not accounted for as a separate item in the profit and loss accounts.

2 SYMMETRY

Article 168bis(1)3) defines "exceeding borrowing costs" as the amount by which the deductible borrowing costs of a taxpayer exceed taxable interest revenues and other economically equivalent taxable revenues that the taxpayer receives according to national law. However, no definition or examples are included in the Law as regards the notions of "interest income" or "other economically equivalent taxable revenues”. Further, no guidance can be found in the ATAD 1 or the Action 4 Report, despite their importance in the context of the interest limitation rules.

In this respect, to assess these notions, a symmetric approach through analogy to that of borrowing costs should be adopted. As such, applying a symmetric approach to the non-exhaustive list related to "borrowing costs" should provide helpful guidance as regards the notions of interest revenues and economically equivalent income. Therefore, for the purposes of the interest limitation rules, when a cost should be considered as interest or economically equivalent to interest, then any corresponding revenue should be considered as interest or economically equivalent to interest.

The appropriateness of the symmetric approach is fivefold:

i. In the complement to the Luxembourg tax returns for 2019 regarding the determination of the exceeding borrowing costs of a taxpayer, the latter needs to provide information about each element contained in the non-exhaustive list related to, not only its borrowing costs, but also its interest income or other economically equivalent taxable revenues. As such, the symmetric approach seems indirectly to be considered as an appropriate methodology by the Luxembourg direct tax authorities.

ii. It is expressly mentioned in the Action 4 Report[11] as a best practice approach, which specifies that "Throughout this report, references to interest should also be taken to include amounts economically equivalent to interest, unless the context clearly requires otherwise. Similarly, where the report refers to a group's or entity's interest income, this includes receipts of amounts economically equivalent to interest based on the definition and examples in this chapter.".

iii. It is in line with the similarity of the terms used in article 168bis LIR, which refers to "other costs economically equivalent to interest" as well as "other income economically equivalent to interest".

iv. In the commentaries of the bill implementing ATAD, both the Chambre de Commerce[12] and the Conseil d'Etat[13] mentioned the pertinence, if not the need, to apply a symmetric approach when it comes to determining interest income and other economically equivalent taxable revenues for the purposes of the interest limitation rules.

v. A "net income" compared to "gross income" approach has been considered by the Action 4 Report as best practice for the purposes of the interest limitation rules to avoid double taxation, meaning that one should take into account any interest income before applying these rules[14]. In this respect, only a symmetric approach would be in line with such best practice since a different approach, whereby the terms "interest" or "economically equivalent to interest" were construed differently depending on whether it is an income or an expense, would inevitably lead to (a higher risk of) double taxation.

Further, the suitability of the symmetric approach has also be recognised by other relevant EU Member States:

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[11] Action 4 Report, para 38.

[12] Commentaries dated 5 October 2018, p. 18 (2nd and 3rd paragraph).

[13] Commentaries dated 13 November 2018, p. 19 (1st paragraph).

[14] Action 4 Report, para 62 *"A net interest rule would reduce the risk of double taxation, as an entity's interest income would be set against its interest expense before the interest limitation is applied....Taking into account these considerations, the general interest limitation rules contained in this report apply to an entity's net interest expense paid to third parties, related parties and intragroup, after offsetting interest income."*

i. German scholars interpret interest expenses as remuneration for borrowings that have reduced the relevant profit. Symmetrically, interest income is income from capital claims of any kind that have increased the relevant profit.[15]

ii. In France, the symmetry principle is followed in the definition of financial income and financial expense for purposes of the newly introduced interest limitation rule. Further, the French Conseil d'Etat indirectly confirmed the logic of symmetry in a decision dated 12 June 2013.[16]

iii. The symmetry principle is one of the fundamental principles of Dutch tax law and is also followed in the definition of interest income and interest expense for the purposes of the newly introduced interest limitation rule.[17]

[15] A.o. Schiefer in Hagemann/Kahlenberg, Anti Tax Avoidance Directive, Artikel 4 no 218.

[16] France, CE 12 juin 2013 no 351702, Sté BNP Paribas.

[17] Netherlands - Whether or Not Interest Income Should Fall under the Scope of the Tonnage Tax Regime, European Taxation, 2011 (Volume 51), No. 12, Dick van Sprundel, Kasper Dans MSc.

3 RECEIVABLES ACQUIRED AT DISCOUNT

3.1 Different types of discount

Loans may be issued at discount when a borrower issues debt with a certain face value for an immediate cash receipt at a discount ("original issue discount", OID). The OID is the difference between the face amount of a debt instrument and the price at which it is originally sold to an investor by the issuer.[18] When the instrument is eventually redeemed on its maturity date, the said difference represents a profit for the investor. For example, a note is subscribed to by an investor at EUR 800 on issue, while the face value of the note is EUR 1,000. By issuing at a discount, the issuer might be able to negotiate a lower interest rate than the market or receive immediate cash financing. At maturity, the issuer pays the full EUR 1,000 of the bond.

From the lender's (or purchaser's) side, an existing loan or note can be purchased at par, at a discount or a premium. A discount or premium often reflects differences between market interest rates and the interest rate on the loan (such discounts hereafter referred to as "purchase discount").

