Arendt Annual Transfer Pricing Forum 2018

Alain Goebel, Partner
Danny Beeton, Of Counsel
Benjamin Tempelaere, Senior Associate
Alexandre Maschiella, Associate

Arendt House
12 October 2018

Content

- *Welcome and introduction* – Alain Goebel, Partner
- *The changing landscape of transfer pricing and the broad implications for Luxembourg businesses* – Danny Beeton
- *The impact on financial services* – Benjamin Tempelaere
- *The impact on corporates* – Alexandre Maschiella
- *Question and answer session*

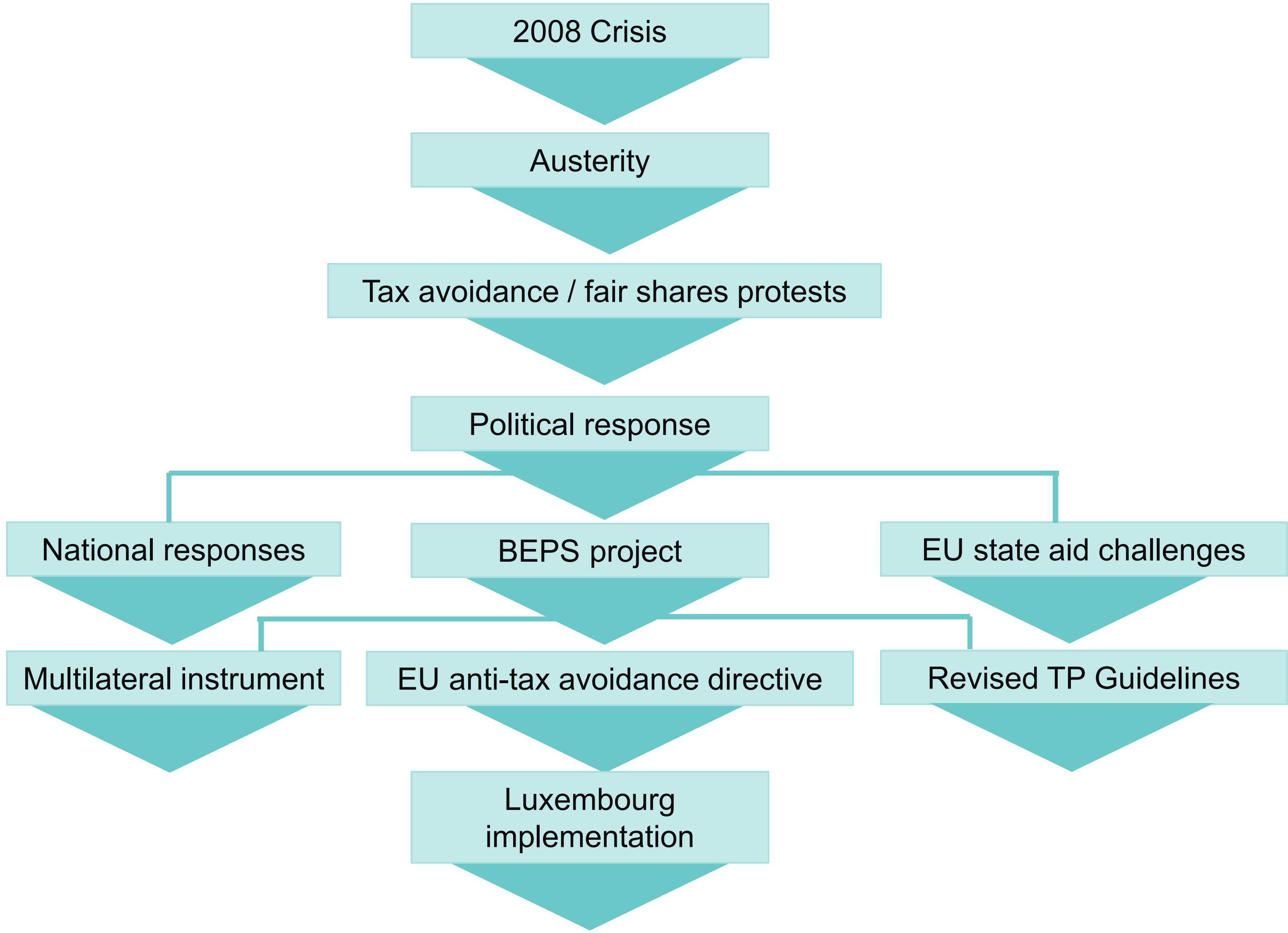
Welcome and introduction

- The purpose of the event
- The target audience
- Arendt’s transfer pricing services
- Introduction to the speakers

