

# New transfer pricing disclosure requirements in the 2017 tax returns

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## In brief

The Luxembourg Tax Authorities (“LTA”) issued new disclosure requirements on transfer pricing - as part of the 2017 tax returns - allowing the LTA to ascertain whether Luxembourg taxpayers are engaged in intercompany transactions. Transfer pricing documentation may be requested, for a desktop review or preparation for a tax audit, to assess compliance with the arm’s length principle. These latest transfer pricing developments highlight an ongoing focus on transfer pricing by the LTA.

## In detail

The Form 500 concerning “Corporate income tax, municipal business and net worth tax return for resident Luxembourg based corporations” requires disclosing the following new information related to transfer pricing as from fiscal year 2017:

- Did the company engage into transactions with related parties (articles 56 and 56bis L.I.R. of the Luxembourg Income Tax Law (**LITL**))?<sup>1</sup>
- Did the company opt for the simplification measure stated in section 4 of the Circular of the Director of the tax administration L.I.R. 56/1 - 56bis/1 as of 27 December 2016?

The second question relates to companies that are engaged in intercompany lending financed by borrowings. The Circular of the Director of the tax administration L.I.R. 56/1 - 56bis/1 (the “**Circular**”) allows for a simplification measure whereby a taxpayer does not have to determine an arm’s length compensation, but can opt for a fixed “safe-harbour” compensation. Taxpayers applying this simplification measure are required to indicate this in their tax return.

### **Company engaged into intercompany transactions**

The reference to articles 56 and 56bis of the LITL makes the new disclosure requirements cover all types of intercompany transactions in which a taxpayer might be involved, including both cross-border and domestic transactions. Examples of transactions with related parties covered with these new disclosure requirements are:

- Intercompany funding (e.g. financing, guarantee, cashpooling, etc.);
- Profit allocation to permanent establishments;
- Cost sharing arrangements;
- Provision or reception of any type of service (e.g. asset management, custody, fund administration, IT, HR, accounting);

<sup>1</sup>Loi concernant l’impôt sur le revenu («**L.I.R.**»).

- Transfer of any type of goods (e.g. finished/semi-finished products, raw materials, inventory etc.);
- Any type of transactions concerning IP (such as, payment for R&D activities, IT platforms, transfer of IP ownership, licensing, etc.);
- In connection with business restructuring: transfers of (portfolio of) assets and/or liabilities or transfers of functions and/or risks; and
- Any other intercompany transactions in which the taxpayer is involved.

### ***Simplification measure for pure intermediary entities***

Section 4 of the Circular of the Director of the tax administration L.I.R. 56/1 - 56bis/1 as of 27 December 2016 provides for a simplification measure. This measure relates to companies meeting the substance requirements set out in paragraph 21 of section 3.1.1.3 of the same Circular and pursue a purely intermediary activity, granting loans or cash advances to related entities that are themselves financed by loans or cash advances granted by related entities.

For such entities the simplification measure consists in assuming that the compensation for their intermediary activity complies with the arm's length principle if they earn a minimum after tax return of 2% on financing assets. This percentage will be regularly reviewed by the tax authorities on the basis of relevant market analysis.

Taxpayers selecting this option shall now disclose this decision in the tax return. They might be also subject to exchange of information depending on whether the taxpayer meets the substance and/or equity requirements as laid down in the Circular.

### ***Luxembourg transfer pricing legislation – general overview***

In Luxembourg domestic law, the arm's length principle as set out in Article 9 of the OECD Model Tax Convention, is anchored in article 56 of LITL, which allows the LTA to perform adjustments on the reported profits if the transfer price differs from prices that would have been agreed between independent entities in comparable transactions carried out in the open market in comparable circumstances.

