Luxembourg

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Luxembourg Reshapes Its Transfer Pricing Landscape

On 19 December 2014, the Luxembourg legislator adopted new transfer pricing legislation that formalizes the application of the arm's length principle and the requirement for specific transfer pricing documentation. While the arm's length principle was already firmly ingrained in Luxembourg tax law, the new rules further elevate the importance of transfer pricing. This article provides an overview of Luxembourg's new transfer pricing landscape.

1. Introduction

Luxembourg is a major holding location used by multinationals and international investors for structuring investments in and through Europe. 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.

As a member of the OECD, Luxembourg adheres to the OECD Transfer Pricing Guidelines for Multinationals and Tax Administrations[1] (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 (2010).[2] Accordingly, transfer prices that are determined in accordance with the OECD TP Guidelines will be accepted by the Luxembourg tax authorities.

Although Luxembourg domestic tax law did not previously provide for specific transfer pricing rules or documentation requirements, transfer pricing has become increasingly important in recent years. In 2011, the Luxembourg tax authorities released two Circulars on the determination of the arm's length margin to be realized by Luxembourg finance companies.[3] The new transfer pricing legislation entered into force on 1 January 2015 and completes the existing transfer pricing rules and concepts found in Luxembourg.

This article provides an overview of Luxembourg transfer pricing rules (section 2.) and considers related documentation requirements (section 3.).

2. Luxembourg Transfer Pricing Rules

2.1. Overview

Luxembourg tax law does not provide for integrated transfer pricing legislation. Instead, transfer pricing adjustments aimed at restating arm's length conditions can be made on the basis of different tax provisions and concepts applicable under Luxembourg domestic tax law.[4] The new article 56 of the Luxembourg Income Tax Law (LITL),[5] however, formalizes the application of the arm's length principle under Luxembourg tax law. In addition, the hidden dividend distributions and hidden capital contributions concepts play a vital role in ensuring that associated companies adhere to the arm's length principle.[6]

2.2. The new article 56 of the LITL (associated enterprises)

2.2.1. Opening comments

The new article 56 of the LITL is largely inspired by a similar provision in the Netherlands Corporate Income Tax Law[7] and provides a legal basis for transfer pricing adjustments where associated enterprises deviate from the arm's length standard.

2.2.2. Scope of article 56 of the LITL

The scope of article 56 of the LITL is limited to transactions between associated enterprises and does not apply to transactions between individual shareholders and a Luxembourg company. In a tax treaty context, tax adjustments made under the new article 56 of the LITL are generally permitted under article 9(1) of the OECD Model (2010).

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1. OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010), International Organizations' Documentation IBFD.
2. *OECD Model Tax Convention on Income and on Capital* (22 July 2010), Models IBFD.
3. Circulaire du directeur des contributions L.I.R. no. 164/2 of 28 Jan. 2011 and no. 164/2bis of 8 April 2011; *see* O.R. Hoor, *Prix de transfert et financement intra-group au Luxembourg: La circulaire 164/2 du 28 janvier 2011*, Les cahiers du droit luxembourgeois no. 12, p. 77 (Apr. 2011).
4. *See* O.R. Hoor, *Précis des prix de transfert au Luxembourg*, Les cahiers du droit luxembourgeois no. 4, p. 30 (June 2009) and *Mémento sur le régime fiscal de la propriété intellectuelle au Luxembourg: perspectives et aspects prix de transfert*, Les cahiers du droit luxembourgeois no. 8, p. 38 (Dec. 2009).
5. LU: Income Tax Law, National Legislation IBFD.
6. Both the concept of hidden dividend distributions and the concept of hidden capital contributions have been extensively shaped and modelled after decisions of the German Reich Tax Court (*Reichsfinanzhof* – RFH) and the German Federal Tax Court (*Bundesfinanzhof* – BFH"); *see* O.R. Hoor, *Hidden dividend distributions & hidden capital contributions* pp. 21 and 81 (Legitech 2011).
7. NL: Corporate Income Tax Act, art. 8b, National Legislation IBFD.

Article 56 of the LITL applies to cross-border transactions and transactions between Luxembourg companies. It remains to be seen, however, how systematically the Luxembourg tax authorities will apply the new article 56 of the LITL in a domestic context given that the upward adjustment at the level of the Luxembourg company granting the benefit should correspond to the downward adjustment at the level of the Luxembourg resident beneficiary.

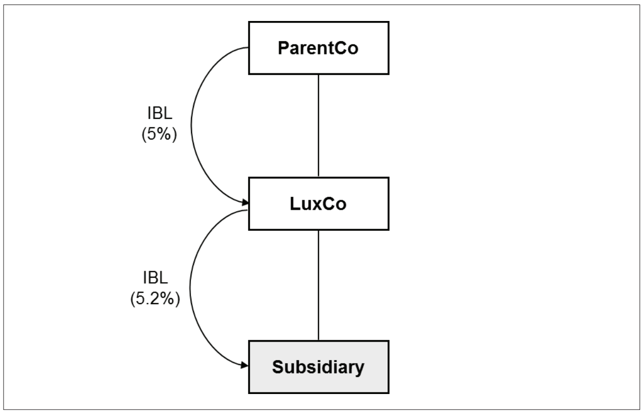
According to the Commentaries on the new article 56 of the LITL, the latter does not only apply regarding the determination of commercial income but may, in theory, also apply in respect of the determination of income derived from agriculture and forestry, and income derived from liberal professions. Nevertheless, given the specific relationship required between the parties to a controlled transaction, in practice, article 56 of the LITL should hardly ever apply in these circumstances.

2.2.3. Tax adjustments under article 56 of the LITL

The new article 56 of the LITL serves as a legal basis for performing upward and downward adjustments in accordance with the arm's length principle. In other words, 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.[8]

Example 1: Upward adjustment

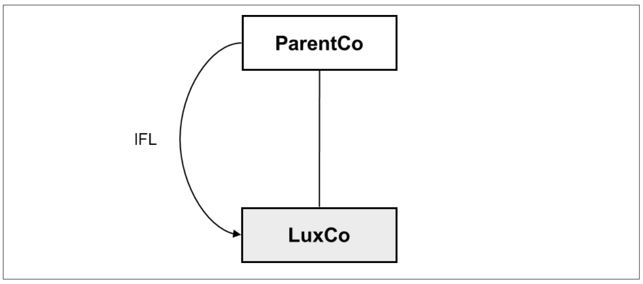
A Luxembourg company (LuxCo) performing financing activities receives a loan (IBL) bearing interest at a rate of 5% from its parent company (ParentCo) and grants a loan of the same amount to its subsidiary, which bears interest at a rate of 5.2%.



Assuming that the Luxembourg tax authorities can reasonably evidence that the arm's length margin should be 30 basis points (bps) instead of 20bps, the taxable income of LuxCo may be increased by the Luxembourg tax authorities (unless LuxCo can substantiate the arm's length character of the 20bps financing margin).[9]

Example 2: Downward adjustment

A Luxembourg company (LuxCo) receives an interest-free loan (IFL) from its parent company (ParentCo) to finance its business activities. LuxCo substantiates, in a transfer pricing study, that the arm's length interest rate would be 4.5%.



In this scenario, LuxCo may perform a downward adjustment amounting to the arm's length interest expenses when determining the taxable income in its corporate tax returns.