The changing landscape of transfer pricing and the broad implications for Luxembourg businesses

- Introduction to transfer pricing (an accounting puzzle with important tax implications!)
- The traditional approach to transfer pricing
- What has changed – BEPS, the ATAD, the revised OECD Transfer Pricing Guidelines, Brexit…
- How Luxembourg is responding
- Key themes in the new transfer pricing world:
    - Commercially rational arrangements or different ones could be assumed
    - People doing what it says in the agreement
    - Profit has to follow the key decision-makers
    - And the synergy benefits of being in one group should be shared appropriately
    - Greatly increased documentation and filing obligations
    - More tax authority challenges, and in new and more complex areas
    - But less chance of agreeing your TP with tax authorities in advance!
- Why taxpayers should do about this

What has happened in Luxembourg? - Background



What has happened in Luxembourg? - Detail

arendt

Income tax law article 56

International tax treaties
Article 9

Requirement for all related party prices to be set as if agreed between unrelated parties

(Exemption for tax-transparent entities and partnerships, i. e. FCPs, securitisation funds, SICAVs, SICAFs, SPFs, SNCs and SCS(p)s, but not SICARs and securitisation companies)

Luxembourg TP Circular on related party financing of December 2016 (L.I.R. No. 56/1-56-bis1) requires credit scoring and calculation of loss-given default, and the application of a cost of equity to be recovered in the interest rate

Article 171 (3) of the general tax law requires taxpayers to provide transfer pricing documentation upon request

Form 500 asks two TP questions: Has the taxpayer entered into any related party transactions? Do these include financing, and if so, has the simplified approach been used?

Taxpayers with turnover of EUR 750m or more must file a country-by-country report showing their revenue, profit, tax paid, employees, assets and subsidiaries by jurisdiction. Will be used to identify high risk taxpayers. Other tax administrations can request it.

The new CFC rules introduce a further requirement for transfer pricing analysis

- The rules attribute the profit of a low tax location subsidiary to its Luxembourg parent company if there is no reason to involve the subsidiary other than tax benefits, and if it cannot do the tasks assigned to it
- This requires a TP analysis of whether the subsidiary’s profit derives from assets or risks for which it does not perform the ‘Significant People Functions’ (SPFs)
- The amount of profit to be reallocated to the parent company is the arm’s length reward for its SPFs on behalf of its subsidiary

What should taxpayers do? – TP documentation

Prepare TP documentation:
- Related party agreements
- Advance Pricing Agreements
- Country-by-country reports
- Master file
- Local files

Prepare other documentation with TP in mind:
- Annual report and accounts
- Prospectuses
- Websites
- …

Ensure consistency in terms of:
- What creates the profit?
- Which are the major risks that can produce a loss?
- In which parts of the business are those assets / functions / risks managed?

