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Luxembourg

4801. Introduction

Luxembourg has enacted tax legislation that addresses transfer pricing but has been little used to date.

4802. Statutory rules, other guidelines and legal cases

The statutory rule on transfer pricing is found in Article 56 of the Luxembourg Income Tax Code. This provides that where there is a transfer of profit rendered possible by the fact that a Luxembourg taxpayer has a special economic relationship with a non-resident, then the tax authorities may estimate the financial result. It is to be assumed that this provision would be applied only in a situation where the transfer of profit was away from Luxembourg. For example, this might be the case if a Luxembourg company paid heavily in excess of the market rate for a service it received.

A further situation where intragroup pricing arrangements might be of concern to the Luxembourg tax authorities is where an advance agreement is to be sought from the tax authorities and such agreement is based on an assertion that one or more intragroup transaction flows will be undertaken at arm's length.

Furthermore, if a shareholder receives an advantage from a company that the shareholder would not have received if there had not been a shareholding relationship, then this could be characterised under the Luxembourg Income Tax Code as a hidden distribution. Again, this might occur in a case where a shareholder charged a Luxembourg company heavily in excess of the market rate for a service provided by the shareholder. Such a hidden distribution would result in an add-back to the taxable profits of the Luxembourg company, and also possibly an obligation to account for withholding tax on the deemed distribution. The rate of withholding tax on a hidden distribution of dividends is 15% of the gross amount received (thus 17.65% of the net amount), unless reduced under the application of a double tax treaty or the EC Parent-Subsidiary Directive. An abnormal advantage granted by a shareholder to an affiliate could be seen as a hidden contribution and taxed at the level of a Luxembourg subsidiary. However, profits corresponding to such hidden contribution could still be deductible against relevant accounting year expenses and offset against losses carried forward.

The Luxembourg legislation does not give further guidance on how any transfer of profit or advantage to a shareholder is to be quantified, or what constitutes an arm's-length arrangement. Nor is there any case law on these issues.

However, it can reasonably be assumed that in any situation where the non-resident entity or shareholder is located in another OECD member country, then the Luxembourg legislation should be construed in conformity with the associated enterprises article of the relevant double tax treaty. Where the wording of such an associated enterprises article follows closely Article 9(1) of the OECD Model Tax Convention (which would normally be the case in double tax treaties concluded by Luxembourg), then further guidance given by the OECD on the use and interpretation of this article can be assumed to have authority, and hence the OECD Guidelines should be regarded as giving important guidance in the Luxembourg environment in the case of any dispute.

Intellectual property regime

As part of its commitment to boost and foster research and development (R&D) activities in Luxembourg, to encourage technical and scientific cooperation as well as technology transfer between the public and private sectors and to stimulate new economic activities, the Luxembourg government has passed a law aimed more specifically at encouraging R&D activities and the creation of intellectual property. The intellectual property rights covered under the regime are copyrights related to software, patents, trademarks, designs, models and domain names. A Luxembourg company or branch can benefit from an exemption of 80% of the income from intellectual property acquired or created after 31 December 2007. The 80% exemption applies to net income derived from the intellectual property and capital gains realised on the sale of intellectual property resulting in an effective tax rate of 5.7% for 2010. Deductible expenses include (amongst others) R&D costs, depreciation, and impairment of the value of the intellectual property.

In the case of self-developed patents used by the taxpayer in its own activity, it would receive an 80% notional deduction of a deemed net income from a third party as consideration for the right to use the said patent. Further, full net wealth tax exemption is available for the qualifying intellectual property rights.

One of the conditions to be fulfilled is that the intellectual property should not have been acquired from a person who is assimilated to an “affiliated company”. Company A is considered as affiliated to Company B in the meaning of the law if:

- It directly holds at least 10% of the share capital of B;
- B holds at least 10% of its share capital; and
- At least 10% of the share capital of A and of B is directly held by a third company.

For the disposal of the intellectual property, the valuation could be determined according to any well-accepted method for the valuation of intellectual properties or the available market value. In the case of small- and medium-size enterprises, they are entitled to value the intellectual property at 110% of the expenses that have reduced their tax base for the tax year of the disposal and of any previous tax year.

The regime thus addresses two objectives. It allows a full deduction of all R&D expenses for projects that do generate any commercial results. However, successful R&D projects are not penalised through excessive taxation once they come to fruition.