Debt may be acquired at a significant discount reflecting the fact that the debtor is in financial distress ("non-performing loans", NPL). A distressed / non-performing debt (NPL) can be broadly defined as a debt instrument that is distressed if, based on all the facts and circumstances, there is no reasonable expectation that the holder will recover the debt instrument's principal amount and any unpaid interest that accrued before the instrument became distressed. In an EU regulatory context, it is a financial exposure that is either "overdue by 90 days"

[18] In certain circumstances an OID could also reflect certain types of fees (e.g. arrangement fees). In general, the same treatment as outlined in section 1.2. should apply.

or which debtor is "assessed unlikely to repay its debt". A financial exposure includes "all debt instruments [...]".[19]

In a securitization context, the contemplated situation is where debt receivable(s) purchased (or in some cases issued) at a discount are transferred to a securitization vehicle (SV), usually by a bank as original holder. That entails such new debt-holder to either hold directly the debt and receive the income derived therefrom from the borrower, or to keep the original holder fronting the relationship with the borrower and acting as collecting agent whereas the SV will receive the income synthetically under an instrument entered into with the original debt-holder.

Receivables acquired or subscribed at discount will typically deliver two types of returns to the SV: the interest accruing under the debt as contractually agreed with the original holder ("contractual interest") – in relation to NPL, if any interest accrues at all considering the non-performing nature of the loan - and the accretion of discount due to the transfer at a discount.

Contractual interest that accrues (which may not be the case for NPLs) is to be considered as interest income and will not be further analyzed in this paper.

The present section focuses on the treatment of the discount in the hands of the SV holding a receivable: OIDs and purchase discounts are covered in section 3.2. while NPLs are covered in 3.3.

[19] European Banking Authority, EBA FINAL draft Implementing Technical Standards "On Supervisory reporting on forbearance and non-performing exposures under article 99(4) of Regulation (EU) No 575/2013".

3.2 Tax treatment of original issue discounts and purchase discounts

3.2.1 Understanding of commercial accounting treatment

3.2.1.1 Luxembourg GAAP

We understand that under Lux GAAP there are three acceptable ways to account for such discounts in the hands of the creditor:

1. Recognition of the profit at maturity
2. Amortization of the discount over the remaining term of the loan
3. In exceptional cases it may be possible to recognize the full discount on day 1.

The income resulting from the amortization of the discount or the recognition at maturity would be recognized as financial income in the Lux GAAP accounts. We understand that the amortization of discount would be reflected as "interest" in the ledger accounts, which could be reflected in the notes to the accounts.

3.2.1.2 IFRS

Under IFRS, the discount of interest-bearing notes (or financial instruments) should be accrued over the lifetime of the investment and until its maturity (as the instrument increases its value until it converges with the par value at maturity). IFRS 9 recommends using the "effective interest rate" (**EIR**) method to determine the amount to be accrued over time.

The objective of determining an effective interest rate is to identify the economic rate of return of a financial asset based on the concepts of accrual accounting (as recommended under IFRS 9 Financial Instruments). The difference between the purchase price of an investment and the amount due at maturity (the premium or discount), coupled with any coupon interest paid over the investment's life (including acquisition costs), is used to determine the investor's rate of return for its investment (the so-called IRR). The EIR formula takes into account the following parameters, for the purpose of determining the amount to be accrued: (i) the interest rate implied by the discounted issuance price or purchase price, (ii) fees and other acquisition costs, (iii) the value at maturity, and (iv) the term to maturity.

Based on IFRS 9, the amortization of premiums and the accretion of discounts are to be booked as interest income (including certain deferred origination costs and fees). This results in the recognition of interest income based on the effective rate of return on the financial instrument.

3.2.2 Luxembourg tax treatment

3.2.2.1 Original issue discount

"Imputed interest on instruments such as convertible bonds and zero-coupon bonds" is included in the examples of borrowing costs given in article 168bis (2) LIR. As a result, by analogy to the treatment of discounts in context of a zero-coupon bond, the recognition of the OID in the hands of the issuing entity should be considered as interest expense.

Based on symmetry as summarized in 2. above, the recognition of income representing the OID in the hands of the creditor should, therefore, also be considered as interest income in the hands of the creditor. The timing of income recognition should follow the accounting treatment.

3.2.2.2 Purchase discount

Purchase discount may often be related to interest rate developments. Where the discount is recognized in the Lux GAAP accounts of the creditor as interest income, the income recognized in the Lux GAAP accounts should also qualify as “interest income" or "other taxable interest revenues taxable income economically equivalent to interest". As is the case for the OID, the timing of income recognition should follow the accounting treatment.

3.3 Distressed / Non-performing debt

3.3.1 Interest and NPL

In the absence of a formal definition of what “interest” or “costs that are economically equivalent to interest” are under Luxembourg tax law, we found that consensual definitions are that interest represents “payment for the time value of money”[20] and / or “remuneration of [the risk taken by] someone in relation to the use of the capital that this person made available to another person”[21].

The aggregate of both summarizes in our opinion the relation that is established by a bank when making capital available to someone: the interest rate will be determined according to (i) the maturity of the loan and to (ii) the risk that the bank is taking by lending to that borrower for that specified amount of time.

However, in an NPL situation, this relation has been altered since the original assessment made by the original debtholder on risk and maturity is no longer valid. Therefore, even though the SV will purchase a debt that has the characteristics initially agreed upon between the original debtholder and the debtor, the economic reality of that debt is no longer the same.

[20] E.g., L. Sheppard, Hedge Funds and the interest barrier Rule, tax Notes Int’l, p.1024, March 2019.

[21] E.g., with identical or similar wording : ALJB – Bulletin Droit et Banque N°62 – Juin 2018, Généralités sur les intérêts négatifs ; Nicolas Thieltgen & Caroline Mangold. Non-italic wording, our addition; Art. 11§3 OECD Model Convention – Commentary on article 11 concerning the taxation of interest.