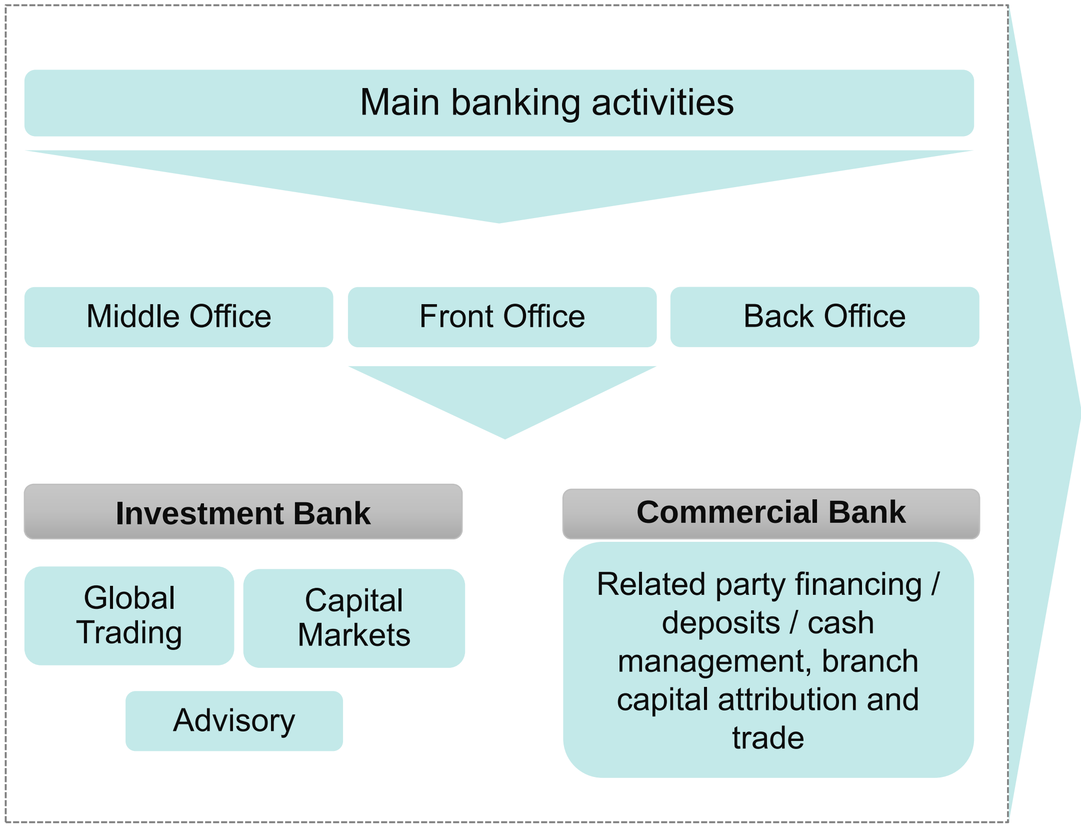
What should taxpayers do – TP planning and controversy

- Follow these TP planning principles:
  - Ensure that arrangements are commercially rational and better than any alternative for both parties (for non-tax reasons)
  - Put substance and decision-making where it is needed
  - Draft an agreement that the parties really mean to operate
  - Subject to the above, TP planning can still involve favourable locations for IP, finance and risks
- Prepare for more TP controversy in the areas of:
  - IP valuation
  - Interest rates and guarantee fees
  - Cash pooling arrangements
  - Captive insurance
  - Reallocation of profit based on location of key decision-makers
  - Alternative allocations of synergy benefits
  - Recharacterisation of arrangements if agreements are not kept to
  - Disregard of arrangements which are not optimal for one of the parties, or have no non-tax rationale

The impact on financial services

- Banking
- Asset management and funds
- Insurance

How is the banking industry affected?