2.3. The concept of hidden dividend distributions

2.3.1. Characteristics of hidden dividend distributions

Luxembourg tax law does not provide for an exhaustive definition of hidden dividend distributions. The term hidden dividend distribution is only mentioned in article 164(3) of the LITL, which provides that hidden dividend distributions arise when a shareholder receives directly or indirectly advantages from a company that a third party would not have received. In addition, the said article states that such profit distributions are to be included in the company's taxable income.[10]

In accordance with the relevant case law, hidden dividend distributions within the meaning of article 164(3) of the LITL bear the following characteristics:
– a decrease (or adverted increase) of a company's net equity that:
– is motivated by the shareholding relationship;
– impacts the company's taxable income (i.e. either in the form of expenses or income that has been abandoned);[11] and
– is not a regular dividend distribution (under Luxembourg commercial law).[12]

8. Downward adjustments may, in particular, be made in regard to services granted for no or a reduced consideration to a Luxembourg company (for example, an interest-free loan or advisory services).
9. While the tax adjustment may also be based on article 164(3) of the LITL (hidden dividend distribution), article 56 of the LITL seems to be the more appropriate legal basis. Otherwise, the tax authorities would have to evidence that the interest rate charged on the loan granted by ParentCo to LuxCo is too high. Given that there is always a more or less broad range of arm's length interest rates, it should be easier for the Luxembourg tax authorities to evidence that the finance margin did not adhere to the arm's length standard. Therefore, the profit adjustment relating to the finance margin should be based on article 56 of the LITL. This conclusion should not be impacted by the fact that Tax Circular no. 164/2 of 28 Jan. 2011 determining the Luxembourg transfer pricing regime applicable to financing companies states that tax adjustments may be based on article 164(3) of the LITL.
10. *See* L. Kunsch, *La Réforme de l'impôt sur le revenu des collectivités*, Études fiscales Nos. 29 and 30, p. 50 (1 Dec. 1969); *see* O.R. Hoor, *Hidden Dividend Distributions in Luxembourg: A Technical Guide*, 51 Eur. Taxn. 9/10, p. 383 (2011), Journals IBFD; the text of the law is in line with the generic definition of hidden dividend distributions that existed in the case law of the German Federal Tax Court at the time Luxembourg Income Tax Law was implemented; for example, DE: BFH, 25 Oct. 1963, I 325/61 S, BStBl. III, p. 17 (1964).
11. In other words, a hidden dividend distribution within the meaning of article 164(3) of the LITL requires an overstatement of expenses or an understatement of income.
12. For some examples *see* DE: RFH, 9 July 1935, I A 37/34, RStBl, p. 1128 (1935); I 325/61 S (25 Oct. 1963); DE: BFH, 3 Feb. 1971, I R 51/66, BStBl

It follows that advantages granted to a shareholder may be classified as hidden dividend distributions. The concept is applicable to advantages shifted by a company to corporate and individual shareholders and is not limited to cross-border cases.

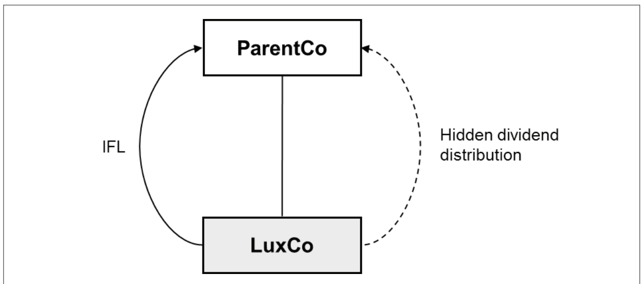
2.3.2. Tax treatment of hidden dividend distributions

For Luxembourg tax purposes, hidden dividend distributions require tax adjustments at the level of both the company and the shareholder. These tax adjustments need to be analysed on a case-by-case basis. In general, however, the taxable income of the company should be increased by the fair market value of the advantage shifted by the company to its shareholder.

The advantage is further classified as income within the meaning of article 97(1), no. 1 of the LITL, which is generally subject to Luxembourg withholding tax at a standard rate of 15%.[13] Under certain conditions, corporate shareholders may benefit from a withholding tax exemption under domestic tax law.[14] In a cross-border context, tax treaties concluded by Luxembourg may provide for a reduced or zero withholding tax rate. At the level of a Luxembourg shareholder, hidden dividend distributions are treated as regular dividend distributions.[15] The deemed income may benefit from a full[16] or partial tax[17] exemption under domestic tax law.

Example 3: Hidden dividend distribution

A Luxembourg company (LuxCo) grants an interest-free loan to its parent company (ParentCo). It is assumed that the arm's length interest rate amounts to 4%.



The advantage shifted by LuxCo to ParentCo should be classified as a hidden dividend distribution. Hence, the taxable income of LuxCo should be increased by deemed income amounting to the arm's length interest income (i.e. 4%). Furthermore, ParentCo is deemed to receive income within the meaning of article 97(1), no. 1 of the LITL, which is generally subject to Luxembourg withholding tax at a standard rate of 15%[18] unless an exemption applies.[19] If ParentCo is a Luxembourg company, the deemed dividend income may benefit from the Luxembourg participation exemption regime.[20] At the same time, ParentCo may deduct deemed expenses amounting to the arm's length interest expenses.[21]

2.3.3. Triangular cases involving company groups

The scope of hidden dividend distributions extends to advantages shifted by a company to a related party of the shareholder. Here, a rebuttable presumption that the advantage was motivated by the shareholding relationship is derived from the relationship between the shareholder and the related party thereof.

Related party transactions may, in particular, involve company groups shifting (1) advantages through the chain or (2) between (indirect) sister companies. Whilst unrelated parties should have no interest in shifting advantages to each other, related parties may, in the absence of a divergence of interest, intentionally circumvent the arm's length principle in order to reduce the overall tax burden.

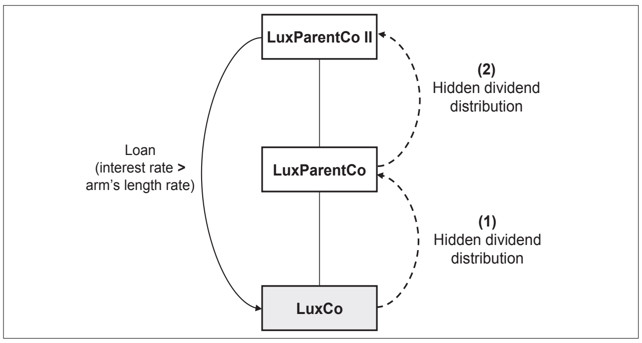
Hidden dividend distributions through the chain may be considered where a company shifts an advantage to an indirect shareholder. Here, the company may, in the absence of a direct shareholding relationship, not directly distribute the advantage to the beneficiary of the advantage. Rather, for tax purposes, several hidden dividend distributions are deemed to be performed subsequently:

(1) the company is deemed to shift an advantage to its direct shareholder (hidden dividend distribution 1);
(2) the direct shareholder is deemed to shift an advantage to the indirect shareholder (hidden dividend distribution 2).[22]

Chain transactions may involve any number of intermediary companies (and, therefore, any number of hidden dividend distributions).

Example 4: Chain transaction

A Luxembourg company (LuxParentCo II) grants a EUR 5,000,000 interest-bearing loan to its indirect subsidiary LuxCo. The applicable interest rate is 10%, but the arm's length interest rate is 6%. Accordingly, an advantage of EUR 200,000 per year (= EUR 5,000,000 * [10% – 6%]) is shifted to LuxParentCo II.



II, p. 408 (1971); DE: BFH, 30 July 1975, I R 110/72, BStBl II, p. 74 (1976); DE: BFH, 23 Oct. 1985, I R 247/81, BStBl II, p. 195 (1986); DE: BFH, 10 June 1987, I R 149/83, BStBl II, p. 25 (1988); DE: BFH, 22 Feb. 1989, I R 44/85, BStBl II, p. 475 (1989); and DE: BFH, 24 Mar. 1999, I R 20-98, BStBl II, p. 612 (2001).

13. Art. 146(1), no. 1 LITL in connection with art. 148(1) LITL.
14. Art. 147 LITL.
15. Art. 97(1), no. 1 LITL.
16. In respect of Luxembourg companies, article 166 of the LITL provides for a full tax exemption if certain conditions are fulfilled (participation exemption regime). In cross-border cases, tax treaties concluded by Luxembourg may provide for a tax exemption even if the conditions of the Luxembourg participation exemption regime are not met.
17. Article 115, no. 15 a) of the LITL provides for a 50% tax exemption. This partial tax exemption applies to Luxembourg resident individuals and Luxembourg companies to the extent the Luxembourg participation exemption regime does not apply.
18. Art. 146(1), no. 1 LITL in connection with art. 148(1) LITL.
19. Art. 147 LITL.
20. Art. 166(1) LITL.
21. These expenses are not directly linked to the hidden dividend distribution and may be deducted for Luxembourg tax purposes; *see* O.R. Hoor, *Hidden dividend distributions & hidden capital contributions: A technical guide* p. 55 (Legitech 2011).
22. DE: BFH, 29 Jan. 1975, I R 135/70, BStBl II, p. 553 (1975); I R 247/81 (23 Oct. 1985); and DE: BFH, 9 Sept. 1986, VIII R 159/85, BStBl II, p. 257 (1987).

