

UNOFFICIAL ENGLISH TRANSLATION¹

of the circular issued by the Luxembourg director of taxation

LIR no. 56/1 – 56bis/1 dated 27 December 2016²

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RE: TAX TREATMENT OF COMPANIES ENGAGED IN INTRA-GROUP FINANCING TRANSACTIONS

1. Definitions

1. A company carrying out group financing transactions (hereinafter “**group financing company**”) means any entity that carries out intra-group financing transactions. For the purposes of the preceding sentence, activities in connection with the holding of participations are not taken into consideration.

2. An intra-group financing transaction comprises any activity consisting in the granting of loans or advances remunerated by interest to related enterprises financed by financial instruments such as public issuance of debt, related party loans, advances or bank loans. Pursuant to article 56 of the Luxembourg income tax law (“**LIR**”), two enterprises are considered related enterprises where one of them participates directly or indirectly in the management, control or capital of the other or if the same persons participate directly or indirectly in the management, control or capital of both enterprises.

2. Background information

3. The arm's length principle as set out in Article 9 of the OECD model tax convention on income and capital constitutes the international standard adopted by OECD member countries to be used for the determination of transfer prices relating to cross-border transactions carried out between related enterprises. To ensure the application of this principle, the OECD has developed regularly updated guidelines to be observed by both multinational enterprises and tax administrations in the framework of establishing the transfer prices relating to transactions carried out between related enterprises³.

¹ This represents an unofficial English translation. The wording of the French text of the Circular shall at all times prevail. Due to the insertion of this foot note 1, the footnotes 2 through 6 as used hereinafter correspond to footnotes 1 through 5 of the actual Circular issued.

² This Circular replaces the circulars LIR no. 164/2 dated 28 January 2011 and LIR no. 164/2bis dated 8 April 2011 as from 1 January 2017.

³ Principles of the OECD applicable to transfer pricing for multinational enterprises and tax administrations.

4. Under domestic law, the arm's length principle is included in article 56 LIR, which allows adjusting the profits as reported in the event that the transfer prices differ from the transfer prices that would have been agreed upon between independent enterprises for comparable transactions taking place in an open market under comparable circumstances.

5. When an intra-group financing transaction has been carried out it is necessary to determine, as for any other type of intra-group transaction, whether the agreed price, taking into account the economic nature of the transaction, is in line with the arm's length principle, i.e. corresponds to the price that would have been used and accepted by independent enterprises in comparable circumstances. In order to determine whether transactions between independent enterprises are comparable to transactions between related enterprises, a comparability analysis is required.

6. The new Article 56bis LIR, introduced by article 3, number (2) of the law of 23 December 2016 on the Luxembourg budget for 2017, which will enter into force on 1 January 2017, contains the basic principles to be observed when performing a transfer pricing analysis. This new article which focuses on comparability analysis takes into account new elements to be taken into account in a comparability analysis and sets out the technique to be used and the methodology to be adopted for the application of the arm's length principle.

7. Pursuant to paragraph 171 of the general tax law (*Abgabenordnung*), any taxpayer must be able to justify the information included in its tax returns, including the transfer prices used in the context of controlled transactions, i.e. transactions carried out between related enterprises.

3. The application of the arm's length principle in respect of intra-group financing transactions

3.1. The comparability analysis

8. Paragraph 4 of article 56bis LIR states that a comparability analysis comprises two parts:

1. The identification of the commercial or financial relations between the related enterprises and the determination of the material economic conditions and circumstances which relate to those relationships in a way so as to define precisely the controlled transaction;
2. The comparison of the material economic conditions and circumstances of a controlled transaction, to be precisely defined, with similar comparable transactions as carried out between independent enterprises.

3.1.1. Identification of commercial or financial relations between related enterprises and the determination of material economic conditions and circumstances

9. In order to be able to precisely define the scope of individual controlled transactions and to determine the arm's length remuneration, it is useful to describe the role of each entity, party to the controlled transactions, in view of its commercial or financial position within the group of enterprises of which it is a member. In this way, it may be wise to understand the structure and organization of the group of enterprises and the extent to which they influence the manner in which the group of enterprises operates. Equally, it may be advisable to know the interdependent links between the functions performed by the enterprises parties to the controlled transactions and the rest of the group, the contribution by the associated enterprises to the creation of value in the broader group and how this contribution affects the arm's length remuneration of each enterprise party to the controlled transactions. Indeed the relevant economic characteristics of a transaction are related to the economic circumstances in which the transaction takes place.