Overview of the Banking Industry

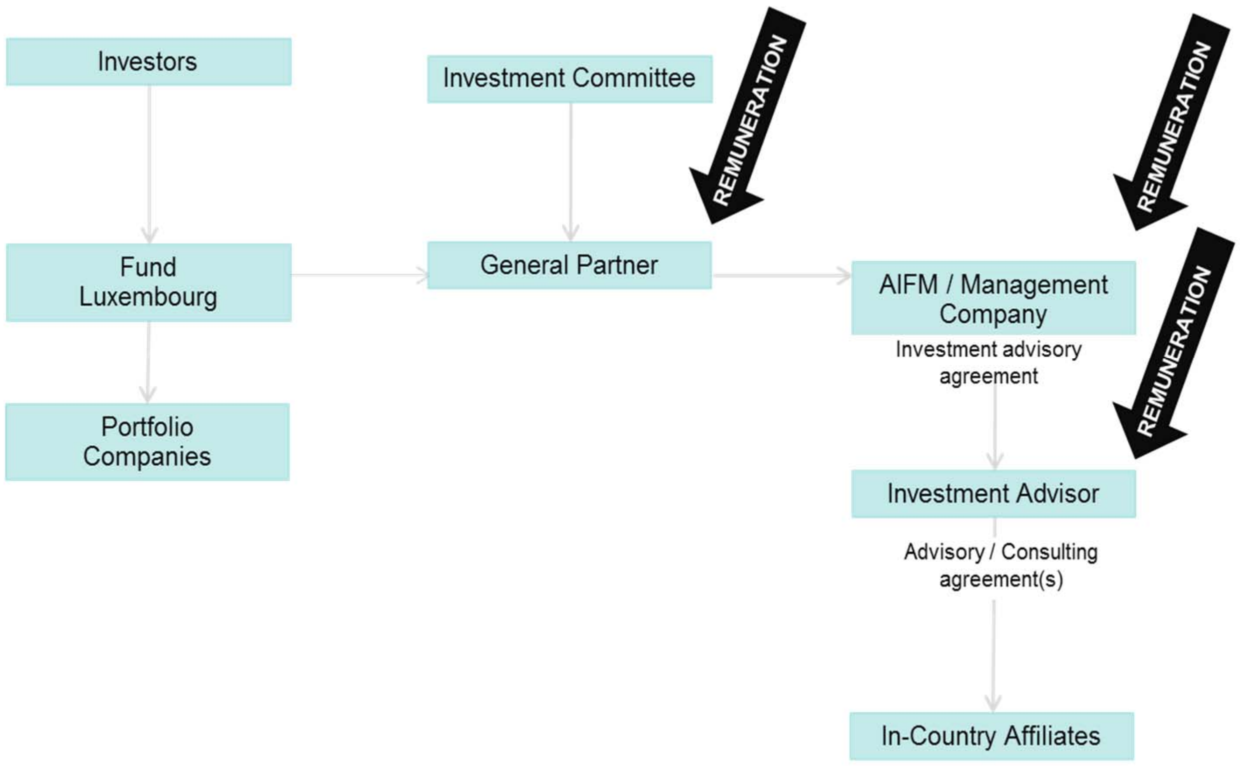
General comments

- Global trading can involve back office service fees, sales commissions, or a split of profit – the 'delineation' of the arrangements is now more important.
- Branch capital attribution requires the linking of capital and its cost to the risk which is entered into locally – the extension of the new TP concepts to notional transactions within a single company
- The location of key risk decision-makers is now particularly important

Specific transfer pricing issues for banks

- How to allocate profits amongst multiple trading centres?
  - A residual profit split methodology is commonly used, with employee compensation as an allocation key.
  - However, compensation as an allocation key is being questioned, as the correlation between losses and local employee compensation is unclear.
  - Tax authorities may seek to attribute losses by using allocation keys that do not reflect the real contribution of each location – a more economically sound profit and loss sharing model is required.
- Technology development – for a service fee or with an entitlement to a share of the resulting cost savings or revenue generation?
- Centralised support services – which costs should stay in the head office, which should be allocated and how?
- Use of the name – for a royalty? – trust in the brand versus access to a global network

Asset management

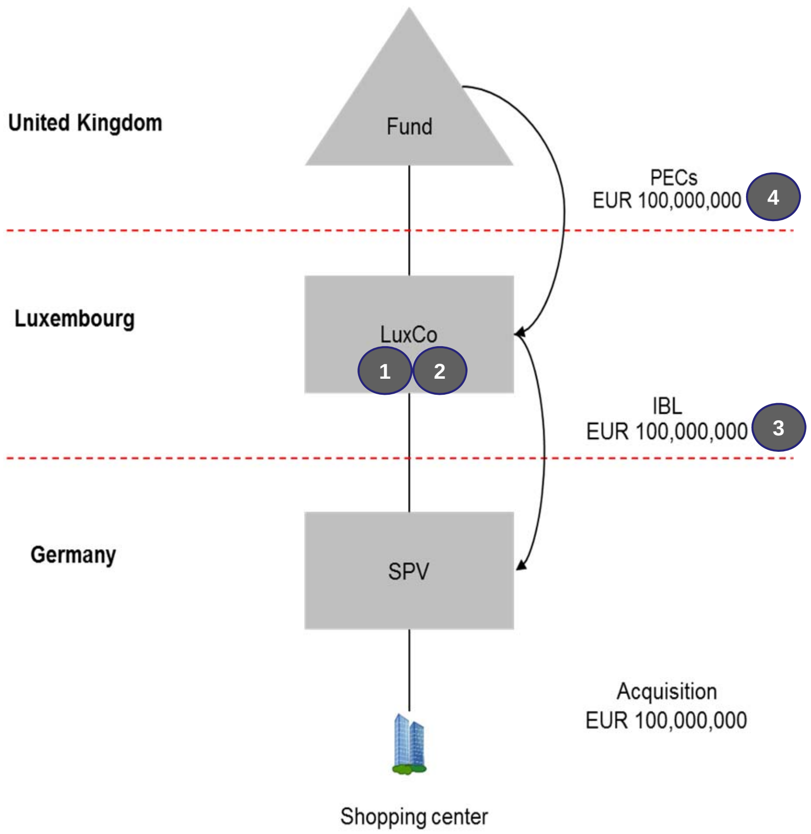


Related party transactions

- Fund administration and other back/middle office services
- Investment relationship and capital raising
- Investment advisory services
- Portfolio monitoring fees
- Cost allocations
- Related party loans and financing transactions

