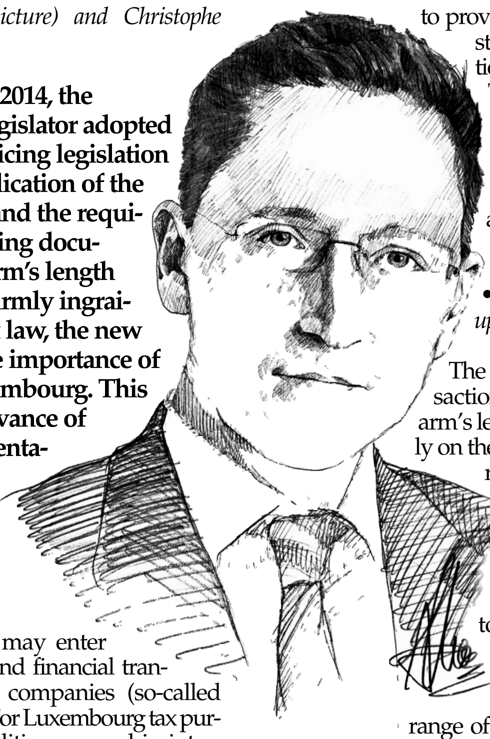
The Emerging Importance of Transfer Pricing Documentation in Luxembourg

*By Oliver R. HOOR (picture) and Christophe DARCHE, ATOZ**



On 19 December 2014, the Luxembourg legislator adopted new transfer pricing legislation that formalizes the application of the arm's length principle and the requirement for transfer pricing documentation. While the arm's length principle was already firmly ingrained in Luxembourg tax law, the new rules further elevate the importance of transfer pricing in Luxembourg. This article analyses the relevance of transfer pricing documentation and provides best practice recommendations.

I. Introduction

Luxembourg companies may enter into diverse commercial and financial transactions with associated companies (so-called "controlled transactions"). For Luxembourg tax purposes, the terms and conditions agreed in intragroup transactions have to adhere to the arm's length principle. Under the arm's length principle, transactions within a group are compared to similar transactions between unrelated entities to determine acceptable transfer prices.

As a member of the OECD, Luxembourg adheres to the organisation's "Transfer Pricing Guidelines for Multinationals and Tax Administrations" (the "OECD TP Guidelines") which reflect the consensus of OECD member countries towards the application of the arm's length principle as provided in Article 9 (1) of the OECD Model Tax Convention. Accordingly, transfer prices that are determined in accordance with the OECD TP Guidelines will be accepted by the Luxembourg tax authorities.

Although Luxembourg domestic tax law did not provide for specific transfer pricing rules or documentation requirements, transfer pricing has become increasingly important in recent years. In 2011, the Luxembourg tax authorities released two Circulars on the determination of the arm's length margin to be realized by Luxembourg finance companies.[1] The new transfer pricing legislation entered into force on 1 January 2015 and completes the existing transfer pricing rules and concepts found in Luxembourg. Importantly, the new version of Article 56 of the Luxembourg Income Tax Law ("LITL") does not only serve as a legal basis for upward adjustment but also for downward adjustments when a Luxembourg company receives an advantage from an associated enterprise.

II. Why is Transfer Pricing Documentation important?

1. Review of transfer pricing

A Luxembourg company's transfer prices are generally reviewed by the tax authorities as part of the tax assessment procedure.[2] They can also be reviewed during the course of a tax audit spanning several years.[3] Where a request for an APA is filed, the transfer pricing of a controlled transaction between related companies will be verified before the Luxembourg tax authorities decide on the case.[4] As a rule, the Luxembourg tax authorities are under a duty to investigate all the facts and circumstances of a tax case.[5] Conversely, the taxpayer is under a duty of co-operation with the tax authorities.[6] Both principles go hand in hand and complement each other.

2. The taxpayer's duty of co-operation

Article 171 of the General Tax Code is the basis for Luxembourg taxpayers' duty to cooperate with the tax authorities. According to this provision, taxpayers are under an obligation to evidence facts and provide information assuming the evidence is (i) available, (ii) reasonable for the taxpayer to have and (iii) relevant for clarification purposes. Thus, in accordance with Article 171 of the General Tax Code, the taxpayer merely has to obtain and to provide already existing documents, not to prepare special transfer pricing documentation. The new Article 171 (3) of the General Tax Code explicitly extends a taxpayer's duty of co-operation to transactions between associated enterprises although no specific transfer pricing documentation requirements are detailed therein. While the new provision is merely there for clarification purposes, it confirms that the Luxembourg authorities are relying more heavily on transfer pricing documentation.[7]

3. Burden of proof

Under Luxembourg tax law, the burden of proof is generally split between the taxpayer and the Luxembourg tax authorities. For facts and circumstances resulting in an increase in the taxpayer's taxable income, the burden of proof is on the Luxembourg tax authorities, whilst the taxpayer has to prove those facts and circumstances that entail a reduction in the taxable income.[8] Thus, with regard to the burden of proof in case of transfer pricing adjustments, it has to be distinguished between upward and downward adjustments.

