Luxembourg Government proposes to formalize transfer pricing legislation

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In brief

The Luxembourg Government on October 12, 2016, presented a Bill (no.7050) to the Luxembourg Parliament outlining the Government's 2017 budgetary measures. One article in the Bill sets out new transfer pricing provisions, augmenting the basic arm's-length rule in force since January 1, 2015 that — formally adopted the OECD standard into Luxembourg law. The proposed new wording follows closely some of the key text of the OECD Transfer Pricing Guidelines — in their 2016 revised form following the BEPS Actions 8-10 Final Report — and thus makes more explicit the already authoritative status in Luxembourg of these Guidelines. Assuming that the Bill is enacted, the new provision will apply from January 1, 2017.

In detail

Since January 1, 2015, Luxembourg's transfer pricing regime has been based on article 56 of the Luxembourg Income Tax Law (LITL), which broadly replicates the wording of the arm's-length principle as set out in Article 9 of the OECD Model Tax Convention.

The OECD Transfer Pricing Guidelines (OECD TP Guidelines) have been substantially rewritten between 2013 and 2015 as part of the OECD's Base Erosion and Profit Shifting (BEPS) Project. In particular, guidance for applying the arm's-length principle – Section D of Chapter I – has been substantially augmented, in order to seek to address some of the key issues identified as causing BEPS. This revision covers the fundamental topics of comparability analysis, the need to carry out a full analysis that ensures that controlled transactions are 'accurately delineated' (délimitées de façon précise), and the better analysis of risks and the linking of reward to the function of management of risk.

This revision also raises the possibility that — in certain very specific situations — transactions between controlled parties can be disregarded for transfer pricing purposes. This issue of 'non-recognition' and the extent to which it might be applied, had been the cause of considerable debate during the BEPS Project. The BEPS Final Report concluded that its application needed to be carefully restricted. The BEPS Project text was formally adopted into the OECD TP Guidelines in May 2016 by the OECD Council.

The Bill published on October 12, 2016 now proposes to introduce a further article, 56bis, into the LITL. As drafted, its one and one-half pages of text bring explicitly into the law some of the key principles set out in the OECD Guidelines in their 2016 form.

Definitions

The proposed art. 56bis begins by defining terms in its paragraph (1). These are very similar to some of the terms defined in the glossary that prefaces the OECD TP Guidelines, or else synthesise their usage. Of particular note are the following definitions:

*"**Transaction**: the transfer of a tangible or intangible asset, the provision of a service or rights; whether or not formalised in writing, that would be remunerated on the open market."*

Observation: The recognition that there can be a transaction without a written contract is significant.

*"**Comparable open market transaction**: a transaction between two independent parties which is comparable with the controlled transaction being examined. This may involve a comparable transaction between one party to the controlled transaction and an independent party ('internal comparable') or between two independent parties neither of which is party to the controlled transaction (external comparable)."* Other than using the term 'open market' instead of 'uncontrolled,' this definition replicates that of 'comparable uncontrolled transaction' in the OECD TP Guidelines glossary. The concepts of 'internal' and 'external' comparables are thus formalised in Luxembourg.

*"**Arm's length price**: the price or tariff that would be applied to a comparable transaction on the open market".*

Observation: Although used in the OECD TP Guidelines, this term is not expressly defined by the OECD. However, its use in the Luxembourg transfer pricing regime reasonably can be assumed to be entirely consistent with the OECD TP Guidelines.

Principles and methodology

Paragraphs (2) to (6) of the proposed art. 56bis restate briefly some of the key principles set out in the OECD Guidelines in their 2016 form.

Paragraph (2) explicitly imposes the obligation to use for corporate income tax purposes the 'arm's-length price', which is the basic principle of the OECD TP Guidelines. The Bill wording requires that: "*In the context of an analysis that an enterprise carries out with the aim of checking conformity with the arm's length principle, the enterprise must apply to all controlled transactions a setting of prices and tariffs that respects the arm's length price."*

This paragraph in the Bill goes on to deal with transactions that are seldom or never undertaken between independent enterprises, pointing out that: "*the fact that a given transaction may not be observed between independent parties does not automatically signify that it cannot be in line with the arm's length principle.*" This reiterates the statement to this effect made at paragraph 1.11 of the OECD TP Guidelines.

Paragraphs (3) and (4) of the Bill text introduce the OECD concept of comparability analysis, as follows.

"(3) The technique to be implemented in determining the arm's length price in order to assure the application of the arm's length principle is based on comparability analysis. This involves making a comparison between the conditions imposed on a controlled transaction and those imposed on a comparable open market transaction. For such a comparison to be significant, it is necessary that the economic characteristics of the transactions being examined are sufficiently comparable.

(4) Transactions are sufficiently comparable whenever no material differences exist between the transactions being compared that could have a significant influence from a methodological perspective on the determination of the price, or where reasonably reliable adjustments can be made to eliminate the effect on the determination of the price.

The comparability analysis of a transaction is based on two key aspects:

a) identifying the commercial or financial relations between the associated enterprises and determining the conditions and economically significant circumstances attaching to those relations as the way to delineate accurately the controlled transaction;

b) comparing the conditions and the economically significant circumstances of the controlled transaction, as accurately delineated, with those of comparable open market transactions."

Again, these principles closely follow the OECD. The explanation of the 'comparability analysis' follows the wording of paragraph 1.33 of the OECD TP Guidelines in its post-BEPS form as set out at page 15 of the BEPS Actions 8-10 Final Report.

