

# Luxembourg strengthens its Transfer Pricing Rules

**Luxembourg reinforces its domestic Transfer Pricing rules as of 1 January 2017 by the enactment of:**

- (I) General guidelines applicable to Transfer Pricing analysis with the introduction of article 56bis in the Luxembourg income tax law (“LITL”)**
- (II) Circular LIR N°56/1 – 56bis/1 of 27 December 2016 applicable to intra-group financing activities.**

## EXECUTIVE SUMMARY

### Article 56bis LITL

Article 56bis LITL is a complement to article 56 LITL modified in 2015:

- Article 56 LITL introduced the general arm’s length principle based on article 9 of the OECD model tax treaty ;
- Article 56bis LITL introduces general guidelines applicable to transfer pricing analysis performed to determine the arm’s length price applicable to intra-group transactions.

The basic principle of article 56bis LITL is to determine how to perform the comparability analysis and chose the appropriate criteria to compare an intra-group transaction to relevant third-party transactions. Several criteria need to be retained such as (i) contractual terms, (ii) functions exercised and risks assumed, (iii) type of asset, service or engagement and (iv) economic circumstances (of the parties and the market).

Article 56bis LITL adds that the technical methods used to determine the arm’s length price must be consistent with the nature of the transactions and must enable to obtain the best possible determination of the applicable arm’s length price.

Such relevant methods should be chosen amongst the transfer pricing methods identified by the OECD.

### Circular n°56/1 – 56bis/1 of 27 December 2016

#### Content

The main rules are as follows:

- Advance Pricing Agreements obtained under Circular 164/2 of 28 January 2011 do no longer bind the Luxembourg tax authorities as of 1 January 2017.
- Transfer pricing analysis based on Circular 164/2 of 28 January 2011 LITL should be revised based on the rules set out in the new Circular.
- The arm’s length remuneration must be determined based on the guidelines set out in article 56bis LITL. Relevant comparables shall be based on a functional analysis (functions exercised, risk assumed, assets engaged) and an economic analysis (data on comparable third party transactions). The new Circular is based on the same principles than Circular 164/2 on that point but provides more technical details to be followed.
- The process to determine the arm’s length remuneration shall be transparent, systematic

and verifiable. The research of potential comparables to determine the arm's length remuneration shall be made by using all available sources of information at the date of implementation of the transaction.

- Substance requirements remain basically unchanged compared to the ones described in Circular 164/2 (where such requirements were already reinforced and precise).
- The minimum equity requirements must be based on the transfer pricing analysis and the ability of the Luxembourg financing company to assume the financial risk if it realizes. The threshold equity level of 1% of the loans granted or EUR 2 million is thus no more applicable.
- For companies performing functions comparable to regulated financing and treasury companies, the remuneration shall comprise a return on the equity of 10% after tax (percentage being regularly revised by the tax authorities).
- The Circular contains simplified rules: for companies acting as mere intermediaries and opting for the simplified regime, a minimum return of 2% after tax of the assets financed (percentage being regularly revised by the tax authorities) should be considered as compliant with the arm's length principle. There are constraints and risks associated to this option.
- Taxpayers can apply for the obtaining of a formal Advance Pricing Agreement binding on the Luxembourg direct tax authorities based on certain conditions and requirements.
- For taxpayers which do not opt for the filing of an Advance Pricing Agreement with the tax authorities, the latter can request that the transfer pricing analysis having been used to determine the prices of its intra-group financing

transactions are communicated to them upon request.

### ***Entry into force and actions required***

Circular n°56/1 – 56bis/1 enters into force as of 1 January 2017. It is however expected that taxpayers have until the end of 2017 to be compliant with the new Circular.

Advance Pricing Agreements filed before 31 December 2016 are no more binding on the Luxembourg direct tax authorities. Luxembourg companies willing to secure their arm's length prices shall apply for the obtaining of a new Advance Pricing Agreement.

Taxpayers which opt to not file an Advance Pricing Agreement shall review their transfer pricing policies and prepare the documentation enabling them to justify the intra-group prices applied which should be available upon request of the tax authorities. Preparing transfer pricing analysis compliant with the new Circular and revised OECD Guidelines are strongly recommended.

More detailed descriptions are included in the following pages.



**Clément & Avocats**  
LUXEMBOURG

*For more information, please contact:*

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Christophe Clément | Partner  
clement@cc-law.lu | +352 2837 1004 40

Olympe Alexandre | Tax Counsel  
alexandre@cc-law.lu | +352 2837 1004 42

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[www.cc-law.lu](http://www.cc-law.lu)

## **I – General guidelines on transfer pricing analysis: article 56bis LITL**

### ***General transfer pricing principle***

The Finance Bill for 2015 modified article 56 LITL to introduce a general transfer pricing principle within Luxembourg domestic tax laws. This article is inspired by article 9 of the OECD model and sets the principle whereby transactions taking place between related parties should comply with the arm's length principle otherwise their tax basis could be re-assessed.

