# INTRODUCTION OF THE NOTIONAL INTEREST DEDUCTION REGIME : THE RIGHT TIME ?


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The Luxembourg macroeconomic and budgetary situation and outlook for 2020 and 2021 are sobering. The first round of effects of COVID-19 and the impacts of a new wave of infections are difficult to capture, so no one can predict at this stage how the situation will actually unfold in the coming months.

Several reports were recently released by Luxembourg and European organisations and institutions analysing the economic situation and anticipated economic developments[1]. As far as Luxembourg is concerned, among the key highlights mentioned in these reports are the projected GDP fall by 6¼% in 2020 as a result of the COVID-19 outbreak. Furthermore: "The volatility on financial markets following the outbreak of the health crisis and the decline in economic activity is projected to weigh on the value added of the financial sector, which represents a large share of Luxembourg's GDP. For 2021, a rebound in GDP growth to 5½% is expected, but with risks that are mainly on the downside, depending on the evolution of the health situation and the developments in the financial and external sectors[2]."

The message from Carlo Thelen, CEO of the Luxembourg Chamber of Commerce, is apt and to the point: "Despite the uncertainties and questions regarding the final impact of the crisis, we must be proactive, anticipate the effects of the crisis on economic players by implementing effective and rapid aid measures, and prepare for the post-crisis period with an ambitious recovery plan[3]." This call for action is further reflected in the Luxembourg Chamber of Commerce working paper released in July in which the Chamber of Commerce sets out its recommendations on how to address current and forthcoming challenges and to boost the Luxembourg economy[4]. Tax is one of the five pillars detailed in this paper.

The tax proposals detailed in the Chamber of Commerce paper could indeed serve as an effective and powerful lever. A further decrease of the corporate income tax (CIT) rate (after the progressive but relatively limited decreases initiated in 2017) and adjustments to the net wealth tax (NWT) rules and to the investment tax credit regime are some of the proposals which undoubtedly deserve some attention and are continuously mentioned by the financial centre as necessary tools to maintain Luxembourg competitiveness. The abolition or reduction of the withholding on dividend distributions is another important topic.

Given the current economic and social context, the major tax reform for the fiscal year 2021 announced by Finance Minister Pierre Gramegna in July 2019, which left the outlines of new tax measures aimed at revitalizing and boosting businesses, will be postponed. As Prime Minister Xavier Bettel rightly said during the State of the Nation speech on 13 October 2020, measures that would place a heavy burden on the State budget cannot be put on the agenda. On the otherhand, given the current dramatic economic situation of improving corporate taxpayers, a fiscal measure capable of importing the resilience of companies while having a virtuallity neutral impact on the State budget would be urgent to put in place, followed by other measures, once the time comes for the expected tax reform.

Regrettably, the implementation of a notional interest deduction (NID) regime does not appear on the list of tax measures announced by the Prime Minister on 13 October 2020. For the reasons explained in this article, the authors

1. European Economic Forecast, Summer 2020 (Interim); Institutional Paper 132, July 2020; Idea Foundation, "Tableau de bord économique et social du Luxembourg", July 9, 2020; Bulletin Économique de la Chambre de Commerce, Actualité et Tendances, n°25, "Des idées pour la relance. Un cadre propice pour les entreprises"; "The Five prerequisites for limiting the socio-economic damage from this unprecedented crisis", Carlo Thelen blog, April 6, 2020; "Laying the groundwork for recovery and the post-crisis period", Carlo Thelen blog, May 12, 2020.
2. European Economic Forecast, Summer 2020 (Interim) ; Institutional Paper 132, July 2020, p. 27.
3. "Laying the groundwork for recovery and the post-crisis period," Carlo Thelen blog, May 12, 2020.
4. Bulletin Économique de la Chambre de Commerce, Actualité et Tendances, n°25, "Des idées pour la relance. Un cadre propice pour les entreprises".

believe that such regime should, however, be an important measure to be presented by the government in tax matters. It could indeed allow rebalancing the debt: equity financing of Luxembourg enterprises, making them more resilient, while its impact on the Luxembourg budget could be controlled.

