Luxembourg issues new TP Circulaire for the fiscal treatment of intra-group financial transactions

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In brief

On December 27, 2016, the Luxembourg Tax Authorities issued a new Circulaire (the Circular) providing guidance for the fiscal treatment of intra-group financial transactions. The Circular — effective as from January 1, 2017 — closely follows the application of the arm's-length principle of the OECD Transfer Pricing Guidelines. All existing transfer pricing rulings (unilateral APA) no longer are valid as from that date.

The new Circular, which no longer includes the rule to determine the equity at risk (i.e., 1% or € 2m), stipulates the importance of adequate substance and a functional analysis, covering the functions, assets, and risks of the transacting parties and their commercial relationship to determine the appropriate equity level.

At the time of the Circular's publication, the following arm's-length compensation may be observed in the market for entities performing:

- Similar functions to those of regulated financial and treasury entities: a percentage of return on equity of 10% after tax.
- Pure intermediation functions: as simplification, a return on invested assets of 2% after tax.

In detail

With the new Circular effective as from January 1, 2017, taxpayers applying the 2011 Circular should perform an impact analysis to determine:

- How does the new Circular impact their structure?
- Which level of equity would be required going forward?
- Does the taxpayer's existing functional analysis and substance require updating?
- Is the actual conduct of transacting parties aligned with agreements (substance over form)?
- Will the change result in an increased taxable income?

In line with the OECD guidance (e.g., Base Erosion and Profit Shifting), the economic reality gains ground (substance over form) as from January 1, 2017 to determine the arm's-length compensation, whereas the legal agreements may be aligned afterwards. Thus, the mismatch between economic and legal reality may cause a (temporary) deviation between statutory and tax accounts.

Although only published on December 27, 2016, the Circular (L.I.R: nr 56/1 – 56bis/1 replacing the circulaires L.I.R.

nr 164/2 of January 28, 2011 and L.I.R. 164/bis of April 8, 2011) is effective as from January 1, 2017. Understanding in detail the impact on existing structures and adapting to the new rules obviously will not be possible by that date. This Tax Insight covers the key elements of the Circular. Technical analysis will be covered in a separate Tax Insight.

Summary of the Circular

The Circular tackles the tax treatment of entities carrying out intra-group financing transactions.

Definition

Under the Circular, entities carrying out group financing transactions means any entity that conducts intra-group financing transactions and refers to any activity consisting of granting loans or (cash) advances to related parties that are remunerated by interests and are refinanced by funds and financial instruments like public offerings, private loans, cash advances, or bank loans.

General aspects

The new article 56bis L.I.R. — introduced by Article 3, number 2 of the law of December 23, 2016 on the budget law for fiscal year 2017, which entered into force as from January 1, 2017 — contains the basic principles to be followed in conducting a transfer pricing analysis. The main focus of this new article is on the comparability analysis while applying the arm's-length principle. It allows adjustments to be performed on the reported profits if the transfer price differs from prices that would have been agreed between independent entities in comparable transactions carried out in the open market in comparable circumstances.

Application of the arm's-length principle to intra-group financial transactions

Comparability analysis

The application of the arm's-length principle to intra-group financing transactions must be in line with the comparability analysis stated at paragraph 4 of article 56bis L.I.R., which consists of two elements:

- 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, and
- Comparing the conditions and the economically significant circumstances of the controlled transaction, as accurately delineated, with those of comparable open market transactions.

Value chain analysis

For the analysis of the arm's-length nature of controlled transactions between related parties, the roles of the parties and their commercial or financial relationship are essential. In that context, a value chain analysis is necessary, translating the contribution of the parties to the controlled transaction.

Substance over form

Under the new Circular, the economic reality of the transaction prevails over the contractual terms of the agreement. If the actual behavior of the parties to the transaction differs from what was contractually agreed, it is the actual conduct of the parties that must be taken into account for the analysis of the transaction performed.

Functional analysis

The purpose of the functional analysis is to identify the economically significant activities, responsibilities and functions, assets employed or provided, and the risks assumed by the parties in the context of the transaction.

The functions assumed in connection with the granting of loans or advances of funds to related entities are in essence comparable to the functions assumed by independent financial institutions subject to the supervision of Commission de Surveillance du Secteur Financier (CSSF). As a consequence, companies need to address the differences between the controlled transaction and those covered by the CSSF regulatory framework.

A non-exhaustive list of functions performed by companies conducting intra-group financing transactions has been provided in the Circular covering:

- Initiation of the transaction.
- Transaction management.

The identification of the functions performed and the assets used is essential to understand the risks associated with the financing transaction.

Risk analysis and equity level

The main idea of the risk analysis is that before granting a loan or a cash advance, a financial institution will perform a risk analysis to assess the exposure to which it may be subject. In this context, the capacities to manage and to assume the risk are economically significant characteristics, which must be identified to accurately delineate the controlled financing transaction.

Safe harbour for equity level: When the comparability analysis reveals (1) that an intra-group financing entity has a comparable profile to those of entities submitted to the European regulation (EU) n°575/2013 of the European Parliament and Council dated June 26, 2013 concerning the prudential requirements applicable to the credit establishments and to the investment companies and modifying the regulation (UE) n°648/2012 and (2) that it has an amount of equity respecting solvency criteria determined by this regulation, its equity level is then seen as high enough to support the financial consequences if the risks happen.

