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Determining Arm's Length Remuneration for Luxembourg Finance Companies

Oliver R. Hoor and Keith O'Donnell
ATOZ Tax Advisers (Taxand Luxembourg)

Luxembourg is a preferred location for the structuring of intra-group financing activities. Finance companies need to report an arm's length remuneration on their financing activities in conformity with the OECD Transfer Pricing Guidelines. This article depicts a remuneration model for finance companies.

Oliver R. Hoor, Tax Partner, and Keith O'Donnell, Managing Partner, ATOZ Tax Advisers (Taxand Luxembourg)

Luxembourg is a financial center that has traditionally been a preferred location for the structuring of intra-group financing activities. In accordance with Luxembourg transfer pricing rules, Luxembourg finance companies need to have a real presence in Luxembourg, bear the financial risks in relation to the financing activity and realize an arm's length remuneration in this respect. This article analyzes how to determine an arm's length remuneration for financing activities.

On December 27, 2016, the Luxembourg tax authorities released a new transfer pricing circular (Circular L.I.R. N° 56/1- 56bis/1 of December 27, 2016) (the "Circular") on the tax treatment of Luxembourg companies performing financing activities. The Circular applies as from January 1, 2017 and replaces the previous circular (Circular L.I.R. N°. 164/2 of January 28, 2011) that was released in 2011. The new transfer pricing regime is consistent with the 2017 version of the Organisation for Economic Co-operation and De-

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velopment ("OECD") Transfer Pricing Guidelines which has been significantly revised as a result of the OECD Base Erosion and Profit Shifting ("BEPS") Project.

The scope of the Circular covers entities that are engaged in intra-group financing transactions. The term "intra-group financing transaction" is to be interpreted very broadly and includes any activity involving the granting of loans (or advancing of funds) to associated enterprises irrespective of whether these loans are financed by internal or external debt (intra-group financing, bank loans, public issuances, etc.).

Luxembourg finance companies should assume the risks in relation to their financing activities and actively manage these risks over the lifetime of the investment. This requires that a Luxembourg finance company has control over the risk and the financial capacity to assume the risk. Therefore, the amount of equity financing should suffice to cover the risk in relation to the financing activity (i.e., the equity at risk). The amount of equity at risk should further be remunerated with an arm's length return on equity. The amount of equity at risk and the arm's length character of the remuneration need to be substantiated in a transfer pricing study.

Determination of the Equity at Risk

Overview

The economic analysis will generally begin with a determination of the equity at risk. While under the previous transfer pricing regime, the so-called real risk requirement was deemed to be met when the equity (at risk) in relation to the financing activities amounted to at least (i) 1 percent of the outstanding loan or (ii) 2 million euros (until 2016, the risk of a Luxembourg finance company has generally been limited contractually through a limited recourse clause, guarantees or other contractual arrangements), under the new rules the equity at risk has to be determined on a case-by-case basis.

The method to be applied for the determination of the equity at risk depends on the functional and risk profile of the Luxembourg finance company. Here, the Circular distinguishes two profiles:

- a finance company that has a profile comparable to a regulated financial institution; and
- a finance company that has a profile which differs significantly from the one of a regulated financial institution.

In practice, most if not all Luxembourg finance companies should fall into the second category. Hence, the equity at risk will not be determined in accordance with the solvency criteria relevant for banks. Instead, the equity at risk should be determined on the basis of economic methodologies.

In general, the equity should at least cover the loss arising from a potential default of the borrower. While it is not possible to determine in advance the loss a finance company might suffer in a given year, it is possible to forecast the average level of credit loss which can reasonably be expected. This loss is referred to as the Expected Loss ("EL").

The EL on the financing activity is assumed to be equal to the probability that the borrower defaults in a given time frame (probability of default, "PD"), multiplied by the loss given default rate ("LGD") (i.e., the percentage of exposure that will not be recovered by the finance company in case of default) and multiplied by the outstanding exposure at default ("EAD"). Hence, the EL can be written:

EL = PD * LGD * EAD

The different factors of this formula are analyzed in the following sections.

Probability of Default

The PD is based on the credit rating grade of the borrower which is given by the average percentage of borrowers that default in this rating grade in a given time frame. Independent credit agencies (e.g., Standard & Poor's, Moody's, Fitch) provide credit ratings for borrowers and specific debt instruments.