10. By way of illustration, a group finance company can grant loans or advances to related entities for various commercial reasons:

- Financing of fixed assets;
- Financing of movable assets;
- Long-term strategic financing;
- Other miscellaneous financing.

11. Although this list is not exhaustive, it nevertheless follows that the material economic characteristics of a financing transaction are closely linked to the commercial relations existing between the related entities and to the economic objectives pursued by the parties involved.

12. As part of the process of precisely defining the scope of a controlled financing transaction, it is necessary to determine the characteristics of the transaction, including its terms, the functions performed, the assets used and the risks assumed by the related enterprises. The extent to which one of the comparability factors is of material economic significance for a particular transaction depends on the extent to which independent enterprises would take it into account when assessing the terms of the same transaction, if it would be concluded between them.

3.1.1.1. The contractual arrangements

13. A transaction is the expression of a commercial relationship between the parties. For the comparability analysis, it is irrelevant whether such transaction has been formalised in writing or not. The behaviour of the parties to the transaction is paramount in identifying and defining precisely the scope of a controlled transaction. Consequently, even if a contract is formalised in writing, if the actual behaviour of the parties to such transaction differs from what is contractually concluded, it is the actual behaviour of the parties which must be taken into account in defining the scope of the transaction actually effected.

3.1.1.2. The functional analysis

14. The purpose of the functional analysis is to identify the material economical activities, responsibilities and functions, the assets used or provided and the risks assumed by the parties to the transactions. The functions performed in connection with the granting of loans or advances to related enterprises are, in substance, comparable to the functions performed by independent financial institutions subject to the supervision of the *Commission de Surveillance du Secteur Financier* (CSSF). It should be stated that material functional differences can be observed in connection with financing transactions carried out by related enterprises which are not governed by the regulations imposed by the CSSF. The functional analysis focuses on what the parties actually do and the assets they deploy. These functions include decision-making, notably as regards business strategy and risks. In this context, it is necessary inasmuch as possible to determine the legal rights and obligations of each of the parties in the performance of these functions.

15. Without being exhaustive, the following functions can be performed by enterprises engaged in intra-group financing transactions:

A) The creation of the transaction

- Marketing of the transaction (customer identification, product proposal, etc.);
- Negotiation (setting the terms of a contract, assessing the risks associated with the granting of loans, etc.);
- Identification of the refinancing structure related to the financing activity;
- Control of compliance with contractual commitments before the final conclusion of the transaction (value of guarantees, solvency analysis ...).

B) The management of the transaction

- Administration of the financial transaction;

- Monitoring of credit risk (review of guarantees and risks related to the transaction);
- Refinancing management.

16. The identification of the functions performed and the assets used is essential in order to be able to identify the risks relating to the financing transaction.

3.1.1.3. Risk analysis in financial relations

17. Before granting a credit or an advance, financial institutions, or any other party engaged in the granting of credit, perform an analysis of the risks to which they are exposed. In the frame of this analysis, they notably examine the annual accounts of the borrower in order to assess the financial risks associated with the contemplated transaction. They verify the existence of guarantees and consider the object of the credit, its duration and any other material factor, in order to be able to assess the risk associated with the borrower. In general, in an open market, the acceptance of an increasing risk generates a higher remuneration. The capacity to manage the risk and the capacity to assume that risk are economically relevant characteristics that need to be identified to precisely define the scope of the controlled financial transaction.

18. It is therefore necessary to evaluate, on the basis of the specific facts and circumstances of each case individually, the specific material economic risks associated to the financing transaction, the functions performed which are related to or affect the assumption of or the impact of these risks, as well as the party or parties to the transaction who assume these risks. In general, a group finance company is considered to assume the risk when it has the financial capacity to manage the risk and to bear the financial consequences if the risk materializes. The financial capacity to manage the risk can be defined as the necessary access to financing to assume or avoid the risk, pay the risk management functions and bear the consequences if the risk materialises.

