TAX NEUTRAL OR CAUGHT IN THE NET? WORLD OF LUXEMBOURG SECURITIZATION VEHICLES

Authors
James T. O'Neal
Naima Bouzago Ouali

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Hybrid Mismatch
Interest Limitation Rule
Investor Payments
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Structured Arrangements

James T. O'Neal is co-head of Maples and Calder (Luxembourg)'s Tax Team, where he advises Fortune 500 companies, private equity, real estate funds and start-ups on many aspects of Luxembourg taxation, including holding activities, cross border financing, securitization vehicles, mergers and acquisitions, and restructuring.

Naima Bouzago Ouali is an Associate in Maples and Calder (Luxembourg)'s Tax Team, specializing in international tax planning for multinationals and investment funds, cross-border financing, securitization vehicles, mergers and acquisitions, and restructurings.

INTRODUCTION

The Luxembourg securitization vehicle ("Lux S.V."), governed by the Securitization Law of 22 March 2004 ("Lux Securitization Law"), remains a core pillar in structured finance and asset repackaging across Europe. As Luxembourg continues to implement European Union ("E.U.") directives such as A.T.A.D. I & II, D.A.C.6., and the O.E.C.D.'s B.E.P.S. action plan – Including Pillar Two and substance-driven anti-abuse frameworks – Lux S.V.'s face growing scrutiny. This article analyzes how two of the principal, potentially applicable anti-abuse rules to Lux S.V.'s – namely A.T.A.D. I & II's Anti-Hybrid Rules ("Hybrid Mismatch Rules") and A.T.A.D. I's interest limitation rules ("I.L.R.'s") – can still be successfully navigated in the appropriate set of facts, thus preserving their tax neutrality.

We focus on these two rules in particular. First, as we elaborate below, the Lux Securitization Law allows tax deductibility on all forms of payments to investors of Lux S.V.'s. For example, a Lux S.V. will often issue profit participating loans ("P.P.L.'s") or could even issue types of share classes. In all such cases, payments on these financial instruments would be considered from the Lux Securitization Law as deductible for tax purposes. Tax deductible payments on such equity like financial instruments (the elusive "tax deductible dividend") would lead a skillful tax practitioner to question such presumably deductible dividend payments as a trap for the anti-hybrid rules now enacted across the E.U. and elsewhere. However, as we will discuss below, despite such "deductible dividends," the Lux S.V. can navigate through the anti-hybrid rules when the right conditions are fulfilled.

Secondly, under the Lux Securitization Law, all such deductible payments to investors ("Investor Payments"), from a Luxembourg tax point of view, are essentially characterized as interest expenses. Accordingly, any Lux S.V. contemplating holding assets that generate income other than interest or its economic equivalent is exposed to the risk of the application of the I.L.R.'s, which generally limit the deduction of interest quite dramatically. As explained below, Luxembourg as an E.U. Member State dutifully enacting A.T.A.D. has I.L.R.'s that limit interest expense financing of other types of income (*e.g.*, equity returns, royalties, other types of investment income, etc.) to 30% of E.B.I.T.D.A. or, to put it more bluntly, denying up to 70% of interest expense attempting to offset these other types of income. Nonetheless, Lux S.V.'s even when investing into these noninterest income generating assets may still achieve tax neutrality when certain conditions are fulfilled.

As we elaborate below, Lux S.V.'s can often still achieve tax neutrality with the right set of facts, even when applying the Hybrid Mismatch Rules and I.L.R.'s.

LUX S.V.'S IN CORPORATE FORM: LEADING CONTENDER IN STRUCTURED FINANCE

Lux S.V.'s are often chosen as the cross-border structured financing vehicles, establishing Luxembourg as a leading hub for securitization both in Europe and globally.[1] As of March 2025, there were over 1,586 active Lux S.V.'s operating under the Lux Securitization Law. In 2022, Luxembourg accounted for more than 28% of all Euro area Financial Vehicle Corporations, second only to Ireland, and ranked just behind Ireland and Italy in terms of securitized asset volumes.