For Luxembourg tax purposes, the advantage shifted up the chain should be classified as a hidden dividend distribution via the direct parent company (LuxParentCo). Accordingly, a first hidden dividend distribution is considered from LuxCo to LuxParentCo (EUR 200,000), and a second from LuxParentCo to LuxParentCo II (EUR 200,000).

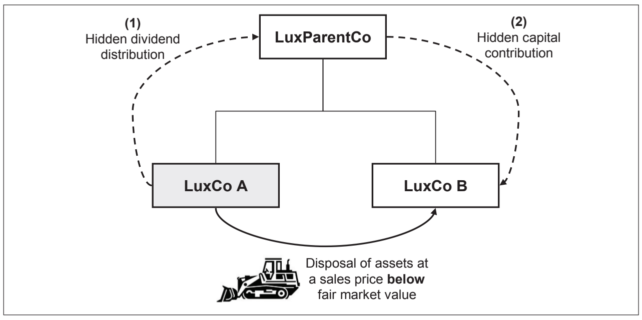
Advantages may also be shifted between sister companies. Here, the advantage is deemed to be motivated by the relationship with the common shareholder. Therefore, for Luxembourg tax purposes, the advantage is deemed to be:

(1) granted to the common shareholder (hidden dividend distribution);
(2) that subsequently shifts the advantage to the beneficiary sister company (hidden capital contribution).[23]

Whilst the advantage shifted to the common shareholder should be classified as a hidden dividend distribution, the advantage shifted to the beneficiary companymay qualify as a hidden capital contribution.[24]

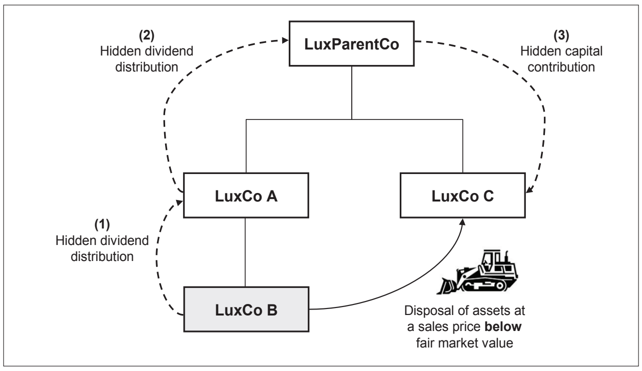
Example 5: Advantages shifted between sister companies

LuxCo A sells an excavator worth EUR 100,000 for EUR 70,000 to its sister company LuxCo B. Although LuxCo A grants the advantage (EUR 30,000) directly to LuxCo B, the economic reason is to be found in the companies' common shareholding relationship with the Luxembourg parent company (LuxParentCo). A hidden dividend distribution is, therefore, considered from LuxCo A to LuxParentCo, and a corresponding hidden capital contribution from LuxParentCo to LuxCo B.



Example 6: Advantages shifted between indirect sister companies

LuxCo B sells an excavator worth EUR 100,000 for EUR 70,000 to its indirect sister company LuxCo C. An indirect hidden dividend distribution is considered from LuxCo B to LuxParentCo through LuxCo A (EUR 30,000), and a related hidden capital contribution from LuxParentCo to LuxCo C (EUR 30,000). For tax purposes, therefore, two subsequent hidden dividend distributions are followed by a hidden capital contribution.



2.4. Hidden capital contributions

2.4.1. Characteristics of hidden capital contributions

Broadly, hidden capital contributions refer to advantages shifted by a shareholder to a company. While the concept is not defined in Luxembourg tax law, hidden capital contributions bear the following characteristics in accordance with the relevant case law:

- a shareholder or a related party of the shareholder;
- grants, motivated by the shareholding relationship;
- an advantage to a company that may be reflected in the balance sheet, i.e. either an increase in assets or a decrease in liabilities (insofar as the shareholder does not receive arm's length consideration);and
- the contribution is not a regular contribution (pursuant to Luxembourg commercial law).[25]

In principle, contributions increase the net equity in the receiving company's balance sheet. The object of a hidden capital contribution should, therefore, directly relate to balance sheet items, namely an increase in assets or a decrease in liabilities.[26] In contrast, any advantage (including free services)[27] shifted by the company to its shareholder(s) should be classified as a hidden dividend

23. DE: BFH, 29 Jan. 1964, I 209/62 U, BStBl III, p. 27 (1965); DE: BFH, 23 Oct. 1968, I 228/65, BStBl II, p. 243 (1969); DE: BFH, 21 Dec. 1972, I R 70/70, BStBl II, p. 449 (1973); I R 135/70 (29 Jan. 1975); I R 247/81 (23 Oct. 1985); VIII R 159/85 (9 Sept. 1986); DE: BFH, 22 Oct. 1986, I R 107/82, BStBl II, p. 293 (1987); *see* G. Heintz, *L'impôt sur le revenu des collectivités*, Études Fiscales, p. 69 (Saint Paul 1999).
24. I 209/62 U (29 Jan. 1964); I 228/65 (23 Oct. 1968); I R 70/70 (21 Dec. 1972); DE: BFH, 19 May 1982, I R 102/79, BStBl II, p. 631 (1982); DE: BFH, 20 Aug. 1986, I R 150/82, BStBl II, p. 455 (1987); I R 107/82 (22 Oct. 1986); DE: BFH, 26 Oct. 1987, GrS 2/86, BStBl II, p. 348 (1988); DE: BFH, 9 June 1997, GrS 1/94, BStBl II, p. 307 (1998); and DE: BFH, 15 Oct. 1997, I R 103/93, BFH/NV, p. 572 (1998); however, where services are provided for partial or no consideration between sister companies (for example, interest-free loans and rent-free lettings of real estate), such advantages should be classified as a hidden dividend distribution to the common shareholder, but not as a hidden capital contribution by the common shareholder to the beneficiary sister company; *see* P. Neefs & O.R. Hoor, *Hidden Capital Contributions in Luxembourg – Clearing the Mist*, 49 Eur. Taxn. 5, p. 243 (2009), Journals IBFD.
25. *See* Heintz, *supra* n. 23, at pp. 30 and 68; *see* O.R. Hoor, *L'apport cache: Un chemin dans la brume*, Les cahier du droit luxembourgeois no. 3, p. 13 (Apr. 2009); *see* J.-P. Winandy, *Les impôts sur le revenu et sur la fortune* p. 831 (Promoculture 2002); *see* C. Duro & R. Faltz, *Transfer pricing in the absence of comparable market prices*, Luxembourg Country Report, *IFA Cahiers de droit fiscal international*, vol. 82a (Sdu Fiscale & Financiële Uitgevers 1992), p. 507, Online Books IBFD; *see* J. Olinger, *Etudes fiscales – Le droit fiscal* p. 20 (Saint-Paul 1994); DE: RFH, 28 July 1936, I A 83/36, RFHE 39, p. 303; DE: RFH, 8 June 1937, I A 378/36, RFHE 41, p. 274; DE: RFH, 22 June 1943, I 204/42, RStBl 1943, p. 587; DE: BFH, 28 Feb. 1956, I 92/54 U, BStBl III, p. 154 (1956); DE: BFH, 3 May1967, I 263/63, BFHE 88, 425, BStBl III, p. 42 (1967); DE: BFH, 19 Feb. 1970, I R 24/67, BStBl II, p. 442 (1970); I R 51/66 (3 Feb. 1971); DE: BFH, 14 Aug. 1974, I R 168/72, BStBl II, p. 123 (1975); DE: BFH, 26 Nov. 1980, I R 52/77, BStBl II, p. 181 (1981); DE: BFH, 9 Mar. 1983, I R 182/78, BFHE 139, 139, BStBl II, p. 744 (1983); DE: BFH, 22 Nov. 1983, GmbHR, p. 110 (1984); DE: BFH, 11 Apr. 1984, I R 175/79, BStBl II, p. 535 (1984); DE: BFH, 14 Nov. 1984, I R 50/80, BStBl II, p. 227 (1985); DE: BFH, 24 Mar. 1987, I R 202/83, BStBl II, p. 705 (1987); GrS 2/86 (26 Oct. 1987); DE: BFH, 27 July 1988, I R 147/83, BStBl II, p. 615 (1989); DE: BFH, 21 Sept. 1989, IV R 115/88, BStBl II, p. 86 (1990); DE: BFH, 28 Feb. 1990, I R 43/86, BStBl II, p. 615 (1990); DE: BFH, 18 Dec. 1990, VIII R 17/85, BStBl II, p. 512 (1991); and DE: BFH, 8 May 1991, I B 30/90, BFH/NV, p. 414 (1992).
26. Advantages that may be contributed within the framework of regular contributions may qualify as hidden capital contributions; *see* Winandy, *supra* n. 25, at p. 831; GrS 2/86 (26 Oct. 1987).
27. For example, an interest-free loan or free advisory services.