Asset management – greater use of the profit split method likely

Funds – changes to the treatment of back-to-back acquisition loans



1 Equity at risk of LuxCo:

No more standard rule to determine the equity at risk (i.e. 1% capped at EUR 2M). Application of the Expected Loss methodology and the equity to cover the EL.

2 Arm's length remuneration and implied financing cost of LuxCo:

Determination of the expected return on LuxCo's equity at risk using the CAPM.

3 Determination of the interest rate

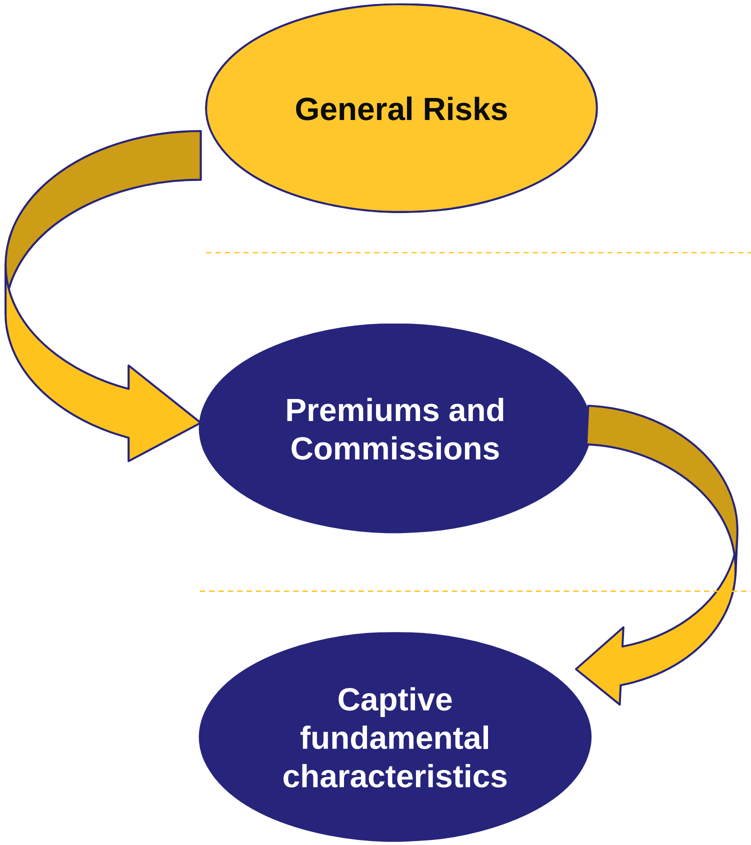
The LTA will increasingly require taxpayers to justify the arm's length character of the interest rate based on the creditworthiness of the borrower.

Controversial point: 2018 OECD financial draft suggests building-up an interest-rate by adding to the lender's cost of funds a mark-up on the agency functions of the LuxCo.

4 Contractual documentation

Limited recourse clause can no longer be used to limit the risk of the financing company. The effect of other loan conditions on the interest rate should be considered.

Insurance industry – captive insurance issues



Tax authorities may seek to challenge captive structures in various ways:

- Permanent establishment or CFC challenges
- Partly non-deductible premiums (e.g. where not all risk is transferred because risk management is disbursed)
- Level of premiums and commissions must be at arm's length rates
- Possible challenge that captive should only earn same return as comparable insurers
- But alternative argument that captive is over-capitalised
- Possible challenge that captive does not have the essential characteristics of an Insurance business:
  - Assumption of risk by the insurer
  - Distribution of risk / pooling of a portfolio of risk

The impact on corporates

- The transfer pricing issues facing corporates – goods, services, intangibles, finance
- The major threats to commonly-used arrangements
- How companies should change to comply with the new principles while still arranging their affairs in a tax-efficient manner

The evolution of transfer pricing planning for corporates

Early transfer pricing planning

- IP companies charging royalties
- Finance companies charging interest or guarantee fees, or factoring accounts receivable
- Captive insurance companies charging premiums

