

New Tax Rules for Intra-Group Financing in Luxembourg

In this note, the authors discuss two administrative circulars on the tax treatment of intra-group financing transactions issued by the Luxembourg tax authorities in January and April 2011, which clarify the application of the OECD Transfer Pricing Guidelines to debt-funded intra-group financing activities, list conditions that need to be met in order for a taxpayer to obtain a binding advance pricing agreement and provide for a grandfathering period for existing structures.

1. Introduction

In January and April 2011, the Luxembourg tax authorities issued two administrative circulars (the 2011 Circulars) both covering the tax treatment of intra-group financing transactions. The first circular, Circular LIR No. 164/2 of 28 January 2011 (Circular 164/2), clarifies the application of the OECD Transfer Pricing Guidelines to debt-funded intra-group financing activities. In addition, it provides a list of conditions that need to be met in order for a taxpayer to obtain a binding unilateral advance pricing agreement (APA) from the Luxembourg tax authorities. These conditions include a list of requirements in relation to the organizational and economic substance of a financing company, which is a novelty since this is the first time that a concrete list of requirements has been issued in Luxembourg.

Although this first circular provides the general tax rules applicable to intra-group financing activities, it is silent as to the implications for existing companies carrying out activities covered by the circular. This is dealt with in the second circular, Circular LIR No. 164/2bis of 8 April 2011 (Circular 164/2bis), which provides for a grandfathering period until the end of 2011 for existing structures.

Although the scope of the two circulars is limited to debt-funded intra-group financing activities, some of the points covered in the circulars, such as the explicit substance requirements and the conditions for an APA to be binding on the authorities, may extend beyond mere financing structures.

This article analyses the contents and the likely implications of the two circulars. It does not, however, purport to provide guidelines on the practical application of the circulars to specific cases, such as the choice of appropriate transfer pricing method and similar questions.

2. Background and Context

The 2011 Circulars are not the first circulars to deal with the tax treatment of intra-group financing activities in

Luxembourg. An administrative circular issued in July 1989 (Circular LIR No. 120 – the 1989 Circular) already dealt with the tax treatment of Luxembourg intra-group financing companies forming part of an international group and having the exclusive object of granting loans to other group companies financed by loan payables. In this respect, the 2011 Circulars cover, to some extent, the same areas as the 1989 Circular. However, while the scope may be somewhat similar, the consequences are different: the 1989 Circular provides that financing companies that meet certain conditions are to be taxed on a lump-sum basis, while the 2011 Circulars merely clarify that the existing general transfer pricing rules apply to financing companies.

In addition to the differences in tax consequences, the 1989 Circular and the 2011 Circulars also differ in their scope. The 1989 Circular required that the company be engaged exclusively in financing activities, while the 2011 Circulars apply to companies that only predominantly carry out financing activities. Moreover, the 1989 Circular contained a minimum capital requirement of (at the time) LUF 7.5 billion (roughly equivalent to EUR 185 million today) for the parent company of the financing company. Capital requirements are also contained in the 2011 Circulars. However, these requirements refer to the company carrying out the financing activities and not the parent company, and are a result of the application of the transfer pricing principles contained in general Luxembourg tax law that are applicable to all Luxembourg companies.

The 1989 Circular required that the financing company be exposed to limited risks by requiring that the receivables and payables be in the same currency and have the same maturity date. If these conditions were met, the companies were subject to tax on a minimum commercial profit of 0.25% of the principal amount of the loans. This margin was reduced to 0.125% if a legal guarantee existed.

The determination of profit from intra-group financing activities on a lump-sum basis met with criticism at the EU level, both from the European Commission and the Code of Conduct (Business Taxation) group, which included the regime governed by the 1989 Circular. In par-

* Executive Director, Luxembourg Tax Desk, Ernst & Young New York. The author can be contacted at anja.taferner@ey.com.