19. When the comparability analysis reveals that a group finance company has a profile comparable to that of entities subject to Regulation (EU) no. 575/2013 of the European Parliament and of the Council of 26 June 2013 concerning prudential requirements measures applicable to credit institutions and investment firms and amending regulation (EU) no. 648/2012 and that it has equity meeting the solvency criteria laid down in that regulation, it is considered that its own equity is sufficiently high to bear the financial consequences when the risk materializes.

When the comparability analysis reveals significant differences in the functional profile (assets used and functions performed) of a group finance company compared to the entities subject to the aforementioned regulation, it is necessary to determine the level of equity needed to assume the risks on the basis of other methods and in particular by using credit analysis methods developed by recognized professionals. These methods are based on analyses of balance sheet items, market factors and other important factors in determining the risks associated with a financing activity⁴.

20. A group finance company manages the risk if it has the decision-making capacity to enter into a commercial relationship that gives rise to such risks and has the capacity to take the decision to negotiate the related risks and is effectively exercising such decision-making functions. A finance company can outsource the daily activities of risk management. In this case, it must have the capacity to determine the objectives of the outsourced activities, decide to call on the provider responsible for the risk management functions, assess whether the objectives are properly respected and, if necessary, to decide to adapt or terminate the contract with the service provider concerned and that it exercises that function effectively.

21. A group finance company must therefore have a real presence in Luxembourg in order to justify risk management. A group finance company has a real presence in Luxembourg if it meets notably all the conditions set out hereafter.

- The majority of the members of the board of directors, directors or managers who have the capacity to bind the group finance company are either residents or professionally resident in Luxembourg carrying out a professional activity that falls under one of the first four categories of income referred to in article 10 LIR⁵ and which are subject to Luxembourg tax in respect of at least 50% of the total of such income. In case a legal entity is a member of the board of directors, it must have its statutory seat and its central administration in Luxembourg.

⁴ Recognised providers on regulated or non-regulated financial markets whose objective is the provision of credit risk analyses and the development of scientific models to determine the risk associated with a credit activity.

⁵ Article 10 LIR :

Only the following shall be taken into account in determining the total net income within the meaning of the second paragraph of Article 7:

1. Commercial profit;
2. Agricultural and forestry profits;
3. Profits from the exercise of professional independent services;
4. Net income from employment;
5. ...

- The company must have the qualified personnel adapted to the needs to manage the transactions carried out. However, the company may subcontract for a fee the functions that do not have a significant impact on the risk management. Key decisions regarding the management of the company must be taken in Luxembourg. In addition, for companies for which company law provides for the holding of general meetings, at least one general meeting must be held each year at the place indicated in the articles of association.
- The company must not be considered a tax resident of another country.

3.1.2. Comparison of the controlled and precisely defined transaction with comparable transactions between independent enterprises and the determination of the arm's length remuneration

22. In order to determine the arm's length remuneration it is necessary to compare the precisely defined controlled transaction with comparable transactions carried out on an open market.

23. The arm's length remuneration is the remuneration that would have been agreed upon on the open market under comparable conditions. Therefore, in order to be able to determine such remuneration it is important to identify comparable transactions. The process for identifying potential comparables has to be transparent, systematic and verifiable. The research for potential comparables must be done by means of using all available sources of information at the time of the implementation of the transaction.

24. The practices of the comparable sector concerned must also be taken into account. In the case of enterprises performing similar functions to those performed by regulated financing and treasury companies, i.e. enterprises covered by paragraph 19 of section 3.1.1.3., a percentage of return on equity of 10% after tax can be observed on the market and can be considered a reflection of an arm's length remuneration for such financing and treasury functions at the time of the publication of the present circular. This percentage will be regularly reviewed by the direct tax authorities on the basis of relevant market analyses.

25. The adjustments of comparability can be made in accordance with internationally accepted standards in the field, if they prove necessary to improve the reliability and quality of the comparability analysis.

3.1.3. Transactions without commercial rationality

26. It must be noted that, during the comparability analysis and in the frame of the precise scope of one or several controlled transactions, it can occur not only that this or these transactions per se cannot be observed on the open market, but that they are also deprived of any commercial rationality, insofar as independent parties would not have accepted to conclude such transactions in the same conditions. In this case, this or these transactions, as well as the related tax consequences, must be ignored to ensure compliance with the arm's length principle.