Liquidity shortage may be an obstacle for some groups and enterprises that will necessarily continue to seek to rely heavily on external debt financing. The benefit of a NID regime may also be more limited as far as companies with exempt assets or low capital are concerned. But the situation is very different from one group/enterprise to another, and the variety of activities and types of companies is sufficiently large in Luxembourg so that a NID regime will undoubtedly benefit a large number of those. Another important point to be considered is the significant pressure currently being brought onto banks to bear[5]. Although banks are considered by politicians and economic leaders to be part of the solution, their capacity to finance the economic recovery has its limits. Moreover, a debt-fuelled economic restart comes along with higher financial leverage resulting in increasing vulnerabilities to financial stability during already uncertain times. It appears that a more diversified set of funding sources would benefit a larger population of corporates and foremost those with limited access to debt-financing. The introduction of a NID regime would undoubtedly be an essential piece of legislation in the shaping of a successful economic recovery plan.

In December 2013, when the program was presented, the newly appointed government in Luxembourg, Prime Minister Xavier Bettel, announced the government's intention to introduce a NID regime with a view to encouraging the financing of enterprises with equity (as opposed to the disproportionate debt funding thereof[6]). Almost seven years after this program was presented and while the worldwide economy is severely impacted by COVID-19 and the international tax landscape has dramatically changed – not only by OECD initiatives and European directives, but also by regulations and case laws limiting the room of government to manoeuvre year after year, this project still seems to be dormant.

Until the beginning of this year, the priority of the Luxembourg government in the tax field was twofold: firstly, it had to hold up demonstrating that Luxembourg was fully committed to tax transparency and to fighting against aggressive tax planning[7]; secondly, it had to continue attracting new investors and to further strengthen its robust economy, including its dynamic financial sector. While these priorities remain, they have been strongly skewed by the COVID-19 impacts. The top priority for the government today is to allow the economy to survive the crisis, to recover and to restart. Next to the tax measures announced by Prime Minister Xavier Bettel during the State of the Nation speech, the opportunity for Luxembourg to implement a NID regime, as announced by the Luxembourg government in 2013, should be assessed now a NID regime. This article highlights the reasons why such regime should be introduced into Luxembourg law, its mechanism and how it could strengthen the resilience of Luxembourg companies and of the economy.

## I. DEBT BIAS AND DEBT SHIFTING

In the 1950s, Franco Modigliani and Merton Miller demonstrated that the financing structure of a company does not affect its value. In other words, the value of a company is determined by the return of its investments, irrespective of the amount of debt and equity financing thereof. The model presented by the two economists was based on certain strong assumptions, including the absence of taxes and of "bankruptcy costs". In such a scenario, managers could concentrate on the complex financial and commercial aspects that rule the choice between equity financing and debt financing: the costs of financing, the profitability and maturity of the investment, and the risk profile of the investment.

In the real world, taxes do exist, however, and they impose a major cost for companies, influencing economic and financial decisions on a daily basis. When taxes are included in the above-mentioned Capital Structure Theory by Modigliani and Miller, the value of a leveraged company increases compared to its equity-financed peers. This is generally explained by the fact that, in most jurisdictions, payments of interest are tax-deductible, whereas dividend distributions are not. In the specific case of Luxembourg, the discrepancy is even more important: not only arm's length interest payments are deductible for CIT purposes (albeit subject to certain limitations described below)

**5.** European Central Bank, Banking Supervision, Supervision Newsletter, May 13, 2020: Leveraged lending: banks exposed to risks amid COVID-19; Institute of International Finance; Global Debt Monitor, COVID-19 Lights a Fuse, April 6, 2020; IMFBlog, COVID-19 Crisis Poses Threat to Financial Stability, April 14, 2020; *Financial Times*, "The seeds of the next debt crisis", March 4, 2020.

**6.** Programme gouvernemental 2013 – p.28: "Le Gouvernement mettra aussi en place un mécanisme d'intérêt notionnel afin d'encourager les entreprises à renforcer le financement par fonds propres (tout en mettant en place les mesures nécessaires pour éviter des abus)."

**7.** See EU Commission Recommendation (COM [2019] 516 final) of June 5, 2019 for a Council Recommendation on the 2019 National Reform Programme of Luxembourg and delivering a Council opinion on the 2019 Stability Programme of Luxembourg.

whereas dividends are not, but they also are not subject to WHT, whereas dividends are. Last but not least, debt is deductible from the NWT basis of the company, whereas equity is not.