The method used by these credit agencies relies on an analysis of both the qualitative and the quantitative characteristics of the borrower. A rating reflects the opinion of credit rating agencies on the borrower's creditworthiness, capacity and willingness to meet its obligations in relation to a financing transaction over the lifetime of that transaction.

A credit rating can change over time as a result of a borrower's financial performance, the current economic environment in which a borrower operates and the future economic and financial outlook of the sector in which the borrower operates. Therefore, an in-depth analysis of the borrower's key performance indicators ("KPIs"), industry and geographical exposures is required to properly estimate the borrower's credit rating and subsequent PD.

When determining the PD to be applied, an important question to be answered is the period of the PD to be considered in the economic analysis. In general, relevant databases provide information on PDs for periods ranging from 1–12 months and from 1–35 years. In practice, the period to be considered depends on the facts and circumstances of each individual case and should be chosen based on different factors as analyzed below.

The new transfer pricing regime is characterized by the expectation that Luxembourg finance companies actively manage their financing activities, assume related financial risks, respond to a change in the risk profile of the loan portfolio and prepare transfer pricing documentation (including regular updates). The risk management function ("risk management" refers to the function of assessing and responding to the risk associated with the commercial activity) takes a prominent role in this respect and includes two types of activities, namely control over risk and risk mitigation functions.

Control over risk means having the capability and authority to take and implement a decision regarding the risk and to decide whether and how to respond to the risk, including the actual performance of the decision-making functions (see Paragraph 1.65 in Chapter I of the OECD Guidelines; however, control over risk should not necessarily be understood in a way that the risk itself can be influenced or that uncertainty can be nullified). Risk mitigation functions are

defined as (i) the capability to mitigate risks (i.e., the capability to take measures that affect risk outcomes) and (ii) the actual performance of such risk mitigation (see Paragraph 1.62 in Chapter I of the OECD Guidelines).

However, it is not necessary to perform the day-to-day risk mitigation in order to assume the risk (see Paragraph 1.62 in Chapter I of the OECD Guidelines). Thus, certain functions may still be outsourced to associated enterprises or qualified service providers as long as the directors of the financing company supervise the outsourced functions and consider their outcome when performing the risk management function.

Whenever a Luxembourg finance company grants a new loan, the risks in relation to this transaction and the impact on the company's equity at risk have to be considered. Moreover, a finance company has to determine the credit rating of the loan portfolio at least once a year. Should the credit rating of the loan portfolio decline, the directors of the company need to decide how to respond to this. When it is decided that the financing activity should be continued as it is, the equity of the finance company should be increased for the latter to be able to have the financial capacity to assume the increased risk. Other options may include the transfer of (certain) loan receivables or requesting early repayment.

When a Luxembourg company manages its financing activities in such an active manner, it should generally be appropriate to rely on a one-year PD when determining the equity at risk. Additional arguments that speak for choosing a one-year time horizon include:

- Under the Basel II capital framework, it is proposed that financial establishments provide an estimate of the PD associated with each grade over a one-year time horizon. The Basel Committee's Range of Practices Paper and its discussions with the industry suggest that one-year PDs are the typical inputs into internal capital allocation systems, where one year coincides both with the usual financial reporting period and the typical minimum frequency with which ratings are reviewed internally. Since the risk profile of the loan portfolio needs to be reviewed at least once per year, it is reasonable to apply the same logic to finance companies.
- This is consistent with guidance of the EU on prudential requirements for credit institutions and investment firms that suggest institutions to consider a one-year PD (see Article 180 of Regulation (EU) No. 575/2013 of the European Parliament and of the Council of June 26, 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No. 648/2012).
- A finance company generally has a number of options realistically available to react to changes regarding its financing activity, such as (i) the transfer of some or all of the loans to a related or third party (for example, a bank or a debt fund), (ii) requesting the early repayment of the loan, or (iii) keeping the financing activity as it is (and making the necessary changes to respond to a declining credit rating), unless the terms and conditions of the loan agreements do not allow any of these options. The implementation of any of these measures should not take longer than a year.
- Loan agreements often include specific clauses dealing with events of default under which the principal amount of the loan (including accrued interest) becomes payable immediately.
- Based on Luxembourg commercial law, a finance company is obliged to establish financial accounts on an annual basis. In this context, the valuation of the loan receivables in the books of the company has to be reviewed with regard to potential impairments in case the fair market value of these loans is expected to be (permanently) lower than their acquisition costs.
- The board of directors of a Luxembourg finance company has to hold at least one meeting a year during which, among others, the financing activities and the related risk management functions are discussed and decisions are taken in regard to the financing activities (given that the risk of Luxembourg companies in regard to their financing activities is no longer limited contractually, the risk management function became extremely important for the directors of the finance company, also with respect to their own responsibility as a director).