4. Simplification measure

27. When a group financing company duly complies with the criteria set out in paragraph 21 of section 3.1.1.3. and performs a purely intermediary financing activity by granting loans or advances to related enterprises which it financed by loans or advances granted by related enterprises⁶, it is accepted that, taking into account the risks associated with such transactions and for simplification purposes, these transactions are considered to be compliant with the arm's length principle provided the relevant company realizes, in connection with such controlled transactions, a minimum return, after taxation, of 2% on the assets financed. This percentage will be regularly reviewed by the direct tax authorities on the basis of relevant market analyses.

28. It should be noted that this percentage of minimum return on assets financed for purely intermediate financing companies with reduced functions cannot be used, without a transfer pricing analysis, with a view to determine the arm's length remuneration for any other intra-group financing transactions.

29. To benefit from this simplification measure, the enterprise must communicate its application to the direct tax authorities in the relevant section of its income tax return.

30. A deviation from the minimum return established in the first paragraph of this section will not be accepted except in exceptional cases duly justified by a transfer pricing analysis.

31. Taxpayers who opt for the protective regime set out above will be subject to the exchanges of information provided for in the framework of:

- The law of 29 March 2013, as amended, on administrative cooperation in the field of taxation;
- Tax treaties (in force) to prevent double taxation;
- The law of 26 May 2014 approving the Multilateral Convention on Mutual Administrative Assistance in tax matters as well as its amending protocol, signed in Paris on 29 May 2013 and amending the general tax law (*Abgabenordnung*).

⁶ The purely intermediary nature of such activity is not influenced by the number, amount, nature, maturity and other characteristics of such loans or advances.

5. Content of a request for information that has the effect of binding the direct tax authorities in respect of transfer pricing at the level of a group financing company

32. Depending on the specific facts and circumstances of each case, any request for an advance ruling addressed to the direct tax authorities in accordance with the provisions of paragraph 29a of the general tax law (*Abgabenordnung*) should at least contain the following information and documents:

1. The precise name of the applicant (name, address, identification number, if any) and the entities or branches involved in the transactions or arrangements which are covered by the application;
2. A detailed description of all intra-group financing transactions relating to the company as well as the legal arrangements and acts referred to in the request, accompanied by a detailed justification of the legal position of the applicant;
3. The qualifications of the relevant employees and the description of their duties;
4. The other country/countries concerned by the transactions or arrangements;
5. A presentation of the legal structure of the group, including information concerning the economic beneficiary or beneficiaries of the capital of the applicant;
6. The tax years concerned by the request;
7. A transfer pricing study in accordance with the principles set out in the previous sections and as laid down by the OECD in the area of transfer pricing, including:
 - The description of the calculation of the capital required and necessary to assume the risks;
 - The description of the group and the interdependent links between the functions performed by the enterprises parties to the controlled transactions and the rest of the group, as well as the description of the creation of value in a broad sense in the by the enterprises parties to the transactions
 - The defined scope of the analysed transactions;
 - The complete list of the comparables researched;
 - The matrix of potential comparables not taken into consideration as well as the reason why these comparables were not taken into account;

- The final list of the comparables used, on the basis of which the enterprise determined the arm's length remuneration applied to the precisely defined scope of intra-group transaction(s);
 - A general description of the market situation;
 - A review of all the relevant ancillary tax issues arising from the proposed methodology;
 - The list of advance pricing agreements concluded in other countries in connection with the analysed transaction(s);
 - The list of advance pricing agreements relating to the analysed enterprise which are still in force at the time the application is submitted;
 - The projections of the profit and loss account for the years covered by the request for advance pricing agreement;
8. The assurance that the information needed to assess the facts is complete and in line with reality.

6. Decisions of the direct tax authorities taken before the entry into force of article 56bis LIR.

33. Any individual administrative decision with respect to the arm's length principle made on the basis of the rules applicable before the entry into force of article 56bis LIR no longer binds the direct tax authorities as from 1 January 2017 for tax years commencing after 2016.

34. Companies that wish to benefit from a new decision must submit a new application to the competent tax authorities which meets the conditions laid down in chapter 5 of the present circular.

Luxembourg, 27 December 2016

The Director of Taxation