Reshaping international taxation

The Anti-Tax Avoidance directives

2019 delivered substantial changes to Luxembourg and international taxation.

The transposition of the EU Anti-Tax Avoidance Directive (ATAD 1) into Luxembourg tax law and the bill of August 2019 transposing the EU Anti-Tax Avoidance Directive 2 (ATAD 2) has significantly and permanently moved the goalposts for loan fund actors and alternative investment players.

ATAD’s aim is to provide a baseline level of protection for the internal market and to strengthen the average level of protection against aggressive tax planning.

Effective in Luxembourg since 1 January 2019, the ATAD 1 transposition law introduced provisions covering five main topics:

- interest limitation
- exit taxation
- a general anti-abuse rule (GAAR)
- controlled foreign companies (CFCs)
- intra-EU hybrid mismatches.

The limitation of interest deduction and the anti-hybrid provisions are particularly relevant for SOPARFIs in the loan fund market, since regulated investment funds are generally exempt from corporate income tax and net wealth tax. Therefore, SOPARFIs would require debt financing of their loan receivables to offset otherwise taxable interest income.

Luxembourg’s ATAD law limits the deductibility of net interest expenses — i.e. taxable interest income minus deductible interest expenses — of up to 30% of the taxpayer’s adjusted EBITDA or EUR€3,000,000, whichever is higher (calculated annually).

For SOPARFIs involved in the back-to-back intragroup financing of plain vanilla loans, this rule should not trigger adverse Luxembourg tax implications because the company would achieve an arm’s length margin. And, if a gain on distressed debt/non-performing loans is included in the definition of interest income or equivalent, this new limit should not negatively affect SOPARFIs. There is currently no clear guidance on the definition of “interest income” or “other economically equivalent income”, however clarification is expected in the coming months.
Implementation of anti-hybrid provisions

In August, the ATAD 1 rules regarding anti-hybrid mismatches between EU countries were expanded by the ATAD 2 transposition bill to cover hybrid mismatches with third countries.

The bill confirms the scope of the anti-hybrid mismatches as foreseen by ATAD 2, such as the non-deductibility of interest charges under a debt instrument regarding (i) payments made to associated enterprises or (ii) payments related to structured arrangements that trigger either a “deduction without inclusion” or “double deduction” outcome due to hybrid mismatches involving:

- hybrid instruments
- hybrid entities
- permanent establishments
- imported mismatches
- hybrid transfers
- residency mismatches.

The Luxembourg bill provides much-needed clarification for investment funds. In short, investment funds, held by several unrelated investors while managed by the same person, could potentially benefit from the presumption that their investors do not qualify as “associated enterprises” under ATAD 2.

This is because the anti-hybrid rules focus on payments made to “associated enterprises” that require participation of at least 25% for hybrid financial instruments — i.e. voting rights, capital or profit entitlement — and 50% for hybrid entities. In principle, these thresholds should, de facto, exclude investment funds held by several investors.

However, the bill also introduces the concept of “acting together” which aggregates the holding percentage of investors “deemed” to be acting together regarding an entity’s voting rights or capital ownership — e.g. an investment fund.

The bill provides a “de minimis” exception for applying the acting together principle. An individual or enterprise that holds either directly or indirectly less than 10% in the capital of an investment fund — and is entitled to receive less than 10% of the profit — is exempt from acting together and should, therefore, fall out of the anti-hybrid provision’s scope.

Further clarifications and guidance on the concrete application of the anti-hybrid provisions are expected in the coming months. The provisions will become effective from 1 January 2020, apart from the reverse hybrid provisions that apply as from 1 January 2022 and must follow the legislative process.
EU SUSTAINABLE FINANCE

Green loans

What are green loans and why are they taking off?

Green loans are a hot topic in the loan market. Even though they are relatively new, their volume has shot up over the past few years. Green loan issuance globally amounted to USD$60 billion in 2018, up by more than 30% from 2017. The largest issuers are in the US, the UK, Spain and India and the majority of proceeds are used for renewable energy projects1.

Green loans are any type of loan instrument that exclusively finances or refinances — in whole or in part — new and/or existing eligible green projects. Any issuer can use these financial instruments regardless of ESG status — because it’s how the proceeds are used that is important.

A New Green Market

Sustainability debt issued by instrument type

Source: BloombergNEF
What standards ensure a loan’s greenness?