When a Luxembourg company begins to perform financing activities, it will often not be possible to determine a credit rating based on actual investments. Here, in the absence of actual investments, a synthetic credit rating may be developed considering the investment strategy, the target jurisdictions and other relevant elements. In these circumstances, the economic analysis needs to be as specific as possible and the transfer pricing documentation should be updated once investments are made (for example, after a year).

Loss Given Default

The LGD provides the percentage of exposure the finance company might lose in case the borrower defaults. The LGD is driven by the degree of subordination of the financing and the order of repayment of the debts of the borrower. Thus, the LGD depends on the terms and conditions governing the financing activity (in particular, the type and amount of collateral, seniority and expected proceeds from the work-out of the assets).

Generally, a higher seniority and the security of the financing in the capital structure of a borrower imply a good recovery in case of default, and consequently a low LGD. Similarly, a financing without any security and subordinated to all other debts of the borrower implies an important loss in case of default, and consequently a high LGD.

Exposure at Default

The EAD is the amount outstanding at the time of default and mostly depends on the principal repayment characteristics (e.g., amortized, bullet or balloon) and interest payment characteristics (e.g., capitalized or not).

Case Study

A Luxembourg real estate fund (Reserved Alternative Investment Fund, "RAIF") invests via a Luxembourg

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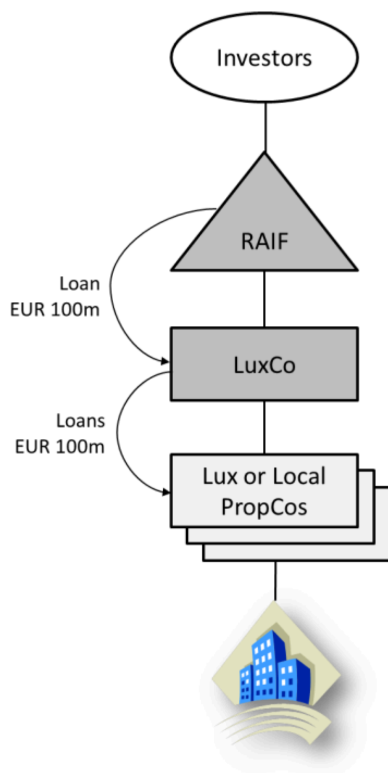
company ("LuxCo") and Luxembourg or local property companies ("Lux or local PropCos") into opportunistic real estate assets situated throughout Europe. The PropCos are financed by a mixture of equity and debt (i.e., 100 million euros) in accordance with local requirements. LuxCo finances the loan receivables with a loan granted by the RAIF. Hence, LuxCo performs a financing activity that comes within the scope of the Circular.



EL calculation:

It is assumed that the credit score of the loan portfolio corresponds to bb, considering the opportunistic nature of the underlying assets and the KPIs of the different property companies. The PD for a bb-rated loan portfolio is as follows:

1yr PD	2yr PD	3yr PD	4yr PD	5yr PD	6yr PD	7yr PD	8yr PD	9yr PD	10yr PD
1,60%	6,27%	8,38%	10,84%	13,34%	15,37%	17,39%	19,28%	20,95%	22,67%

Assuming that LuxCo actively manages its financing activities (including the risk management function) and the company has options to respond to a declining credit rating within a one year period, the one-year PD is the logical choice in this case.

The LGD on subordinated loans is assumed to be 70 percent.

Since the risk of LuxCo has not been reduced contractually, the entire amount of the loan receivables would be the EAD (i.e., 100 million euros).