** Partner, Ernst & Young Luxembourg. The author can be contacted at marc.schmitz@lu.ey.com. The authors would like to thank their colleague Nicolas Gillet for sharing his insight on transfer pricing methodologies. The views expressed in this note are purely those of the authors and may not, under any circumstances, be regarded as stating an official position of Ernst & Young.

ticular, this measure was included in the 1999 Primarolo Report,¹ which listed 66 measures considered harmful to tax competition within the European Union. One of the reasons for listing the regime governed by the 1989 Circular in the Primarolo Report was that, “the rules for profit determination in respect of activities within a multinational group of companies depart from internationally accepted principles, notably the rules agreed upon within the OECD”. The Code of Conduct group, in particular, criticized the fact that the regime governed by the 1989 Circular (similar to financing regimes existing in other countries at that time) allowed for, “fixed margins for pass-through financing without a regular review of those margins against normal commercial criteria.”²

However, as the circular had already been abolished by February 1996, it was no longer in effect by the time the Primarolo Report was issued and, therefore, the implications of inclusion in the report were minimal. After 1996, the taxation of financing companies was not governed by specific rules, but by the general tax rules applicable to all Luxembourg companies, essentially resulting in a Luxembourg financing company being taxed on its commercial profit, subject to adjustment for any non-arm’s length transactions within a group. Such adjustments are based on Art. 18 of the Luxembourg Income Tax Code (*loi modifiée du 5 décembre 1967 concernant l’impôt sur le revenu*, LIR), Art. 56 of the LIR and/or Art. 164(3) of the LIR. Art. 18 of the LIR provides that a company’s taxable profit is to be determined as the difference between its net assets at year end and its net assets at the beginning of the year, subject to certain adjustments (the addition of withdrawals by shareholders and the deduction of contributions from shareholders). The concept of withdrawals and contributions also includes informal or hidden contributions and withdrawals, which include benefits in the form of non-arm’s length transactions. Art. 56 of the LIR authorizes the tax authorities to adjust a taxpayer’s tax base for non-arm’s length transactions. Finally, Art. 164(3) of the LIR stipulates that hidden dividend distributions have to be added back to a company’s tax base. Hidden dividend distributions include the non-arm’s length element of intra-group transactions if the beneficiary of the transaction is the shareholder of the Luxembourg taxpayer or is linked to the Luxembourg taxpayer through the shareholder of the Luxembourg company (for example, a sister company).

However, even though these rules required that transactions between a Luxembourg company and other members of its group be carried out at terms comparable to those prevailing in third-party transactions, until the 2011 Circulars were issued no explicit reference had been made in the tax legislation or administrative guidance to the OECD Transfer Pricing Guidelines.

3. The 2011 Circulars

3.1. Purpose and legal value of administrative circulars

Administrative circulars are issued by the director of the tax authorities in order to provide guidance for the

tax officers on the interpretation of specific provisions of Luxembourg tax legislation. The publication of such guidelines provides transparency and certainty to taxpayers in that they are able to anticipate how the tax authorities will interpret certain provisions of the tax legislation. Moreover, circulars contribute to a uniform and fair application of Luxembourg tax legislation to taxpayers, ensuring that the different tax offices apply rules in a consistent manner.

In keeping with the nature of internal guidelines for the tax authorities on the application of specific provisions of the tax legislation, circulars are binding for tax officers. However, since circulars do not go through a legislative process, they cannot create additional legal obligations for taxpayers or otherwise deviate from the provisions of the tax code. Therefore, they are also not binding on the courts³ and the courts may be asked to decide whether or not the tax authorities’ interpretation of a provision, as laid down in a circular, is in line with the law.

As a result, like all circulars, the 2011 Circulars only provide guidelines on how the tax authorities will apply specific provisions of the tax legislation to financing activities and, strictly speaking, taxpayers are not legally obliged to follow them. Nevertheless, a taxpayer would be at risk of an adjustment to its tax base by the tax authorities should the taxpayer decide not to comply with the 2011 Circulars. Of course, the taxpayer would be able to appeal the tax authorities’ decision and could, ultimately, bring the case before an administrative court in Luxembourg. However, since Luxembourg is a member of the OECD and has not made any reservations to Art. 9 of the OECD Model Tax Convention (OECD Model) and the OECD Transfer Pricing Guidelines, it is unlikely that a Luxembourg tax court would conclude that a requirement to comply with the OECD Transfer Pricing Guidelines, as laid down in the 2011 Circulars, is in violation of Luxembourg tax legislation.