3.3.2 Economic reality and tax law

From a Luxembourg tax perspective, the economic reality of a transaction is dealt with under the principle of "substance over form", and dates back to the Steueranpassungsgesetz (loi d'adaptation fiscale, or **StAnpG**) of October 16, 1934, where the notion of "verdecktes Stammkapital" was theorized by the State to fight against tax evasion[22] and the abuse of law[23].

This economic approach in tax law has been confirmed from time to time by the legislator under the concept of "wirtschaftliche Betrachtungsweise", as can be found in Luxembourg parliamentary documents linked to bills of laws[24,25]. Case law also confirms regularly this approach, with a recent case being particularly explicit in this respect : "Il va de soi qu'ici, comme dans les autres domaines touchant au droit fiscal, la Cour est amenée à opérer suivant une « wirtschaftliche Betrachtungsweise » et à considérer la situation au regard de la réalité économique existante. "[26]

Considering the change in economic reality since the loan was originally granted to the borrower and, in particular, the borrower's economic difficulties, we believe that the return to be earned on the debt transferred to the SV has to be reassessed according to the economic reality at the time of the transfer, including a re-assessment of risks, and, therefore, an economic valuation must be made according to market standards.

[22] Article 5 StAnpG
[23] Article 6 StAnpG.
[24] Bill of law number 4992 amending the Law of August 10, 1915 on commercial companies, document 4992-05 by the Conseil d'Etat: *« [...] l'on ajoute à cela encore l'autonomie du droit fiscal par rapport au droit civil et au droit commercial ainsi que les principes d'interprétation qui sont différents en droit civil et en droit fiscal (wirtschaftliche Betrachtungsweise) et où l'un s'attache surtout aux textes et l'autre à la réalité économique.»*
[25] Bill of law number 5924 amending the LIR Act: "le droit fiscal se sert du concept économique ("wirtschaftliche Betrachtungsweise")".
[26] Case n°41351C of Court of Appeal, p.5.

3.3.3 Market standard in the determination of return for NPLs

Market standard for the determination of return in the field of NPLs is based on a valuation of the recovery that the SV should expect when it acquires the debt[27]. Once the maximum recovery amount has been reasonably assessed, it will be used to determine the internal rate of return (IRR).

The IRR will provide the return that capital invested in this debt asset will achieve if collections are made according to expectations. The IRR being based on a forecast of income, some accounting norms such as IFRS 9 refer rather to it as being an expected interest rate (EIR) on invested capital, which would be adjusted for credit-impaired assets, i.e. a credit-adjusted effective interest rate[28].

Therefore, to the extent that this method to assess revenue recognition is considered as a valid method representing what is practiced in the market, the interest rate that is derived therefrom should be accepted as being adequate remuneration for the risk taken by the SV in holding the debt for a certain maturity.

3.3.4 Luxembourg GAAP treatment

We understand that, under Luxembourg GAAP, any income from NPL recognized in the P&L is presented in the accounts as “income from other investments, other securities and loans forming part of the fixed assets”. In the notes to the accounts the details of these income items should be given, differentiating between capital gains, interest income and other income.

[27] Assertion based on discussions held within the Lux CMA group.
[28] IFRS 9, 5.4.1 *"Interest revenue shall be calculated by using the effective interest method. This shall be calculated by applying the effective interest rate to the gross carrying amount of a financial asset except for: purchased or originated credit-impaired financial assets. For those financial assets, the entity shall apply the credit-adjusted effective interest rate to the amortized cost of the financial asset from initial recognition."*

We understand it is acceptable under Lux GAAP (particularly considering the requirement for the accounts to give a true and fair view) to reflect income up to the amount of the original reasonable expectation as "interest income".[29] There may be certain differences as regards timing of recognition as income, but these timing differences are not considered relevant for SVs.

Any further collection beyond the initial forecast will generally be considered as capital gains.

3.3.5 LuxCMA position

In our view, the GAAP treatment as described above clearly reflects the economic approach. As a result, there is no reason, from a tax perspective, to deviate from the general rule set forth by article 40 LIR and consequently the qualification of the return for tax purposes should follow its qualification in the commercial accounts. As a result, to the extent that forecasted income on an NPL has been assessed upon, or shortly after, purchase in line with accounting requirements to determine the reasonable repayment price and, provided the income is reflected as such in the Lux GAAP accounts, then income up to the forecasted income (i.e. payments up to the reasonable repayment price) should qualify as "payments that are economically equivalent to interest". The same should apply to income realized on disposal of the receivable. Any amount realized in excess of the recoverable amount would have to be recognized as another type of income, most likely capital gains.

[29] See also opinion from the Luxembourg accounting standards board on the application of the optional principle of substance under Luxembourg GAAP (as provided by Art. 29 (3) of the law of 19 December 2002 on the commercial register as amended):
https://www.cnc.lu/fileadmin/user_upload/publications/doctrine/Q_A_CNC_20-021_Principe_optionnel_de_substance_-_vf.pdf.

4 SWAPS

4.1 General

In general, the taxation of derivatives under Luxembourg law is complex due to the variety of derivative contracts. This makes it difficult to provide a generic classification of the payments under a derivative contract as constituting interest or not for Luxembourg income tax purposes. Luxembourg does not have any tax provisions that specifically deal with derivatives and the general corporate income tax rules apply to these types of instruments.

In Luxembourg, the tax treatment generally follows the accounting treatment unless otherwise provided for by Luxembourg tax legislation (article 40 LLIR) and this is, therefore, the starting point in determining the tax treatment of a financial instrument. In addition, based on specific statements in parliamentary documents and as confirmed by the Luxembourg courts, a "substance over form" categorization test should be applied, whose conclusion may differ from the Luxembourg GAAP treatment (e.g. an instrument categorized as a debt from an accounting and legal perspective could be re-categorized into an equity instrument in certain circumstances if such instrument predominantly has equity features).

