Luxembourg: Guidance on Application of Transfer Pricing Rules to Companies Regarding Intra-Group Financing Transactions

The Luxembourg tax authorities today published a transfer pricing circular aiming at clarifying the tax treatment of companies principally regarding intra-group financing transactions. *Circulaire du directeur des contributions L.I.R. n°164/2 du 28 janvier 2011.*

KPMG Observation

For Luxembourg taxpayers, the publication of this circular is viewed as a significant step forward with respect to the application of transfer pricing principles. To date—except for specific provisions in Luxembourg's income tax law and general tax law—no transfer pricing rules have been formalized, until now.

Summary

The circular refers to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the OECD Guidelines) for the application of transfer pricing principles to multinational groups investing through Luxembourg and performing an intra-group financing activity within the Luxembourg territory.

The circular also provides clear rules that may assist multinational groups provide evidence of the arm's length character of their Luxembourg financing transactions.

Scope of Application and Definitions

The scope of the circular applies to all entities principally realizing intra-group financing transactions. As such, "holding activities" are outside of the scope of this circular.

The circular defines very broadly "intra-group financing transactions" as any activity consisting of the granting of loans or advancing of funds to associated enterprises, including refinancing by instruments such as public issuances, private loans, fund advances or bank loans.

The definition of "associated enterprises" in the circular is based on the OECD Guidelines and Article 9 of the OECD Model Tax Convention, and is any direct or indirect participation in the sense of management, control, or capital that will lead to the qualification of associated enterprise.

KPMG Observation

Considering that the Luxembourg market is largely used to locate intermediary financing activities, it is anticipated that the circular will apply to a significant number of Luxembourg taxpayers and transactions.

General Rules

The application of the arm's length principle, as defined in the OECD Guidelines and in Article 9 of the OECD Model Tax Convention,* is required for all intra-group services (including intra-group financing transactions) performed by a Luxembourg entity.

* Where “conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.”

The circular also provides general guidance as to how to apply the arm's length principle—one that is fully in line with the OECD Guidelines—and highlights the importance of performing comparability analysis.

KPMG Observation

This aspect of the circular is viewed as being a positive development for multinational groups, since most transfer pricing laws of the OECD Member States are influenced by the OECD Guidelines.

Guidance to Determine the Arm's Length Price: Comparability to the Financial Sector

The circular compares, to a certain extent, intra-group financing companies to independent financial institutions that are regulated in Luxembourg by the *Commission de Surveillance du Secteur Financier*.

Thus, the circular underscores the importance of determining arm's length prices used by intra-group financing companies in the same way as financial institutions usually do. This puts a strong emphasis on the analysis of risks supported by the company performing the intra-group financing transaction. In this regard, different factors will need to be taken into account—such as the solvency of the borrower, potential guarantees for specific financing transactions, the costs in relation to the financing transaction, or the actual value of the underlying assets.

The risk element is considered to be one of the main factors to be taken into consideration in determining arm's length remuneration of the intra-group financing transactions. This is fully in line with the current evolution of transfer pricing practices and, in particular with the 2010 OECD Guidelines.

Capital Requirements

In order to cover the risks supported, the circular details that the financing company must have sufficient equity in relation to the transaction.

Arm's Length Character of the Tested Transaction

The circular does not provide details on what elements are to be tested to confirm the arm's length character of an intra-group financing transaction.

KPMG Observation

Considering the specificities of the Luxembourg market, it is likely that transfer pricing studies performed to evidence the arm's length character of intra-group transactions will focus more on the magnitude of the margins to be realized by Luxembourg entities, rather than on the interest rates. In this respect, the risk profile of the entity itself (from an agent to an entrepreneur) will play a significant role in the level of margin that will be benchmarked.

Binding Information From the Tax Authorities

Beginning from the date of publication of the circular (28 January 2011), the Luxembourg tax authorities will give binding information only if:

- The company has a real presence in Luxembourg (and not only if it is considered to be a Luxembourg tax resident because it has been incorporated under the Luxembourg law).
- The company assumes the risks in relation with the financing activity.

The substance requirement will be deemed to be satisfied, based on analysis of the following elements

- The Luxembourg residence of the members of the board of directors' or managers' authorized to engage the entity—specifically, the majority of board members must be Luxembourg residents or, if non-Luxembourg residents, must be taxable for at least 50% of their income (as listed in the circular) in Luxembourg
- Adequate professional knowledge and competence of those members in view of the activity of the entity and qualified personnel
- The place of management of the entity being located in Luxembourg and not abroad
- The opening of a bank account in a Luxembourg resident bank or in a Luxembourg branch of a non-Luxembourg resident bank
- Compliance with all tax return filing obligations
- The fact that the entity is not considered as a tax resident of a foreign country
- The capital requirement as described above

KPMG Observation

The capital requirement in the circular is critical, since it may have consequences in situations when the taxpayer would request binding information from the Luxembourg tax authorities. Indeed, the

circular not merely indicates that capital must be adequate with respect to the functions performed, risks assumed, and assets owned, but it also refers to a capital requirement of at least 1% of the financing volume or €2 million as being generally adequate to the risks assumed by an intra-group financing entity.

Apart from specific requirements described below, if the above-mentioned level of capital contributed to the financing entity for the financing of its debt receivables is satisfied, the Luxembourg tax authorities may approve the financing structure.

Moreover, to attain certainty on the transfer prices of transactions of an intermediary financing company, the tax authorities will request certain information. In particular, the company will need to provide a transfer pricing report that is compliant with the OECD Guidelines, *i.e.*, comprising a functional and risk analysis followed by the choice of a method to be applied and an economic analysis of the transaction under review.

The binding information given by the Luxembourg tax authorities will be valid for five years (and renewable for a second five-year period) as long as the facts and circumstances of the case at hand remain unchanged.

The circular does not address the question of its application to existing intra-group financing companies and transactions when no transfer pricing study has been conducted before the publication of the circular. Moreover, the circular does not provide a de minimis rule below which no transfer pricing study would need to be performed

KPMG Observation

The circular provides basic guidance as to how to apply the arm's length principle to intra-group financing transactions of Luxembourg companies. It also highlights the growing importance of transfer pricing in the Luxembourg market. While there are some imprecise or unclear areas within the circular, these areas may be viewed as opportunities for Luxembourg taxpayers to comply even more with international standards (in particular the European Union and the OECD).