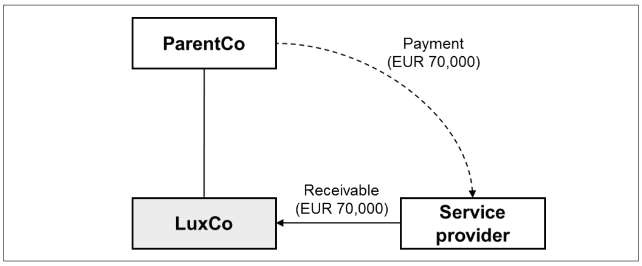
distribution. Consequently, the scope of hidden capital contribution and that of hidden dividend distribution do not mirror each other, though both concepts share the same objective, namely the separation of the realm of the company from that of its shareholders.[28]

2.4.2. *Tax treatment of hidden capital contributions*

Hidden capital contributions may require complex tax adjustments at the level of the company and the shareholder, and need to be analysed on a case-by-case basis. In general, income realized accounting-wise by the company in relation to the hidden capital contribution should be excluded from the company's taxable income.[29] At the level of the shareholder, the book value of the participation in the company receiving the advantage should be increased by the fair market value of the contribution and deemed income corresponding to the amount of the hidden capital contribution should be considered when determining the taxable income.

Example 7: Hidden capital contribution

A Luxembourg company (LuxCo) has a EUR 70,000 liability towards a service provider. The parent company of LuxCo (ParentCo) pays the liability of LuxCo and waives its claim towards LuxCo to receive a refund. LuxCo records the transaction accounting-wise as extraordinary income amounting to EUR 70,000, whereas ParentCo records expenses amounting to EUR 70,000.



The advantage of EUR 70,000 shifted by ParentCo to LuxCo should be classified as a hidden capital contribution. Accordingly, the income linked to the hidden capital contribution should be excluded from the taxable income of LuxCo. If ParentCo were a Luxembourg company, the expenses reflected accounting-wise would be neutralized by deemed income amounting to EUR 70,000. At the same time, the book value of the participation in LuxCo would be increased by the amount of the hidden capital contribution in ParentCo's tax balance sheet.

2.4.3. *Triangular cases involving company groups*

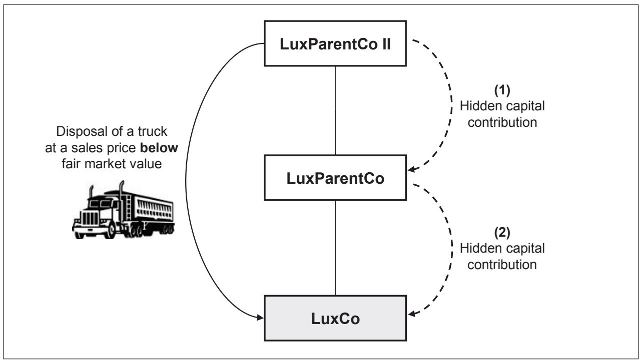
Advantages wilfully granted by a related party of the shareholder to the company may also be classified as hidden capital contributions.[30] Related party transactions may, in particular, involve company groups shifting advantages (1) through the chain or (2) between sister companies. Whilst unrelated parties should have no interest in shifting advantages to each other, related parties may, in the absence of a divergence of interest, intentionally circumvent the arm's length principle in order to reduce the tax burden.

Hidden capital contributions through the chain may be considered where a corporate shareholder shifts an advantage to an indirect subsidiary. Here, the shareholder may, in the absence of a direct shareholding relationship, not directly distribute the advantage to the beneficiary of the advantage. Rather, for tax purposes, several hidden capital contributions are deemed to be made subsequently:
(1) the corporate shareholder is deemed to shift an advantage to its direct subsidiary (hidden capital contribution 1); and
(2) the direct subsidiary is deemed to shift an advantage to the indirect shareholder (hidden capital contribution 2).

Chain transactions may involve any number of intermediary companies (and, therefore, any number of hidden capital contributions).

Example 8: Chain transaction

LuxParentCo II disposes of a truck worth EUR 120,000 for EUR 80,000 to its indirect subsidiary LuxCo. Here, the advantage shifted down the chain is classified as a hidden capital contribution via LuxParentCo. Accordingly, LuxParentCo II makes a hidden capital contribution to LuxParentCo (EUR 40,000), itself making a hidden capital contribution to LuxCo. [31]



Advantages may also be shifted between sister companies. Here, the advantage is deemed to be motivated by the relationship with the common shareholder. Therefore, for Luxembourg tax purposes, the advantage is deemed to be:

(1) granted to the common shareholder (hidden dividend distribution);
(2) that subsequently shifts the advantage to the beneficiary sister company (hidden capital contribution).[32]

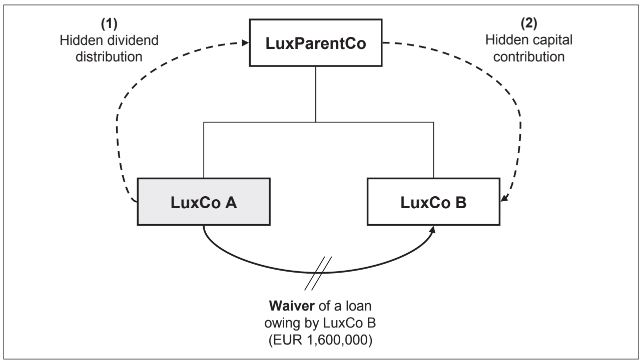
Whilst the advantage shifted to the common shareholder should be classified as a hidden dividend distribution, the

28. In the past, some Luxembourg authors argued in favour of downward adjustments under the hidden capital contribution concept where free services (including interest-free loans) have been granted to a Luxembourg company. Going forward, the new article 56 of the LITL provides for a clear legal basis for downward adjustments in event the hidden capital contribution concept may not be applicable.
29. The tax adjustment is made in the company's corporate tax return. The legal basis for the exclusion of income relating to hidden capital contributions is article 18(1) of the LITL, providing that contributions should be deducted from the tax base.
30. I A 83/36 (28 July 1936); I A 378/36 (8 June 1937); and I B 30/90 (8 May 1991).
31. I R 135/70 (29 Jan. 1975); I R 247/81 (23 Oct. 1985); and VIII R 159/85 (9 Sept. 1986).
32. I 209/62 U (29 Jan. 1964); I 228/65 (23 Oct. 1968); I R 70/70 (21 Dec. 1972); I R 135/70 (29 Jan. 1975); I R 247/81 (23 Oct. 1985); VIII R 159/85 (9 Sept. 1986); I R 107/82 (22 Oct. 1986); *see* Heintz, *supra* n. 23, p. 69.

advantage shifted to the beneficiary company may qualify as a hidden capital contribution.[33]

Example 9: Advantages shifted between sister companies

A Luxembourg company (LuxCo A) waives a EUR 1,600,000 loan receivable towards a Luxembourg sister company (LuxCo B). It is assumed that the fair market value of the loan corresponds to its nominal value. The advantage of EUR 1,600,000 granted by LuxCo A to LuxCo B is, for Luxembourg tax purposes, deemed to be shifted via the common shareholder, LuxParentCo. The advantage granted by LuxCo A to LuxParentCo should be classified as a hidden dividend distribution, which is followed by a hidden capital contribution by LuxParentCo to LuxCo B.