• Burden of proof in case of upward adjustments

The onus to prove that transactions do not adhere to the arm's length principle is generally on the Luxembourg tax authorities. It is for the administration to verify whether transfer prices for goods and services transferred between group companies adhere to the arm's length criterion. If the tax authorities can prove that a transfer price is not within the range of arm's length prices, this raises a rebuttable presumption that the transaction does not comply with the arm's length principle.[9] Overall, the burden of proof for the non-arm's length character of intra-group transactions should be relatively low.[10]

Although the burden of proof is on the tax authorities, they may still reasonably oblige a Luxembourg company to provide consistent arguments about its transfer pricing.[11] In this regard, the company must take into consideration that the voluntary production of documents can significantly improve the persuasiveness of the company's approach to transfer pricing before the tax authorities.[12] If the taxpayer is unable to justify the arm's length character of intra-group transactions, the tax authorities may rely on the concept of hidden dividend distributions or the new Article 56 LITL to perform upward adjustments.[13]

• Burden of proof in case of downward adjustments

In case of hidden capital contributions and "downward adjustments" under Article 56 LITL, the fair market value of the advantage shifted to a Luxembourg company is deducted from the company's taxable income. It follows that the underlying facts and circumstances regarding the advantage to be shifted to a Luxembourg company should be evidenced by the taxpayer.[14] In certain circumstances, the Luxembourg tax authorities may reasonably require that the value of a hidden capital contribution or, respectively, the advantage that would result in a downward adjustment under Article 56 LITL is substantiated in a transfer pricing study.

III. The OECD Transfer Pricing Guidelines

As a member of the OECD, Luxembourg has approved the organisation's TP Guidelines which are frequently followed by the Luxembourg tax authorities.[15] A separate chapter of the OECD TP Guidelines assists taxpayers and tax administrations in identifying useful transfer pricing documentation for evidencing the arm's length character of controlled transactions.[16] The OECD TP Guidelines require that taxpayers should prepare or refer to written materials that could serve as documentation of the efforts undertaken to comply with the arm's length principle (general information, factors taken into account, selected method, and so on). The standard for documentation requirement should accord with the prudent business management principles.[17] Nevertheless, this chapter does not intend to impose a greater burden on taxpayers than is required by domestic rules.[18]

Minimum documentation requirements set out in the OECD TP Guidelines include:
- Group structure (including group and organisational charts, information on the legal and operating structure);
- Relevant transactions (including terms and conditions, functions performed, and risks assumed by the parties);
- Relevant legal documentation (including agreements, price lists, and information deriving from financial controlling); and
- Transfer pricing computations indicating compliance with the arm's length principle.[19]

These minimum requirements are in line with the duty of cooperation set out in Article 171 (1) of the General Tax Code which according to paragraph 3 is explicitly extended to transactions between associated enterprises. When requesting supporting transfer pricing documentation, tax authorities should balance the need for documentation against the cost and administrative burden to the taxpayer. Indeed, taxpayers should not be expected to incur disproportionately high costs and burdens to obtain documents from foreign associated enterprises or to engage in an exhaustive search for comparable data from uncontrolled transactions if the taxpayer reasonably believes either (i) that no comparable data exists or (ii) that the cost of locating the comparable data would be disproportionately high relative to the amounts at stake.[20] The documentation/cost balance should, however, be interpreted broadly; it is generally accepted that the preparation of transfer pricing documentation will involve costs. Finally, the Guidelines suggest that tax authorities should not require taxpayers to provide unavailable documentation or evidence so as to avoid wholly unreasonable requests.[21]

IV. What will the OECD BEPS Project Change?

The topic of transfer pricing documentation is high on the agenda of the OECD BEPS Project. The Report on BEPS Action 13 contains revised standards for transfer pricing documentation that are meant to replace the current version of Chapter V of the OECD Transfer Pricing Guidelines. According to this draft guidance, multinational enterprises (MNEs) would be requested to prepare a master file covering their global business operations and a local file in each country. In the master file MNEs would be required to provide tax administrations with high-level information regarding their global business operations and transfer pricing policies. In the local file MNEs would be required to provide more transactional transfer pricing documentation, identifying relevant related party transactions, the amounts involved in those transactions and the company's analysis of the related arm's length character of the transfer pricing.