In many jurisdictions, the different tax treatment of debt and equity financing generated a preference for external as well as internal (or intragroup) financing, which in many cases leads to the over-indebtedness of companies. This imbalance of the companies' financing is generally referred to as the "debt bias". Financial studies demonstrate a direct correlation between the CIT rate of a certain jurisdiction and the average debt-to-asset ratio of enterprises in that jurisdiction: a CIT rate of 25% (approximately, the rate currently applicable in Luxembourg) might be responsible for leverage ratios of about 7 percentage-points higher compared to systems where debt and equity are treated equally from a tax perspective.

Excessive debt financing comes at a cost, in the first place as it increases the risk of the borrowing company; according to the Monetary Fund Report of October 2016[8] (IMF Report), the distortion the debt bias creates in risk behaviour and investment decisions generates excessive agency costs[9] and higher risk premiums. A high amount of debt also creates an unfair imbalance between highly indebted companies and companies that do not wish to, or cannot, be debt-financed. This is especially a concern for new ventures and start-ups, whose development is high on the agenda of the Luxembourg government.

As highlighted in the IMF Report, the tax aspects connected to debt financing may also lead to the so-called "debt shifting", where lenders and borrowers in different jurisdictions are combined to obtain a deduction of interest expenses where tax rates are higher and inclusion of interest income in the taxable basis where tax rates are lower. When debt shifting is brought to the extreme, it is in certain cases possible to achieve the full deduction of interest in one jurisdiction without inclusion in the other jurisdiction concerned; these structures, which exploit a different qualification of an instrument or of an arrangement in the two or more jurisdictions are commonly referred to as "hybrid structures".

Both practices, excess debt financing and hybrid financing, were addressed by the Organisation for Economic Cooperation and Development (OECD)'s Base Erosion and Profit Shifting (BEPS) initiative and resulted in the adoption and recent implementation of ATAD 1 and ATAD 2 across the EU Member States. Both measures are discussed in more detail below. On debt shifting, the BEPS Final Report on Action 4[10] (Action 4 Report) states: "These opportunities surrounding inbound and outbound investment potentially create competitive distortions between groups operating internationally and those operating in the domestic market. This has a negative impact on capital ownership neutrality, creating a tax preference for assets to be held by multinational groups rather than domestic groups."

## II. TAX MEASURES CONCERNING DEBT FINANCING

Whilst tax measures limiting the deduction of borrowing costs are quite common in Western countries, they are not necessarily addressing over-indebtedness; the fact that they are often collectively referred to as "(anti)thin capitalisation rules" may be misleading.

As far as Luxembourg is concerned, such rules are briefly described below.

- The 15:85 rule. The Luxembourg tax authorities have been requiring in practice that holding activities are financed, at inception, with related-party debt for an amount not exceeding 85 % of the investment. This informal rule is based on the consideration that companies financed by related parties should not be more thinly capitalised than their third-party financed equivalents. The 15 % minimum equity financing is a broad estimate of the equity financing required in the market to cover potential losses on participations[11] over the entire holding period[12].

- The minimum equity of intragroup financing companies. Such intragroup financing companies (companies that, as their main activity, grant loans or advances to related parties) are also required to be partly equity financed, whether the debt financing comes from a related party or not[13]. This provision is also based on an elementary transfer pricing consideration: companies investing in risky activities should have a market-level capitalisation to face the "expected loss" of their portfolio. Also in this

8. Tax policy, Leverage and Macroeconomic Stability, available here : https://www.imf.org/en/Publications/Policy-Papers/Issues/2016/12/31/Tax-Policy-Leverage-and-Macroeconomic-Stability-PP5073.
9. The cost arising from the conflict of interest existing between the management/shareholders of an indebted company and the debt holders.
10. Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4–2015 Final Report available at : https://read.oecd-ilibrary.org/taxation/limiting-base-erosion-involving-interest-deductions-and-other-financial-payments-action-4-2015-final-report_9789264241176-en#page17.
11. Marc Schmitz, Philip Warner, "Luxembourg in International Tax", IBFD 2015, p. 111-112.
12. In case of losses, the tax authorities generally do not require a recapitalization of the company.
13. In this case, the minimum equity financing is a constant requirement. In case of losses, the company needs to be recapitalised.

case, the right level of equity financing is left to the determination by the market (even though there is no safe harbour and a benchmark is generally required).

