2017 Budget Draft Law Introduces a More Robust Transfer Pricing Framework

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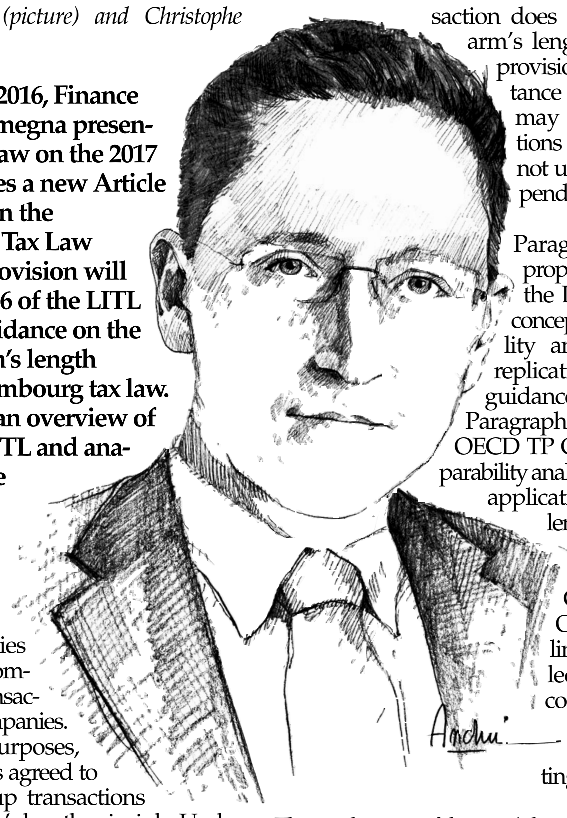


On 12 October 2016, Finance Minister Gramegna presented the draft law on the 2017 budget which includes a new Article 56bis to be included in the Luxembourg Income Tax Law ("LITL"). The new provision will complement Article 56 of the LITL and provide more guidance on the application of the arm's length principle under Luxembourg tax law. This article provides an overview of Article 56bis of the LITL and analyses its impact on the Luxembourg transfer pricing landscape.

1. Introduction

Luxembourg companies may enter into diverse commercial and financial transactions with associated companies. For Luxembourg tax purposes, the terms and conditions agreed to in respect of intra-group transactions have to adhere to the arm's length principle. Under the arm's length principle, transactions within a group are compared to similar transactions between unrelated entities to determine acceptable transfer prices.

Over the last few years, transfer pricing and related documentation has become increasingly more important in Luxembourg. Before 2011, Luxembourg domestic tax law did not provide for any specific transfer pricing rules or documentation requirements. Then, on 28 January 2011, the Luxembourg tax authorities issued a Circular on the determination of the arm's length margin to be realized by Luxembourg finance companies.

In 2015, the Luxembourg legislator adopted an amended version of Article 56 of the LITL that formalizes the application of the arm's length principle under Luxembourg tax law. More precisely, Article 56 of the LITL provides a legal basis for transfer pricing adjustments (upward and downward adjustments) where associated enterprises deviate from the arm''s length standard. In addition, the concepts of hidden dividend distributions and hidden capital contributions are cornerstones of Luxembourg's transfer pricing rules which play a vital role in ensuring that associated companies adhere to the arm's length principle.

As a member of the OECD, Luxembourg adheres to the OECD Transfer Pricing Guidelines for Multinationals and Tax Administrations (the "OECD TP Guidelines"), which reflect the consensus of OECD member countries towards the application of the arm's length principle as provided in Article 9(1) of the OECD Model Tax Convention. As part of the OECD Base Erosion and Profit Shifting ("BEPS") Project, several chapters of the OECD TP Guidelines have been substantially amended. The draft Article 56bis of the LITL formalizes the authoritative nature of the OECD TP Guidelines and provides for some definitions and guiding principles in relation to the application of the arm's length principle. The wording of the proposed Article 56bis of the LITL closely follows some of the key paragraphs of Chapter I (Arm's length principle) of the OECD TP Guidelines.