Such approach would be in line with Action 4 Report according to which "In deciding whether a payment is economically equivalent to interest, the focus should be on its economic substance rather than its legal form."[30]

In addition, the Action 4 Report explains that "payments that are economically equivalent to interest include those which are linked to the financing of an entity

[30] Action 4 Report, para 35.

and are determined by applying a fixed or variable percentage to an actual or notional principal over the time."[31]

Moreover the non-exhaustive list of payments which are equivalent to interest provided by article 168bis LIR and the Action 4 Report, includes "notional interest amounts under derivative instruments or hedging arrangements related to an entity's borrowings". According to the Action 4 Report , certain payments should therefore generally not be qualified as economically equivalent to interest, if not related to an entity's borrowings or in connection with the raising of finance, i.e. "the amounts under derivative instruments or hedging arrangements which are not related to borrowings, for example commodity derivatives" .

In our view "notional principal" refers to the assumed amount of principal involved in a financial transaction where the principal does not change hands, which is why it is considered notional, or theoretical. For example, in the context of an Interest Rate Swap, the rates are actual components in the transaction and change hands whereas the principal is theoretical. Considering this, the payments made under an Interest Rate Swap which exchanges two streams of cash flows should be payments "economically equivalent to interest" and, as they are linked to receivables and / or payables of the SV should be considered as "linked to the financing of an entity" and should therefore constitute interest income and expense.

In general, the use of a swap instrument should not result in a conceptual improvement of the SV's position in view of the interest limitation rule.

Based on the above, we have analysed the impact of the interest limitation rules on payments made under the most frequently used swap agreements entered into by Luxembourg SVs.

[31] Action 4 Report, para 35.

4.2 Interest Rate Swap

Interest Rate Swaps involve one party buying e.g. a variable rate asset and simultaneously entering into a swap to convert the variable interest cash flow to fixed rate cash flows or vice versa. Such swaps may be entered into to hedge an exposure or for speculative reasons.

According to example 3 provided in the Action 4 Report[32], any payment made under an Interest Rate Swap in relation to a notional principal should be considered as interest on a debt or an expense economically equivalent to interest. Applying the symmetrical approach summarized in 2. above, the payments made by the Swap Counterparty to the Luxembourg SV under the Interest Rate Swap in respect of a notional principal should be considered as interest income (or other income economically equivalent to interest income) for Luxembourg tax purposes.

This would generally be in line with the Luxembourg GAAP treatment, which would generally qualify such payments as interest. We understand that, Luxembourg GAAP profit and loss account would generally contain a single line for “Income from other investments and loans forming part of the fixed assets” and / or “Other receivables and similar income” and / or “Income from participating interests” and / or “Interest payable and similar expenses” – which includes both interest and other financial return / cost which is not interest, as per the Luxembourg Accounting Advisory Body (Commission des normes comptables). A breakdown of that line would typically then be provided in the notes to the annual accounts, which should indicate whether the relevant item of income or expense constitutes interest.

Considering the above, the payments due by the Luxembourg SV to the Swap Counterparty under the Interest Rate Swap agreement should in principle equal the amounts of interest income received under the Debt portfolio by the

[32] Annex I.D, p. 100

Luxembourg SV. Such expenses, which qualify as interest expenses from a Luxembourg GAAP perspective and according to paragraph 35 of the Action 4 Report, should therefore be considered as interest expenses (or other type of costs economically equivalent to interest and the costs incurred within the context of a financing) for Luxembourg tax purposes.

By application of the symmetrical approach outlined in 2., the payments due by the Swap Counterparty to the Luxembourg SV under the Interest Rate Swap agreement would typically equal the amounts of interest expenses payable by the Luxembourg SV to the Noteholders in respect of the notes and such income, which qualifies as interest income from a Luxembourg GAAP perspective, should therefore be considered as interest income (or other income economically equivalent to interest income) for Luxembourg tax purposes.

There may be an additional element of complexity due to the Luxembourg SV being entitled to receive from the Swap Counterparty or obliged to pay to the Swap Counterparty an early termination amount in respect of the early termination of the Swap Agreement. Where early termination amounts hedge interest risks under an entity's borrowings, resulting expenses should be considered as "interest amounts under hedging arrangements related to an entity's borrowings". In line with the symmetrical approach outlined above, any income as a result of early termination that is related to hedging interest exposures should be considered as interest income.

However, early termination payments that are not related to hedging interest exposures should not be considered as leading to interest income and interest expenses. The reflection in the (notes to) Luxembourg GAAP accounts as a loss on early termination of the Swap Agreement, rather than as interest expense, may provide an indication.

As speculative interest rate swaps that are not linked to a receivable or payable do not meet the definition of being "related to an entity's borrowings", as required in the definition of "notional interest amounts under derivative instruments or hedging arrangements related to an entity's borrowings", profits and losses from such swaps should not be regarded as interest income or borrowing cost.

4.3 Cross-currency / Foreign Exchange Swaps

Cross-currency Swaps and Foreign Exchange Swaps are both derivative instruments used for hedging foreign currency exposures and involve the exchange of two different currencies at inception and a reversal of the same currencies at the end of the contract.

These Cross-currency / Foreign Exchange Swaps differ from Interest Rate Swaps in that they may also involve principal exchanges.