3.2. Circular of 28 January 2011

3.2.1. Scope

Circular 164/2 applies to companies predominantly exercising intra-group financing activities. “Financing activities” are defined as “all activities consisting in the granting of loans or cash advances to associated enterprises, refinanced by funds and financial instruments such as public offerings, private debts cash advances or bank loans”.⁴

This definition clearly only brings debt-funded financing activities within the scope of the circular. As a result, any equity-funded financing activities are clearly outside the scope of the circular.

-
1. Final Report of the Code of Conduct Group to the ECOFIN Council on 29 November 1999, available at http://ec.europa.eu/taxation_customs/resources/documents/primarolo_en.pdf.
 2. Id., Para. 34.
 3. Luxembourg District Court (*Tribunal d’Arrondissement*), 21 January 2011, No. 277/2010 and Court of Appeal (*Cour d’Appel*), 2 February 2011, No. 61/11.
 4. Authors’ translation of the wording used in Circular 164/2, p. 1.

Circular 164/2 only applies to companies that predominantly carry out financing activities as defined in the circular. The definition of “predominance” is unclear, since the circular only gives the example of a company that has financing and holding activities, in which case the holding activities are to be ignored. As a result, Circular 164/2 clearly applies to companies with mixed holding and debt-funded financing activities. However, the circular is silent as regards other activities, such as combined licensing and financing activities, a mix of debt-funded financing and other types of financing activities or other possible combinations. Luxembourg tax law does not contain a general definition of “predominance” and, therefore, it is unclear what threshold should apply. The Circular is also silent on the basis to which the “predominance” test would apply: possible options include testing the pro rata share of intra-group financing activities in terms of overall revenues or overall assets or analysing the functions performed by the company’s executives and staff. In the authors’ view, the focus should not be on isolated tests, but on an overall consideration of a company’s activities, to ensure that only companies that are mainly engaged in true debt-funded financing activities come within the scope of the circular.

Where a company is engaged in different types of activities, the question arises as to how frequently the predominance of intra-group financing activities, compared to other activities, would have to be tested. In view of the need to determine an arm’s length remuneration for a specific financing transaction, the only appropriate time would be the moment when the company enters into such a transaction, as it is at that time that the risks associated with the financing need to be analysed and the correct remuneration established.

According to the circular, two companies are considered associated companies:

[...] if one of them participates directly or indirectly in the management, control or the capital of the other, or if the same persons participate directly or indirectly in the management, control or the capital of both companies.⁵

This definition is the same as the definition in Art. 9 of the OECD Model. Defining “association” through either management, control or capital goes further than the definition in the 1989 Circular, which only referred to a link through capital or voting rights.

Since Circular 164/2 only applies to companies lending to associated enterprises, this implies that banks and other financial institutions that provide loans to third parties are clearly excluded, even if such loans are funded by deposits and loan payables. However, banks may, in addition to their corporate object of providing loans to third parties, also grant loans to group companies. Such intra-group loans will likely only constitute a portion of the overall lending activities of the company. In general, a bank should predominantly be engaged in third-party lending activities and should, therefore, be outside the scope of the 2011 Circulars. By contrast, in-house banks, i.e. financing companies that act as banks within a group of companies, are not, as such, excluded from the scope

of the Circular. Nevertheless, they would have to meet the general criteria in order to be covered by the circular, such as being predominantly engaged in debt-funded financing activities.

3.2.2. *Application of the OECD Transfer Pricing Guidelines to intra-group debt-funded financing activities*

The remuneration for intra-group financing activities covered by Circular 164/2 needs to be at arm’s length. Effectively, this means that the pricing of financing transactions between related companies should be comparable with the pricing of the same or similar transactions between unrelated parties.