EL = PD * LGD * EAD

EL = 1,6% * 70% * EUR 100m

EL = EUR 1.12m

In light of the above, the EL would correspond to 1.12 million euros and the equity financing should at least amount to 1.12 percent of the financing volume.

Determination of an Arm's Length Return on Equity

The amount of equity at risk should be remunerated with an arm's length return on equity. The benchmarking of such remuneration requires a search for returns on equity realized by companies which perform comparable activities. In this regard, it is important to identify comparable transactions. The process of finding and selecting comparable data needs to be properly documented, including the disclosure of the different selection criteria (see No. 23 of the Circular).

When searching for comparables, it might be considered to look for the return on equity realized by other financing companies that should have a fairly similar functional and risk profile. However, given that other financing companies are also engaged in controlled transactions with other group companies, these transactions may not be considered as comparables in the transfer pricing analysis (the conditions made or imposed in controlled transactions are to be compared to the conditions agreed upon by independent parties in comparable transactions and circumstances (as these are the result of market forces) and not to other controlled transactions).

As a conservative approach, it might be considered to rely on the return on equity realized by diversified banks. Given that these should have a richer functional and risk profile than a finance company, the expected return on equity should be at the upper end of the range which might be expected in case of finance companies.

In contrast, the use of industry specific returns on equity (automotive, telecommunications, real estate, etc.) depending on the business activities of the group is in our view not appropriate. This is because the arm's length principle requires that conditions made or imposed in controlled transactions are in line with the conditions that independent parties would agree in comparable transactions under comparable circumstances. Thus, the profitability of a Luxembourg company performing financing activities should be consistent with third parties performing the same kind of activities, rather than the entities borrowing from the finance company. (The industry specific risk is already taken into account in the equity at risk calculation, so taking it into account again would be a form of double counting.)

Determination of the Arm's Length Gross Remuneration

As the return on equity is defined as the ratio of net profit to equity, the multiplication of the arm's length return on equity and the finance company's equity at risk provides a net (after-tax) remuneration.

In order to determine an arm's length gross remuneration (defined as the difference between interest income and interest expense), the net remuneration requires to be grossed up by the applicable corporate tax rate and recurring operating expenses related to the financing activity.

Hence, the gross remuneration can be expressed as follows:

$$Gross\ remuneration = \frac{Net\ remuneration}{(1 - corporate\ tax\ rate)} + operating\ expenses$$

In the corporate tax returns, it should be tested whether the arm's length net remuneration has been realized. Should the amount of net remuneration actually realized remain below the net remuneration determined in the transfer pricing analysis, a transfer pricing adjustment (i.e., upward adjustment) should be performed in accordance with Article 56 of the Luxembourg Income Tax Law in the corporate tax returns.

Planning Points

Under Luxembourg transfer pricing rules, finance companies are required to have a real presence in Luxembourg, to determine the equity at risk and to report an arm's length remuneration on their financing activities in conformity with the OECD Transfer Pricing Guidelines. The arm's length remuneration should further be substantiated in a transfer pricing study.

The focus of the economic analysis is on the determination of the equity at risk and an arm's length return on equity. The equity at risk is commonly determined through the application of the Expected Loss Method which relies on different parameters that consider the specificities of the financing company, the underlying loan portfolio and contractual aspects. With regard to the return on equity to be realized on the equity at risk, taxpayers may adopt a conservative approach and rely on diversified banks as comparables given that other financing companies should not be involved in arm's length transactions.

Considering that Luxembourg finance companies bear all the risks in relation to their financing activities and perform various functions in relation thereto, such companies have a comprehensive and diverse functional and risk profile. Ultimately, the Luxembourg transfer pricing regime is robust from an international tax and transfer pricing perspective and consistent with all applicable post-BEPS OECD and EU standards. This should positively contribute to Luxembourg's position as an attractive location for the implementation of financing activities.

Oliver R. Hoor is a Tax Partner (Head of Transfer Pricing and the German Desk) and Keith O'Donnell is the Managing Partner with ATOZ Tax Advisers (Taxand Luxembourg).

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The authors may be contacted at: oliver.hoor@atoz.lu; keith.odonnell@atoz.lu; www.atoz.lu

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