The Green Loan Principles (GLP) of the International Capital Market Association (ICMA) defines a consistent methodology to assess green loans and promote their integrity on the market.

Similar to the Green Bond Principles, which were developed in March 2018, the GLP defines four key components that make a loan green:

/ Use of proceeds: the fundamental element of a green loan is the use of its proceeds for green projects, including related and supporting expenditures such as research and development. This should be appropriately stated in the finance documents and, if applicable, the marketing materials. The GLP provides a non-exhaustive list of environmental issues that apply, such as climate change, natural resources depletion, loss of biodiversity and air, water and soil pollution.

/ Process of evaluating and selecting projects: the borrower of a green loan should clearly communicate to its lenders the loan’s environmental sustainability objectives, and how its projects fall under the eligible green categories including related eligibility criteria.

/ Management of proceeds: the proceeds of a green loan should be credited to a dedicated account or otherwise tracked by the borrower appropriately, to maintain transparency and promote the integrity of the product.

/ Reporting: borrowers should provide and keep readily-available and up-to-date information on how the proceeds are being used. This includes a list of green projects, qualitative performance indicators and, where feasible, quantitative performance measures.

Also, a borrower can certify its green loan or associated green loan framework against an external green assessment standard. The green loan is tested against the criteria of the assessment standard by qualified third parties/certifiers, such as auditors.
EU sustainable finance — taxonomy

The EU Technical Expert Group on Sustainable Finance (EU TEG) is currently finalizing its work on selected points of the EU Action Plan on Sustainable Finance. One of these elements is the taxonomy. The EU Parliament has already developed its position on the legislative proposal regarding taxonomy and the next step is to reach an agreement with the Commission and the Council. The resulting Directive will be implemented in future national-level regulations.

An EU taxonomy plays an essential role in making EU climate targets implementable in practice. It is a classification system that allows the categorization of economic activities/sectors that play key roles in climate change mitigation and adaptation. For an economic activity to be included in the proposed EU taxonomy, it must substantially contribute to at least one environmental objective — while doing “no significant harm” to the other five environmental objectives set out in the legislative proposal.

The classification’s technical screening criteria, methodology and guidance are set out in the EU report on taxonomy. The EU TEG is designing the taxonomy together with extensive stakeholder consultations involving many experts from sectors covered by the taxonomy.

The Regulation on disclosures relating to sustainable investments and sustainability risks — adopted by the European Parliament and Council in April 2019 — states that financial market actors must disclose sustainability risks and impacts. Given that these actors provide financing for and invest across various sectors, the sustainability risks and impacts of these investments must be analyzed to deliver the regulation’s disclosure requirements.

It’s expected that financial market actors will investigate more closely the activities they finance and invest in. Before this new regulation, it was easier to hide unfavorable investments from a climate point of view. As this is no longer an option — and, for example, massive stranded assets and carbon-heavy indicators will require disclosure — this will make non-sustainable investments less tempting.

All of this will likely mean that financial sector actors will make use of the taxonomy to closely analyze the sectors in which they are investing.

Implications

Financial sector actors will likely want to develop the analysis of their investment and financing targets, combine these targets to define their organization’s risks and impacts, and develop them further in a report. The key takeaway questions for financial market actors include:

/ To what extent do our financing/investment objects mitigate climate change and/or promote its adaptation? How do our indices and funds compare to other similar products and to what degree do they exceed reference benchmarks? Are there any emerging business risks resulting from these and what are they? How should we define and analyze these risks?

/ What are the effects of our financing/investments? What can we disclose about these impacts and underlying risks? Do we have a common understanding of what we mean by “impact”? What types of indicators should we use?

/ Have we prepared targets and a methodology for risk and impact assessment, measurement and monitoring? Are we clear on what processes we are following?

/ In many cases, the taxonomy thresholds are based on sector-specific best practices. Therefore, it will be worthwhile for companies to investigate what these sector-specific best practices are, as it is likely that financiers and investors will seek related benchmarks. For companies, key takeaway questions include:

/ Does our business support climate mitigation or adaptation and to what extent?

/ Are we aware of the sustainability criteria, with a specific focus on climate, that is used by our financiers and investors? How does our business compare to our peers?

/ Is the required information easily available to financiers and investors? Do we report this information in a way that is relevant to them?

The goal of ensuring good “financiability” and “investability” at a reasonable cost will only be met if companies devote enough time and effort to attaining it.