

49.

Luxembourg

Introduction

In 2011, the Luxembourg tax authorities issued two circulars on transfer pricing for Luxembourg-based entities that are mainly engaged in intragroup financing activity. The first circular, L.I.R. n°164/2, was issued on 28 January 2011 to clarify the tax treatment for Luxembourg based-entities that are mainly engaged in intragroup financing activities financed by borrowings. On 8 April 2011, the Luxembourg tax authorities issued a second circular, L.I.R. n°164/2bis, to clarify the application of Circular L.I.R. n°164/2 for entities that are mainly carrying out intragroup financing activities (i.e. intragroup lending activities financed by borrowings).

Statutory rules and legal references

The statutory rule on transfer pricing is found in Article 56 of the Luxembourg Income Tax Law (LITL). This provides that where a transfer of profit is 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 outside Luxembourg. For example, this might be the case if a Luxembourg company paid significantly more than the market rate for a service it received.

Another situation on intragroup financing that 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. In this respect, the Luxembourg tax authorities have now provided detailed guidelines, which are discussed in the following paragraphs.

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 article 164 LITL as a hidden distribution. Again, this might occur in a case where a shareholder charged a Luxembourg company significantly more than 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 European Commission (EC) Parent-Subsidiary Directive. An abnormal advantage granted by a Luxembourg 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.

However, it can reasonably be assumed that in any situation where the non-resident entity or shareholder is located in another Organisation for Economic Co-operation and Development (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 a 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 LITL includes a provision aimed 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 5.72% for 2012. 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.

Luxembourg

In addition to the tax incentives, other non-tax incentives are offered by the Luxembourg government. Any company, private research organisation or public organisation can benefit from incentives (generally subsidies or interest-rate subsidies) ranging from 25% to 100% to finance an R&D project.

Transfer pricing guidelines in case of on-lending activity

Circular L.I.R. n°164/2

On 28 January 2011, the Luxembourg tax authorities issued the Circular L.I.R. n°164/2 (the circular) providing guidance on intragroup lending activities financed by borrowings. In the context of the circular, two enterprises are deemed to be related where one enterprise participates directly or indirectly in the management, control or share capital of the other; or if the same persons participate directly or indirectly in the management or in the share capital of both companies. The term intragroup financing transaction refers to any activity consisting of granting loans or cash advances to related companies.

The scope of the circular applies to entities that are 'principally' engaged in intragroup financing activities. The circular, however, does not provide guidance on when an entity is 'principally' engaged in intragroup financing activities. The circular further states that an arm's-length remuneration should be determined for a Luxembourg entity carrying out such intragroup on-lending transactions in accordance with OECD Guidelines. A functional analysis is to be carried out to determine the remuneration of each entity based on the functions performed and taking into account the assets utilised and risks borne.

Moreover, the circular mentions that a company should have sufficient equity to assume the risks in connection with its financing transactions and that such equity should be effectively used if the risk related to the financing materialises. The minimum equity at risk should amount to 1% of the nominal value of the granted financing or 2 million euros (EUR).

In addition to the equity requirements, companies falling under the scope of the circular are also required to satisfy certain substance requirements in order to be considered to have real substance in Luxembourg.

Luxembourg companies that are mainly engaged in intragroup financing activities must also prepare a transfer pricing study to justify the arm's-length compensation.

Circular L.I.R. n°164/2bis

On 8 April 2011, the Luxembourg tax authorities issued an additional circular (L.I.R. n°164/2bis) to clarify the application of the Circular L.I.R. n°164/2. This additional circular clarifies that confirmations obtained by the tax authorities before 28 January 2011 regarding the arm's-length nature of intragroup financing activities will no longer have effect as from 1 January 2012. Taxpayers must comply with the requirements set out in the 28 January 2011 circular (L.I.R. n°164/2) and file a request in this respect with the Luxembourg tax authorities.

Tax audits and resources available to the tax authorities

When transfer pricing issues arise, 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 is 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.

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 is 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, it may be possible 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.
- 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 approved the adoption of the EU arbitration convention and follows the EU Council Code of Conduct for the effective application of the arbitration convention.

Luxembourg

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.

Advance pricing agreements (APAs)

While there is no procedure for obtaining a formal APA, the tax authorities are quite flexible in this area, and advance agreements in writing can be obtained on an individual basis. For entities which are mainly engaged in financing activities, the tax authorities provide binding information only if the companies have real substance in Luxembourg and if minimum equity is effectively at risk related to the transaction. Such written confirmation is limited to five years. Administrative circulars on the calculation of the cost-plus tax basis for coordination centres have been withdrawn.