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INSIGHT: Fund Management Services in the Focus of Luxembourg Transfer Pricing

By Oliver R. Hoor and Fanny Bueb

Investment funds can be defined as collective investment vehicles which are created for the purpose of gathering investors' capital and investing that capital in a portfolio of assets. Luxembourg is the largest domicile for investment funds in Europe and the second largest fund center worldwide (after the U.S.).

Investment funds may be divided into two broad categories:

- undertakings for collective investments in transferable securities (UCITS) that invest into financial instruments such as stocks, bonds and other securities; and
- alternative investment funds (AIFs) that are created for different types of investments such as private equity, venture capital, real estate and Infrastructure investments.

All funds have in common that they are managed in one way or another by an investment manager. However, the organization of fund management services may vary significantly from one case to another and involve two or more related parties (management companies, advisory companies, etc.).

When fund management services involve controlled transactions between related parties, it is crucial that the parties to these transactions are remunerated at arm's length. Given that the overall amount of fees for fund management services typically ranges between 1% and 2% of the assets under management (or commitments as the case may be), fund management services are frequently material transactions. It is therefore not surprising that the transfer pricing of fund management services is increasingly more in the focus of the Luxembourg tax authorities.

Oliver R. Hoor is a Tax Partner (Head of Transfer Pricing and the German Desk) and Fanny Bueb is a Tax Director with ATOZ Tax Advisers.

Fund Management Services

Fund management services cover a wide range of elements including fund and portfolio management (investment advice, investment performance monitoring, investor relations, etc.), risk management (supervision, portfolio risk management, internal audit, etc.), marketing, valuation and fund administration (accounting, investor administration, depository, reporting, etc.).

In practice, fund management services might be rendered by one single management company or by several companies that might be members of the same group or third parties. While Luxembourg funds are generally managed by a Luxembourg management company, certain aspects of the fund management services may be outsourced to other management or advisory companies resident in Luxembourg or abroad.

The way fund management services are organized depends on a number of factors, such as the particular organization of the investment manager, the size of the investment manager and the type of investment fund (UCITS vs. AIFs).

When Does the Arm's Length Principle Apply?

The transfer pricing analysis of fund management services frequently begins with the mapping of the different transactions. A second step is to analyze whether transactions are arm's length transactions between third parties or controlled transactions between related parties.

When fund management services involve transactions between related parties, the arm's length character of the remuneration earned by the parties to those transactions has to be substantiated for tax purposes.

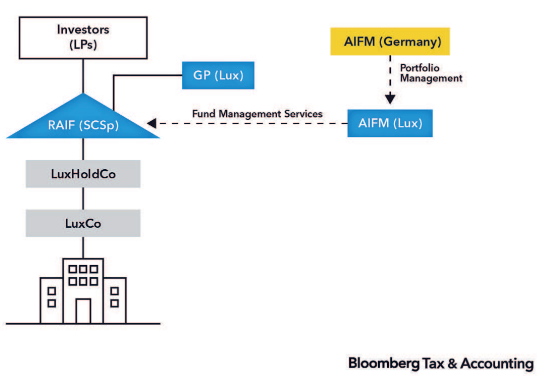
In contrast, transactions between third parties do not have to be tested from a transfer pricing perspective. As such, it can be assumed that the overall fund management fee is arm's length since the investors in the fund are third parties to the investment manager that have accepted the quantum of fund management fees as detailed in the fund's prospectus. Likewise, the fees of third party service providers such as a third party AIF Manager (AIFM), a depositary bank or an auditor are deemed to be arm's length.

When the parties to a controlled transaction are resident for tax purposes in Luxembourg and one or more foreign jurisdictions, the transfer pricing analysis has to satisfy not only the Luxembourg requirements but also, at the same time, the requirements in the foreign jurisdiction(s) involved. Thus, it is important to develop a sound approach that is consistent with the arm's length principle. Otherwise, there would be a risk of economic double taxation and disputes between taxpayers and the tax authorities of the relevant jurisdiction(s) (i.e. when tax authorities perform unilateral transfer pricing adjustments). However, in general it is possible to rely on the Organisation for Economic Co-operation and Development Transfer Pricing Guidelines for Multinationals and Tax Administrations (the OECD Transfer Pricing Guidelines) that reflect the international consensus on the interpretation of the arm's length principle.

Case Study: Luxembourg Real Estate Fund

A Luxembourg real estate fund established as a Reserved AIF (RAIF) in the legal form of a limited partnership (*société en commandite simple*, SCS) is managed by a Luxembourg limited liability company (*société à responsibilité limitée*, S.à r.l.) that is the general partner (GP) of the SCS. The investors in the fund are limited partners (LPs) of the SCS.

The GP of the fund appointed a Luxembourg AIFM (AIFM (Lux)) of the group to perform fund management services. Some of the fund management services, including portfolio management and marketing, are outsourced to a German management company (AIFM (Germany)). The RAIF pays fund management fees corresponding to 1.5% of the assets under management.



In this case, the percentage of the overall fund management fees has been agreed between third parties and does not need to be tested from a transfer pricing perspective.

However, the GP needs to be remunerated at arm's length for the functions performed and the risks assumed. Likewise, the Luxembourg and the German AIFMs are related parties that have to realize an arm's length remuneration for their involvement in the rendering of fund management services.

How are Arm's Length Transfer Prices Determined?

The determination of arm's length prices relies on the application of transfer pricing methods. The OECD Transfer Pricing Guidelines provide for five different methods which are categorized as traditional transaction and transactional profit methods.

