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New Transfer Pricing Circular Regarding Intra-Group Financing Activities

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The Luxembourg tax authorities have released a new transfer pricing Circular regarding intra-group financing activities.

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I. Introduction

On December 27, 2016, the Luxembourg tax authorities have released a new circular (the "Circular") on the tax treatment of intra-group financing activities. The Circular follows the introduction of the new Article 56bis of the Income Tax Law ("ITL")[1] which provides additional guidance on the application of the arm's length principle.

The Circular provides guidance on the practical application of this guidance to intra-group financing activities, ensuring consistency with all international transfer pricing standards. The Circular replaces Circular 164/2 of January 28, 2011 and Circular 164/2bis of April 8, 2011 and becomes applicable as from January 1, 2017.

II. Scope of the Circular

The scope of the Circular remains the same as under the previous Circulars and covers entities that are principally 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. How these loans are financed is irrelevant (for example, intra-group loans, bank loans, public issuances, etc.).

While the former Circulars referred to "cross-border" financing transactions between associated enterprises, the new circular refers more generally to financing transactions between related enterprises. It follows that domestic financing transactions between Luxembourg companies come as much within the

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scope of the Circular as cross-border transactions. This change is consistent with Luxembourg legislative developments and the introduction of a new version of Article 56 of the ITL, which formerly introduced the arm's length principle into Luxembourg tax law.

III. Guidance Provided in the Circular

A. Functional Analysis and Contractual Terms

As under the previous regime, a functional analysis has to be performed in order to identify the activities and economically significant functions performed by the parties (taking into account assets used and risks assumed), in relation to the controlled transaction.

The contractual terms are always the starting point when analyzing a controlled transaction. However, in accordance with OECD transfer pricing guidance, the Circular states that when the behavior of the parties deviates from the contractual terms, the actual behavior is to be considered (i.e., substance over form approach). In the case of financing activities, such deviation from the contractual terms should be very exceptional.

B. Risk Analysis and Capital at Risk

One of the key changes under the new transfer pricing regime is the requirement to determine the capital at risk on a case-by-case basis. In contrast, under the former regime, the so-called equity-at-risk requirement was deemed to be met when the equity (at risk) of the company amounted to at least one percent of the outstanding loan(s) or two million euros.

While under the previous regime, the risk of a Luxembourg financing company has been contractually limited to the lower of one percent of the outstanding loan(s) and two million euros (e.g., through limited recourse clause, guarantee), under the new regime, the risk of a financing company is generally not limited. Instead, the expected loss of the financing activity is determined on the basis of the underlying fact pattern and the credit rating (and related credit default risk) of the borrower.

Once the capital at risk has been determined, a financing company must be financed with sufficient equity to cover the risk in case it materializes. The capital at risk has to be remunerated at arm's length and may be used to finance either the loan portfolio or other assets.

With regard to the determination of the capital at risk, the Circular distinguishes two functional and risk profiles:

- If the comparability analysis shows that the financing company has a profile comparable to entities governed by EU regulation 575/2013 on prudential requirements for credit institutions and investment firms (banks, etc.), and if its own funds are in line with the solvency criteria provided by this regulation, the financing company is considered as having a level of own funds which is sufficient to afford the financial consequences in case of risk realization.
- If the comparability analysis shows that the financing company has a profile which differs significantly (in the assets used and the risks assumed) from the one of entities governed by EU regulation 575/2013 on prudential requirements for credit institutions and investment firms (banks, etc.), then other methods (in particular by performing a credit risk analysis) have to be applied in order to determine the required amount of own funds to assume the risks.

The financing company needs to have control over the risk in relation to its financing activities. Thus, the financing company should own the power of decision to enter into the risk bearing financing transaction and take the decisions to handle the related risks.

Abolishing the previous equity-at-risk requirement is positive for several reasons. First, it improves the beneficial ownership position of Luxembourg financing companies (bearing contractually all the risks in relation to the financing activities). Second, it takes away the only arbitrary element of the previous Luxembourg transfer pricing regime for financing companies. Third, under the previous transfer pricing regime, it was in some cases difficult to contractually limit the risk of the financing company through limited recourse clauses, guarantees, etc. (for example, when bonds are issued on the market and the funds are used to finance the operations of the group). These issues will all disappear under the new regime.

C. Comparability Analysis

The new Article 56bis of the ITL emphasizes the importance of the comparability analysis through a replication of some of the guidance provided in the OECD Transfer Pricing Guidelines. A comparability analysis is critical for the application of the arm's length principle and a cornerstone of any transfer pricing analysis.

While the comparability analysis was already an integral part of transfer pricing reports substantiating the arm's length nature of financing margins, under the new regime, there will be even more emphasis on the comparability analysis in the transfer pricing documentation. The Circular provides for detailed guidance on how to perform a comparability analysis in case of intra-group financing transactions.

