Tax Alert

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Luxembourg to Deny Deductions on Payments to EU Blacklisted Jurisdictions

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Key Points

- As of January 1, 2021, Luxembourg is set to disallow otherwise tax deductible interest or royalty expense for payments made to entities resident in EU blacklisted jurisdictions that qualify as a beneficial owner "related" to the Luxembourg payor.
- If enacted, the new rule would broadly capture Luxembourg holding companies (e.g., a SARL) used in many investment structures and "back-to-back" financing arrangements, provided they make payments to a related blacklisted payee, which may capture certain Cayman Islands payees unless the Cayman Islands is removed from the blacklist by the EU by January 1, 2021.
- Investment fund vehicles established in blacklisted jurisdictions that qualify as fiscally transparent under Luxembourg tax principles (e.g. partnerships) are not expected to be captured, but certain look-through rules may apply.

On March 31, the Luxembourg government published a draft bill of law that will deny Luxembourg tax deductions for interest and royalties owed to related enterprises established in a jurisdiction included on the EU tax "blacklist," which currently includes the Cayman Islands.

Following recommendations approved by the European Union Economic and Financial Affairs Council in December 2019 encouraging EU member states to take defensive tax measures in relation to jurisdictions on the EU's list of non-co-operative jurisdictions, which from February 18 includes the Cayman Islands, it appears that Luxembourg has made an early move to introduce such measures. The move follows the recent introduction of other Luxembourg measures targeting interest expense in connection with certain hybrid mismatches.

The Luxembourg government has published a draft bill under which Luxembourg entities owing interest or royalties to related enterprises established in a jurisdiction mentioned on the EU's list will not be entitled to tax deductions in respect of associated payments or accruals from January 1, 2021. We understand that the measures are intended to apply only to interest or royalties owed to an entity that is fiscally opaque and qualifies as a related beneficial owner under Luxembourg tax

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principles, whether directly or indirectly through an intermediary. Accordingly, payments made to a fund established as a Cayman limited partnership are not expected to be affected if none of such fund's direct or indirect partners are fiscally opaque entities that qualify as related beneficial owners located in a blacklisted jurisdiction.

The draft bill also provides that a Luxembourg entity may avoid the application of the non-deductibility rule if it is able to demonstrate that the transaction resulting in the relevant payments was put in place "for valid business reasons which reflect economic reality." However, it is not yet clear how the Luxembourg tax authorities will interpret this.

It is anticipated that the Cayman Islands will not remain on the EU's list for the long term and we understand that negotiations are continuing for its removal from the list. The earliest the Caymans Islands could be removed is October of this year.

If, however, the Cayman Islands is not removed from the list before January 1, 2021, fund managers may need to consider whether a restructuring of arrangements involving payments of interest or royalties from Luxembourg payors to Cayman affiliates is desirable to preserve the deductibility of any associated expense. For example, fund managers may wish to explore using holding companies in other jurisdictions or alternative financing arrangements.

The other jurisdictions currently on the EU blacklist are: American Samoa, Fiji, Guam, Oman, Palau, Panama, Samoa, Trinidad and Tobago, the U.S. Virgin Islands, Vanuatu and Seychelles.

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