

# Flash News

## Luxembourg tax authorities issue guidance on transfer pricing

January 28, 2011

The recent focus by the Luxembourg tax authorities on transfer pricing has resulted in a transfer pricing Circular describing the tax treatment for entities that are mainly engaged in intra-group lending activities financed by borrowings.

On 28 January 2011, the Luxembourg tax authorities issued a Circular (L.I.R. n°164/2) clarifying the tax treatment for Luxembourg entities that are mainly engaged in intra-group lending activities financed by borrowings.

These guidelines are aimed at assisting the tax authorities and companies dealing with intra-group financing to determine their taxable result in Luxembourg in accordance with the international acceptable transfer pricing principles. The guidance comes as Luxembourg tax authorities follow a general trend

around the globe in the desire for increased transparency. The guidance issued will allow Luxembourg to strengthen its credibility in an international tax environment.

### Transfer pricing

Transfer pricing in the context of international taxation refers to the pricing of cross-border transactions between two related parties. Transactions between two related parties must be established at a price, generally referred to as

“arm’s length” price, which two unrelated parties in uncontrolled conditions would have negotiated.

Luxembourg Income Tax Law (hereafter “LITL”) makes reference to the arm’s length principle in Article 56 and Article 164 LITL. In the absence of detailed transfer pricing guidelines in Luxembourg, the transfer pricing guidelines issued by Organization for Economic Co-operation and Development (‘OECD’) are generally followed.

We have hereafter summarised the main points of the Circular.

### Scope of the Circular: which entities and transactions are involved?

The Circular’s provisions apply to all entities that are principally engaged in intra-group financing transactions. In this respect, the activities related to holding of participations are excluded from the lending activities. Intra-group financing transactions refer to a main activity consisting in the granting of loans or cash advances to related entities, refinanced by, e.g. public offerings, private loans, cash advances and bank loans.

For the application of this Circular, two enterprises are related if one of them participates

directly or indirectly in the other entity through either management, control, or capital; or in the case where the same persons participate direct or indirect in the management, control or in the capital of the other entity.

### General

For the determination of the transfer price between related parties, the internationally accepted arm’s length principle should be observed in respect of cross-border transactions. In this respect, reference is made to article 9 of the OECD Model Convention and the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations that provide guidance on how to establish an arm’s length price.

An intra-group service (that includes an intra-group financing transaction) has been rendered if, in a comparable circumstance, an independent party is willing to pay another independent party for such activity, or if they would have accepted to perform such services themselves. In the event an intra-group service has been rendered, an arm’s length remuneration has to be determined for such transaction.

To determine whether transactions with independent entities are comparable with the

transactions between related entities, a comparability analysis has to be performed. The comparability factors may include the characteristics of goods or services transferred, the functions that have been performed by the parties involved, contractual clauses, economic circumstances, and business strategies that are followed.

The remuneration of each entity to the transaction will be based on the functions performed, taking into account the assets utilised and risks born. To understand the activities performed by each of the entities that are engaged in the intra-group transactions, it is useful to understand the structure of the group as well as the way it is organised.

In view of paragraph 171 Abgabenordnung, all taxpayers should be able to justify their financial data at the moment of filing the tax return, which includes the transfer pricing of the transactions between related parties.

### Determination of the arm’s length compensation

The functions performed in relation to the intra-group financing transactions are, based

on this Circular, in principle comparable with the functions of independent entities that are subject to the regulatory requirements of the “Commission de Surveillance du Secteur Financier” (CSSF). The Circular subsequently considers that the remuneration of the intra-group financing transactions may therefore be based on the ones earned by financial companies (e.g. banks) providing financing.

Furthermore, a connection is made with financial institutions that perform a risk analysis vis-à-vis their borrowers and verifies whether there are any guarantees in relation to the transaction they may enter into. An analysis of the industry of the borrower allows the lender to evaluate the specific risk. Independent financing entities base the remuneration on their costs incurred including a profit margin, taking into account the credit worthiness of the borrower.

The credit risk can be determined based on the contractual conditions and the outcome of the risk analysis. In general, the remuneration is related to the borrowed amount or the assets utilised.