Article 56bis LITL provides for practical requirements (based on the revised OECD Transfer Pricing Guidelines) on how a taxpayer should determine the fair market price applicable to intra-group transactions by providing guidelines applicable to the transfer pricing analysis.

### ***Scope***

The rules apply to any transfer of material or immaterial asset, provision of services and engagement which would be remunerated between third parties.

### ***Comparability analysis***

A Luxembourg company shall determine the arm's length price applicable to intra-group transactions by comparison with the conditions applicable to a comparable transaction between third parties.

The relevance of the comparability analysis is based on two pillars:

- Identification of the commercial or financial relationships between related parties and determination of the conditions and circumstances which are economically significant in order to delineate precisely the controlled transaction;
- Comparison between the conditions and circumstances economically significant of the controlled transaction, precisely delineated,

with comparable transactions between third parties.

More precisely, article 56bis LITL indicates that the conditions and circumstances economically significant to retain comparable transactions (or comparability factors) are the followings:

- 1- The contractual terms of the transaction;
- 2- The functions exercised by each party to the transaction taking into account (i) the assets used and (ii) the risks managed and assumed;
- 3- The features of the asset transferred, the service rendered and the engagement concluded;
- 4- The economic circumstances of the parties and of the market on which the parties exercise their activities;
- 5- The economic strategy followed by the parties.

### ***Choice of the method***

The choice of the technical methods to determine the arm's length price of a given transaction must:

- Take into account the comparability factors identified ;
- Be consistent with the nature of the controlled transaction precisely delineated;
- Correspond to the method which enables the best possible evaluation of the arm's length price applicable to the controlled transaction.

### ***Consequences and actions required***

Each Luxembourg company engaging transactions with related parties should be able to demonstrate to the tax authorities that the economic terms applicable to such controlled transactions are compliant with the arm's length principle and that it applied the guidelines provided for by article 56bis LITL and OECD Guidelines to determine the price applied between related parties.

## **II – Transfer Pricing rules applicable to intra-group financing: Circular LIR n°56/1 – 56bis/1**

### **A - Background: Circular 164/2 of 28 January 2011**

Until 31 December 2016, intra-group financing transactions are governed by Circular LIR 164/2 of 28 January 2011 (and 164/2bis) issued by the Luxembourg direct tax authorities.

The basic principles are that a Luxembourg company entering into intra-group financing activities must (i) have a real presence in Luxembourg and (ii) assume the risks linked to the granting of loans.

#### ***Real presence in Luxembourg***

All the following conditions must be complied with:

- The majority of the members of the board of directors, directors or managers, who have the authority to bind the group financing company are either Luxembourg residents, or non-residents who carry on a professional activity in Luxembourg falling under the scope of article 10 (1 to 4) LITL and who are liable to tax in Luxembourg on at least 50 percent of total income from such activities. Where a corporate entity is a member of the board of directors, its registered office and its central administration must be located in Luxembourg;
- Such members of the board of directors, directors or managers must have the professional knowledge required to exercise their functions and they must have at least the authority to bind the company and ensure that all transactions are properly executed;
- The group financing company must have qualified personnel capable of executing and recording all transactions (the qualified personnel may be the company's own employees or foreign personnel to the company) and the company must be capable of supervising the work performed by said personnel;

- Key decisions concerning the company's management must be taken in Luxembourg. In addition, companies for which Company Law requires the holding of general shareholders' meetings must hold in principle at least one general meeting per year at the place specified in the articles of association;
- The group financing company must have at least one bank account in its own name either at a credit institution established in Luxembourg or at a Luxembourg branch of a credit institution established outside Luxembourg;
- At the time of submission of an Advance Pricing Agreement, the company must have met all its filing requirements. This applies to returns relating to taxes assessed and collected by the direct tax authorities;
- The company should not be considered a tax resident of another jurisdiction;
- The company should maintain an adequate level of equity with regard to the functions performed (taking into account assets used and risks assumed).

#### ***Minimum equity requirements***

Circular 164/2 indicates that the adequate level of equity depends on the risks assumed and assets engaged but that in general, a group financing company is considered to assume the risks related to the granting of loans if its equity is at least equal to 1 percent of the nominal value of the loan(s) granted or EUR 2 million.

#### ***An arm's length remuneration***

The determination of the arm's length remuneration is notably based on:

- Comparability analysis;
- Functions assumed in the granting of the loans and the management of the loans;
- Risks assumed;
- Insolvency risks (linked to the debtor, the market, the activity);
- Liquidity risks and market risks.