Tax-effective supply chain management

- Central entrepreneur companies contracting with suppliers and customers and bearing all significant risks
- All other related parties earn a routine profit margin (or royalty)
- Central entrepreneur may also own the IP

Post-BEPS transfer pricing planning

- A good non-tax reason for the arrangements
- A deal that makes commercial sense for both parties – no better alternatives
- With the key decision-makers employed in the right companies
- And any synergy benefits shared appropriately
- The agreements operated as third parties would do, e.g. demanding payments when due

An example of the new approach – selling IP between related parties

- IP can command large profits in the form of royalties or in sales or products that use the IP
- Hence, having IP in a low tax location can be very beneficial
- However, major international tax cases indicated that IP may have been transferred at undervalue
- The guidance has therefore been tightened up, as follows:
  - Base the valuation on how much profit could be earned from the IP
  - Allocate any synergy benefits appropriately
  - Consider whether unrelated parties would have agreed to share any unexpectedly high profits, as well as receiving an up-front payment
  - Take into account the relative bargaining power of the parties
  - Identify and weight the most likely profit and IP value scenarios
  - Remember that there would be no sale if one of the parties could be better off without it!

Related party loans

- Identifying what should be treated as debt for tax purposes
  - Features of instruments that point to them legitimately being viewed as debt rather than equity:

    - An obligation to pay interest,

    - A right to enforce payment of principal and interest,

    - The extent to which the funds are used to acquire capital assets,

    - Whether the interest rate is fixed or floating etc.
  - Excess lending treated as equity or the entire loan should be reclassified as equity?
  - Other options realistically available:

    - Is there a business need for the funds?

    - Impact of the new debt on the borrower funds given the impact of the new debt on its credit rating and its cost of capital?
  - Key risk-taking functions performed by the provider and the recipient of the funds:

    - Determining creditworthiness and assessing the risks,

    - Ensuring that the funds are available with which to repay the principal and the interest at the time specified.

Related party loans (continued)

- Identifying the Arm's Length Interest Rate
  - Aim

    Limiting the impact of excessive interest deductions
  - How ?

    a) Accurately delineating the financial transactions by conducting a debt capacity analysis of the borrower including:

    - A review of the multinational group's financing policy (business strategies, industry factors)
    - Options realistically available to both parties (the borrower and the lender)

    b) Determining and refining the appropriate credit rating:

    - Use of commercial credit rating tools to determine the credit rating of the borrower or the debt instrument
    - Implicit support should be considered (rating of the parent entity to be considered?)

    c) Benchmarking the interest rate using market-recognized tools

    d) Use of adjustments in order to increase the comparability level of the transaction:

    - Strong reservations about comparables with different currencies / in other countries.
    - If the funder does not make the relevant risk decisions, it will be entitled to a risk-free rate of return.

Group treasury services

- Financial Guarantees
  - Any "legally binding commitment on the part of the guarantor to assume a specified obligation of the guaranteed debtor if the debtor defaults on that obligation“ must be priced
  - Guarantee fees should be net of the value of any ‘implicit support’
- Cash Pooling
  - Arm’s length remuneration of the cash pool leader should be determined based on a detailed functional analysis
  - Several approaches are proposed to allocate the benefits of pooling amongst participants
  - Cross guarantees do not provide any incremental credit enhancement / No guarantee fee is applicable
- Other Centralised Treasury Services
  - E.g. optimising liquidity management / developing longer-term financial risk management strategies
  - Can usually be treated as ‘‘a support service’’ for a cost-plus service fee

Interaction between VAT and Transfer Pricing

- Introduction in the Luxembourg VAT law of the new concept of "valeur normale"/open market value (Article 28§3 of Luxembourg VAT law)
- Applicable to transactions between related parties
- Measure to prevent tax avoidance/evasion in the context of intra-group transactions
- 3 situations where VAT authorities can disregard the consideration agreed between related parties, retaining instead the open market value (i.e. arm's length value)
- Supporting documentation?