The legal and regulatory framework in Luxembourg is both flexible and robust, having proven resilience through various market cycles going back over twenty years, when Luxembourg's securitization regime was first enacted. Issuers and their senior creditors may benefit from compliance with E.U. securitization requirements and the cost advantages offered by compartmentalization. Luxembourg's status as Europe's largest fund center has fostered a strong financial services industry, with deep expertise in securitization.[2]

The vast majority of these vehicles (approximately 95%) are structured as corporate entities (*i.e.*, as Luxembourg S.A.'s, S.A.R.L.'s, or S.C.A.'s) treated as Luxembourg tax resident companies, though benefitting from the Lux Securitization Law's tax efficient regime.[3] On the other hand, only around 5% are established as securitization funds that are tax transparent, often in the form of a Luxembourg Fiduciary Estate.[4]

Notably, most vehicles utilize a multicompartment structure, with many having between two and ten compartments, and some exceeding 500 compartments. It is also worth noting that 98% of Lux S.V.'s opt not to be subject to regulation in Luxembourg, whereas 2% or so of Lux S.V.'s are under regulation by Luxembourg's *Commission de Surveillance du Secteur Financier* ("C.S.S.F.). These supervised entities

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1. Securitization in Luxembourg, PwC Market Survey 2024 (in Cooperation with the Luxembourg Capital Markets Association ("PwC-LuxCMA 2024 Survey").
2. Luxembourg: The Global Fund Centre, Association of the Luxembourg Fund Industry, 2021.
3. PwC-LuxCMA 2024 Survey. In Luxembourg, the three forms of tax resident companies include the *Société Anonyme* ("S.A." or public company), the *Société à Responsibilité Limitée* ("S.A.R.L." or private company), and the *Société en Commandite par Actions* ("S.C.A." or Partnership Limited by Shares).
4. PwC-LuxCMA 2024 Survey. Lux S.V.'s can also be set-up as "Luxembourg securitization funds" in the form of a Fiduciary Estate. In this respect, the Fiduciary Estate ("*fiducie*") is similar to a Common Law trust. Under Luxembourg law, the Fiduciary Estate is a contractual arrangement pursuant to which the "Principal" (similar to a trust's settlor) confers the legal title ownership to a credit institution or regulated entity called the "*Fiduciaire*" (similar to a trustee) to act pursuant to the instructions of the Principal towards the beneficiaries of the Fiduciary Estate. The Lux Securitization Law allows the *Fiduciaire* to be an unregulated Luxembourg company (also often in the form of an S.A.R.L.) rather than a credit institution or regulated entity. The Lux Securitization Fund (as a Fiduciary Estate) is tax transparent and so provided the beneficiaries do not have contacts in Luxembourg (*e.g.*, resident, permanent establishment).

are typically those that issue financial instruments to the public on a continuous basis and involve tranching.[5]

As over 90% of Lux S.V.'s are established in the form a Luxembourg S.A.R.L., the analysis will focus on the application of the Luxembourg tax treatment for such forms of Lux S.V.'s. We briefly highlight that, should the Lux S.V. vehicle be in the form of the Fiduciary Estate, it is generally considered as tax transparent and so the actual application of the Hybrid Mismatch Rules (in particular the anti-financial instrument rule) as well as the I.L.R.'s should not be applicable.

As the name implies, a securitization vehicle is essentially used for the acquisition of income generating assets and the financing of such acquisition by the issuance of securities. The Lux Securitization Law provides for a very broad definition of "securities" which can be issued to its investors.

LUXEMBOURG S.V.'S IN THE FORM OF AN S.A.R.L. – OVERVIEW OF LUXEMBOURG TAX TREATMENT

The Lux S.V. in the form of an S.A.R.L. is considered from a Luxembourg tax point of view as a tax resident company subject to Luxembourg corporate income tax at an aggregate rate of 23.87%.[6] In addition, the investment made by the investors through the subscription of securities issued by the securitization vehicle must be linked/indexed to the assets funded thanks to their investment.

"As the name implies, a securitization vehicle is essentially used for the acquisition of income generating assets and the financing of such acquisition by the issuance of securities."

