

THE IMPORTANCE OF TRANSFER PRICING DOCUMENTATION IN A PRIVATE EQUITY FUND CONTEXT



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Introduction

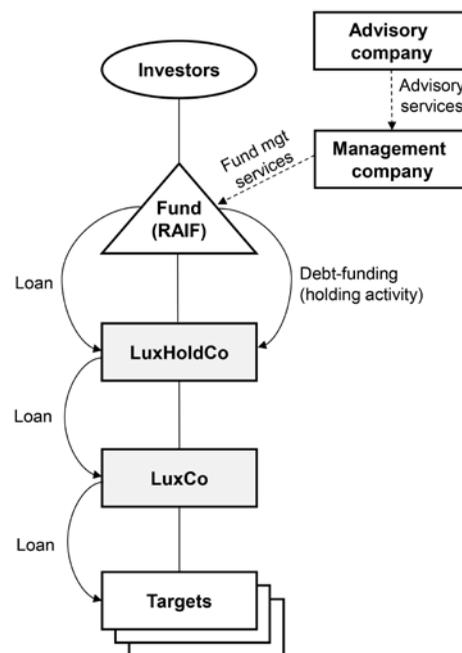
Over the last few years, transfer pricing and related documentation has become the hot topic in Luxembourg taxation in an environment that relies increasingly less on tax rulings. In the past, taxpayers viewed tax rulings as a way to provide legal certainty and to mitigate tax risks relating to investments and intra-group transactions. However, for a number of reasons this is no longer the case. This article analyses the increasing importance of transfer pricing documentation in the context of Private Equity (“PE”) investments.

Intra-group Transactions in a Private Equity Fund Context

PE investments are generally structured via a Luxembourg or foreign fund vehicle and Luxembourg holding companies which are acquiring businesses.

The different entities involved generally enter into a variety of intra-group transactions such as loans, financing activities and intra-group services (fund management services, advisory services, administrative services, etc). For Luxembourg and foreign tax purposes, the conditions of these transactions have to adhere to the arm’s length principle.

Transactions with third parties are by definition arm’s length. Consequently, fund management fees paid by the fund to the management company are at arm’s length because the investors are third parties to the asset manager. However, when services are delegated to related parties (eg advisory services), the pricing agreed again needs to adhere to the arm’s length principle. Therefore, the organisation of fund manage-



ment services has to be thoroughly analysed from a transfer pricing perspective.

The Arm's Length Principle and the Risk of Transfer Pricing Adjustments

Under the arm's length principle, the controlled transactions are compared to transactions between unrelated entities under comparable circumstances to determine acceptable transfer prices. Thus, the marketplace comprising of independent entities is the benchmark for testing transfer prices and their acceptability for tax purposes.

When the conditions agreed upon by associated enterprises in their intra-group transactions are not consistent with the arm's length standard, transfer pricing adjustments might be performed in order to restate arm's length conditions. In practice, transfer pricing adjustments generally result in an increase of the taxable basis and, therefore, tax costs.

Tax adjustments may, for example, be performed to recognise a higher financing margin when the margin actually realised in relation to financing activities is below the arm's length margin. Moreover, when a fund finances the holding activities of a Luxembourg subsidiary with debt instruments, the remuneration of such instrument has to comply with the arm's length principle. Otherwise, the excessive part of the remuneration may be non-deductible for Luxembourg tax purposes and subject to Luxembourg withholding tax.

Another important topic for Luxembourg PE funds relates to the remuneration of fund management

services when a Luxembourg management company delegates some of the functions to an associated foreign management company. Given the amounts at stake and the potential tax risks at the level of the Luxembourg management company, it is crucial to develop a robust transfer pricing approach in these cases.

From a foreign tax perspective, it is particularly important that the arm's length character of the interest rates charged on loans is consistent with the arm's length standard. Likewise, other charges such as service fees for which a deduction is searched in the investment jurisdiction need to be in line with market prices.

The Importance of Transfer Pricing Documentation

As a matter of principle, the arm's length character of intra-group transactions should be substantiated in sound transfer pricing documentation. Despite Luxembourg tax law not specifically requiring the preparation of transfer pricing documentation, taxpayers have 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 for 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 increasingly more difficult from a practical perspective to trace

back the relevant facts and circumstances of the transaction as well as data on comparable transactions. This evidently applies pressure on Luxembourg companies to develop appropriate transfer pricing policies for risk mitigation purposes.

Best Practice Recommendations

Transfer pricing inevitably exerts pressure on taxpayers to find a balance between a comfortable level of security and the costs for 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 tax authorities and assess the magnitude of related tax risks.

Efforts in regard to the determination and documentation of arm's length conditions should be aligned with the significance of the intra-group transaction. It is further important that transfer pricing policies are not disregarded after their implementation. This includes the principle that transfer pricing documentation should be regularly reviewed and updated to reflect the actual fact pattern.

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