Article 168bis (1) LIR is unclear in that it includes "certain" foreign exchange gains and losses on borrowings and instruments linked to financing in the definition of interest expense (see 1.4.) As a result, "certain" gains and losses might be treated as interest income or expense for Luxembourg tax purposes even if they are not viewed as interest for Luxembourg GAAP purposes. Based on the symmetrical approach outlined in 2. above, either both foreign exchange exposures (gains and losses) should be treated as interest income / expense for Luxembourg tax purposes or neither of them. Even if a prudent view is applied as per section 1.4 above that considers any foreign exchange result on borrowings and instruments linked to financing (i.e. including those on principal amounts) as included in the definition of interest income / expense, we would not expect this to adversely impact SVs that hold debt collateral. Where SVs hold non-debt collateral, the swap should generally not change the nature of the underlying transaction.

With respect to early termination, if a prudent view is applied by also including foreign exchange results on principal amounts in the definition of interest, any early termination amounts due by or to the SV should be considered as interest expense or income, respectively.

4.4 Credit Default Swaps – Luxembourg SV buys protection

A credit default swap (CDS) is a financial derivative or contract that allows a Luxembourg SV to "swap" or offset its credit risk with that of another investor. Most CDS will require an ongoing premium payment to maintain the contract, which is like an insurance policy. In a CDS, the buyer of the swap, i.e. the Luxembourg SV, makes payments to the swap's seller, i.e. Swap Counterparty, until the maturity date of a contract. In return, the Swap Counterparty agrees that – in the event that the debt issuer (borrower) defaults or experiences another credit event – the Swap Counterparty will pay the Luxembourg SV the security's value.

Under Luxembourg GAAP, the payments made by the SVs under the CDS should be booked as other expenses and not as interest considering that the premium paid is linked to the performance of the underlying investment and not directly linked to the financing of the SV.

In case of a default event (which would typically result in a loss on the collateral asset) the payment received by a Luxembourg SV should be fully taxable in Luxembourg and characterized for interest limitation purposes in line with the concepts outlined in section 1. If the CDS is to be considered as a hedging agreement in relation to an entity's borrowings (i.e. either the SV's notes or collateralized debt) then premiums should be considered as forming part of borrowing cost.

4.5 Index-linked Swap

Under an index-linked swap, the Luxembourg SV generally pays the interest received on a Debt portfolio to the Swap Counterparty as fixed rate amounts under the Index-linked Swap agreement. The Swap Counterparty pays variable amounts to the Luxembourg SV under the Index-linked Swap agreement. These variable amounts paid by the Swap Counterparty to the Luxembourg SV are periodic payments linked to an equity reference asset which may be, for the purpose of this example, either a basket of shares or an equity index. These amounts finance payments due to the Noteholders, which provide for variable amounts that depend on such equity index. As such, where such amounts represent a periodic funding return in line with the definition of interest provided in section 1, they continue to qualify as interest expense.

In line with comments made in sections 1 and 4.1. above, the payments made by the Luxembourg SV to the Swap Counterparty under the Index-linked Swap agreement should be considered as interest expenses (or other type of costs economically equivalent to interest) for Luxembourg tax purposes to the extent they hedge interest obligations under the notes issued by the SV.

The variable amounts payable by the Swap Counterparty to the Luxembourg SV under the Index-linked Swap agreement linked to the equity reference asset should be considered as interest income (or other income economically equivalent to interest income) for Luxembourg tax purposes to the extent that they hedge interest obligations of the Luxembourg SV under the notes issued to Noteholders, and in application of the symmetrical approach. Even if the notes to the annual accounts disclose that the amount of this payment is based on an equity-linked amount, this should not, of itself, impact the analysis and conclusion above.

5 REMARKS RELATED TO SPECIFIC TYPES OF BONDS ISSUED BY A SECURITIZATION COMPANY

5.1 Credit linked notes

It is common for the repayment price of notes issued by a securitization company to be linked to the amounts received under the collateral assets (often including termination payments or other results under swaps entered into by the securitization company). This mechanism reflects the basic idea of a securitization company in which the investors should be exposed to the significant risks.

Termination payments under such credit linked notes (CLN) may be below or above the nominal value of the notes. Subject to the effect of possible swaps, any loss or gain on the collateral assets is directly passed on to the Noteholders, typically (in the case of a loss on the collateral asset) in the form of a reduced termination payment under the notes or (in the case of a gain on the collateral asset) an increased termination payment of the notes or as variable interest. Variable interest under the notes is to be considered as interest expense for purposes of article 168bis. References to a loss on the CLN termination in the remainder of this section refer to situations where the CLN is redeemed at a higher price that is not legally (variable) yield.

As a result of the mechanics of the CLN, the Luxembourg securitization company would realize a gain on the redemption of the CLN if a loss is realized on the collateral assets and, conversely, a loss on the CLN if a gain is realized on the collateral assets.

As analyzed in section 1, the definition in article 168bis LIR contains a list of expenses representing an annual funding return on a debt instrument as well as certain foreign exchange results and specific fees. The definition is relatively detailed but does not include capital losses on a debt instrument.

Luxembourg tax law includes specific interest income in the capital income definition of article 97 LIR. Even though resident companies do not derive capital income and, therefore, strictly speaking article 97 LIR is not relevant to them, considering that there are no other definitions in the tax law as regards what constitutes interest, article 97 may nevertheless have some relevance. Article 97 includes interest on different types of debt instruments in the definition of capital income. This definition would include fixed interest under an instrument comparable to the CLN but would not include a capital gain on such instrument. This approach is further corroborated by Lux GAAP, according to which capital losses would not be reflected as interest expenses.