In addition, a template for country-by-country reporting is contained in the Annex to draft Chapter V. The new template requires MNEs to report their income, earnings, taxes paid and accrued as well as certain measures of economic activity (for example, employment, capital and tangible assets in each tax jurisdiction) to the tax administrations of the countries where they operate. All of this will result in a significant compliance burden and cost to businesses. It remains to be seen how the new guidance will be implemented in Luxembourg and foreign tax law since the OECD TP Guidelines are as such not binding on taxpayers. While it has been expressly stated that the compliance burden and costs to businesses should be limited, it will be extremely burdensome and costly to implement the new transfer documentation on a global basis. As of today, MNEs do not have this information and will need to implement systems and processes that allow them to produce data on a comparable basis (given the differences under local GAAPs).

V. Best Practice Recommendations

Transfer pricing inevitably exerts pressure on taxpayers to find a balance between a comfortable level of security and the costs for the preparation of sound transfer pricing documentation. In practice, Luxembourg companies should screen major intragroup transactions in order to identify issues that could raise suspicion on the part of the Luxembourg tax authorities and assess the magnitude of related tax risks. Where the Luxembourg tax authorities can reasonably evidence that the transfer pricing of a controlled transaction does not adhere to the arm's length principle, it is for the taxpayer to disproof this rebuttable presumption.

However, transfer prices may be reviewed several years after a transaction takes place which makes it from a practical perspective increasingly difficult to trace back relevant facts and circumstances of the transaction as well as data on comparable transactions. This evidently inserts pressure on Luxembourg companies to develop appropriate transfer pricing policies for risk mitigation purposes amid an international tax environment that elevates transparency in tax matters to a new level. Sound transfer pricing documentation may further be necessary in order to justify the value of a hidden capital contribution or a downward adjustment under Article 56 of the LITL.[22] Last but not least, the Luxembourg tax authorities may require transfer pricing documentation when a Luxembourg company files a request for advance certainty in regard to the tax treatment of a particular transaction.

In the case of cross-border transactions, foreign tax authorities may be more demanding in terms of transfer pricing documentation than their domestic counterparts. In these circumstances, the Luxembourg tax authorities generally accept transfer pricing documentation prepared for foreign tax purposes as long as the documentation is based on the OECD TP Guidelines. Notably, transfer pricing policies cannot be disregarded after implementation (though such practice is widespread). Valuable transfer pricing documentation should regularly be reviewed and updated; particularly upon business restructurings and where new transactions are envisaged.

Transfer pricing documentation is definitely a key element in tax risk management. In the past, Luxembourg companies regularly filed advance tax clearance letters ("ATCs") and advance pricing agreements ("APAs") with the Luxembourg tax authorities. In ATCs the Luxembourg tax authorities provide advance certainty on their interpretation of Luxembourg tax and tax treaty tax law in a specific case, whereas in APAs the arm`s length nature of intra-group transactions is confirmed. However, there seems to be a shift in paradigm. On the one hand, the Luxembourg tax authorities are asking for increasingly more transfer pricing documentation (that provides for a certain comfort). On the other hand, the filing of requests for advance certainty became less attractive for a number of reasons including, in particular, LuxLeaks and the negative perception of ATCs and APAs in the public[23] and the new Luxembourg tax clearance practice applicable as from 1 January 2015.[24]

Therefore, in the current international tax environment, companies should integrate the documentation of transfer prices in their wider tax strategy and use it as a means to reflect the business rationale behind the corporate structure and intra-group transactions.

VI. Conclusion and outlook

It is not new that Luxembourg companies have to adhere to the arm's length standard when entering into transactions with associated companies. However, the new transfer pricing legislation explicitly introduces the arm's length principle into Luxembourg tax law, completing the set of Luxembourg transfer pricing rules. Going forward the new Article 56 of the LITL will serve as a legal basis for upward and downward adjustments when advantages are shifted in controlled transactions.

The new transfer pricing rules come at a time in which transfer pricing and tax transparency is at the top of the international tax agenda and reinforce Luxembourg's intention to comply with all international tax standards. It is expected that the Luxembourg tax authorities will issue a Circular in the second half of this year in order to provide guidance on transfer pricing documentation requirements. Ultimately, the structuring of investments via Luxembourg will rely more heavily on solid transfer pricing documentation that is based on the OECD TP Guidelines. This should make existing and new investment structures even more robust and immune to challenges by foreign tax authorities.