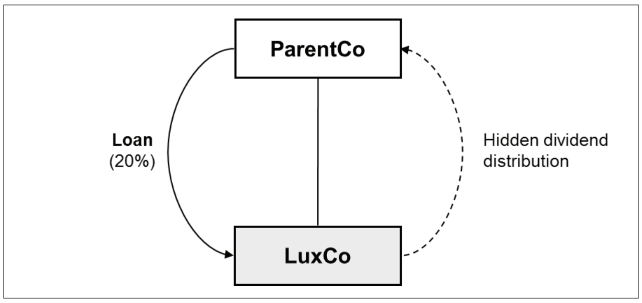
2.5. Hierarchy of norms

Article 56 of the LITL and the hidden dividend distribution and hidden capital contribution concepts operate independently of one another and may apply concurrently. In the event of an overlap, however, the hidden dividend distribution and hidden capital contribution concepts should take precedence over the new article 56 of the LITL. This is because the only tax consequence of the new article 56 of the LITL is an adjustment to the taxable income of the company (in order to reinstate arm's length conditions), whereas the hidden dividend distribution and hidden capital contribution concepts may require additional tax adjustments at the level of the company and the shareholder.[34]

Hence, the scope of new article 56 of the LITL should be limited to cases where advantages shifted between related companies may not be classified as a hidden dividend distribution or a hidden capital contribution. Article 56 of the LITL may, for example, serve as a basis for downward adjustments in accordance with the arm's length principle when a Luxembourg company receives an interest-free loan or free services from an associated company.

Example 10: Hierarchy of norms

A Luxembourg company (LuxCo) receives a loan bearing interest at a rate of 20% from its parent company (ParentCo). The arm's length interest rate is assumed to be 8%.



The advantage shifted by LuxCo to ParentCo in the form of excessive interest payments should be classified as a hidden dividend distribution (i.e. 12% = 20% minus 8% arm's length interest). It follows that the taxable income of LuxCo is increased by the amount of the excessive interest payments.[35] Moreover, the deemed dividend distribution is income within the meaning of article 97(1), no. 1 of the LITL, which is generally subject to Luxembourg withholding tax at a standard rate of 15% (unless an exemption[36] applies). If ParentCo is a Luxembourg company, the deemed dividend income would be taxable but may benefit from an exemption under the Luxembourg participation exemption regime.[37]

2.6. Excursus: Luxembourg financing companies

2.6.1. Opening comments

On 28 January 2011, the Luxembourg tax authorities released a Circular on the tax treatment of companies carrying out intra-group financing activities (the Circular).[38] Under this transfer pricing regime, financing companies are required to have genuine substance, run economic risks and report an arm's length remuneration on their financing activities in conformity with the OECD TP Guidelines.[39] In addition, the arm's length character of the remuneration must be substantiated and documented in a transfer pricing study.

2.6.2. Scope of the circular

The scope of the Circular covers entities that are principally engaged in intra-group financing transactions. The term "intra-group financing transaction" is to be interpreted very broadly and includes any activity involving the granting of loans (or advancing of funds) to associated enterprises. How these loans are financed is irrelevant (for example, intra-group loans, bank loans, public issuances, etc.). The following examples illustrate the scope of the Circular.

The Circular should not apply where a Luxembourg company funded by associated enterprises (in whatever

33. I 209/62 U (29 Jan. 1964); I 228/65 (23 Oct. 1968); I R 70/70 (21 Dec. 1972); I R 102/79 (19 May 1982); I R 150/82 (20 Aug. 1986); I R 107/82 (22 Oct. 1986); GrS 2/86 (26 Oct. 1987); GrS 1/94 (9 June 1997); and I R 103/93 (15 Oct. 1997); however, where services are provided for partial or no consideration between sister companies (for example, interest-free loans and rent-free lettings of real estate), such advantages should be classified as a hidden dividend distribution to the common shareholder, but not as a hidden capital contribution by the common shareholder to the beneficiary sister company; *see* Neefs & Hoor, *supra* n. 24, at p. 243.
34. Otherwise, if the adjustment of the taxable income of the company is based on new article 56 of the LITL, additional tax adjustments would be required in accordance with the hidden dividend distribution and hidden capital contribution concepts.
35. Article 56 of the LITL would lead to the same tax adjustment.
36. Art. 147 LITL.
37. Art. 166(1) LITL.
38. Tax Circular no. 164/2 of 28 January 2011 (the Circular).
39. A second Circular released on 8 April 2011 set out that an advance tax clearance granted before the release of the Circular would lose its binding character as regards the quantum of the finance margin as from 1 January 2012.

form) grants loans to third parties or invests the money otherwise (as long as the recipient is not an associated enterprise).[40] The term "associated enterprises" is defined in accordance with article 9(1) of the OECD Model (2010). Hence, enterprises are considered as associated enterprises:

(1) If one of them participates directly or indirectly in the management, control or capital of the other (for example, a parent company or a subsidiary of the finance company); or
(2) If the same persons directly or indirectly participate in the management, control or capital of the two enterprises (for example, sister companies).[41]

Although the Circular refers to entities that are "*principally* engaged in intra-group financing activities", it does not specify any particular threshold in this respect. Evidently, where a company exclusively performs financing activities, the result of this test is free of doubt. Nevertheless, questions may arise where a Luxembourg company performs different activities (for example, holding, financing, licensing and/or trading).[42] In this regard, the Circular only states that activities related to the holding of participations should be ignored for the purposes of this test.[43]

It must be emphasized that the Circular does not provide any *de minimis* rule or safe haven (for example, a particular threshold in terms of financing volume) that would exclude small finance companies from the scope of the Circular. In practice, all Luxembourg companies performing financing activities should realize an arm's length margin and comply with the requirements set out in the Circular. Moreover, the Luxembourg tax authorities will only confirm the arm's length character of the finance margin if it is substantiated in a transfer pricing study based on the OECD TP Guidelines.

2.6.3. Substance requirements and the real risk requirement

The Circular requires companies engaged in intra-group financing activities to have a real presence in Luxembourg. More precisely, the Circular stipulates a number of substance requirements that need to be met including, inter alia, the involvement of directors/managers that are at least 50% Luxembourg resident and the requirement that key decisions regarding the management of the company be made in Luxembourg.[44]

The Circular further determines that a financing company must bear a certain level of risk connected to its intra-group financing transactions.[45] In this regard, the financing company must be able to demonstrate (1) that it is actually obliged to use its equity upon realization of these risks and (2) that the company has sufficient equity available to cover the risks assumed.[46] In practice, the real risk requirement is often fulfilled by having the financing company run a limited level of credit risk. According to the Circular, the real risk requirement is deemed to be met when the equity (at risk) of the company amounts to at least 1% of the outstanding loan(s) or EUR 2 million (real risk test).[47]

As the equity at risk is a decisive factor in determining the arm's length margin, the guarantee structure will have to be carefully analysed in respect of every intra-group financing transaction.[48]

2.6.4. Arm's length remuneration and transfer pricing documentation

A Luxembourg company should realize (gross) remuneration on its intra-group financing transactions that is consistent with the arm's length principle[49] (such margin needs to be determined for each individual case). The Circular does not, however, provide any detailed guidelines on how to determine the arm's length remuneration of a Luxembourg financing company. Hence, a financing company should be free to select any transfer pricing method as long as the selected method results in arm's length remuneration.

With regard to transfer pricing documentation, the Circular states that a request for advance certainty must include a transfer pricing study in accordance with the OECD TP Guidelines. The latter should substantiate that the finance margin realized by the Luxembourg financing company adheres to the arm's length principle.

However, even when a financing company chooses not to request advance certainty on the arm's length nature of its financing transactions, the importance of sound transfer pricing documentation for the management of tax risks cannot be understated. Evidently, it will be easier for the Luxembourg tax authorities to challenge the financing margin if the Luxembourg company does not produce adequate documentation.

40. For example, where the funds received are invested in the money market.
41. *See* O.R. Hoor, *The OECD Model Tax Convention: A Comprehensive Technical Analysis* p. 138 (Legitech 2010).
42. Luxembourg holding companies frequently perform financing activities in addition to their holding activities. It may even be possible that the same company will perform, for example, holding, financing and licensing activities.
43. *See* section 1 of the Circular, *supra* n. 38; likewise, licensing activities are excluded from the scope of the Circular.
44. These substance requirements must be met at all times, and not only at the moment the loans are provided and advance certainty is requested from the Luxembourg tax authorities; *see* O.R. Hoor, *Prix de transfert et financement intra-groupe au Luxembourg: La circulaire 164/2 du 28 janvier 2011*, Les cahiers du droit luxembourgeois no. 12, p. 89 (Apr. 2011).
45. These may consist of credit risk, market risk and operational risk.
46. *See* Hoor, *supra* n. 44, at pp. 92-99, which provides several examples dealing with the real risk requirement.
47. Where substance requirements or the real risk requirement are not met, the Luxembourg tax authorities may decide to exchange information with the tax authorities of the other jurisdiction involved.
48. It should be noted that the equity at risk should ideally be kept at the minimum level required by the Circular since otherwise the arm's length margin will likely be higher. In addition, more equity will have to be available in order to cover the risks assumed.
49. The application of the arm's length principle is generally based on a comparison of the conditions made or imposed in a controlled transaction with the conditions in transactions between independent enterprises.