As such, this does not constitute a change compared to existing tax legislation and administrative practice. As mentioned in 2., Arts. 18 (on the need to adjust the tax base for withdrawals and contributions by the taxpayer), 56 (on profit adjustments for non-arm’s length transactions) and 164(3) (on the add-back of hidden dividend distributions) of the LIR have always been considered a sufficient basis for profit adjustments. Moreover, as Luxembourg is a member of the OECD, the OECD Transfer Pricing Guidelines have always been referred to and applied, as appropriate, although they were not formally incorporated into Luxembourg tax law.

The Circular states that, in order to determine the arm’s length remuneration, a comparability analysis needs to be carried out. This analysis would typically cover:

[...] the characteristics of the goods or services transferred, the functions assumed by the parties, the terms and conditions of agreements, the economic circumstances of the parties and the industrial or commercial strategies that they pursue.⁶

The resulting remuneration should then reflect the functions assumed by the company, taking into account the assets used and the risks assumed in the transaction. In this respect, the functions of a financing company will generally be comparable to those of an independent credit institution that is subject to supervision by the *Commission de Surveillance du Secteur Financier* (CSSF), the Luxembourg supervisory body for banks. As a result, the Circular foresees that, “the arm’s length price should be based on the remuneration requested by such institutions for similar credit operations”.⁷ Prior to granting a loan, a bank would typically conduct a risk analysis, which would cover credit default risk, market risks, structural risks and operational risks. A similar analysis would have to be carried out by intra-group financing companies when entering into financing arrangements.

Circular 164/2 provides an overview of the analysis typically performed by banks before granting loans. Intra-group financing companies would be expected to go through a similar process of reviewing the financial statements of the borrower, verifying the existence of guaran-

5. Authors’ translation of the wording used in Circular 164/2, p. 1.

6. *Id.*, p. 2.

7. *Id.*, p. 3.

tees and examining the purpose of the loan, including its maturity date and other terms and conditions. In addition to analysing financial statements and evaluating credit default risk, the bank would take into account structural risks and other economic risks in relation to the borrower.

The expenses associated with granting a loan typically consist of an amount covering general costs, as well as additional expenses related to solvency requirements, credit risk, processing fees or foreign exchange risk. These expenses would have to be taken into account in determining the amount of the remuneration to be charged to the recipient of the loan.

Circular 164/2 does not contain a list of methods or detailed guidelines as to how the arm's length remuneration for intra-group financing activities is to be determined. However, due to the explicit reference to Art. 9 of the OECD Model and the resulting implicit reference to the OECD Transfer Pricing Guidelines, it does not appear to be necessary to provide for specific Luxembourg rules.

3.2.3. "Real presence" and requirements for APAs

Luxembourg taxpayers may seek up-front confirmation of their tax treatment from the competent Luxembourg tax authorities. Circular 164/2 foresees the (continued) possibility for taxpayers to request advance certainty. Since these clearances mostly deal with the determination of arm's length remuneration for financing activities, it seems appropriate to refer to them as APAs.

Taxpayers that are covered by Circular 164/2, i.e. companies that engage predominantly in intra-group financing activities, will have to meet two conditions to be able to obtain an APA: (1) they will need to dispose of a "real presence" in Luxembourg and (2) will have to assume the risks associated with the granting of loans. Although, strictly speaking, these substance requirements only apply to financing companies covered by the Circulars, this does not imply that a "real presence" is not required for companies engaged in activities other than financing. However, as was the situation in the past, for non-financing companies, these requirements will have to be analysed on a case-by-case basis and different degrees of substance may be required depending on the company's activities and functions.