## **B – Circular LIR n°56/1 – 56bis/1**

### ***Determination of the arm's length price***

The principle remains unchanged whereby each Luxembourg company must determine the arm's length price applicable to an intra-group financing activity based on the functions exercised, the risk assumed, the assets or means engaged and an economical analysis of data on comparable transactions. The Circular describes the circumstances to take into account to define the comparability analysis which are based on article 56bis LITL but more specifically focusing on intragroup financing activities such as:

- Determination of the role of the Luxembourg company within the group;
- Economic circumstances i.e. type of underlying asset financed (e.g. fixed asset, current assets, long term strategic financing, other);
- Functions exercised, assets used and risks assumed.
- Contractual terms.

### ***Functional analysis – Comparability analysis***

The principle consists in identifying precisely the activities, responsibilities and economic functions, assets used and risks assumed by the parties.

The Circular indicates that the functions and risk assumed are in principle comparable to the ones applicable to functions and risks assumed by entities under the control of the CSSF (the Luxembourg financial regulator) but also indicates that significant differences can be considered in the context of intra-group financing transactions.

The Circular provides some guidelines on the functions that can be assumed by Luxembourg companies engaged in intra-group financing transactions such as:

- Entering into the transaction :
  - (a) Commercialisation of the transaction (i.e. identification of clients, marketing of the product);
  - (b) Negotiation (i.e. negotiation of the terms of the agreement, evaluation of risks associated to the granting of the loans);
  - (c) Identification of the refinancing structure;
  - (d) Control of the compliance of the contractual commitments of the debtor before entering into the transaction (value of the securities; solvability analysis, etc..).
- Management of the transaction :
  - (a) administration of the financial transaction (meaning servicing of the debt);
  - (b) Follow-up of the credit-risk (periodical review of the securities and risk linked to the transactions);
  - (c) Management of the refinancing.

The Circular indicates that the identification of the assets used and the functions exercised are key to identify the risks associated to the transaction and the relevant comparables.

### ***Risk Analysis – Equity requirements***

The Circular indicates that the analysis shall evaluate on the basis of the particular circumstances of a transaction the specific risks associated to the financing transaction (based on the object of the credit, its maturity, the security package offered by the debtor, financial data of the debtor etc), the functions exercised linked to the assumption of such risks and which party within the group assumes such risks.

The Circular specifies that a financing company assumes the risk if it has the financial capacity to take the risk in charge and bear the financial consequences if the risk is realized. The financing capacity to take the risk in charge is defined as the access to the financing needed to (i) assume or avoid the risk, (ii) pay the functions to reduce

the risk and (iii) bear the consequences of the risk if the risk materializes.

The Circular then indicates that if the comparability analysis concludes that an intra-group financing company is comparable to a regulated financing company, its equity is sufficient to bear the financial consequences if the risk materializes to the extent that it has an equity compliant with the solvency criteria provided for by regulation n°575/2013 of the European Parliament and Council of 26 June 2013.

The Circular further indicates that if the comparability analysis concludes that the Luxembourg company engaged in intra-group financing activities has significant differences with such regulated companies (in terms of assets used and functions exercised), it has to determine the level of equity needed to assume the risk using other credit risks analysis methods based on data provided by professionals.

As a result, the 1% or EUR 2 million thresholds set forth by Circular 164/2 are no more applicable.

### ***Substance requirements***

The new Circular indicates the following criteria:

- The majority of the members of the board of directors, directors or managers, who have the authority to bind the group financing company are either Luxembourg residents, or non-residents who carry on a professional activity in Luxembourg falling under the scope of article 10 (1 to 4) LITL and who are liable to tax in Luxembourg on at least 50 percent of total income from such activities. Where a corporate entity is a member of the board of directors, its registered office and its central administration must be located in Luxembourg;
- The group financing company must have qualified personnel adapted to the needs of control of the transactions made. The company can outsource (against remuneration) the

functions which do not have a significant impact of the risks control. On this point, the new Circular diverges from Circular 164/2 LITL.

- Key decisions concerning the company's management must be taken in Luxembourg. In addition, companies for which Company Law requires the holding of general shareholders' meetings must hold in principle at least one general meeting per year at the place specified in the articles of association.
- The company should not be considered a tax resident of another jurisdiction.

Other substance requirements described in Circular 164/2 which are not mentioned in the new Circular will more likely than not remain applicable in practice.

### ***Arm's length remuneration***

The arm's length remuneration is the one that third parties would have agreed in comparable situations.

The process to identify the potential comparables must be transparent, systematic and verifiable.

The research of potential comparables must be done by using the sources of information available at the date of implementation of the financing transaction.