- Interest Deductibility Limitation Rule (IDL Rule), introduced with the implementation of ATAD 1, pursuant to the Action 2[14] reports. Luxembourg implemented ATAD 1, and the IDL Rule, effective on January 1, 2019[15]. Based on the IDL Rule, Luxembourg companies can deduct so-called "exceeding borrowing costs" (interest expenses exceeding interest income derived in the same period) only up to the higher of 30% of their EBITDA and 3 million euros. The IDL Rule applies to plain vanilla interest costs as well as to assimilated payments. Even though the IDL Rule is expected to have a relevant impact on the financing of Luxembourg companies, the view of the authors is that such impact is limited by two considerations: (i) the IDL Rule has no impact on companies investing exclusively in exempt assets, such as participation and foreign real estate investments; on the other hand, it may have a more substantial impact on the distressed debt market, which for obvious reasons is nowadays very active. As of the date of this article, a confirmation from the Luxembourg tax authorities is still expected regarding the assimilation to interest income (thereby correspondingly increasing the amount of deductible borrowing costs) for capital gains realised on the disposal or on the recovery of distressed debt; (ii) the IDL Rule applies for CIT purposes only. Luxembourg companies still have an incentive to be debt financed for WHT and NWT purposes. Last but not least, the IDL Rule cannot effectively address the debt: equity bias as it does not differentiate between big and small companies and between companies with a similar EBITDA but a different risk.

- Anti-Hybrid Mismatch Rules (AHM Rule), introduced with the implementation of ATAD 1 and ATAD 2, pursuant to the Action 4 Report. Even though the AHM Rule may have the effect of reducing the amount of interest payments that a company is allowed to deduct for tax purposes, it merely addresses the exploitation of hybrid debt financing for tax planning purposes rather than the real debt: equity bias.

- EU List Deduction Limitation. It is expected that, as from January 1, 2021, interest and royalties paid or due to associated companies established in a jurisdiction included in the EU list of non-cooperative jurisdictions for tax purposes (EU List Deduction Limitation[16]) will be non-deductible[17]. The measure is aimed at promoting the tax transparency of the blacklisted jurisdictions and at countering aggressive tax planning and base erosion rather than at promoting a balanced debt: equity ratio as such. This is supported not only by the fact that interest payments would be concerned only to the extent they are due or paid to companies established in non-cooperative jurisdictions, but also to the possibility, granted to the taxpayer, of obtaining an exemption where it can demonstrate that the interest debt/payment are supported by genuine commercial reasons.

It is the view of the authors that the currently available tax tools are not, by themselves, able to sufficiently solve the debt: equity bias. The applicable measures are either based on transfer pricing, where companies financed by associated enterprises are led to follow the market (there is no assurance that, in the market, companies choose the appropriate level of indebtedness), or are based on arbitrary caps or thresholds (the 15% equity financing, the EUR 3 million cap – important for smaller enterprises and immaterial for bigger taxpayers), or do not consider the whole tax burden of the taxpayers by only affecting the main corporate tax basis or they simply address aggressive tax planning and base erosion. Paradoxically, the attempt to harmonise tax rules across the EU without a common view on the goals that need to be achieved seems to add confusion to the already complex topic. A recent interesting contribution by Flora Castellani and Jean Schaffner[18] highlights how, even at the level of the EU Commission, there is no full clarity on the deduction of notional interest, condemned in the pending state-aid Huhtamäki case[19] and supported within the ambitious CCTB project[20].

**14.** Neutralising the effects of hybrid mismatch arrangements, Action 4–2015 Final Report available at : https://www.oecd.org/tax/beps/beps-actions/action2/

**15.** Except for the exit tax provisions that will apply as from 2020.

**16.** The measure stems from a December 2019 ECOFIN meeting, which recommended that at least one from a series of additional defensive measures, including denying a deduction for costs and payments directed to entities or persons in a blacklisted jurisdiction, should be adopted by Member States as from 2021, and from the EU Council conclusions on the revised EU list of non-cooperative jurisdictions for tax purposes (Council conclusions on the revised EU list of non-cooperative jurisdictions for tax purposes [2020/C 64/03].