If a guarantee is provided in relation to the intra-group transaction, the credit worthiness of the borrower or an entity of the group may have to be

considered. To the extent the guarantee is made by the lender, the guarantee payment will generally be included in the remuneration to be received. To the extent the guarantee payment is made to an entity of the group, a guarantee payment will in principle have to be made. The Circular considers that this payment should be at a minimum the cost of the guarantor.

For the entities that are involved in on-lending activities, a risk analysis should in principle be made.

In respect of the intra-group financing transactions, there should be sufficient capital available at the level of the entity to assume the related risks. Based on the facts and circumstances of each individual case, the risks and the related appropriate capital have to be determined.

The Circular provides also for guidance in case a taxpayer wishes to obtain a written confirmation by the tax authorities on a particular interpretation or transfer pricing questions in relation to transactions treated by this circular letter.

## Substance

The tax administration is providing a binding written confirmation on pricing and interpretation questions for intra-group financing companies if the concerned entity has real substance in Luxembourg. A company engaged in intra-group financing activities will e.g. be considered having sufficient substance if all of the following requirements are met:

- A majority of the members of the board of directors, directors, or managers having the ability to act on behalf of the entity, are either Luxembourg residents, or non-residents with a professional activity in Luxembourg falling under the scope of article 10 LITL, 1 to 4, and who are liable to tax in Luxembourg for at least 50% of these total revenues. Where a person is part of the board, it has to have its headquarters as well as its central administration in Luxembourg.
- Members of the board, directors and managers, either living in Luxembourg or deriving at least 50% of their total revenues from Luxembourg as seen above (for individuals) or have its headquarters as well as its central administration in Luxembourg (in case of entities), need to have the required professional knowledge to fulfil

their duties correctly. Furthermore, they must have at least the capacity to act on behalf of the entity and to ensure the proper execution of all transactions. The entity must have qualified resources capable of executing and registering the executed transactions (either its own employees or outside personnel on the company's payroll). The entity needs to be able to monitor the work performed by such staff.

- Key decisions concerning the entity's management have to be taken in Luxembourg. In addition, for entities for which the Company Law requires the holding of general meetings, at least one general meeting per year has to be held at the place indicated in the articles of incorporation.

- The entity needs to have at least a bank account in its own name either at a financial institution established in Luxembourg, or at a Luxembourg branch of a financial institution registered outside Luxembourg.

- Upon submission of an application that is binding upon the tax administration, the entity must have met all the requirements related to the filing of tax returns, i.e. returns related to taxes for which the assessment and collection

responsibilities fall to the tax administration.

- The entity should not be considered a tax residence in another State.
- The entity's own capital should be appropriate with regards to the functions performed (taking into account assets used and risks assumed).

### Equity at risk

In relation to the intra-group lending transactions financed by borrowings, it is considered that the entity takes a credit risk with a minimum of 1.0% of equity (nominal value) or EUR 2.000.000 to assume the related risks. The entity performing this activity should bear a real risk in this respect.

### Request for confirmation by tax authorities

Based on the facts and circumstances of each individual case, the following documentation will at least be required when requesting for confirmation from the authorities:

1. Information of taxpayer filing the request (name, domicile, file number, if available);
2. Detailed description of the transactions, arrangements

or contemplated legal acts covered by the request;

3. The other states to which the transactions or arrangements relates;
4. A presentation of the legal structure of the group, including information concerning the economic beneficial owner of the required capital;
5. The fiscal years for which the confirmation is requested;
6. A transfer pricing study respecting the principles as laid down by the OECD, and a detailed description and application of the methodology, which for instance may include the results of the comparables and eventually the results;
7. A general description of the industry circumstances;
8. An analysis of all related tax matters in respect of the proposed methodology;
9. Ensure that all facts required to this confirmation are complete and represent the truth.

A confirmation issued by the authorities will be binding upon the authorities for a term which would depend on the facts and circumstances of each individual transaction. However, any confirmation should be limited to 5 years. After this initial period, the taxpayer can request for an

extension of the ATA under the same conditions for another period of 5 years.

## Contacts:

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