However, the Luxembourg Income Tax Law ("L.I.T.L.") provides that all payments made to investors and all other types of creditors ("Investor Payments") are characterized, for Luxembourg tax purposes, as deductible expenses. As a result, these payments benefit from a deduction from the Luxembourg corporate tax base of the Lux S.V.[7] As previously mentioned, the Lux Securitization Law provides a very broad definition of the types of financial instruments that a Lux S.V. can issue to its investors, which generate deductible "Investor Payments," such as preferred shares and P.P.L.'s.

Unlike other tax resident Luxembourg companies, the Lux Securitization Law removes the application of withholding tax on Investor Payments by characterizing all such Investor Payments as interest expenses for Luxembourg tax purposes.

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5 PwC-LuxCMA 2024 Survey. These supervised Lux S.V.'s are Securitization entities within the meaning of Article 2, point 2, of Regulation (EU) No 2017/2402 of the European Parliament and of the Council of 12 December 2017 creating a general framework for securitization and a specific framework for simple, transparent, and standardized securitizations, and amending Directives 2009/65/EC, 2009/138/EC, and 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012.

6 The Luxembourg aggregate income tax rate consists of Luxembourg corporate income tax at 16%, a surcharge for the unemployment fund of 7% on the corporate income tax charge, and municipal business tax of 6.75% (assuming Luxembourg City's rate).

7 L.I.T.L. Article 46.14 provides that expenses paid to investors and all other forms of creditors of a securitization company are considered as deductible business expenses (*les engagements assumés vis-à-vis des investisseurs et de tout autre créancier par une société de titrisation rentrent parmi les dépenses d'exploitation*).

Under Luxembourg tax law, interest payments are excluded from the application of withholding tax.[8]

ANTI-ABUSE RULES IMPACTING LUX S.V.'S

Hybrid Mismatch Rules Impact on the Lux S.V.

As discussed above, the Lux S.V.'s Investor Payments are tax deductible under the Lux Securitization Law due to their automatic characterization as interest expenses. This invariably result in outcomes that normally trigger the Hybrid Mismatch Rules – particularly involving the anti-hybrid rules aimed at financial instruments discussed in more detail below. As mentioned earlier, it is not uncommon for Lux S.V.'s to be P.P.L.'s or even classes of shares with dividend rights, which include a provision entitling the investor to a *pro-rata* percentage of the Lux S.V.'s profits. As a result, such characterization could lead to such deductible "interest expense" from the Luxembourg tax perspective that could be treated as tax exempt dividends in the investor's jurisdiction, as would occur under a participation exemption that does not tax dividends received. This would seem at first glance to be an ideal mismatch scenario with a deductible dividend on the Luxembourg side of the equation and similarly risk of exemption in the investor's jurisdiction. However, as discussed further below, the O.E.C.D. addresses this issue in its B.E.P.S. Report which enables the Lux S.V. to maintain its tax neutrality.[9]

The E.U. Anti-Tax Avoidance Directive II ("A.T.A.D. II") rules aim to prevent tax benefits, such as an interest deduction claimed through Lux S.V.'s, from being obtained under a variety of circumstances involving transactions between Associated Enterprises[10]

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[8] L.I.T.L. Articles 97.1(5) provides that interest expense is a type of income from capital and Article 97.6. specifically provides clarification that "distributions and other products allocated to investors and other creditors of a securitization entity constitute income from capital within the meaning of paragraph 1, number 5 of this article" (*Les distributions et autres produits alloués aux investisseurs et autres créanciers d'un organisme de titrisation constituent des revenus provenant de capitaux mobiliers au sens de l'alinéa 1er numéro 5 du présent article*). L.I.T.L. Article 146 lists the types of income from capital subject to withholding tax and does not specifically enumerate interest expenses as defined in L.I.T.L. Article 97.1(5).

[9] O.E.C.D.'s Final Report on B.E.P.S. Action 2 on Hybrid Mismatches, 2015.