** Oliver R. HOOR is an International Tax Director (Expert Comptable, Steuerberater) and Christophe DARCHE is a Partner (Corporate Finance & Transfer Pricing) with ATOZ. The authors may be contacted at: oliver.hoor@atoz.lu and christophe.darche@atoz.lu*

www.atoz.lu

1) Circulaire du directeur des contributions L.I.R. No. 164/2 of 28 January 2011 and No. 164/2bis of 8 April 2011; see Oliver R. Hoor, "Prix de transfert et financement intra-group au Luxembourg: La circulaire 164/2 du 28 janvier 2011", Les cahiers du droit luxembourgeois No. 12, Legitech, April 2011, p. 77.
2) Section 166 (1) General Tax Code.
3) Section 162(10) General Tax Code.
4) Where a Luxembourg finance company files a request for advance certainty such request must be based on a transfer pricing study. This is in line with a trend at the level of the Luxembourg tax authorities to ask more systematically for transfer pricing documentation substantiating the arm's length nature of intra-group pricing.
5) § 204 (1) General Tax Code.
6) § 171 General Tax Code; Tribunal Administratif, Decision of 3.6.2009, No. 24935; Tribunal Administratif, Decision of 10.9.2008, No. 23544.
7) Article 171 (1) General Tax Code applied already in the past to Luxembourg companies that are part of a group of companies.
8) Article 59 of the Law of 21 June 1999.
9) Here, the Luxembourg tax authorities may look to public databases and data from comparable transactions in other cases (under certain conditions).
10) According to Luxembourg case law, the tax authorities only need to evidence that it is likely that an advantage has been shifted by the company (without having to determine exactly a breach of the arm's length principle) in order to cause a reversal of the burden of proof; Tribunal Administratif, Decision of 27.11.2006, No. 21033 (ID 675); Tribunal Administratif, Decision of 31.12.2007, No. 22777 (ID 6149); Tribunal Administratif, Decision of 9.6.2008, No. 23324 (ID 7946); Cour Administrative, Decision of 12.2.2009, No. 24642C (ID 9626); Tribunal Administratif, Decision of 16.2.2009, No. 24105 (ID 9414).
11) The taxpayer has to provide consistent arguments underpinning the arm's length character of the transfer price representing at least a probable possibility.
12) Where the arm's length character of the transfer pricing is substantiated in a transfer pricing study, the burden of proof for the non-arm's length character of intra-group transactions should be significantly higher; see Oliver R. Hoor, "Documentation prix de transfert au Luxembourg: Ce que peuvent attendre les autorités fiscales luxembourgeoises", Les cahiers du droit luxembourgeois, No. 11, Legitech, September 2010, p. 26.
13) § 217 (1) AO.
14) At the level of the shareholder, the hidden capital contribution should result in an increase in taxable income (for example, when assets are sold to the company at a sales price below fair market value). Thus, in the case of Luxembourg shareholders, the burden of proof that the terms and conditions of a transaction did not adhere to the arm's length principle should be on the Luxembourg tax authorities.
15) The Circular of 28 January 2011 regarding finance companies as well as the commentaries to the new transfer pricing provisions make explicit reference to the OECD TP Guidelines.
16) Chapter V of the OECD TP Guidelines.
17) Whether documentation or evidence is required for other (i.e. non-tax) matters is wholly irrelevant; Chapter V, Paragraphs 5.3. and 5.4. of the OECD TP Guidelines.
18) Chapter V, Paragraph 5.2. of the OECD TP Guidelines.
19) Chapter V, Paragraph 5.17. of the OECD TP Guidelines.
20) Chapter V, Paragraph 5.6. of the OECD TP Guidelines.
21) Documents that are not reasonably available include, for example, information that cannot be legally obtained, or that is not actually available to the taxpayer because it is confidential to the taxpayer's competitors or because it is unpublished and cannot be obtained by normal enquiry or market data.
22) For example, when a Luxembourg company receives an interest-free loan from an associated company and claims a downward adjustment for the interest expenses saved, the arm's length interest rate should be determined and substantiated in a transfer pricing study.
23) While asking for legal certainty in accordance with all applicable laws and treaties is fully legitimate, misleading reports in the media have led to a negative perception of ATCs and APAs in the public.
24) Since 1 January 2015, the filing of ATCs and APAs is subject to a fee ranging between EUR 3,000 and EUR 10,000. Thus, taxpayers must perform a cost/benefit analysis when considering the filing of an ATC or APA. Moreover, the Luxembourg tax authorities do not have to decide on a specific request within a certain period of time (i.e. long waiting periods may be expected).