2.6.5. Request for an advance pricing agreement (APA)

Financing companies may request advance certainty on the Luxembourg tax treatment of their financing activities if they comply with the aforementioned substance requirements and the real risk requirement. In this respect, the Circular clearly defines which information and documentation should be included in a request for an APA. As mentioned in section 2.6.4., the Luxembourg tax authorities will only confirm the tax treatment of the finance margin if the arm's length character of the margin is substantiated in a transfer pricing study.

The confirmation provided by the Luxembourg tax authorities will bind the administration in accordance with the principle of good faith for a maximum period of five fiscal years (depending on the facts and circumstances of each individual case). Following the initial confirmation period, the financing company may file a new request for advance certainty (under the same conditions).

2.7. Restrictions under tax treaty law

Tax adjustments according to Luxembourg domestic tax law may be restricted by applicable tax treaties. Most tax treaties in Luxembourg's treaty network follow the OECD Model (2010).

2.7.1. Taxation of associated enterprises

Whereas profits derived by an enterprise are, in principle, exclusively taxable in the residence state of the enterprise (article 7(1) of the OECD Model (2010), article 9(1) provides, under certain conditions, for the possibility to make profit adjustments in accordance with the arm's length principle. More precisely, article 9(1) of the OECD Model allows the state of residence to adjust the profits accruing to a domestic enterprise associated with a foreign enterprise to the extent that the business profits concerned were affected by (commercial) terms and conditions differing from those that would have been agreed to between unrelated enterprises. Thus, tax adjustments in accordance with article 56 of the LITL or the hidden dividend distribution and hidden capital contribution concepts should not be restricted by applicable tax treaties.

2.7.2. Interest and royalties

With regard to interest and royalties, articles 11(6) and 12(4) of the OECD Model (2010) take precedence over article 9 of the OECD Model. According to these provisions, the source state's taxing right regarding interest[50] and royalties[51] is restricted to the amount considered not to be excessive as a result of a "special relationship" between the parties. The term "special relationship" is wider than the criteria for enterprises to be considered associated under article 9 of the OECD Model. Both aforementioned provisions solely apply, however, to "excessive" interest or royalties. Consequently, an adjustment of interest or royalty payments below the arm's length price is permissible only if the conditions of article 9 of the OECD Model are met.

2.7.3. Non-discrimination rules

The non-discrimination principle laid down in article 24 of the OECD Model (2010) is also applicable to associated enterprises.[52] According to article 24(5) of the OECD Model, interest, royalties, and other disbursements paid to residents of the other contracting state shall be deductible under the same conditions as if they had been paid to a resident enterprise. The same rule shall further apply with regard to the deductibility of debts when determining taxable capital (for net wealth tax purposes). The legal basis for tax adjustments and for the deductibility of expenses is grounded (even in the context of a tax treaty) exclusively in domestic tax law. Tax adjustments relating to the profits of enterprises controlled by an enterprise of the other contracting state are, however, restricted in two respects; firstly, by the arm's length criterion laid down in article 9 of the OECD Model and, secondly by any applicable more restrictive adjustment rules (within the limits of the arm's length principle) applied to domestically controlled enterprises.[53]

2.7.4. The relationship between tax treaty rules and domestic tax law

The relationship between treaty rules corresponding to article 9 of the OECD Model (2010) and domestic tax law is characterized by the fact that tax treaties merely restrict, rather than generate, domestic tax law. It follows that article 9 of the OECD Model (2010) cannot serve as a legal basis for tax adjustments under Luxembourg tax law. Instead, tax adjustments may be made under the new article 56 of the LITL and the hidden dividend distribution and hidden capital contribution concepts.

2.8. Dispute settlement

2.8.1. Domestic dispute settlement process

The tax assessment procedure relating to corporate tax returns is finalized upon the assessment of corporate income tax, municipal business tax and net wealth tax to be paid by the Luxembourg companies.[54] Such tax assessment may either be in line with the statements made in the corporate tax return or be based on modified assumptions (for example, adjusted transfer prices). The Luxembourg tax authorities are, however, entitled to issue a tax assessment notice based on the tax return filed by Luxembourg companies in order to expedite the assessment process; a procedure that is commonly applied by the Luxembourg tax authorities.[55] In this scenario, the preliminary tax assessment notice is not final and may be amended within a five-year timeframe. The Luxembourg tax authorities are not required to provide the taxpayer with a final assessment upon request. It follows that the taxpayer will

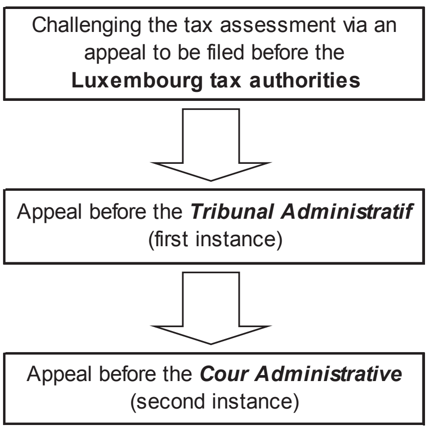
50. Art. 11 *OECD Model* (2010).
51. Art. 12 *OECD Model* (2010).
52. Art. 24(2)(b) *OECD Model* (2010).
53. Art. 24(6) *OECD Model* (2010).
54. LU: General Tax Code (*Abgabenordnung* – AO), sec. 210(1).
55. Sec. 100a(1), (2) AO.

have to wait up to five years to be certain that the amount of taxes temporarily determined will indeed be the definitive amount of tax liability.[56]

Any claim against the assessment has to be filed within three months following the receipt of the tax assessment and needs to define the claimant, the relevant tax assessment and the extent to which it is being challenged. Furthermore, the taxpayer should specify which aspects he challenges and provide sufficient documentary evidence.[57] It is recommended that the claim be filed in writing though it is also possible to put it on record at the tax authorities' offices or by fax.[58] The Luxembourg tax authorities are obliged to review the claim. Nevertheless, filing a claim does not suspend the effect of the tax assessment.[59]

Should a taxpayer disagree with the decision of the Luxembourg tax authorities on the appeal, he may challenge such a decision by filing an appeal before the Luxembourg Administrative Court of first instance (*Tribunal administratif*).[60] As a measure of last resort, the taxpayer may file an appeal against the decision of the Administrative Court of first instance before the Administrative Court of second instance (*Cour administrative*).

Diagram: Luxembourg dispute settlement process



2.8.2. *Tax treaties*

According to article 9(2) of the OECD Model (2010), any increase in profits in one contracting state must be offset by a corresponding change in the other contracting state (matching adjustment). Thereby, it is the only treaty provision designed to avoid economic double taxation (i.e. taxation of the same taxable income in both contracting states in the hands of different persons that economically constitute one entity). The only possible factor that can generate a matching adjustment is a profit adjustment between associated enterprises within the meaning of article 9(1) of the OECD Model.[61]

In contrast, articles 23 A and 23 B of the OECD Model (2010) aim to avoid double taxation in the hands of the same person (referred to as "juridical double taxation"); they may, therefore, not be considered as a supplementary means in circumstances in which article 9(2) of the OECD Model applies.

While the contracting state making an adjustment under article 9(1) of the OECD Model (2010) is implementing a measure against a resident enterprise based on its own domestic law, a matching adjustment according to article 9(2) of the OECD Model requires consensus between the two contracting states with regard to both the circumstances justifying the profit adjustment and the appropriate amount thereof (i.e. the arm's length price). Hence, the other contracting state is only committed to making a matching adjustment where both contracting states come to the conclusion that the initial adjustment was justified.[62]

In these circumstances, article 25(1) of the OECD Model (2010) grants taxpayers a right to raise issues relating to the appropriate application of the treaty with the competent authorities of their residence state. If that state is not able to satisfactorily resolve the issue, article 25(2) and (3) of the OECD Model foresee that the two competent authorities shall endeavour to reach a mutual agreement that eliminates the taxation that is asserted by the taxpayer not to be in accordance with the treaty (referred to as the "mutual agreement procedure"). Where unresolved issues have prevented the competent authorities from reaching a mutual agreement within two years, article 25(5) of the OECD Model provides that the issues that are preventing them from reaching an accord will, at the request of the taxpayer who presented the case, be resolved through an arbitration process.[63] The arbitration provision provided for in article 25(5) of the OECD Model was not, however, included in the OECD Model until the 2008 Update[64] and is not, therefore, included in every bilateral tax treaty.