[10] As detailed in LITL Section 168ter(18) "Associated Enterprise" is generally defined as provided for in the A.T.A.D I & II Directives and includes the following: (i) an entity or individual owning directly or indirectly 50% (for a hybrid entity) or 25% (for a hybrid instrument) of votes, capital, and profits of a taxpayer (and vice versa); (ii) an entity forming part of the same consolidated financial group; (iii) an enterprise having a noticeable influence on management of a taxpayer (and vice versa); or (iv) an individual or entity "acting together" with another individual or entity in respect of the voting rights or capital ownership of an entity, should be considered as holding a participation in all of the aggregated voting rights or capital ownership of that entity that are held by the other individual or entity. If the aggregated ownership or rights is above the 25% (for hybrid instruments) or 50% (for hybrid entities), these persons or entities acting together can be in scope of the hybrid mismatch, even if individually they would not make the threshold. Two persons should be treated as acting together in respect of ownership or control of any voting rights or equity interests if, *inter alia*: (i) one person regularly acts in accordance with the wishes of the other person in respect of ownership or control of such rights or interests, (ii) they have entered into an arrangement in respect of ownership or control of any such rights or interests; or (iii) the ownership or control of any such rights or interests are managed by the same person or group of persons. For Luxembourg investment funds, investors holding less than 10% of capital or voting rights in the fund are assumed not to be acting together (unless proven otherwise).

that use, *inter alia*, hybrid entities or hybrid financial instruments ("Hybrid Mismatch Rules").[11] A hybrid entity is generally considered tax transparent in one jurisdiction but tax opaque in another. To illustrate, Country A considers the entity a corporation, but Country B considers the same entity a transparent partnership. A hybrid instrument is generally considered equity in one jurisdiction but debt in another. To illustrate, Country A considers the instrument debt giving rise to a taxable deduction, but Country B considers the same payment a dividend and exempts it from tax. The A.T.A.D. II anti-hybrid rules focus on shutting down hybrid mismatch outcomes, where for example, an item of income is deductible in one jurisdiction but not included as taxable income in any other jurisdiction ("deduction / no inclusion" or "D/NI") or when there is a double deduction ("D/D"). Luxembourg has implemented A.T.A.D. II's Hybrid Mismatch Rules in 2020.

Specifically, Hybrid Mismatch Rules include the following categories, which could most often apply to Lux S.V.'s:[12]

- **Hybrid Instrument:** A hybrid mismatch involving a hybrid instrument between "associated enterprises"
- **Structured Arrangement:** A "structured arrangement," broadly defined as an arrangement involving a hybrid mismatch, where the mismatch is priced into the terms of the arrangement, or an arrangement that has been designed to produce a hybrid mismatch

Policy Impacting Hybrid Financial Instruments and Lux S.V.'s

It is important to highlight that the E.U. Council has taken the position that the interpretation of the A.T.A.D. Directives should be based on the "final reports on the O.E.C.D. Action Items against B.E.P.S." and that the E.U.'s anti-hybrid rules should also be "consistent with O.E.C.D. B.E.P.S. conclusions."[13] Furthermore, the preamble to A.T.A.D. II makes clear the following rule of application:

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[11] European Council Directive 2017(952 of 29 May 2017 ("A.T.A.D. II Directive"), amending European Council Directive 2016/1164 as Regards Hybrid Mismatches with Third Countries ("A.T.A.D. II").

[12] Other anti-hybrid rules which are described in L.I.T.L. Article 168ter but not elaborated on in this article include: (a) reverse hybrid mismatch: a hybrid mismatch resulting from a payment to or from a hybrid entity to an associated enterprise; (b) dual residency: a situation of dual residency (*i.e.* being subject to tax in two or more jurisdictions); (c) no tax residency: a situation where the entity is not tax resident in any jurisdiction; and (d) Imported hybrid mismatches: occurs when a taxpayer in one country (Country A) claims a tax benefit (such as a deduction) as a result of a hybrid mismatch (*e.g.*, D/NI or DD) that actually takes place between two other countries (Countries B and C) and the benefit is "imported" into Country A because the taxpayer is connected, directly or indirectly, to the arrangement in Countries B and C. Additionally, there is the reverse entity hybrid under L.I.T.L. Article 168quater that is only applicable to Luxembourg tax transparent entities. It should not impact Lux S.V.'s in corporate form as discussed in this Article.