In addition to the tax incentives, other non-tax incentives are offered by the Luxembourg government. Any company, private research organisation or public

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organisation can benefit from incentives (generally subsidies or interest-rate subsidies) ranging from 25% to 100% to finance an R&D project.

4803. Tax audits and resources available to the tax authorities

Due to the relatively low profile of transfer pricing in Luxembourg, the tax authorities have no specialist resources for dealing with any transfer pricing issues. If any transfer pricing issues do arise, then they will be dealt with by the tax bureau that normally handles the taxpayer's affairs. However, the transfer pricing of all transactions and all industries is open to challenge, and in the event that the tax authorities seek to adjust a taxpayer's tax return, then the burden of proving that the adjustment is not valid lies with the taxpayer.

Transfer pricing adjustments

A local tax inspector (there is no central Luxembourg team of transfer pricing auditors) can scrutinise all transactions of all sectors of business and have the power of investigation, including requesting information from third parties. Should such an audit result in an amendment of the taxpayer's tax return, the burden of proof will be reversed, and it will thus be up to the taxpayer to prove the arm's-length nature of the transaction targeted by the tax authorities. Potential adjustments could result in penalties of 0.6% per month on the tax assessed for the taxpayer. However, there is a very limited experience of litigations. No cases have been taken up for a mutual agreement procedure.

In practice, the Luxembourg tax authorities may accept compensating adjustments under certain conditions.

- The adjustment has been made by the other tax authority on sound technical grounds with supporting documentation to evidence the calculation and adjusted pricing of the transaction, rather than on an overall ad hoc basis;
- The adjustment does not result in a loss for the Luxembourg company, especially in cases where the Luxembourg company had been characterised as a low-risk entity and therefore remunerated on a cost-plus basis;
- Year of accepting an adjustment:
 - The adjustment will be effected only for open tax assessment years and not where the assessment has been completed;
 - Where the adjustment was made by the other tax authority for a completed assessment year, there may be a possibility to make an adjustment for the prior year in the year the assessment is yet to be completed in Luxembourg;
 - Where the financial statements of a year have been signed and filed, without the inclusion of the adjustment, but the return is yet to be submitted, the adjustment only in the return may be acceptable; and
- In all of the above-mentioned situations, if the adjustment is made only on the tax return for any period without a corresponding accounting adjustment, the Luxembourg tax authorities are likely to require both that the financial statements of the first subsequent period for which accounts have not yet been signed and filed show a prior-year adjustment to reflect the aggregate transfer pricing adjustments, and that the settlement between the parties is made to implement the amended pricing.

It is yet to be tested whether the tax authorities would accept a compensating adjustment in cases where a minimum taxable profit has been agreed on transactions as part of a unilateral tax agreement.

Elimination of double taxation

Most of the tax treaties concluded by Luxembourg provide for an exchange of information procedure and contain mutual agreement procedure (MAP) provisions.

With the law passed on 24 April 1993 and subsequent amendments, Luxembourg had approved the adoption of the EU arbitration convention and follows the EU Council Code of Conduct for the effective application of the arbitration convention.

4804. Availability of comparable information

Luxembourg companies are required to make their annual accounts publicly available by filing a copy with the local court. However, the accounts do not necessarily provide much information on potentially comparable transactions or operations because they do not normally contain much detailed financial information.

4805. Advance pricing agreements

While there is no procedure for obtaining a formal APA, the tax authorities are quite flexible in this area, and advance agreements in writing are regularly obtained on an individual basis. Administrative circulars on the calculation of the cost-plus tax basis for coordination centres, and on group finance companies, have been withdrawn. It is, however, possible to agree on a case-by-case basis with the tax authorities, an acceptable arm's-length result for a spread on financing operations, or for other financing-related transfer pricing issues as well as appropriate fee levels for intragroup services in the investment management and banking industry, if necessary, prior to the completion of a transaction. Similarly, advance agreements on royalty rates and other aspects of the structuring of intellectual property holdings are also possible. In discussing any advance agreement, it should be recognised that while the tax authorities have few resources at their disposal, their awareness of the commercial environment is strongly developed. Hence, in presenting any proposals for negotiation, well-thought-through but succinct documentation, supporting the reasonableness of the desired result, is always going to be of benefit.

It is not clear whether the Luxembourg tax authorities would be prepared to negotiate a bilateral APA. No such APAs have been negotiated.