The traditional transaction methods include the comparable uncontrolled price (CUP) method, the cost-plus method and the resale price method. The transactional profit methods include the transactional net margin method (TNMM) and the profit split method, which might be applied in different ways.

Each of these methods has its strengths and weaknesses and cannot be applied in every case. Therefore, the most appropriate method has to be determined on a case-by-case basis, considering the functional analysis.

The transfer pricing methods that are most appropriate with regard to fund management services include the CUP method, the cost-plus method and the profit split method. The CUP method may, for example, be applicable when one of the entities has a functional profile that is comparable to that of a management company that offers services to third parties (here, one may rely on external comparables). Moreover, when a management company renders services to related parties and similar services to third parties, these internal comparables may be used to establish the arm's length price.

In other cases, a cost-plus remuneration might be most appropriate in the absence of comparable data that would enable the application of the CUP method. The cost-plus method is often applied for determining an arm's length remuneration regarding functions performed by a Luxembourg general partner on behalf of a Luxembourg fund. A cost-plus remuneration may further be appropriate in case of administrative services.

However, in practice, fund management services may be highly integrated and rendered by several parties that provide highly specialized services and contribute valuable intangibles. In these circumstances, the determination of an arm's length remuneration may often rely on the application of the profit split method.

The profit split method may either rely on a contribution or a residual analysis. Under a contribution analysis, the combined profits (i.e. the total profits from the controlled transactions under examination) are divided between the associated enterprises based on a reasonable approximation of the division of profits that independent enterprises would have expected to realize from engaging in comparable transactions.

A residual analysis is appropriate where the contributions of the parties to the combined profits include contributions that can be directly and reliably valued by reference to comparables.

A residual analysis divides the combined profits from the controlled transactions under examination in two stages:

- in the first stage, each party engaged in the controlled transactions is allocated an arm's length remuneration for those categories of contributions which can be directly valued; typically, routine contributions for which reliable comparables can be found. Ordinarily this initial remuneration would be determined by applying one of the traditional transaction methods (i.e. the CUP or the cost-plus method) to identify the remuneration of comparable transactions between independent enterprises;
- in the second stage, any residual profit (or loss) remaining would be allocated among the parties. Typically, this allocation will be based on the relative value of the second category of contributions of the parties in a manner similar to the contribution analysis outlined above.

Importance of Transfer Pricing Documentation

As a matter of principle, the arm's length character of material intra-group transactions should be substantiated in sound transfer pricing documentation. Despite the fact that Luxembourg tax law does not specifically require the preparation of transfer pricing documentation, taxpayers are under a duty to co-operate with the Luxembourg tax authorities and have to evidence facts and provide information in regard to statements made in the tax returns.

When the Luxembourg tax authorities can reasonably evidence that the transfer pricing of an intra-group transaction does not adhere to the arm's length principle, it is the responsibility of the taxpayer to disprove this rebuttable presumption. Another factor to be considered is that transfer prices may be reviewed several years after a transaction takes place. This makes it more and more difficult from a practical perspective to trace back relevant facts and circumstances of the transaction as well as data on comparable transactions. All these factors evidently exert pressure on Luxembourg companies to develop and apply appropriate transfer pricing policies for risk mitigation purposes.

Moreover, since the creation of a new tax audit division, tax audits are now performed more systematically by the Luxembourg tax authorities. As tax assessments in Luxembourg may generally be revised for a period of five years, potential tax risks may span several years, which requires an appropriate and active tax risk management function.

Experience shows that transfer pricing is frequently put under the microscope during tax audits. Tax authorities can more easily challenge transfer pricing when no transfer pricing documentation has been prepared: how could taxpayers make informed decisions if no transfer pricing analysis was performed before the price of intra-group transactions was determined? Therefore, transfer pricing should always be considered before agreements are concluded.

However, taxpayers should not consider the preparation of transfer pricing documentation as a compliance exercise. Instead, in the current international tax environment of heightened transparency and scrutiny, Luxembourg companies would be wise to take it one step further and to integrate the documentation of transfer prices in their wider tax strategy, using it as a means to reflect the business rationale behind their investment structures and intra-group transactions.

Transfer pricing policies should not be disregarded after their implementation. As a matter of best practice, taxpayers should review their transfer pricing documentation at least once a year in order to assess whether the fact pattern is still consistent with reality and to determine whether an update might be necessary.

To Sum Up

Fund management services play an important role in Luxembourg for both UCITS and AIFs. The way fund management services are organized varies significantly from one case to another. When fund management services are rendered by several related parties, the remuneration earned by each of these entities has to adhere to the arm's length standard.

Given the amounts at stake, fund management fees frequently attract the attention of the Luxembourg tax authorities. The transfer pricing of fund management services may be challenged by the Luxembourg tax authorities when reviewing the tax returns or during tax audits that span several years. Hence, transfer pricing challenges may entail significant tax risks for Luxembourg (management) companies.

Planning Point

Ultimately, tax risks in relation to transfer pricing may be effectively mitigated through robust transfer pricing documentation that analyzes the value chain of fund management services and establishes an arm's length remuneration for Luxembourg and, potentially, foreign companies involved.

Oliver R. Hoor is a Tax Partner (Head of Transfer Pricing and the German Desk) and Fanny Bueb is a Tax Director with ATOZ Tax Advisers.

The authors may be contacted at: oliver.hoor@atoz.lu; fanny.bueb@atoz.lu

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