The question could be raised whether such losses constitute an “expense in relation to financing” ((i.e., "charge supportée dans le cadre de financements"). As discussed in sections 1.2, 1.3. and 1.4, the scope of the French wording may be wider than the wording of the English and German language versions of the Directive, which refers to “amounts in connection with the raising of finance”. Based on the same reasoning as that developed in sections 1.2, 1.3. and 1.4. there are arguments to limit the definition of “expense in relation to financing” to those that are related to the raising of finance and, as a result, to exclude capital losses on the redemption of an instrument.

Considering that the interest limitation rules contained in the Action 4 Report (which are the sources of ATAD 1 and article 168bis LIR) are largely inspired by the German interest barrier rules, we believe that German guidelines on how to interpret “interest” may also be relevant. According to a Letter by the German Ministry of Finance dated 4 July 2008,[33] impairments on and results from the

[33] Ministry of Finance Letter in relation to interest barrier rule (Schreiben betr. Zinsschranke of 4 July 2008 § 4 h EStG; § 8 a KStG) of 4 July 2008 (BStBl. I S. 718), BMF IV C 7 -S 2742-a/07/10001.

alienation of debt assets are not considered as interest income or interest expenses.[34]

As a result, there may be arguments to consider that the termination gain on the CLN should not be considered as interest income for the Luxembourg securitization company and a termination loss on the CLN should not be considered as interest expense.

5.2 Delta-1 Notes

Delta-1 notes are defined in a broad manner as financial derivatives that have no optionality and as such have a delta of one (or very close to one), whereby delta measures the sensitivity of a derivative's value to changes in the price of the underlying asset. Consequently, Delta-1 notes can be characterized by the feature that, for a given instantaneous move in the price of the underlying asset, there is an identical move in the price of the derivative, being the Note. The repayment price of Delta-1 notes increases or decreases in function of the development of the collateral assets (and, where relevant, results under swaps and other agreements concluded by the securitization company).

Delta-1 notes do not usually provide for any interest and the redemption price may not provide the investor with a positive return. Whether or not the Noteholder will realize a positive return does not depend on time, contrary to interest which accrues at a fixed or variable percentage, with the total interest increasing in function of the time the loan is outstanding. This is not the case for the Delta-1

[34] MN 28 Ministry of Finance Letter. See also Haisch/Helios, „Rechtshandbuch Finanzinstrumente", § 4. Besteuerung von Finanzinstrumenten im Betriebsvermögen: "Keine Zinsaufwendungen und -erträge ergeben sich hingegen aus der Bewertung oder Verwertung von Geldforderungen, selbst wenn sie unter § 20 Abs. 2 EstG fallen würden; dies gilt auch für Bewertungs- und Verwertungsergebnisse aufgrund von Wechselkursschwankungen."

notes whose value only depends on the underlying reference assets, but not on time or a specific rate.

As analyzed in section 1, the definition in article 168bis LIR contains a list of expenses representing an annual funding return on a debt instrument as well as certain foreign exchange results and specific fees. The definition is relatively detailed but does not include capital losses on a debt instrument.

It may be argued that an amount of notional interest on the Delta-1 notes should be determined. While we believe this may not reflect the nature of the Delta-1 notes that specifically do not provide a return in function of time, if this approach were to be applied we believe such interest would have to be limited to an amount that reflects the general financing nature, without consideration given to the significant risks assumed by the Noteholder in subscribing to Delta-1 notes, such risks going significantly beyond the risks generally assumed by a creditor.

The question could be raised whether such losses constitute an “expense in relation to financing” ((i.e., "charge supportée dans le cadre de financements"). As discussed in sections 1.2, 1.3. and 1.4 the French wording may be wider than the wording of the English and German language versions of the Directive, which refers to “amounts in connection with the raising of finance”. Based on the same reasoning as that developed in sections 1.2, 1.3. and 1.4. there are arguments to limit the definition of “expense in relation to financing” to those that are related to the raising of finance and, as a result, to exclude capital losses on the redemption of an instrument.

As a result, there may be arguments to consider that, other than a potential notional interest amount, a loss resulting from the redemption of Delta notes at higher than original nominal should not be considered as interest expense for the Luxembourg securitization company. Where the Delta Notes contain elements that result in a lower redemption price, in case of losses on the collateral assets (similar to the mechanics of CLN), there may be arguments to consider that any capital gain resulting from such redemption at lower redemption price should not be considered as interest income for the Luxembourg securitization company.

6 TREATMENT OF INVESTMENTS HELD IN PARTNERSHIPS AND FUNDS

For the purpose of this section, mutual funds, common limited partnerships and special limited partnerships are considered as tax-transparent domestic entities, irrespective of their regulatory status. Foreign vehicles would similarly be regarded as tax-transparent from a Luxembourg standpoint, if their features are sufficiently similar to those of tax-transparent domestic entities, based on article 175 LIR and applicable case law. The developments included in this section encompass both domestic and foreign tax-transparent entities.

As a preliminary carveout, equity investments held by a Luxembourg SV in a non-transparent entity are not considered in this section, as income / gains derived by a Luxembourg SV from such investments would certainly not be regarded as economically equivalent to interest income. Based on the same reasoning, equity investments held by a Luxembourg SV in a tax transparent entity holding assets that do not derive interest (or economically) equivalent income should also be excluded.

First, the tax treatment of a Luxembourg SV holding equity investments in a tax-transparent entity, which in turn holds debt assets, is hardly debatable and should be analyzed on the basis of general principles[35]. In this case, interest income as well as other economically equivalent income (see other sections) derived by the tax transparent entity from the debt assets should equally be considered as interest income (and economically equivalent) at the level of the Luxembourg SV, irrespective of their actual collection by the latter.