D. Substance of the Financing Company

The Luxembourg financing company needs to have a real presence in Luxembourg. For this purpose, the majority of the managers/directors should be (professionally) resident in Luxembourg. However, despite the wording of the Circular, it is expected that in accordance with the previous administrative practice, it suffices if at least 50 percent of the managers/directors are Luxembourg residents within the meaning of the Circular.

In addition, the company should have personnel whose qualification should be such that they are able to control the activities performed by the company. Nevertheless, the company may still outsource or delegate some of the functions to the extent that these functions are supervised by the managers/directors of the company and have no significant impact on the control of the risk (which is a management function).

The Luxembourg company should further hold its annual shareholder meeting in Luxembourg at the registered seat of the company and should not be considered as tax resident in another jurisdiction. Overall,

the substance requirements broadly replicate those defined under the previous Circular.

E. Comparable Transactions Between Unrelated Enterprises

In order to determine the arm's length remuneration of financing activities, reference has to be made to the remuneration realized by entities in a comparable sector. In case the financing company has a profile comparable to the one of entities falling within the scope of EU regulation 575/2013 on prudential requirements for credit institutions and investment firms (banks, etc.), a return after tax on own funds of 10 percent (to be revised by the Luxembourg tax authorities over time) is considered as a level of return commonly seen in practice currently and thus considered as an arm's length remuneration. Nonetheless, even in these circumstances, it will be possible to determine an arm's length return for a specific case (which may be lower than 10 percent return on the equity).

F. Lack of Valid Commercial Rationality

In the same way as mentioned in the new Article 56bis ITL, the Circular includes some language on circumstances in which a transaction may be disregarded because there is a lack of valid commercial rationality and a third party would not have entered into a specific transaction. However, this guidance should not have any significant relevance in practice and only concerns very exceptional cases.

G. Measure of Simplification for Financing Companies Acting as Intermediary

In a case where a Luxembourg financing company falling within the scope of the Circular acts only as an intermediary, given that the risks are very limited in these cases, it is assumed that the remuneration realized by the company is at arm's length if the company realizes a minimum return of two percent after tax on its receivables.

However, companies merely involved in the on-lending of funds will still have the possibility to benchmark a lower return in a transfer pricing study. Given the relatively high return required under the simplified regime (two percent return on the assets corresponding to a 200 bps margin), it should make sense for most taxpayers to produce transfer pricing documentation in these cases.

This percentage will be revised on a regular basis by the Luxembourg tax authorities. In order to benefit from this simplified measure, a formal request has to be filed with the tax return. Should a company opt for this system, a procedure of exchange of information will be launched (based on the Luxembourg rules on administrative cooperation or in accordance with double tax treaties).

H. Advance Pricing Agreement

The procedure for obtaining an advance pricing agreement ("APA") remains unchanged. However, the content of the transfer pricing documentation needs to be even more detailed than before, including a description of the qualification and functions of the employees of the financing company.

However, when a transfer pricing analysis is properly done, an APA does not add much additional comfort, creates unnecessary costs (for the preparation of the APA and the filing costs of 10,000 euros levied by the Luxembourg tax authorities) and, potentially, the suspicion of foreign tax authorities.[2] Hence, in general there should be no good reason for the filing of an APA.

Given that the new guidelines become effective as from January 1, 2017, APAs which have been granted in accordance with the former circulars will be no longer valid as from January 1, 2017.

However, it is expected that transfer pricing studies prepared under the old regime will not be challenged for a reasonable amount of time, to give taxpayers the possibility to smoothly adapt to the new requirements (to the extent the financing activity is still consistent with the underlying fact pattern in the transfer pricing study).

IV. Conclusion and Recommendations

The new Circular is positive for Luxembourg as it will make Luxembourg financing structures even more robust and strengthen the beneficial ownership position of Luxembourg financing companies, which is key in the current international tax environment.

The new transfer pricing regime adheres to the arm's length principle and OECD Transfer Pricing Guidelines and, therefore, makes the new transfer pricing regime immune against challenges from the EU Commission or foreign tax authorities. The Circular is another step in a trend towards more and more substantial transfer pricing documentation requirements in Luxembourg. However, this does not mean that the new regime will result in higher (arm's length) financing margins to be realized.

Transfer pricing documentation has become a key element in tax risk management in an environment that relies increasingly less on tax rulings and APAs. In the current international tax environment of heightened transparency and scrutiny, companies would be wise to take it one step further and integrate the documentation of transfer prices in their wider tax strategy, using it as a means to reflect the business rationale behind their corporate structure and intragroup transactions.

Since the new rules become applicable as from 2017, companies performing financing and on-lending activities in Luxembourg should review their transfer pricing policy and related transfer pricing documentation to make sure that these are in line with the new requirements.

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[1] Article 56bis of the ITL has been introduced into Luxembourg tax law as from January 1, 2017.

[2] Tax rulings and APAs are subject to exchange of information with other Member States of the EU and the OECD.