2. Analysis of the Proposed Article 56bis LITL

The proposed Article 56bis of the LITL begins with the definition of several terms that are relevant in a transfer pricing context (e.g. controlled transaction, comparable uncontrolled transaction, arm's length price). These definitions resemble very much the definitions that can be found in the glossary of the OECD TP Guidelines.

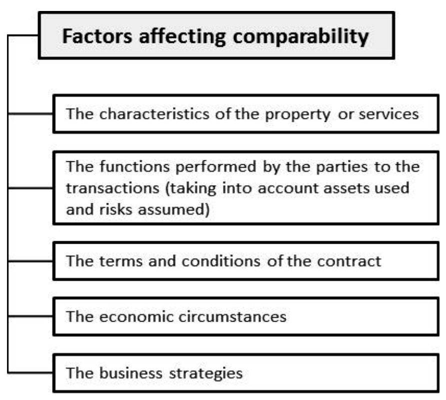
Paragraph 2 of the proposed Article 56bis of the LITL clarifies that the arm's length principle has to be respected whenever a Luxembourg company enters into a controlled transaction with an affiliate. Conceptually, the arm's length principle requires a calculation of the taxable income that might reasonably be expected if the parties were dealing at arm's length with one another. It does this by contrasting the choices made and the outcomes achieved by the taxpayer with those that would have resulted from market forces. In effect, this uses the open market results or the behaviour of independent parties dealing at arm's length with each other as a benchmark.

The draft law explicitly addresses transactions that may not be observed between independent enterprises. In this regard, it is stated that the fact that a specific transaction cannot be observed between independent enterprises does not mean that a transaction does not adhere to the arm's length standard. This provision is of great importance as related parties may enter into transactions that are in practice not undertaken by independent enterprises.

Paragraphs 3 – 5 of the proposed Article 56bis of the LITL introduce the concept of the comparability analysis through a replication of some of the guidance provided in Paragraphs 1.33 – 1.36 of the OECD TP Guidelines. A comparability analysis is critical for the application of the arm's length principle and a cornerstone of transfer pricing. Chapter III of the OECD TP Guidelines provides detailed guidance on the comparability analysis and the actual process of conducting such analysis.

The application of the arm's length principle is generally based on a comparison of the prices or margins used or obtained by non-arm's length parties with those used or obtained by arm's length parties engaged in similar transactions. The purpose of the comparability analysis is to identify the most reliable comparables. For a comparison of prices or margins to be useful, the economically relevant characteristics of the transactions being compared must be sufficiently similar so as to permit reasonably accurate adjustments to be made for any differences in such characteristics.

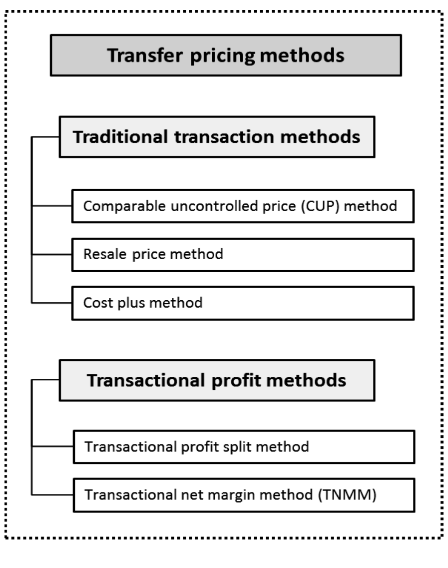
Here, the proposed Article 56bis of the LITL identifies the following five comparability factors that may be important when determining comparability:



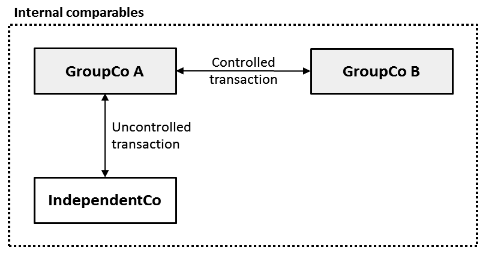
For controlled and uncontrolled transactions to be considered comparable, one must be able to confirm either:
(i) that there are no differences between the transactions which would materially affect the price in the open market; or, if there are material differences,
(ii) that reliable adjustments can be made to eliminate the material effects of such differences.