[35] Reference is made to the German interpretation of the German interest limitation rules (Schreiben betr. Zinsschranke (§ 4 h EStG; § 8 a KStG) of 4 July 2008 (BStBl. I S. 718).

The question would however arise as to whether debt investments held by a Luxembourg SV towards a tax-transparent entity (and no equity investments being held) would entail a different tax outcome. We believe that a consensus can be reached on this point, as the tax-transparent status of an entity would be irrelevant at the level of its third-party creditors. The tax-transparency concept is indeed to be grasped at the level of the partners only. On this basis and in such scenario, the Luxembourg SV would only recognize tax-wise the income derived from the debt investments held towards the tax-transparent entity, irrespective of the nature of the assets held by the latter.

7 EQUALIZATION PROVISION

Equalization provisions / reserves are built under Lux GAAP to correctly reflect the economics of a securitization structure. Losses on and impairments of the collateral assets will be reflected in the Lux GAAP accounts of the Issuer based on the general Luxembourg accounting rules. Due to the limited recourse nature of the notes issued, losses during the year as a result from sales, default, lower market value or operating costs directly impact the value of the notes issued. Consequently, it is standard practice, under Lux GAAP, that a provision for the decrease in the repayable value of the notes will be built as an “equalization provision” and neutralizes the expense recorded in relation to the reference asset in the same year.

Gains during the year as a result of a reversal of value adjustments, realized or unrealized profit or exceptional gains may cause an increase in the repayable value of the notes issued. Correspondingly, such increases in value will be reflected in the profit and loss account of the company as affecting the Equalization provision (in this case representing expenses).

As a result, the Lux GAAP accounts should reflect the economic reality of risks and rewards of the reference assets being borne by the Noteholders. The mechanism of the equalization provision also results in gains (on notes as well as reference assets) being accounted for in the same accrual period as losses (on notes and reference assets).

Depending on the contractual arrangements, allocations to or reversals from the equalization provision may reflect interest expenses or interest income (e.g. variable interest on notes), losses/gains in principal amounts on the notes or fee or other payments to be made to contracting parties.

We understand that movements in the equalization provision are reflected in the profit and loss account of the SV under other operating income / expenses. We also understand that while there is a ledger account “equalization provision”, it is not typically reflected separately in the annual accounts of the SV, but the notes are reflected at their acquisition cost plus/minus equalization provision.

The equalization provision needs to be analyzed in light of article 23 LIR, according to which debt positions are to be valued at their acquisition cost or at their higher going concern value. This also needs to consider the requirements of article 40 LIR according to which the tax values must follow the Lux GAAP values, unless tax rules require a different value.

As a result of the above, where the notes would be repayable at less than nominal value, for tax purposes it may not be possible to recognize a debt at lower than acquisition cost. Likewise, where assets are valued at an amount above acquisition cost it may not be possible to follow the valuation for tax purposes. This would result in generally recognizing expenses before income and would require the acceptance of tax loss carry-forwards for SVs by the tax authorities. At the same time, ignoring the equalization provision would result in a difference in the timing of recognition of expenses and income even though they are economically linked and may not fully reflect the features of SVs according to which risks are assumed by the investors, i.e. the Noteholders in case of debt-financed orphan SVs.

In our view, where it is not unduly complex to prepare a separate tax balance sheet and provided the tax authorities accept the possibility for SVs to carry forward tax losses, the analysis could be based on a tax balance sheet. This would generally result in only including items from the equalization provision that represent a risk for the SV.

However, particularly in case of more complex securitization vehicles, and based on past Luxembourg administrative practice that did not require separate tax balance sheets, it should also be possible to base the tax analysis on the Lux GAAP accounts. Even though article 23 (4) LIR would not allow the recognition of the debt at a value different from acquisition cost, there are arguments to consider the equalization provision as a separate position (i.e. an asset or liability depending on the situation), even if the provision is not reflected separately in the accounts (which could be considered as merely being the result of a decision on presentation in the accounts).

Considering the reasoning behind the provision, which is the neutralization of timing effects by correctly reflecting the economic situation of the securitization company, to determine the character of any allocation to or reversal from the equalization provision, the underlying contractual reason for building or releasing (part of) the provision should be considered.

Consequently, taking into account the economic substance of the income / expenses in relation to equalization provision, and considering the Letter by the German Ministry of Finance dated 4 July 2008 with regard to the definition of interest, in line with the considerations discussed in 5.2. and 5.3., there may be arguments to consider that the allocation to and the reversal from the equalization provision, in respect of capital gains/losses on notes, should not be considered as interest income / borrowing costs in the sense of article 168bis LIR.

8 ANTI-HYBRID MISMATCH – SV NOT A PARTY TO STRUCTURED ARRANGEMENT

8.1 Definition of structured arrangement

In the context of SVs issuing notes on the market, the main question is to determine when payments made by an SV under the notes issued by an SV could be considered as a "structured arrangement" under article 168ter LIR.

According to article 168ter (1) 17 LIR, a "structured arrangement" means an arrangement involving a hybrid mismatch where the mismatch outcome is priced into the terms of the arrangement or an arrangement that has been designed to produce a hybrid mismatch outcome, unless the taxpayer or an associated enterprise could not reasonably have been expected to be aware of the hybrid mismatch and did not share in the value of the tax benefit resulting from the hybrid mismatch. This definition is in line with that given in Council Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries ("ATAD 2").