[13] E.U. Council Directive 12 July 2016 (2016/1164) laying down rules against tax avoidance practices that directly affect the functioning of the internal market ("A.T.A.D. I"), preamble, paragraph 2.

> Member States should use the applicable explanations and examples in the O.E.C.D. B.E.P.S. report on Action 2 as a source of illustration or interpretation to the extent that they are consistent with the provisions of this Directive and with European Union law.[14]

In the O.E.C.D.'s Final Report on B.E.P.S. Action 2 on Hybrid Mismatches ("O.E.C.D. B.E.P.S. Action 2 Final Report") for Recommendation 1.5, the O.E.C.D. specifically addressed the situation where investment vehicle regimes, including R.E.I.T.'s and S.V.'s, are allowed to have tax deductible dividend payments because of a tax policy of preserving the tax neutrality of both the payer and payee. This report specifically cites the following:

> Although the payment of a deductible dividend is likely to give rise to a mismatch in tax outcomes, such a payment will not generally give rise to a hybrid mismatch under Recommendation 1 provided any resulting mismatch will be attributable to the payer's tax status rather than the ordinary tax treatment of dividends under the laws of that jurisdiction.[15]
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> Accordingly, the exception applies where the regulatory and tax framework in the establishment jurisdiction has the effect that the financial instruments issued by the investment vehicle will result in all or substantially all of the income of the vehicle being paid and distributed to holders within a reasonable period of time and where the tax policy of the establishment jurisdiction is that such payments will be subject to tax in the hands of investors. Recommendation 1.5 specifically notes that the defensive rule in Recommendation 1.1(b) should continue to apply to such payments on receipt.[16]

The O.E.C.D. Final Report even provides specifically in Example 1.10, that if a "deductible dividend" occurs due to the tax status of the payer and not due the specific terms and conditions of the hybrid instrument, then even if this would otherwise result in a "D/NI" hybrid mismatch, the hybrid mismatch rule should not apply. The O.E.C.D. Final Report states, that in such cases, it is the responsibility of the payee jurisdiction to enact a defensive rule under Recommendation 2.1. (*i.e.*, tax an otherwise deductible dividend). However, whether or not the payee jurisdiction has enacted a rule for Recommendation 2.1 should not impact the deductibility of the dividend payment in such cases (*i.e.*, due to the tax status).

As mentioned above pursuant to the O.E.C.D. B.E.P.S. Report, the special tax status of the Lux S.V., benefitting from the Lux Securitization Law, is what enables the tax deductibility of these Investor Payments (whether P.P.L., preferred share, or other similar instrument with strong equity-like characteristics) and not due to the terms and conditions of the instrument itself. Going back to our example above,

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14 AT.A.D. II, Preamble, paragraph 28.

15 O.E.C.D. Action 2 Final Report, Paragraph 100.

16 *Id.*, Paragraph 101.

dividends paid by a Lux S.V. which are deducted for Luxembourg tax purposes might be considered to be equity in another jurisdiction and thus result in a "D/NI" outcome. However, because the tax deduction would be a result of the "tax status" rather than the terms of the financial instrument, this mismatch should be outside the scope of the hybrid mismatch rules per O.E.C.D. Policy and the E.U.'s deference to such policy recommendations. Accordingly, Lux S.V.'s in most cases should be able to navigate successfully a D/NI outcome based on this policy.

Structured Arrangements

Generally speaking, Lux S.V.'s should fall outside the scope of structured arrangements. A key requirement for an arrangement to be classified as a "structured arrangement" and thus trigger this anti-abuse rule is the presence of a hybrid mismatch that is either intentionally priced into the terms of the arrangement or where the arrangement has been designed to produce a hybrid mismatch outcome. In the absence of these elements, Lux S.V.'s would typically not be considered structured arrangements for the purposes of the anti-abuse rules.