**17.** The above-mentioned list currently contains twelve jurisdictions, including the Cayman Islands. A draft law is currently pending before the Luxembourg Parliament, awaiting approval.

**18.** F. Castellani, J. Schaffner, Fiscalité équitable et liberté de gestion des entreprises : de l'abstrait au concret, Revue de droit fiscal n. 8, septembre 2020.

**19.** State aid case SA.50400 (2019/C) (ex 2019/NN-2) – Possible State aid in favour of Huhtamäki.

**20.** In October 2016, the Commission proposed to relaunch the Common Consolidated Corporate Tax Base. The relaunched CCCTB will be implemented through a two-step process and will be mandatory for the largest groups in the EU. Additional information can be found here : https://ec.europa.eu/taxation_customs/business/company-tax/common-consolidated-corporate-tax-base-ccctb_en.

## III. THE NOTIONAL INTEREST DEDUCTION: A CORRECTIVE SOLUTION?

### A. General Principles

The Allowance for Corporate Equity (ACE), also called Notional Interest, is an alternative system for addressing the debt bias. It involves making a notional return on equity tax deductible, thus creating an equivalent, parallel measure to the deduction of interest costs[21].

It is, first of all, important to mention that ACE or ACE-type regimes seem to be EU and OECD stamped. This point is crucial in the current tax environment:

The European Commission's proposal for a Council Directive on a Common Corporate Tax base (CCTB) mentions for instance a rule against debt bias with a view to neutralising the current framework that discourages equity financing with a NID on equity financing (with some specific features in the form of an Allowance for Growth and Investment – "AGI[22, 23]").

References to regimes that grant deemed interest deductions for equity capital can also be found in the BEPS action plan. It is indeed indicated in Action 2 of the BEPS action plan regarding the neutralisation of the effects of hybrid mismatch arrangements that: "The hybrid mismatch rules focus on payments and whether the nature of these payments gives rise to a deduction for the payer and ordinary income for the payee. Rules that entitle taxpayers to a unilateral tax deduction for invested equity without requiring the taxpayer to make a payment, such as regimes that grant deemed interest deductions for equity capital, are economically closer to a tax exemption or similar taxpayer specific concessions and do not produce a mismatch in tax outcomes in the sense contemplated by Action 2[24]."

The NID regime should therefore also not be targeted by the ATAD 2[25] provisions, which transpose Action 2 of the BEPS action plan. To the extent there is no payment, there should be no hybrid mismatch arrangement.

As far as the IDL Rule is concerned, the Action 4 Report explicitly provides that: "Where a country has a rule which grants a deemed deduction by applying a specified percentage to the equity capital of an entity, these deemed deductions are not treated as being interests or a payment economically equivalent to interest for the purposes of this report. These rules and rules having similar effect should be considered further by the OECD in separate work[26]." This point is critical as it means it would be possible to implement a NID regime in Luxembourg without notional interest to fall under the IDL Rule.

It should finally be compliant with Action 5 ("Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance") and Actions 8–10 ("Aligning Transfer Pricing Outcomes with Value Creation") of the BEPS action plan while, briefly summarised, the regime should not apply to a specific category of taxpayers only and will comply with at arm's length principles.

Also, several examples of successfully implemented ACE or notional interest regimes within the EU, validated at EU level, must be reported. Variances exist between the different regimes but overall these regimes rely on a deduction calculated as a percentage of the equity determined according to local accounting laws[27]. In addition to the Belgian NID regime (which is probably the one that comes immediately to mind when discussing ACE regimes[28]), Italy (with the reintroduction of a NID regime in 2011[29] which was, however, repealed in 2019 but finally restored with retroactive effect), but also Cyprus (in 2015[30]), Malta (applicable as from the year of assessment