The requirement to have a "real presence" in Luxembourg goes beyond the legal requirements of the Luxembourg income tax legislation, according to which a company is considered resident in Luxembourg if it has either its statutory seat or its central management in Luxembourg (Art. 159(1) LIR). However, due to the fact that the tax treaties concluded by Luxembourg generally provide that a dual-resident company is considered resident in the country in which its place of effective management is situated, companies engaged in cross-border activities, generally, have always been required to have a certain level of substance in Luxembourg, particularly if they needed to obtain and rely upon residence certificates from the Luxembourg tax authorities. Moreover, in order to be able to be considered the "beneficial owner" of the interest

income, as is required under most tax treaties to benefit from a reduced withholding tax, a company will generally also be required to have a certain level of economic substance.

Circular 164/2, for the first time, defines the required substance of a financing company. According to the circular, a company will be considered to have sufficient "real presence" in Luxembourg if it meets the following conditions related to organizational and economic substance:⁸

- the majority of the members of the board of directors, directors⁹ or managers¹⁰ that have the capacity to bind the company must either be (1) Luxembourg residents, or (2) non-residents exercising a professional activity in Luxembourg that leads to income of one of the first four income categories contained in Art. 10 of the LIR (i.e. business income, income from agriculture and forestry, income from self-employment or employment income) and must be liable for tax in Luxembourg on at least 50% of such income. If a legal person is part of the board of directors of the financing company, both the registered office, as well as the central administration of the legal person, need to be in Luxembourg;
- the above-mentioned board members, directors or managers need to have the professional experience and qualifications required to exercise their functions. They need to have the power to engage the company and to ensure proper execution of all financial transactions. Moreover, the company needs to have qualified personnel (either on its payroll or third-party personnel) that are capable of carrying out and accounting for the transactions. The company must be capable of supervising the work carried out by its personnel;
- the key decisions in relation to the management of the company must be made in Luxembourg. Moreover, for those companies that are required to hold annual shareholders' meetings, at least one such meeting must be held once a year in the place that is indicated in the company's articles of association;
- the company must have at least one bank account in its own name with a credit institution established in Luxembourg or a Luxembourg branch of a foreign credit institution;
- at the time of filing the request for an APA, the company must have complied with all of its filing obligations in relation to direct taxes (i.e. income and net worth taxes);
- the company may not be considered a resident of a state other than Luxembourg; and
- the company needs to be adequately capitalized with respect to its functions (taking into account the assets used and the risks assumed).

8. Id., p. 5.

9. Directors of a public limited company (*société anonyme*).

10. Directors of a private limited company (*société à responsabilité limitée*) are typically referred to as "managers" (*gérants*).

The requirements listed above are similar to the list of requirements contained in the Dutch decree covering Dutch entities engaged in financing (and other) activities.¹¹ In contrast to the Dutch list, however, the Luxembourg requirements in relation to resident board members, directors or managers also allow individuals that are non-residents, but derive the majority of their professional income from Luxembourg sources (i.e. individuals that have their “professional residence” in Luxembourg) to qualify as directors or managers. This difference is due to the particular economic circumstances of Luxembourg, which relies heavily on non-resident frontier workers commuting to the country on a daily basis.

Despite the inclusion of non-resident frontier workers in the group of required “resident” directors of a Luxembourg company, the requirement to have a majority of resident or professionally resident directors seems unnecessarily restrictive. Luxembourg companies are often holding and financing entities for multinational groups of companies, as well as private equity and other funds and are, therefore, naturally situated in the upper tier of the corporate structure. Luxembourg companies often hold and finance different sub-groups within a multinational group or act as the intermediary holding company between a fund and the operating business. Therefore, the board of Luxembourg companies is often composed of managers from different parts of the group that gather in Luxembourg on a regular basis to make strategic business decisions affecting the group or the relevant sub-group. In a globalized economy, these managers no longer necessarily spend their working days where they are resident, but often need to travel to the different subsidiaries operating various businesses in different markets. Therefore, where they meet, hold their discussions and, ultimately, make their decisions seems more relevant than where they are resident, particularly since they may not be spending much more than their weekends at their and their family’s place of residence.