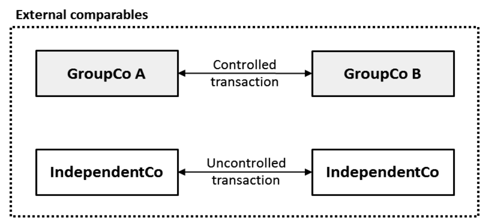
A comparability analysis is by nature two-fold as it includes an examination of the factors affecting the taxpayer's controlled transactions and an examination of the factors affecting uncontrolled transactions.

MNEs may apply several internationally accepted methodologies to determine arm's length prices. The OECD TP Guidelines distinguish five major transfer pricing methods that provide the conceptual framework for the determination of arm's length prices. These methods are divided into two groups, the traditional transaction methods and the transactional profit methods.



These transfer pricing methods are intended to provide a basis for testing the related party choices and outcomes against arm's length benchmarks. All these transfer pricing methods rely either directly or indirectly on the comparable profit, price or margin information of comparable transactions. The data on comparable transactions may be an "internal comparable" based on similar uncontrolled transactions between the entity and a third party or an "external comparable" involving independent enterprises in the same market or industry.





With regard to the selection of a transfer pricing method, Article 56bis of the LITL explicitly states that the most appropriate method shall be applied. For this purpose, the selection process should take account of the respective strengths and weaknesses of the OECD recognised methods. Traditional transaction methods are regarded as the most direct means of establishing whether conditions in controlled transactions are consistent with the arm's length principle. Therefore, when a traditional transaction method can be applied, it would take precedence over the application of a transactional profit method. Moreover, when the CUP method and another transfer pricing method can be applied in an equally reliable manner, the CUP method is to be preferred.

Article 56bis of the LITL also includes some language on circumstances in which a transaction as structured by a taxpayer may be disregarded because there is a lack of valid commercial rationality and a third party would not have entered into a specific transaction. Nevertheless, the non-recognition of a transaction should only occur in very exceptional situations. This is consistent with the amended guidance provided in the OECD TP Guidelines.

3. Transfer Pricing Documentation Requirements

Transfer pricing documentation has become the hot topic in Luxembourg taxation over the last few years in an environment that relies increasingly less on tax rulings (including advance pricing agreements). In the past, businesses viewed tax rulings as a way to provide certainty and avoid risks when structuring investments or intra-group transactions. However, for a number of reasons this is no longer the case. This means that multinationals and international investors need to develop a solid strategy for transfer pricing and related documentation in order to mitigate tax risks.

In general, taxpayers are under a duty to co-operate with the Luxembourg tax authorities and to evidence facts and provide information in regard to statements made in the tax returns. In 2015, the taxpayer' s duty of co-operation was extended to transactions between associated enterprises, although no specific transfer pricing documentation requirements were given. While the new provision is included merely for clarification purposes, it confirms that the Luxembourg authorities are now relying more heavily on transfer pricing documentation to verify the arm's length character of intra-group transactions. In addition, Luxembourg is in the process of implementing Country-by-Country Reporting ("CbCR") rules.

Transfer pricing inevitably exerts pressure on taxpayers to find a balance between a comfortable level of security and the costs involved in the preparation of sound transfer pricing documentation. Accordingly, the question as to whether it is appropriate to prepare transfer pricing documentation also involves a cost/benefit-analysis.

In practice, Luxembourg companies should screen major intra-group transactions in order to identify issues that could raise suspicion on the part of the Luxembourg tax authorities and assess the magnitude of tax risks. Where the Luxembourg tax authorities can reasonably evidence that the transfer pricing of a controlled transaction does not adhere to the arm's length principle, this raises a rebuttable presumption that the transaction does not comply with the arm's length principle. It is for the taxpayer to provide counterarguments. In these circumstances, transfer pricing documentation is of immense value. Overall, the burden of proof for the non-arm's length character of intra-group transactions should be relatively low.