The Circular further indicates that for companies exercising functions similar to the ones exercised by regulated financing or treasury companies, a return on equity of 10% after tax is currently observed on the market and could thus be considered as being compliant with the arm's length principle (this percentage being regularly revised by the Luxembourg tax authorities).

### ***Simplified measure***

The Circular provides for a simplified process under the following conditions and constraints:

- The company must comply with the substance requirements set forth by the new Circular;

- The company exercises a mere intermediary activity and grants loans or makes advances to related parties refinanced by loans or advances granted by related parties (it should be sustained by a functional analysis);
- The company must communicate its option for the simplified regime in its tax return;
- The company remains subject to the exchange of information procedures applicable to the Luxembourg tax authorities;
- The company must earn a minimum return of 2% after tax of the assets financed.

Such simplified process may weaken the quality of beneficial owner of the company which is described in the Circular as having a mere intermediary role. Such mere intermediary activities are usually not sufficient to justify the quality of beneficial owner of interest received by such companies within the international tax context. The option for the simplified process should thus be carefully considered.

### ***Advance Pricing Agreements***

Advance Pricing Agreements can still be granted by the Luxembourg direct tax authorities, are valid for a period of 5 years and are binding on the Luxembourg tax authorities.

Any Advance Pricing Agreement application should contain the following information and documents:

1. Precise description of the taxpayer and the entities or branches parties to the transactions or arrangements being part of the application ;
2. Detailed description of all the intra-group financial transactions relating to the company and the arrangements or legal agreements referred to in the application;

3. Qualifications of the employees and description of their functions;
4. Indication of the jurisdictions concerned by the transactions or arrangements;
5. Presentation of the legal structure of the group, including information relating to the beneficial owner(s) of the equity of the applicant;
6. Tax years covered by the application;
7. A transfer pricing study compliant with the principles set out under the Circular and as recommended by the OECD in this respect and comprising notably:
  - the description of the computation of the capital/equity required to assume the risks;
  - the description of the group and the interdependence links between the functions exercised by the companies which are parties to the related/controlled transactions and the rest of the group as well as the description of the value creation (in large terms) within the group of the companies being parties to the transactions;
  - the precise delimitation of the transactions under analysis;
  - the complete list of the comparables which have been researched;
  - the matrix of the rejection of potential comparables, and the reasons of the rejection;
  - the final list of retained comparables on the basis of which the company has determined the arm's length remuneration applicable to the intra-group transactions under review;
  - a general description of the situation of the market;

- an examination of all the relevant accessory tax issues raised by the proposed methodology;
  - the list of the advance pricing agreements concluded in other jurisdictions in relation to the transactions under review;
  - the list of advance pricing agreements in relation to the companies under review which are in force at the date of submission of the application;
  - the projections of profit and loss accounts for the tax years covered by the application for the advance pricing agreement.
8. The insurance / declaration whereby the indications needed to the appreciation of the facts are comprehensive and in line with the reality.

#### ***Need for an Advance Pricing Agreement ?***

- Existing Advance Pricing Agreements confirmed by the Luxembourg tax authorities are no longer applicable and no more binding upon the Luxembourg tax authorities after 31 December 2016.
- Taxpayers can file an application to obtain a new binding Advance Pricing Agreement based on the conditions described in the Circular. An Advance Pricing Agreement, if obtained, is valid for 5 years. Advance Pricing Agreements are subject to the exchange of information procedures.
- Taxpayers which opt to not file an application for an Advance Pricing Agreement shall perform a transfer pricing analysis based on the guidelines of the Circular and have such analysis available upon request of the Luxembourg direct tax authorities.

- The non compliance with this requirement could trigger the impossibility to obtain certificates of residence from the Luxembourg direct tax authorities and difficulties to demonstrate its residence or quality of beneficial owner to foreign tax authorities. It also weakens the position regarding non compliant companies in the context of an exchange of information procedure (being initiated by foreign tax authorities or spontaneously initiated by the Luxembourg direct tax authorities).

#### **Actions needed**

Any company which has entered into an intra-group financing transaction shall assess its position towards the Circular and prepare a transfer pricing analysis which is acceptable for the Luxembourg direct tax authorities based on Circular 56/1-56bis/1 LITL and the revised OECD Transfer Pricing Guidelines and further decide to apply or not for a formal binding Advance Pricing Agreement.



**Clément & Avocats**  
LUXEMBOURG

*For more information, please contact:*

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Christophe Clément | Partner  
clement@cc-law.lu | +352 2837 1004 40

Olympe Alexandre | Tax Counsel  
alexandre@cc-law.lu | +352 2837 1004 42

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[www.cc-law.lu](http://www.cc-law.lu)

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