In particular, the new OECD requirement for a higher standard of functional analysis, which 'accurately delineates' the controlled transaction, is formally brought into the Luxembourg transfer pricing regime. The requirement for sufficient comparability in paragraph (3), and what this constitutes, follows directly from the definition of 'comparability analysis' of the OECD glossary.

Paragraph (5) goes on to list the five main areas that have to be looked at when 'accurately delineating' a controlled transaction:

"a) the contractual terms of the transaction;

b) the functions undertaken by each of the parties to the transaction, taking account of assets utilised and risks managed and assumed;

c) the characteristics of the asset transferred, the service provided, or the rights granted;

d) the economic circumstances of the parties and the market in which the parties carry on their activities;

e) the business strategies pursued by the parties."

This largely replicates the text of paragraph 1.36 of the OECD TP Guidelines in its post-BEPS form as set out at page 16 of the BEPS Actions 8-10 Final Report. The only component absent in the Luxembourg text is the OECD requirement to look at functions in the wider context of where value is added within an overall multinational corporation group.

Critically, however, the inclusion of this paragraph 1.36 also emphasises that the whole of the new OECD TP Guidelines material (paragraphs 1.41 to 1.118), examining issues that have to be considered in performing the 'comparability analysis,' will be fully applicable under the Luxembourg transfer pricing regime. This includes the new rigorous six-step approach to risk analysis. The Commentary on the Bill dealing with this paragraph explicitly emphasises the link to paragraphs 1.41 to 1.118 of the OECD.

Lastly, paragraph 1.36 of the OECD TP Guidelines specifies that all of the 'comparability analysis' material described above needs to form part of a taxpayer's 'local file,' as called for under the measures regarding transfer pricing documentation recommended as part of the BEPS Action 13 Final Report, and now forming Chapter V of the OECD TP Guidelines.

Observation: While the Bill text does not explicitly replicate this requirement, it can be assumed that the Luxembourg tax authorities will, as their practice evolves, insist on this comparability analysis forming part of the mandatory TP documentation when conducting transfer pricing audits.

The Commentary on the Bill also confirms the background to the text of paragraph (6) of the draft art. 56bis, stating that this implements into Luxembourg law the whole of Chapters 2 and 3 of the OECD TP Guidelines. These Chapters describe the 'traditional transaction methods' and 'transactional profit methods' respectively. Paragraph (6) provides as follows:

"The methods selected for determining the appropriate comparable price must take account of the comparability factors identified, and must be coherent with the nature of the transaction as accurately delineated. The price thus identified, by comparing the transaction as accurately delineated with comparable open market transactions, will be the arm's length price applied to the transaction, analysed with respect to the arm's length principle. The choice of the method of comparison selected must be that corresponding to the method that allows the best possible approximation to the arm's length price."

Observation: The last sentence, in attempting to synthesise, goes somewhat beyond the OECD requirement, which is simply to aim at finding the most appropriate method. At this stage it is not clear whether this discrepancy is significant.

Non-recognition

The last paragraph of the draft Bill text contains a GAAR-type measure, which potentially could be significant. Paragraph (7) provides as follows:

> "Where a transaction has been effected and all or part of that transaction as accurately delineated includes one or more elements which in substance do not have valid commercial rationality and which have a significant impact on the determination of the arm's length price, this transaction or this part of the transaction is to be ignored in determining the arm's length price with the aim of respecting the arm's length principle."

The Commentary on the Bill confirms that the intention of the paragraph is to bring into Luxembourg law the principles of paragraphs 1.122 to 1.125 of the OECD TP Guidelines in its post-BEPS form as set out at pages 39-40 of the BEPS Actions 8-10 Final Report. The Commentary also spells out the scope of the provision in somewhat more detail, introducing the concept of making a comparison with third-party choices of action. It notes that "Whenever a transaction has been entered into and it can be **proved** that a third party would not have entered into this transaction or a part of the transaction, because of the lack of commercial rationale, this transaction or a part of the transaction can be ignored, with the consequences that this would have on the determination of the taxable base."

Observation: As the Luxembourg Government adheres fully to the OECD TP Guidelines, we assume that they also apply the OECD safeguarding guidance. The inclusion and scope of these ‘non-recognition’ measures in the BEPS recommendations was a topic that was hotly debated during the consultation phase of the BEPS Project. The outcome in the Final Report that now comprises Section D.2 of the OECD TP Guidelines reassuringly emphasises the exceptional nature of the measures. For example, Paragraph 1.121 points out that: *“A tax administration should not disregard the actual transaction or substitute other transactions for it unless the exceptional circumstances described … apply.”*

The takeaway

If enacted, new art. 56bis will, further codify the arm’s-length principle in Luxembourg. It is anticipated to take effect from January 1, 2017.

Many of the key principles of the OECD TP Guidelines in their augmented, post-BEPS form, then will be embedded explicitly in Luxembourg law, including the requirement for comparability analysis that looks at functions, risks, and contractual terms, all conducted as described in these Guidelines.

The five principal methods for transfer price setting as described by the OECD also are given authority within the Luxembourg transfer pricing regime.

All this does not represent a radical change, as Luxembourg already has recognized the application of the OECD TP Guidelines. The legislation, however, now makes the rules more explicit in this area, and at the same time adopts the new recommendations stemming from the OECD BEPS Project.

The explicit inclusion of a ‘non-recognition’ clause within the text of the art. 56bis set out in the Bill sounds a note of caution. An important priority should be included within transfer pricing documentation, good support evidencing the commercial rationale behind all controlled transactions, notably those that provide significant financing to Luxembourg companies.

Let's talk

For a deeper discussion of how this may affect your business, please contact:

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