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21. Tax Reforms in EU Member States 2015 – Tax policy challenges for economic growth and fiscal sustainability – Challenges related to broadening tax bases and other design issues, p. 49.
22. COM (2016) 685 final, October 25, 2016, detailed explanation of the specific provisions of the proposal, p. 10, Allowance for Growth and Investment (AGI): "The re-launch initiative aims to tackle the asymmetry whereby interest paid out on loans is deductible (subject to some limits) from taxpayers' common base whilst this is not the case for profit distributions. The outcome is a definitive advantage in favour of financing through debt as opposed to equity. Given the risks that such a situation entails for the indebtedness of companies, the relaunch proposal for a common corporate tax base will include a rule against debt bias, in order to neutralise the current framework that discourages equity financing. Taxpayers will be given an allowance for growth and investment according to which increases in their equity will be deductible from their taxable base subject to certain conditions, such as measures against potential cascading effects and anti-tax avoidance rules. As part of the review of the common tax base, the Commission shall give specific consideration to the functioning of the AGI as a basis for considering adjustments to its definition and calibration."
23. Article 11 "Allowance for growth and investment (AGI)", par. 3, of the proposal for a Council Directive on a Common Corporate Tax base (CCTB) provides that "An amount equal to the defined yield on the AGI equity base increases shall be deductible from the taxable base of a taxpayer […]." – See also European Commission – Working paper N. 72–2018. How effective is an incremental ACE in addressing the debt bias ? Evidence from corporate tax returns.
24. OECD/G20 BEPS – Action 2: 2015 Final Report – Neutralising the effects of hybrid mismatch arrangements.
25. Council Directive (EU) 2017/952 of May 29, 2017, amending ATAD 1 as regards hybrid mismatches with third countries.
26. OECD/G20 BEPS – Action 4: 2015 Final Report – Limiting Base Erosion involving Interest Deductions and Other Financial Payments, par. 42, p. 31.
27. See a summary of the regimes in the Working Paper of the International Monetary Fund, WP/18/239, A Destination-Based Allowance for Corporate Entity by Shafik Hebous and Alexander Klemm, https://www.imf.org/~/media/Files/Publications/WP/2018/wp18239.ashx
28. This regime has been amended in the framework of a global reform of the Belgian corporate income tax, adopted by the Belgian Parliament in a program law dated December 25, 2017. The NID regime, as amended, is applicable to any taxable periods starting as from January 1, 2018 (tax assessment year 2019) – http://data.consilium.europa.eu/doc/document/ST-14364-2018-ADD-1/en/pdf
29. http://data.consilium.europa.eu/doc/document/ST-14364-2018-ADD-4/en/pdf
30. https://data.consilium.europa.eu/doc/document/ST-9652-2019-ADD-1/en/pdf

2018[31]), Portugal (originally applicable as from 2008, with amendments in 2014, 2017 and 2018[32]) and Poland (2019) can be mentioned. Denmark had also announced the introduction of an ACE-type regime in the coming years. The Cyprus, Italian, Maltese and Portuguese NID regimes were validated by the EU Code of Conduct Group in April 2018[33].

Outside the EU, Switzerland should also be mentioned with the adoption by the Swiss voters in a referendum held on May 19, 2019, on the Federal Act on Tax Reform and AVS Financing (TRAF). One of the measures included in the TRAF is the option for high-tax cantons (only the canton of Zurich should meet the requirements) to introduce a NID on excessive equity.

### *B. NID computation*

From a technical point of view, the NID regime would allow deducting from the taxable result of a resident corporate taxpayer "interest" remunerating supplementary contributions to the capital (or assimilated) of that taxpayer.

The below (simplified) formula could be used to compute the NID:

> NID = (return on equity rate × weighted increase of equity during the financial year) + NID from previous years (if no capital reductions)

Where the return on equity rate should comply with market conditions, this rate could (like it is for instance the case in Italy and Cyprus) be the yield of the 10-year government bond, increased by a markup. It could alternatively be determined based on a transfer pricing study. The "premiums" to be applied will obviously play an important role on the attractiveness of the NID regime. Too much calibration on a risk-free rate (10-year government bond for instance) could induce undesirable results based on how much interest will go into negative territory in the future. Also, operations of many companies in Luxembourg are unrelated to the Luxembourg economy. The use of a more global risk-free rate such as the German bond could therefore be envisaged. From a financial perspective, one might also recommend making the NID dependent on the financial position of the group: the "mark-up" would be a function of a number of risk factors of the company/group (size, sector, country of operations, development stage of operations, etc.). The determination of the cost of equity in the so-called WACC (weighted average cost of capital) could be a source of inspiration.