If the comparability analysis reveals significant differences between the functional profile of the group financing company and the aforementioned regulated entities, it is necessary to determine the appropriate equity level to assume the risks, based on recognised methods to determine the credit risk.

Substance requirements

The Circular also stresses that an intra-group financing entity only controls the risk if it has the decision-making capabilities to execute a transaction and to monitor the risk. Outsourcing would only be possible if the entity has the capability to determine the objective for the external service provider, monitor its performance, and amend or terminate the contract.

The substance of a Luxembourg-based intra-group financing entity needs to meet all the following conditions:

- The majority of the managing directors with decision-making power to bind the entity need to be either Luxembourg residents or non-residents with a professional activity subject to tax in Luxembourg. In the event that a legal person is a board member, it must have its legal office and central administration in Luxembourg;
- The company needs to employ qualified personnel to manage and control the transactions. Supporting activities may be outsourced. Key decisions need to be taken in Luxembourg. In case the bylaws of the company provide for general meetings, at least one meeting per year must be held in Luxembourg; and
- The company cannot be considered resident of another State.

Determination of the arm's-length compensation/guidance for regulated entities

In order to determine arm's-length remuneration, a comparability analysis must be performed.

Safe harbour for return on equity: In the case of companies performing similar functions to those performed by regulated financing and treasury companies, which are covered in section 3.1.1.3 of the Circular, a percentage of return on equity of 10% after tax may be observed in the market and may be considered as reflecting arm's-length compensation for the financing and treasury functions in question at the time of publication of this circular. This percentage will be regularly reviewed by the Tax Authorities on the basis of relevant market analysis.

Comparability adjustments need to meet internationally accepted standards to safeguard the comparability analysis.

Transactions without commercial rationale

If further to a comparability analysis it is concluded that the controlled transactions cannot be observed in the open market, lack commercial rationale, and would not be concluded between independent parties under the same conditions, these transactions and the associated tax consequences must be disregarded to ensure full compliance with the arm's-length principle.

Simplification measures for pure intermediary entities

When a group financing company meets the substance criteria set out in section 3.1.1.3. of the Circular and pursues a purely intermediary activity, simplification prevails — transactions are then deemed to comply with the arm's-length principle if the analysed company has at least a 2% return after tax on the financed assets.

This percentage will be regularly reviewed by the Tax Authorities on the basis of relevant market analysis. The wording of the Circular could be read in such a way that for the simplification, no transfer pricing analysis to determine the arm's-length compensation is required.

This minimal return for financing entities with limited functions cannot be applied to entities with a different functional profile. To benefit from this simplification measure, the entity has to communicate its application to the tax authorities with the submission of the tax return.

On exception, a deviation from the minimum return of 2% is only accepted with a justification by a transfer pricing analysis.

The taxpayers selecting this option will be subject to exchange of information.

Content of an information request binding the "Administration des contributions directes" in respect to transfer pricing to an intra-group financing company (extract of the Circular)

Any request for an advance ruling should include a transfer pricing study in compliance with the principles set out in the previous sections and as recommended by the OECD in this area. This report should include:

- A description of the computation of equity allocation required to be able to assume the risks;
- A description of the value creation, by the enterprises which are party to the transactions;
- The full comparability analysis on the basis of which the enterprise has determined the arm's-length price applied to the intra-group transactions whose scope has been determined precisely; and
- Projected profit-and-loss accounts for the years covered by the advance ruling.

Decisions made by the Luxembourg direct tax authority before article 56bis of the L.I.T.L. enters into force

Any individual decision relating to the arm's-length principle that the authority has made on the basis of the rules applicable before article 56bis L.I.T.L enters into force no longer is binding.

Immediate action points

It is important to perform an assessment of the impact these new measures have on the taxpayer's existing and future structures and what actions need to be taken.

Step 1 - GAP and impact analysis

- Identify whether the financing structures fall within the scope of the changes. Depending on the current equity at risk level and specific circumstances, certain structures may not be impacted.
- Analyse the impact on the identified financing structures according to the requirements for substance and equity at risk, taking into account the functional and risk profile of the financing structure and assessing the equity required to assume the risk.
- Determine the consequences for the financing structures with a limited risk profile. This analysis requires identifying commercial rationale, including risk limitations.

Step 2 - Identify alternatives and actions needed to become compliant

Once the substance, equity at risk, and remuneration impact has been established, alternative approaches to determine the total arm's-length compensation can be simulated. Based on this, the recommendations for the implementation of the actions to become compliant with the Circular should be formulated.

The takeaway

Luxembourg entities should consider carefully the impact these new measures have on existing and future structures and what actions need to be taken:

- Financial structures under the 2011 Circular and with notably limited functional and risk profile are impacted by the new transfer pricing regulations, including the new Circular.
- The new transfer pricing regulations (including the new Circular) are applicable as from January 1, 2017. No grandfathering provision has been foreseen.

Let's talk

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

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