Following Recital 28 of ATAD 2, Member States should use the applicable explanations and examples in the OECD BEPS report on Action 2 ("Action 2 Report")[36] as a source of illustration or interpretation, to the extent that they are consistent with the provisions of this Directive and with Union law. The law introducing ATAD 2 in Luxembourg makes explicit reference to this Recital 28 in its explanatory statements.[37]

[36] Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report.
[37] Exposé des motifs, draft law 7466.

8.2 “Mismatch priced into the terms of the arrangement”

According to the Action 2 Report, “the hybrid mismatch will be considered priced into the terms of the arrangement if the mismatch has been factored into the calculation of the return under the arrangement. The test looks to the actual terms of the arrangement, as they affect the return on the arrangement, and as agreed between the parties, to determine whether the pricing of the transaction is different from what would have been agreed had the mismatch not arisen.

This is a legal and factual test that looks only to the terms of the arrangement itself and the allocation of risk and return under the arrangement rather than taking into account broader factors such as the relationship between the parties or the circumstances in which the arrangement was entered into. The test would not, for example, take into account “the consideration paid by a taxpayer to acquire a hybrid financial instrument unless the instrument is issued and sold as part of the same arrangement.”[38]

As a result, the criterion would be met where the pricing of the hybrid mismatch is factored into the calculation of the return under the arrangement, leading to a return that does not correspond to what would normally be expected to be achieved on the market. Conversely, where it appears that the return corresponds to an expected market rate of return, the mismatch outcome should not be considered as priced into the terms of the arrangement.

For notes issued by SVs on the market the return will typically not consider the tax treatment of the notes by the SV or the holder and, therefore, the notes should not be considered a structured arrangement as a result of a mismatch that is priced into the arrangement.

[38] Action 2 Report, para 323.

8.3 "Designed to produce a hybrid mismatch outcome"

8.3.1 The principle

The question of whether arrangements are structured will depend on facts and circumstances. In this respect, Recommendation 10 of the Action 2 Report provides for a non-exhaustive list of factors that would lead an "objective and well-informed observer"[39] to conclude that the arrangement has been designed to produce a mismatch outcome.

For instance, there will be a structured arrangement if it results from written or oral advice or documents produced before the taxpayer enters into the arrangement that such taxpayer was materially involved in the design, or was aware, of the arrangement giving rise to mismatch in tax outcomes.[40]

Furthermore, an arrangement will also be structured if there is no substantial business, commercial or other reason for inserting the step or the transaction into the arrangement and the mismatch would not have arisen in the absence of such step or transaction.[41]

There will also be a structured arrangement if the latter is marketed as a tax-advantaged product. The Action 2 Report specifies that this could include, for example, a prospectus that indicates that the borrower should be entitled to a tax deduction for the payments it makes[42] to the investors. In this respect, it is important to note that the tax section of prospectuses generally includes a comprehensive description of the tax treatment related to the Luxembourg issuer. In the case of the SV, the prospectus would usually mention that the SV will be able to deduct as operational expenses, for tax purposes, commitments it makes to pay

[39] Action 2 Report, para 326.
[40] Action 2 Report, para 330.
[41] Action 2 Report, para 333.
[42] Action 2 Report, para 335.

interest or dividends to its investors. Such generic statements in our view do not imply that the arrangement is marketed as a tax-advantaged product. The prospectus should only be considered as a tax marketing document when it includes tax treatment relating specifically to the investors (e.g. that any return from the issuer is not included in the tax base of the investor). In practice, this specific issue will not arise if the tax section provides only the usual general information that is commonly found in prospectuses (i.e. the potential application of a withholding tax to payments by the SV).

In the absence of marketing material, the arrangement could still be considered as "designed" if, in practice, the arrangement is primarily marketed to taxpayers located in jurisdictions that would not include the return on the SV notes in their taxable income. Conversely, the fact that the arrangement is widely marketed should not make the notes a structured arrangement if no specific investors are targeted and there is no indication of the notes being "designed to produce a hybrid mismatch outcome".

8.3.2 Exemptions

Once the objective observer reaches the conclusion that there is a structured arrangement and the taxpayer is integrated in such an arrangement, the taxpayer could still be excluded from the structured arrangement rule if it is not a "party" to the structured arrangement.

According to the definition of structured arrangement provided in the Luxembourg law, the taxpayer would not be a party to the structured arrangement if:

(a) It could not reasonably have been expected to be aware of the hybrid mismatch; and

(b) It did not share in the value of the tax benefit resulting from the hybrid mismatch.

8.4 Conclusion

Where the notes were not designed to produce a hybrid mismatch outcome and the hybridity was not considered when the notes were priced and the structure involving the SV was not designed to produce any specific tax benefit to any of the investors, the notes issued by the SV should not constitute a structured arrangement.

About the LuxCMA – Luxembourg Capital Markets Association

Created on 1 March 2019, the LuxCMA is a not-for-profit association (a.s.b.l.), registered at the RCSL (F12205), whose registered office is 6 rue Jean Monnet, L-2180 Luxembourg. The LuxCMA today represents memberships detailed on LuxCMA's website (www.luxcma.com), which is composed by banks, law firms and services providers, amongst others.

Task Force – Securitization & ATAD

The main purpose of the Securitisation and ATAD Task Force is to provide guidance on the implementation of the EU Securitisation Regulation and ATAD for Luxembourg securitisation vehicles. The aim is to identify unclear topics in typical securitisation structures, discuss the issues and propose technical positions from the perspective of the market participants. The outcome will be position papers and interpretations issued by the LuxCMA. The Securitisation and ATAD Task Force intends to work closely with policy makers and other associations on common topics.

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