Transfer pricing has become more in focus since the change in the transfer pricing legislation that became effective on 1 January 2015. The 2015 transfer pricing legislation aligned the arm's length principle with the OECD Transfer Pricing Guidelines (article 56 LITL) and made the transfer pricing documentation mandatory for all intercompany transactions (a new subparagraph 3 in paragraph 171 of the general tax law was introduced). Further guidance can be found in the commentary to the aforementioned law, which refers to Chapter V of the OECD Transfer Pricing Guidelines as being the "directing principles relating to documentation".

Article 56bis LITL has entered into force as from 1 January 2017 containing the basic principles to be followed in conducting a transfer pricing analysis in addition to the existing transfer pricing documentation requirements. This article's main focus is on the comparability analysis while applying the arm's length principle, which in principle consists of two elements:

- Identification of commercial or financial relations between related parties and determination of economically significant conditions and circumstances, and
- Comparing the economically significant conditions and circumstances of the controlled transaction, precisely defined, with the conditions of comparable transactions between independent parties.

### ***When to consider transfer pricing?***

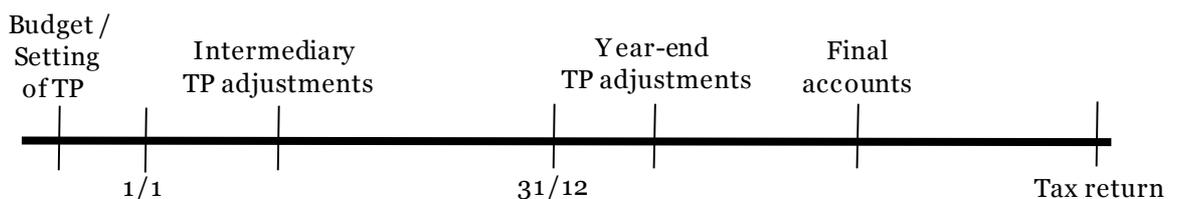
With the existing transfer pricing documentation requirements and the latest disclosure requirements on Luxembourg transfer pricing, the question is when to consider your transfer pricing?

In order to mitigate the risk of transfer pricing reassessments that can be imposed by tax authorities on both sides of the intercompany transaction, it is important to consider your transfer pricing proactively at an early stage. Generally, the transfer pricing should be set at the onset of a new intercompany transaction. Subsequently, it should be reconsidered on an annual basis, as follows:

- **Prior to the fiscal year:** transfer pricing would need to be reflected at the time of the preparation of the budget. Prices for interest rates, goods and services and the resulting profitability need to meet the arm’s length principle. This step also requires the integration of the policy into the financial manuals and accounting system set up;
- **During the fiscal year:** intercompany transactions would need to be monitored to ensure they are being priced in compliance with the arms’ length principle. If not, adjustments might be needed to be performed (so-called “intermediary adjustments”);
- **At closing of the year:** intercompany transactions should be tested to determine whether – despite the monitoring - a final transfer pricing adjustment (so-called “year-end adjustment”) should be made to ensure the pricing and resulting profitability comply with the arm’s length principle. The year-end adjustment should be made prior to finalizing the annual accounts;
- **After the year-end:** the taxpayer should document the intercompany transactions in a transfer pricing report;
- **When preparing the tax return:** a review is to be performed comparing the profit in the annual accounts to an arm’s length profit level. Mismatches may require an adjustment in the taxable income in the tax return.

Generally, after the tax return has been filed with the LTA, the supporting documentation that taxable income as reported is in line with the arm’s length principle should be available at the taxpayer’s site.

### ***Transfer Pricing Timeline – yearly phases reflecting when TP may be addressed***



### ***What’s next?***

With the implementation of the latest Luxembourg transfer pricing legislation, guidance, and disclosure requirements, the next likely step would be that the LTA increase the level of investigations and/or tax audits specifically on transfer pricing. We therefore recommend to follow a pro-active approach to understand your transfer pricing positions, take the necessary steps to ensure they meet the arm’s length principle and document them in an OECD Transfer Pricing guidelines compliant report.

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