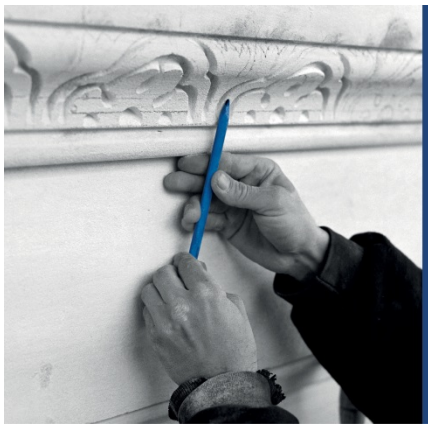

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New Circular Letter on the tax treatment of companies engaged in intra-group financing transactions

On 27 December 2016 the Luxembourg Tax Authorities (*Administration des contributions directes*) issued Circular Letter L.I.R. – N° 56/1 – 56bis/1 (the "New Circular Letter") on the tax treatment of companies engaged in intra-group financing transactions.

The New Circular Letter replaces the previous circular letters LIR N° 164/2 and 164/2bis dated 28 January and 8 April 2011 in order to render the Luxembourg transfer pricing rules compliant with the revised Chapter I Section D of the OECD Transfer Pricing Guidelines ("Revised OECD Guidelines"). The Revised OECD Guidelines have been transposed into the Luxembourg domestic income tax law ("ITL") as a new article 56bis by the budget law dated 23 December 2016 (see also our newsflash dated 13 October 2016 available on our website, www.arendt.com section Publications/Newsflash).

According to the Revised OECD Guidelines, a "comparability analysis" lies at the heart of the application of the arm's length principle: the arm's length principle is based on a comparison of the conditions of a controlled transaction with the conditions that would have been made had the parties been independent and undertaking a comparable transaction under comparable circumstances.

The main changes in the New Circular Letter may be summarised as follows:

Definitions and scope

The New Circular Letter applies to all companies engaged in intra-group financing transactions, as opposed to the former regime which, at least in theory, only applied to companies that were "mainly" engaged in such transactions. An intra-group financing transaction is further defined as any activity which consists in granting loans or advances remunerated by interest to affiliated enterprises and refinanced by financial means and instruments such as public or private debt

issuances, advances or bank loans. The definition of affiliated enterprises remains unchanged and follows the definition given by the OECD guidelines.

The New Circular Letter further points out that the arm's length principle provided by article 9 of the OECD Model Convention constitutes the international standard for the determination of transfer pricing for cross-border transactions between affiliated enterprises. The arm's length principle is enshrined in article 56 ITL and the new article 56bis ITL provides further guidance on the basic principles that must be observed by a transfer pricing analysis, in particular the conduct of a comparability analysis. Finally, paragraph 171 of the General Tax Law obliges taxpayers to be able to justify their transfer pricing in controlled transactions through appropriate transfer pricing documentation.

Application of the arm's length principle in intra-group financing transactions

Following the Revised OECD Guidelines, the New Circular Letter sets the comparability analysis as the main element for the application of the arm's length principle. The comparability analysis includes 2 main parts:

(i) analysing the commercial and financial relations between affiliated enterprises and determining the economically significant circumstances of said relations in order to precisely identify the controlled transaction

This part of the analysis should firstly include a detailed functional analysis, including a value chain analysis, which identifies the activities, the liabilities, the economically significant functions as well as the assets and risks of each party to the controlled transactions. The New Circular Letter, by comparison with the previous regime, gives further technical guidance as to the methodology of the functional analysis, thus increasing the requirements as to the identification of the functions assumed and the assets used.

Secondly it should include a risk analysis which estimates on the basis of the facts and circumstances of each individual case the economically significant specific risks related to the financing transaction, the functions exercised which have a link or an influence on the assumption or impact of these risks, as well as the party which assumes them. The New Circular Letter considers it a general rule that an intra-group financing company must assume these risks if it has the financial capacity therefor, *i.e.* the necessary equity at risk. To date, an intra-group financing company has been deemed to be assuming the risks of the financing transaction if the amount of its equity at risk corresponded to at least (i) 1% of the nominal amount of the loan(s) granted or (ii) € 2 million. However, given that the lump sum determination of these criteria is not compatible with the Revised OECD Guidelines, the New Circular requires that the amount of equity at risk must be determined by an appropriate transfer pricing analysis on a case-per-case basis. To take an example, if the comparability analysis reveals that the intra-group financing company has a profile similar to a financial institution governed by Regulation (EU) N° 575/2013 of 26 June 2013 on prudential requirements for credit institutions and investment firms, adopted at the level of the European Union to implement Basel III Agreement, and its equity complies with the solvency requirements thereunder, it is deemed to have an appropriate equity at risk. In

case it has a different profile, the equity at risk needs to be determined on the basis of other methodologies, notably by means of a credit risk analysis developed by the industry which includes a balance sheet and market analysis as well as other elements that are relevant for the determination of the risks linked to a financing activity. Further, in order to be able to control these risks, an intra-group financing company must have a genuine presence in Luxembourg, which requires a minimum of business substance in Luxembourg, as follows:

- the majority of the members of the board of managers, directors or managers having power to bind the company must be (i) Luxembourg residents or (ii) non-residents who pursue a professional activity (*i.e.* a business, agricultural/forest, independent or salaried activity) in Luxembourg and who are taxable in Luxembourg for at least 50% of their professional revenue. In case a company is part of the management board, it must have its statutory seat and central administration in Luxembourg;

- the company must have qualified personnel able to control the transactions performed. The company may however outsource functions that do not have a significant incidence on the control of the risks. In this respect, the New Circular Letter deviates from the previous regime, according to which the company could use either its own employees or outside staff capable of executing and registering the transactions performed, as long as the company could guarantee the supervision of the work executed by the staff. According to the New Circular Letter, it seems that this only remains possible as long as the outsourced function does not have any significant incidence on risk control;

- key decisions regarding the management of the company must be taken in Luxembourg. Companies that are required by corporate law to hold shareholder meetings must hold at least one annual meeting at the place indicated in the articles of incorporation; and

- the company must not be considered a tax resident of another State.

It is noteworthy that the New Circular Letter, as opposed to the former regime, does not require that the company must maintain at least one Luxembourg bank account and that the managers must possess appropriate professional knowledge to exercise their functions. This being said, in practice Luxembourg companies usually need a Luxembourg bank account for the purpose of their incorporation and proof of the professional knowledge of the managers has now become part of the information to be provided for the application of an advance pricing agreement ("APA").

(ii) comparing the economically significant conditions and circumstances of the controlled transaction with uncontrolled transactions between third parties

In order to determine the arm's length remuneration, the New Circular confirms that the controlled transaction must be compared with the uncontrolled transaction. As such, the New Circular follows the former regime, although it provides further technical guidance in respect of research on comparable transactions.

However, it also indicates that industry practice should be taken into account. For example, it refers to companies whose functions are comparable to those of enterprises governed by Regulation (EU) N° 575/2013 of 26 June 2013 and for which a remuneration of the equity at risk of 10% after taxes may currently be considered as arm's length (such percentage being subject to a periodical review of the tax authorities on the basis of their market analysis).

The general principle of substance over form also remains applicable to the comparability analysis. Where a transaction or part of a transaction between related parties does not have a commercial rationale (*i.e.* a third party would not have entered into the transaction), this transaction or this part of the transaction may be disregarded, with all the attendant tax consequences.

Simplification measure

The New Circular Letter provides for a simplification regime for financing companies that exercise a pure intermediary activity: given the low risks of said transactions (to be duly justified by the risk analysis), it is admitted that they comply with the arm's length principle if the company realises a minimum yield on its financings of currently 2% after taxes (such percentage being subject to a periodical review of the tax authorities on the basis of their market analysis). Companies opting for the simplification measure remain however subject to an exchange of information with foreign tax authorities under the applicable laws.

Content of advance transfer pricing request

The New Circular extends the list of information to be provided to the Luxembourg tax authorities for APA applications. In addition to the requirements under the former regime, the following needs to be provided:

- the qualifications of the relevant employees as well as a description of their functions; an OECD compliant transfer pricing analysis observing the new rules set out hereabove, including in particular (i) the description of the methodology used to determine and fund the equity at risk, (ii) a description of the group, the relations between the functions of the parties to the controlled transaction and the rest of the group, as well as the value chain, (iii) the precise limits of the analysed transactions, (iv) the complete list of comparables (included those rejected and the motivation therefor), (v) an indication of any advance transfer pricing requests concluded with other States regarding the company(ies)/transaction(s) which are still in force at the time of the application, as well as (vi) the financial projections (*i.e.* P&L account) for the years to be covered by the APA.

Entry into force

The New Circular Letter enters into force as of 1 January 2017. Any APA issued under the former rules will cease to be binding on the Luxembourg tax authorities as from 1 January 2017 for taxation years commencing after 2016. Companies that wish to benefit from a new APA must

file a request with the competent taxation offices which will apply the rules of the New Circular Letter.

How can we help?

Further to the release of the New Circular Letter, companies engaged in intra-group financing transactions should revisit their current transfer pricing documentation in the light of the new rules in order to determine if and to what extent it needs to be amended.

Our transfer pricing team, as well as your usual tax contacts at Arendt & Medernach, are of course at your disposal to assist you therewith.

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