Sound transfer pricing documentation may further be necessary in order to justify the value of a hidden capital contribution or a downward adjustment under article 56 of the LITL. Moreover, transfer pricing documentation requirements may be induced from a foreign tax perspective to substantiate the arm's length character of the transfer pricing in Luxembourg. Likewise, several European countries implemented already or are about to implement the requirement for the preparation of a master file and a local file in accordance with the OECD guidance on transfer pricing documentation. Hence, Luxembourg alternative investment funds investing in pan-European assets may have to prepare a master file because of the transfer pricing rules in the target jurisdiction.

Notably, transfer prices may be reviewed several years after a transaction takes place. This makes it, from a practical perspective, increasingly difficult to trace back relevant facts and circumstances regarding the transaction, as well as data on comparable transactions. This puts pressure on Luxembourg companies to develop appropriate transfer pricing policies for risk mitigation purposes amid an international tax environment that elevates transparency in tax matters to a new level. It is important that transfer pricing policies are not disregarded after their implementation. This includes that transfer pricing documentation should be regularly reviewed and updated to reflect the actual fact pattern; particularly upon business restructurings and where new transactions are envisaged.

Ultimately, transfer pricing documentation has become a key element in tax risk management. Its role will only increase in coming years. In the current international tax environment of heightened transparency and scrutiny, companies would be wise to take it one step further and integrate the documentation of transfer prices in their wider tax strategy, using it as a means to reflect the business rationale behind their corporate structure and intra-group transactions.

Conclusion

The new Article 56bis of the LITL provides fundamental guidance regarding the application of the arm's length principle and cements the authoritative nature of the OECD TP Guidelines for Luxembourg tax purposes. However, Luxembourg, as a member of the OECD, and the Luxembourg tax authorities have always adhered to the OECD TP Guidelines and consistently applied the methodologies recommended by the OECD. Therefore, the introduction of Article 56bis of the LITL is more to be considered as a formalisation of the current practice and as a commitment to adhere to international tax standards.

At the same time, it creates a more robust and solid framework for transfer pricing and the application of the arm's length principle under Luxembourg tax law. Although the new draft legislation does not set out any transfer pricing documentation requirements, transfer pricing documentation has become increasingly more important in Luxembourg as a tax risk management tool.

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1) Circulaire du directeur des contributions L.I.R. No. 164/2 du 28 janvier 2011.
2) See Oliver R. Hoor, "Luxembourg`s New Transfer Pricing Circular on Intra-Group Financing Activities", Tax Notes International, May 2011, p. 413 – 426.
3) When a Luxembourg company shifts an advantage to another group company, the Luxembourg tax authorities may increase the company's taxable income. Conversely, when a Luxembourg company receives an advantage from an associated company, the taxable income of the Luxembourg company may be reduced by a downward adjustment reflecting arm's length conditions.
4) See Oliver R. Hoor, "Hidden Dividend Distributions in Luxembourg: A Technical Guide", IBFD, European Taxation, September/October 2011, p. 383 – 395.
5) See Oliver R. Hoor, "Hidden Capital Contributions in Luxembourg – Clearing the Mist", IBFD, European Taxation, May 2009, p. 241 – 248.
6) See Oliver R. Hoor, "Luxembourg Reshapes its Transfer Pricing Landscape", IBFD, European Taxation, May 2015, p. 131 – 142.
7) Paragraph 1 of the proposed Article 56bis.
8) This statement is consistent with the guidance provided in Paragraph 1.11 of the OECD TP Guidelines (2016).
9) See Paragraph 1.33 in Chapter I of the OECD TP Guidelines.
10) Transactions between non-arm's length parties should not be used for purposes of these comparisons because the terms and conditions may not be arm's length.
11) See Paragraph 1.33 in Chapter I of the OECD TP Guidelines.
12) Paragraph 1.121 in Chapter I of the OECD TP Guidelines.
13) In the master file MNEs would be required to provide tax administrations with high-level information regarding their global business operations and transfer pricing policies.
14) In the local file MNEs would be required to provide more transactional transfer pricing documentation, identifying relevant related party transactions, the amounts involved in those transactions and the company's analysis of the related arm's length character of the transfer pricing.