2.8.3. *EU Arbitration Convention*

In an EU context, enterprises may further rely on the EU Arbitration Convention (90/436),[65] which establishes a two phase procedure to resolve cases of international double taxation resulting from transfer pricing adjustments (i.e. upward adjustments).[66] The scope of the EU Arbitration Convention is, however, restricted to transactions between enterprises of different Member States of the European Union.[67]

56. Sec. 100a(3) AO.
57. Sec. 249(4) AO.
58. Sec. 249(1) AO.
59. Sec. 251 AO.
60. Sec. 228 AO.
61. *See* Hoor, *supra* n. 41, at p. 138.

62. In practice, the contracting states involved will not readily agree to matching adjustments to their disadvantage. Without a matching adjustment, however, double taxation will continue.
63. *See* Hoor, *supra* n. 41, at p. 228.
64. *OECD Model Tax Convention on Income and on Capital* (17 July 2008), Models IBFD.
65. Arbitration Convention (1990): Convention 90/436/EEC of 23 July 1990 on the Elimination of Double Taxation in Connection with the adjustment of Profits of Associated Enterprises, OJ L 225 (1990), EU Law IBFD.
66. In order to more uniformly implement specific elements of the Arbitration Convention, such as certain time limits, a code of conduct for that implementation was adopted in 2004.
67. The EU Arbitration Convention (90/436) is also not applicable in respect of non-EU enterprises even if they are doing business through a permanent establishment situated in one of the Member States.

The EU Arbitration Convention provides for mandatory arbitration in cases in which Member States cannot reach mutual agreement on the elimination of double taxation within two years from the date on which the case was first submitted to one of the competent authorities of the Member States involved. Following this two-year period, an advisory commission is convened (by the competent authorities), which has to deliver an opinion within a six-month period. Thereafter, the competent authorities may either adhere to the opinion of the advisory commission or benefit from an additional six-month period to seek another agreement to eliminate double taxation. If the competent authorities do not reach an agreement within six months, they must conform to the opinion of the advisory commission.[68]

3. Transfer Pricing Documentation

3.1. Review of transfer pricing and the taxpayer's duty of co-operation

3.1.1. Opening comments

As a rule, the Luxembourg tax authorities are under a duty to investigate all the facts and circumstances of a tax case.[69] Conversely, the taxpayer is under a duty of co-operation with the tax authorities.[70] Both principles go hand in hand and complement one another.[71]

A Luxembourg company's transfer prices are generally reviewed by the tax authorities as part of the tax assessment procedure.[72] They can also be reviewed during the course of a tax audit spanning several years.[73] Where a request for an APA is filed, the transfer pricing of a controlled transaction between related companies will be verified before the Luxembourg tax authorities decide on the case.[74]

3.1.2. The taxpayer's duty of co-operation

Article 171 of the General Tax Code is the basis for the duty of Luxembourg taxpayers to cooperate with the tax authorities. According to this provision, taxpayers are under an obligation to evidence facts and provide information, assuming the evidence is (1) available, (2) reasonable for the taxpayer to have and (3) relevant for clarification purposes.[75] Thus, in accordance with article 171 of the General Tax Code, the taxpayer merely has to obtain and to provide existing documents, not to prepare special transfer pricing documentation.

The new article 171(3) of the General Tax Code explicitly extends the taxpayer's duty of co-operation to transactions between associated enterprises, although no specific transfer pricing documentation requirements are detailed therein. While the new provision is merely there for clarification purposes, it confirms that the Luxembourg authorities are now relying more heavily on transfer pricing documentation.[76]

3.1.3. Burden of proof

Under Luxembourg tax law, the burden of proof is generally split between the taxpayer and the Luxembourg tax authorities. For facts and circumstances resulting in an increase in the taxpayer's taxable income, the burden of proof is on the Luxembourg tax authorities, whilst the taxpayer has to prove those facts and circumstances that entail a reduction in taxable income.[77] Thus, with regard to the burden of proof in respect of transfer pricing adjustments, upward and downward adjustments have to be distinguished.

3.1.3.1. Burden of proof in respect of upward adjustments

The onus to prove that transactions do not adhere to the arm's length principle is generally on the Luxembourg tax authorities. It is for the administration to verify whether or not transfer prices for goods and services transferred between group companies adhere to the arm's length criterion. If the tax authorities can prove that a transfer price is not within the range of arm's length prices, this raises a rebuttable presumption that the transaction does not comply with the arm's length principle.[78] Overall, the burden of proof for the non-arm's length character of intra-group transactions should be relatively low.[79]

Although the burden of proof is on the tax authorities, they may still reasonably oblige a Luxembourg company

68. *See* B. Gibert & X. Daluzeau, *EU Joint Transfer Pricing Forum: Overview of the Pending Mutual Agreement Procedures under EU Arbitration Convention and of Advance Pricing Agreement Possibilities*, 15 Intl. Transfer Pricing J. 6, p. 251 (2008), Journals IBFD; B. Damsma, *Proposed Changes to the Code of Conduct for the Arbitration Convention*, 17 Intl. Transfer Pricing J. 1, p. 39 (2010), Journals IBFD; and L. de Hert, *A New Impetus for the Arbitration Convention*, 12 Intl. Transfer Pricing J. 2, p. 50 (2005), Journals IBFD.
69. Sec. 204(1) AO.
70. Sec. 171 AO; LU: Tribunal Administratif, 3 June 2009, n o. 24935; LU: Tribunal Administratif, 10 Sept. 2008, no. 23544; DE: BFH, 7 Dec. 1955, V z 183/54 S, BStBl III. p. 75 (1955).
71. DE: BFH, 25 Mar. 1955, III 81/54 U, BStBl III, p. 133 (1955); V z 183/54 S (7 Dec. 1955); DE: BFH, 7 Apr. 1959, I 2/58 S, BStBl III, p. 233 (1959); DE: BFH, 29 Oct. 1959, IV 579/56 S, BStBl III, p. 26 (1960); DE: BFH, 13 July 1962, VI 100/61 U, BStBl III, p. 428 (1962); DE: BFH, 20 Feb. 1979, VII R 16/78, BStBl II, p. 268 (1979).
72. Sec. 166(1) AO.
73. Sec. 162(10) AO.
74. Where a Luxembourg finance company files a request for advance certainty, such request must be based on a transfer pricing study. This is in line with a trend at the level of the Luxembourg tax authorities to ask more systematically for transfer pricing documentation substantiating the arm's length nature of intra-group pricing.
75. DE: BFH, 19 Dec. 1952, V z 66/53, BStBl III, p. 63 (1953); DE: BFH, 20 Jan. 1959, I 155/57, BStBl III, p. 222 (1959); VI 100/61 U (13 July 1962); DE: BFH, 12 July 1974, III R 116/72 BStBl II, p. 25 (1975); DE: BFH, 16 Apr. 1980, I R 75/78, BStBl II, p. 492 (1981); *see* O.R. Hoor & P. Neefs, *TP Documentation in Luxembourg: What the Luxembourg tax authorities may expect*, Tax Planning Intl. Transfer Pricing, p. 25 (Dec. 2009).
76. Art. 171(1) of the AO was already applied in the past to Luxembourg companies that were part of a group of companies.
77. LU: Law of 21 June 1999, art. 59; DE: BFH, 24 June 1976, IV R 101/75, BStBl II, p. 562 (1976); and I R 175/79 (11 Apr. 1984).
78. Here, the Luxembourg tax authorities may look to public databases and data from comparable transactions in other cases (under certain conditions).
79. According to Luxembourg case law, the tax authorities only need to evidence that it is likely that an advantage has been shifted by the company (without having to determine exactly a breach of the arm's length principle) in order to cause a reversal of the burden of proof; LU: Tribunal Administratif, 27 Nov. 2006, no. 21033 (ID 675); LU: Tribunal Administratif, 31 Dec. 2007, no. 22777 (ID 6149); LU: Tribunal Administratif, 9 June 2008, no. 23324 (ID 7946); LU: Cour Administrative, 12 Feb. 2009, no. 24642C (ID 9626); and LU: Tribunal Administratif, 16 Feb. 2009, no. 24105 (ID 9414).

to provide consistent arguments about its transfer pricing.[80] In this regard, the company must take into consideration that the voluntary production of documents can significantly improve the persuasiveness of the company's approach to transfer pricing before the tax authorities.[81] If the taxpayer is unable to justify the arm's length character of intra-group transactions, the tax authorities may rely on the concept of hidden dividend distributions or new article 56 of the LITL to perform upward adjustments.[82]

3.1.3.2. Burden of proof in respect of downward adjustments

In the event of hidden capital contributions and "downward adjustments" under article 56 of the LITL, the fair market value of the advantage shifted to a Luxembourg company is deducted from the company's taxable income. It follows that the underlying facts and circumstances regarding the advantage to be shifted to a Luxembourg company should be evidenced by the taxpayer.[83] In certain circumstances, the Luxembourg tax authorities may reasonably require that the value of a hidden capital contribution or, respectively, the advantage that would result in a downward adjustment under article 56 of the LITL is substantiated in a transfer pricing study.