In addition, the Luxembourg State Council stated the following in its opinion to the draft Luxembourg law implementing A.T.A.D. II:

> * * * if a Luxembourg company issues a financial instrument on the market without knowing at the time of issuance who the subscribers will be and without having deliberately drawn up the terms of that financial instrument with a view to actively approaching investors for whom that instrument will be the source of a hybrid mismatch, the State Council considers that there can be no question of a structured arrangement.[17]

"Generally speaking, Lux S.V.'s should fall outside the scope of structured arrangements."

As discussed above, Lux S.V.'s are chosen in light of the various legal and regulatory reasons, including the significant legal and regulatory benefits, as well as the policy objective of creating a tax neutral vehicle for cross-border structured finance. Given that all securities owed to investors are already structured to enable tax deductibility, such abusive scenarios as described by the Luxembourg State Council should generally fall outside the scope of the Lux S.V. and their approach to investors.

INTEREST LIMITATION RULES ("I.L.R.'S"): POTENTIAL BRUTAL APPLICATION & EXEMPTIONS AVAILABLE TO LUX S.V.'S

Overview of the I.L.R.'s in Luxembourg

Luxembourg's I.L.R.'s were introduced as part of the implementation of A.T.A.D. I, effective from January 1, 2019. The I.L.R.'s are designed to limit the deductibility of

[17] Opinion of the State Council (*Avis du Conseil d'Etat*), 10 December 2019.

excess “exceeding borrowing costs” (“E.B.C.’s”) for corporate taxpayers, thereby preventing base erosion through excessive interest deductions.[18]

The I.L.R.’s provide that the deduction of E.B.C.’s of a taxpayer is limited to 30% of its taxable E.B.I.T.D.A. (earnings before interest, tax, depreciation and amortization) or €3.0 million, whichever is higher. The E.B.C.’s correspond to the amount by which the deductible borrowing costs of a taxpayer exceeds taxable interest income and other economically equivalent taxable revenues accrued.[19]

Consequently, if a Lux S.V. receives interest income and equivalent taxable revenues that equal or exceed its tax-deductible borrowing costs, the Lux S.V. will have no E.B.C. and will therefore not be impacted by the E.B.C. disallowance rules. However, if (i) the Lux S.V. is set up to receive other types of income such as dividends or other returns on equity, royalties, lease payments, or any other type of income not qualifying as interest or its economic equivalent and (ii) the E.B.C.’s exceed €3.0 million, then up to 70% of its revenue would be taxed. To put this in perspective, if the I.L.R.’s were to hit with full force and fury, the Lux S.V. would end-up with an

18 L.I.T.L. Article 168bis. The Luxembourg law of 21 December 2018 implemented the I.L.R.’s of A.T.A.D. 1. Borrowing costs are defined as interest expenses on all forms of debt (to both related and unrelated parties), other costs economically equivalent to interest and expenses incurred in connection with the raising of finance, including, without being limited to (non-exhaustive list): payments under profit participating loans, imputed interest on instruments such as convertible bonds and zero coupon bonds, amounts under alternative financing arrangements (*e.g.*, 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 connected with the raising of finance, guarantee fees for financing arrangements, and arrangement fees and similar costs related to the borrowing of funds.

19 In practice, this means that E.B.C.’s that do not exceed € 3.0 million annually are fully tax deductible in the hands of a taxpayer, irrespective of any other element. However, where E.B.C.’s exceed €3.0 million annually, the overall deductible amount is to be computed based on the Lux S.V.’s taxable E.B.I.T.D.A. The I.L.R.’s do not define the notion of taxable interest income and other economically equivalent taxable revenues. However, a tax circular published by the Luxembourg tax authorities on 25 mars 2022 (n°168bis/1) confirms that this concept should be interpreted consistently and symmetrically with the notion of borrowing costs. From this perspective, amounts that are not considered as borrowing costs at the level of the borrower are in principle not to be considered as interest income and other economically equivalent taxable revenues. Please note that the above-mentioned tax circular has not yet clarified whether a gain on debt investments (*e.g.* nonperforming loans) should be considered as “other economically equivalent income” for the purpose of the I.L.R.’s. Such classification may depend on the accounting treatment of the gain and on the application of the economic approach concept under which the gain remunerating the risk taken by the creditor could be seen as economically equivalent to an interest payment for the purpose of the I.L.R.’s. The same circular also provides that: (1) only foreign exchange gains or losses relating to the interest of a debt are included in the definition of borrowing costs (foreign exchange gains and losses arising from the principal amount are not taken into account) and (2) deduction for impairment of loan receivables does not trigger any borrowing costs for the creditor.

effective Luxembourg corporate income tax rate of 16.71% and that would hardly be the cherished tax neutral vehicle sought after (*i.e.*, 70% of E.B.I.T.A. x Luxembourg corporate income tax at the aggregate rate of 23.87%).