The introduction of a NID regime should finally be tailored so that it also entails correcting the taxable basis of a taxpayer from an NWT point of view. In that context, an adjustment of the Luxembourg *Bewertungsgesetz* of October 16, 1934 (as amended), would be required. Possible adjustments to the Luxembourg income tax law should also be considered with a view to addressing WHT considerations.

### *C. Safeguard Measures*

As indicated in the program of the government in 2013, the NID regime should include specific anti-abuse measures. The regime could notably only apply to equity increases after its date of implementation. "Old" equity would be preserved. As rightly mentioned in the working paper of the European Commission N. 72 of 2018, "anticascading rules" should be implemented "to avoid doubling the receipt allowance corresponding to the same initial increase in equity[34]". By limiting the deductibility of the notional interest to new equity only, the possible reduction of tax revenue resulting from the regime should be limited. Specific limitations could potentially also be implemented as far as required capital is concerned (typically for insurance companies or banks). The deduction would, furthermore, be subject to existing specific and general anti-abuse provisions in Luxembourg laws.

As illustrated above, the NID regime should, in our view, not be affected by the IDL Rule. Likewise, notional interest should in our view also not fall under the EU List Deduction Limitation, for the following reasons:

– The EU List Deduction Limitation refers to interest "paid or due", which does not seem to concern notional interest; and

**31.** http://data.consilium.europa.eu/doc/document/ST-14364-2018-ADD-6/en/pdf
**32.** http://data.consilium.europa.eu/doc/document/ST-14364-2018-ADD-8/en/pdf
**33.** See Code of Conduct Group (Business Taxation) – Report to the Council, June 8, 2018, 9637/18: "The Group will continue to monitor standstill and the implementation of rollback, with a particular focus on […] notional interest deduction (NID) regimes. […]. Once the assessment of the five notified NID regimes will have been closed [NB: Cyprus, Italy, Portugal, Malta and Belgium], the Group will consider developing a guidance for other Member States wishing to implement a similar regime.
**34.** See European Commission – Working paper N. 72–2018, How effective is an incremental ACE in addressing the debt bias? Evidence from corporate tax returns, p. 5: "Net capital increases are computed as the sum of new equity and profits retained minus the reduction in firm's own capital which has been distributed to shareholders. Another reduction to the ACE base stems from anti-abuse and anti-elusive rules. In particular, anticascading rules impose that participations held within the group (domestic and foreign) have to be subtracted from the ACE base to avoid doubling the receipt allowance corresponding to the same initial increase in equity. However, the ACE base is capped at zero. This asymmetric feature of the ACE does not completely eliminate the possibility of such cascading, in particular in the case of participations financed by debt (Zangari [2014], International Monetary Fund [2016]). To address this opportunity for tax planning the ACE should give rise to addition to the tax base as in the AGI in the CCCTB proposal. […]. New equity from shareholders living in so-called 'tax heavens' and from profits retained for non-disposable reserves cannot be deducted. The sterilization of the ACE base also applies to the entity making contribution in cash to group companies, buying the business or parts of a business from other group companies, granting financing to other group companies."

– The EU List Deduction Limitation is mostly aimed at promoting transparency, rather than at penalising the EU deducting entity as such.

## IV. CONCLUSION/IMPLEMENTATION IN LUXEMBOURG

Despite the proliferation of provisions limiting the deductibility of interest payments, the Luxembourg tax system does not have in place an effective equalization tool that can help solve the debt bias, and all the non-tax consequences thereof, in the most direct and natural way: by making debt financing and equity financing equally attractive for tax purposes. As shown by the experience of other EU Member States, the NID regime may be a simple and effective tool to reduce the debt: equity dilemma.

The implementation of a NID regime may also help minimise certain adverse/distortive effects of the IDL Rule effective in Luxembourg since 2019. It would be optional and could be combined at a later stage, and when the economy recovers, with other incentive tax measures such as a further reduction of corporate taxes (CIT, WHT and NWT). It would finally apply to all corporate taxpayers thereby limiting EU state aid risks. To the extent certain limitations and safeguards are provided (see above), the NID regime should, furthermore, not have a detrimental impact on the budget, also taking into account the broadened tax base resulting from the ATAD implementation in Luxembourg.