3.2. Documentation requirements

3.2.1. Opening comments

Luxembourg companies have to document that the transfer prices agreed to in intra-group transactions adhere to the arm's length principle. What, however, is the minimum standard to be respected and what may be considered to be the best practice? These questions are explored in the following sections.

3.2.2. Reference to the OECD TP Guidelines

As a member of the OECD, Luxembourg has approved the OECD's TP Guidelines and they are frequently followed by the Luxembourg tax authorities.[84] A separate chapter of the OECD TP Guidelines assists taxpayers and tax administrations in identifying useful transfer pricing documentation for evidencing the arm's length character of controlled transactions.[85]

The OECD TP Guidelines require that taxpayers prepare or refer to written materials that could serve as documentation of the efforts undertaken to comply with the arm's length principle (general information, factors taken into account, selected method, and so on). The standard for documentation requirements should accord with prudent business management principles.[86] Nevertheless, this chapter does not intend to impose a greater burden on taxpayers than is required by domestic rules.[87]

Minimum documentation requirements set out in the OECD TP Guidelines include:
- group structure (including group and organizational charts, as well as information on the legal and operating structure);
- relevant transactions (including terms and conditions, functions performed and risks assumed by the parties);
- relevant legal documentation (including agreements, price lists and information deriving from financial controlling); and
- transfer pricing computations indicating compliance with the arm's length principle.[88]

These minimum requirements are in line with the duty of co-operation set out in article 171(1) of the General Tax Code, which, according to paragraph 3, is explicitly extended to transactions between associated enterprises.

When requesting supporting transfer pricing documentation, tax authorities should balance the need for documentation against the cost and administrative burden to the taxpayer. Indeed, taxpayers should not be expected to suffer a disproportionately high burden and costs to obtain documents from foreign associated enterprises or to engage in an exhaustive search for comparable data from uncontrolled transactions if the taxpayer reasonably believes either that (1) no comparable data exists or (2) the cost of locating the comparable data would be disproportionately high relative to the amounts at stake.[89] The documentation/cost balance should, however, be interpreted broadly; it is generally accepted that the preparation of transfer pricing documentation will involve costs. Finally, the Guidelines suggest that tax authorities should not require taxpayers to provide documentation or evidence that is unavailable so as to avoid wholly unreasonable requests.[90]

The topic of transfer pricing documentation is high on the agenda of the OECD BEPS Project. The Report on BEPS Action 13 contains revised standards for transfer pricing documentation that are meant to replace the current version of Chapter V of the OECD TP Guide-

80. The taxpayer has to provide consistent arguments underpinning the arm's length character of the transfer price representing at least a probable possibility; DE: RFH, 21 Dec. 1938, RStBl p. 307 (1939); and I 2/58 S (7 Apr. 1959).
81. Where the arm's length character of the transfer pricing is substantiated in a transfer pricing study, the burden of proof for the non-arm's length character of intra-group transactions should be significantly higher; *see* Hoor & Neefs, *supra* n. 75, at p. 26.
82. Sec. 217(1) AO.
83. At the level of the shareholder, the hidden capital contribution should result in an increase in taxable income (for example, when assets are sold to the company at a sales price below fair market value). Thus, in the case of Luxembourg shareholders, the burden of proof that the terms and conditions of a transaction did not adhere to the arm's length principle should be on the Luxembourg tax authorities.
84. The Circular of 28 January 2011 regarding finance companies, as well as the commentaries to the new transfer pricing provisions make explicit reference to the OECD TP Guidelines.
85. Ch. V OECD TP Guidelines.
86. Whether documentation or evidence is required for other (i.e. non-tax) matters is wholly irrelevant; Ch. V, paras. 5.3. and 5.4. of the OECD TP Guidelines.
87. Ch. V, para. 5.2. OECD TP Guidelines.
88. Ch. V, para. 5.17. OECD TP Guidelines.
89. Ch. V, para. 5.6. OECD TP Guidelines.
90. Documents that are not reasonably available include, for example, information that cannot be legally obtained, or that is not actually available to the taxpayer because it is confidential information of the taxpayer's competitors or because it is unpublished and cannot be obtained by normal enquiry or market data.

lines. According to this draft guidance, multinational enterprises (MNEs) would be requested to prepare a "master file"[91] covering their global business operations and a "local file"[92] in each country. In addition, a template for country-by-country reporting is contained in the Annex to the draft Chapter V. The new template requires MNEs to report their income, earnings, taxes paid and accrued, as well as certain measures of economic activity (for example, employment, capital and tangible assets in each tax jurisdiction) to the tax administrations of the countries where they operate.[93] All of this will result in a significant compliance burden and cost to businesses. It remains to be seen how the new guidance will be implemented in Luxembourg and under foreign tax law since the OECD TP Guidelines are, as such, not binding on taxpayers.

3.2.3. Practical documentation recommendations

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. 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, it is for the taxpayer to disprove this rebuttable presumption. Transfer prices may, however, be reviewed several years after a transaction takes place, which 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 evidently 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.

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.[94] Last, but not least, the Luxembourg tax authorities may require transfer pricing documentation when a Luxembourg company files a request for advance certainty in regard to the tax treatment of a particular transaction.

In respect of cross-border transactions, foreign tax authorities may be more demanding in terms of transfer pricing documentation than their domestic counterparts. In these circumstances, the Luxembourg tax authorities generally accept transfer pricing documentation prepared for foreign tax purposes as long as the documentation is based on the OECD TP Guidelines.

Notably, transfer pricing policies cannot be disregarded after implementation (though this practice is widespread). Valuable transfer pricing documentation should regularly be reviewed and updated; particularly upon business restructurings and where new transactions are envisaged.

Transfer pricing documentation is definitely a key element in tax risk management. In the current international tax environment, however, companies should integrate the documentation of transfer prices in their wider tax strategy and use it as a means to reflect the business rationale behind the corporate structure and intra-group transactions.

4. Conclusions

It is not new that Luxembourg companies have to adhere to the arm's length standard when entering into transactions with associated companies. The new transfer pricing legislation, however, explicitly introduces the arm's length principle into Luxembourg tax law, completing the set of Luxembourg transfer pricing rules. Going forward, new article 56 of the LITL will serve as a legal basis for upward and downward adjustments when advantages are shifted in controlled transactions.

The new transfer pricing rules come at a time when transfer pricing and tax transparency is at the top of the international tax agenda and reinforce Luxembourg's intention to comply with all international tax standards. Ultimately, the structuring of investments via Luxembourg will rely more heavily on solid transfer pricing documentation that is based on the OECD TP Guidelines. This should make existing and new investment structures even more robust and immune to challenges by foreign tax authorities.

91. 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.
92. 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.
93. While it has been expressly stated that the compliance burden and costs to businesses should be limited, it will be extremely burdensome and costly to implement the new transfer documentation on a global basis. As of today, MNEs do not have this information and will need to implement systems and processes that allow them to produce data on a comparable basis (given the differences under local GAAPs).
94. For example, when a Luxembourg company receives an interest-free loan from an associated company and claims a downward adjustment for the interest expenses saved, the arm's length interest rate should be determined and substantiated in a transfer pricing study.