However, Luxembourg I.L.R.'s provides two exemptions that could be applicable to Lux S.V.'s in particular, which are the stand-alone entity exception ("Stand Alone Entity Exception") and the single company worldwide group exception ("S.C.W.G. Exception"). These are discussed below.

We also highlight here that the vast majority of Lux S.V.'s are set up as so-called orphan structures in order to achieve bankruptcy remoteness. The most common arrangement for these orphan structures would be the establishment of a Dutch *stichting* which would hold 100% of the common shares of the Lux S.V. (often referred to as an "Orphan Structure") and the Lux S.V. would then acquire its asset portfolio with funds obtained through the issuance of P.P.L.'s or preferred shares (or a variety of their financial instruments) to a pool of investors. These profit linked securities would give rise to Investor Payments and benefit from the tax deductibility afforded by the Lux Securitization Law as described above.

We briefly also mention that the I.L.R.'s contain a comprehensive list of exceptions to the I.L.R.'s (*e.g.*, U.C.I.T.'s, alternative investment funds, insurance companies, and retirement pensions funds) but these are generally not applicable to a typical Orphan Structure involving an unregulated Lux S.V.[20] It is also worth highlighting that one of these exceptions include E.U. Regulated Luxembourg Securitization Vehicles. Note however that the European Commission ("E.C.") has warned Luxembourg (and Portugal) that such exception is not consistent with E.U. Policy on the I.L.R.'s. Nonetheless, the exception remains in the Luxembourg Tax Code despite a lingering 2022 draft tax law calling for its abolition.[21]

Stand Alone Entity Exception

The Stand Alone Entity Exception could be applicable to a Lux S.V. if it cumulatively meets three conditions:

- The Lux S.V. is not part of a consolidated group for financial accounting purposes.
- The Lux S.V. has no Associated Enterprises, including both any entity and any individual that is recognized as being an associated enterprise.
- The Lux S.V. has no permanent establishment ("P.E.") located in a jurisdiction other than Luxembourg.

[20] L.I.T.L. Article 168bis (1)6 under the definition of financial undertakings.

[21] On May 14, 2020, the European Commission sent formal notice letters to advise Luxembourg and Portugal to remove the exemptions from interest limitation rules currently available to certain securitization vehicles ("S.V.'s"), claiming that the respective provisions of applicable domestic legislation go beyond the allowed exemptions under Article 4 of the A.T.A.D. On March 9, 2022, the Luxembourg Ministry of Finance published draft law No.7974 proposing to abolish this exception. However, as of the writing of this article, the exception for Luxembourg E.U. regulated Lux S.V.'s remains in the Lux Tax Law (See L.I.T.L. Section 168bis(1)7.j).

Consequently, a Luxembourg company can only benefit from the standalone entity exception if it is held by shareholders holding directly or indirectly a participation of less than 25% in terms of voting rights, capital ownership, and profit entitlement.[22]

We also highlight that the prevailing interpretation of the Stand-Alone Entity Exception includes the position that "Orphan Structures" should be excluded from benefitting from this exception. The principal source of authority for this is the 2018 Opinion of the Luxembourg Chamber of Commerce on A.T.A.D. I, which concluded a Dutch *stichting* owning 100% of the common shares of the Lux S.V. is an Associated Enterprise. Consequently, the Stand-Alone Entity exception is inapplicable.[23]

S.C.W.G. Exception to the I.L.R.'s

As of January 1, 2025, Luxembourg tax law provides an exception to the application of the I.L.R.'s for taxpayers qualifying as S.C.W.G.'s. The preliminary requirements to qualify for the S.C.W.G. Exception are as follows:

- The Luxembourg entity is not part of a group which files consolidated accounts.
- The Luxembourg entity is not a taxpayer which does not have an associated enterprise or a permanent establishment outside of Luxembourg.[24]

In most cases, both of these conditions are likely to be fulfilled for the relevant Lux S.V. typically held within the Orphan Structure described above. First, the Lux S.V. in the Orphan Structure likely does not prepare consolidated accounts, nor should it be anticipated to be included in any consolidated accounts. In the Orphan Structure, the Dutch *stichting* should be considered as an Associated Enterprise, thereby fulfilling the second condition, as it would normally own 100% of both the capital and voting rights of the Lux S.V., which is well above the Associated Enterprise thresholds which requires of at least 25% of the voting, capital, or profit rights. Additionally, the Dutch *stichting* is located outside of Luxembourg, in the Netherlands.

Additionally, it is required that the Lux S.V.'s ratio of equity to total assets is equal to or greater than the equity to total asset ratio of the group.[25] In the typical Orphan Structure, the "group" should thus consist of the *stichting* and its wholly owned Lux S.V. The investors normally being third parties should not be taken into consideration. As such, the Dutch *stichting* and the Lux S.V. would be the only two entities for purposes of applying this comparative net asset ratio. However, when Lux S.V.'s are utilized within investment groups, additional analysis under the Associated Enterprise rules should be conducted to verify any potential risk of the investors possibly

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22 L.I.T.L. Article 168bis(1)6 and (8)a.

23 Opinion of the Luxembourg Chamber of Commerce (*Avis de la Chambre de Commerce*) on draft law number 7318, section 1.b

24 L.I.T.L. Article 168bis(9). It is also worth highlighting that Ireland has had a similar provision to the S.C.W.G. in its enactment of A.T.A.D.'s I.L.R. in the Irish Finance Act of 2021. See also Office of the Revenue Commissioners Irish Tax and Customs Publication "Guidance on Interest Limitation Rule Part 35D-01-01." In comparison to the receipt by Luxembourg and Portugal negative letters from the E.C. on the exception for E.U. Regulated S.V.'s, Ireland has not received any negative feedback to its S.C.W.G. exception as of the date of publication of this article.

25 *Id.*

qualifying as Associated Enterprises for purposes of applying the comparative equity-to-total assets ratio analysis.

Under the Orphan Structure, the net equity-to-asset ratio should also be fulfilled, provided that the Dutch *stichting* only holds the common shares of the Lux S.V. and Lux S.V. is not anticipated take any debt from the Dutch *stichting* (*i.e.*, only equity and zero debt issued between the Lux S.V. the stichting).

"Lux S.V.'s should remain a popular choice for structured finance vehicles."

In addition to the above requirements, the Lux S.V. must notify the Luxembourg Tax Authority, which as of the writing of this article, would simply be ticking the box on the Luxembourg corporate income tax return.[26]

The application of the S.C.W.G.'s Exception remains subject to Luxembourg's General Anti-Abuse Rule, particularly if there were any artificial steps applied with an aim to fulfilling the equity-to-total asset ratios mentioned above. We highlight that the Orphan Structure is widely implemented among existing Lux S.V. structures and benefits from a well-established and credible business purpose of obtaining bankruptcy remoteness. As such, Orphan Structures aiming to come within the S.C.W.G.'s Exception should not be at risk under the G.A.A.R.[27]

CONCLUSION

The world of cross-border structured finance seems to be growing. The amount of anti-abuse rules seems perpetually on the rise. Nonetheless, as illustrated in this article, Lux S.V.'s should be able to navigate through two or more of potentially applicable anti-abuse rules in effect in the E.U. For this reason, Lux S.V.'s should remain a popular choice for structured finance vehicles.

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26 *Id.* As of the writing of this article, it is expected that the Luxembourg Corporate Income Tax Return (Form 500) will simply have a line where the Lux S.V. can answer "yes" that it is availing itself of the S.C.W.G. Exception.

27 *Id.*