Interaction between VAT and Transfer Pricing

1. Where the consideration is **lower** than the open market value and the **recipient** of the supply does not have a full right of deduction; or

Supplier A → Taxable transaction subject to VAT → **Purchaser B** *Limited input VAT recovery right*

Open market value: 1000

Consideration agreed with A: 500

2. Where the consideration is **lower** than the open market value and the **supplier** does not have a full right of deduction and the supply is VAT exempt; or

Supplier A *Limited input VAT recovery right* → VAT exempt transaction → **Purchaser B**

Open market value: 1000

Consideration agreed with A: 500

3. Where the consideration is **higher** than the open market value and the **supplier** does not have a full right of deduction.

Supplier A *Limited input VAT recovery right* → Taxable transaction subject to VAT → **Purchaser B**

Open market value: 500

Consideration agreed with A: 1000

Biographies

Alain Goebel, Partner

Alain Goebel is a Partner in the Tax Law practice of Arendt & Medernach where he advises an international clientele on the tax and transfer pricing aspects of Luxembourg and cross border transactions, in particular corporate reorganisations, acquisitions and financing structures.

He has been a member of the Luxembourg Bar since 2002. He is a member of ALFI, LPEA, IFA and AIJA. He acted as President of YIN from 2013-2016 and as Luxembourg National Representative for AIJA from 2012-2015.

He was a lecturer in business taxation at the University of Luxembourg from 2009-2016 and is a regular speaker at tax seminars. He has published several papers on tax law, including national reports for IFA and AIJA, and is co-author of the Luxembourg chapter of the International Guide to the Taxation of Holding Companies published by the IBFD (Amsterdam).

Alain Goebel holds a Master's degree in business law and a postgraduate degree in tax law (DEA Fiscalité) from the Université Paris II Panthéon-Assas (France), as well as a Master of Laws degree (LL.M.) in banking and finance law from the King's College London (U.K.).

He is recommended as tax lawyer in the major league tables including Legal 500, Chambers Europe and Best Lawyers.

Email: alain.goebel@arendt.com
Tel: +352 40 78 78 512

Biographies

Danny Beeton, Of Counsel

Danny Beeton is Of Counsel in the Tax Law practice of Arendt & Medernach where he is the senior economist in the Transfer Pricing practice.

He advises clients on the determination of arm's length prices for all types of related party transactions, including goods, services and intellectual property, but with a special focus on financial transactions such as loans, guarantees, group treasury policies and asset management fees.

Danny's assistance is sought in the context of transfer pricing compliance and reporting, controversy and planning, and he has provided expert reports in the context of litigation.

Danny also brings his economics skills to bear in EU state aid matters and in giving general business advice to family-owned businesses.

He has been a member of two HMRC advisory committees, and committees of the Confederation of British Industry and the Chartered Institute of Taxation. Until recently he was Editor-In-Chief of the journal Transfer Pricing Forum. He has been listed in Chambers Tax, World's Leading Transfer Pricing Advisers and World's Leading Tax Controversy Advisers. Danny began his teaching career in the University of London, where he continues to gives post-graduate classes in transfer pricing. He is regular speaker at Tax conferences around the world.

He holds a Master's degree in Economics from the University of Essex as well as a PhD in Economics from the University of London.

Email: daniel.beeton@arendt.com
Tel: +352 621 395 102

Biographies

Benjamin Tempelaere, Senior Associate

Benjamin Tempelaere is a Senior Associate in the Tax Law practice of Arendt & Medernach. He specialises in transfer pricing.

Benjamin advises institutional clients and multinational companies on the pricing of all types of transactions and the valuation of intangible assets, with a particular focus on financial services and asset management.

Before joining Arendt & Medernach in 2015, he worked as a transfer pricing consultant for two big four companies in Luxembourg and France.

He holds a Master's degree in Management and a Master of Science in Legal & Tax Management from EDHEC Business School as well as a Master's degree in Business, Tax & Financial Market Law from Paris-Saclay University.

Email: benjamin.tempelaere@arendt.com
Tel: +352 40 78 78 7684

Biographies

Alexandre Maschiella, Associate

Alexandre Maschiella is an Associate in the Tax Law practice of Arendt & Medernach where he specialises in Transfer Pricing. He advises institutional clients and multinational companies on the pricing of all types of transactions and the valuation of intangible assets, with a particular focus on financial services and asset management.

Alexandre is a Luxembourg qualified lawyer. He is a member of the Luxembourg Bar since 2018.

Alexandre obtained a Master of Laws degree (LL.M.) in Taxation from the University of Luxembourg.

Email: alexandre.maschiella@arendt.com
Tel: +352 40 78 78 7798