In addition to the requirements regarding “real presence”, Circular 164/2 requires that the Luxembourg finance company assume the risks related to the financing activities. According to the circular, this should be the case if the company’s equity corresponds to at least the lesser of EUR 2 million or 1% of the nominal value of the company’s receivables, provided the company is effectively obliged to use its capital if the risks materialize. The amount of “equity at risk” includes both share capital and share premium, but not profit reserves or other reserves. The capital required in order to meet the “equity at risk” condition may be different from the equity that is required as a result of the transfer pricing analysis. For example, the transfer pricing analysis could conclude that, due to the risks associated with the financing activity, a higher amount of equity is required than the amount contained in Circular 164/2.

A company that meets the conditions as regards “real presence” and “equity at risk” may request an APA from the Luxembourg tax authorities. Such a request needs to contain the following information:¹²

- information on the taxpayer requesting the APA (including name, residence and tax number, if available) and on those entities or branches that are parties to the transactions or arrangements that are covered by the request;
- a detailed description of the transactions, arrangements or legal acts covered by the request, including an analysis of the legal position taken by the taxpayer;
- the other state(s) impacted by the transactions or arrangements;
- a legal structure chart of the group, including information on the beneficial owner of the taxpayer’s equity;
- the tax years concerned;
- a transfer pricing study meeting the OECD standards, including, in particular, a complete description of the methodology applied and the information and detailed analyses supporting such a methodology, such as the identification of comparables and the expected range of results;
- a general description of the market;
- an analysis of the relevant tax issues related to the proposed methodology; and
- confirmation that the information required to evaluate the facts is complete and corresponds to reality.

The 1989 Circular mentioned in 2. above also contained a (different) list of information required when requesting a tax clearance. However, since the abolition of the 1989 Circular in 1996, no official list has existed. An internal circular (Circulaire L.G./ N.S. No. 3 of 21 August 1989 – not published) also contained a list of (slightly different) information that a taxpayer needed to provide when requesting a tax clearance, but this circular was an internal document that had never been officially published. As a result, even though Circular 164/2 only applies to certain financing companies, the list of documents and information requested may also have some relevance for other tax clearances requested in circumstances that are not covered by Circular 164/2.

Like any tax clearance, an APA will be binding on the tax authorities on the basis of the principle of good faith, unless an incomplete or incorrect description of the situation or operations has been provided or essential elements of the described operations differ from those stated in the letter. Moreover, the APA will stop being binding if the underlying domestic or international legal provisions change or if one of the essential features of a transaction changes. In this respect, APAs do not differ from other tax clearances. However, Circular 164/2 provides that APAs will only be binding for a period of five tax years unless a shorter period of validity applies based on the individual facts and circumstances, for example, if the financing is all short term). When the APA expires, a new APA may be sought. Such a renewal request will have to meet the same requirements that apply to an initial request. Like

11. International Tax Policy and Legislation Directorate, Multilateral Affairs Division, Decree of 30 March 2001, No. IFZ2001/294M, annex.

12. Authors’ translation of the wording used in Circular 164/2, p. 7.

the original APA, a renewal APA will be binding for a maximum of five years.

3.3. Circular of 8 April 2011

Circular 164/2 of 28 January 2011 contains the general rules that apply to intra-group financing activities, but does not clarify the situation for existing companies carrying out activities within the scope of Circular 164/2. Until the issuance of Circular 164/2bis, there was uncertainty as to whether existing financing structures needed to comply with the conditions of the January Circular immediately and/or whether existing tax clearances ceased to be binding. These questions were answered in Circular 164/2bis, which provides for a grandfathering period until the end of 2011 for existing structures.

According to this circular, advance tax clearance letters issued before 28 January 2011 (the date Circular 164/2 was issued) will continue to be binding on the Luxembourg tax authorities until 31 December 2011. As from that date, tax clearances granted prior to 28 January 2011 will no longer be binding on the authorities. Strictly speaking, the wording of Circular 164/2bis seems to refer to tax clearances received by intra-group financing companies only. This would imply that any other elements contained in the tax clearance even if unrelated to the pricing of a finance transaction (for instance a confirmation in relation to the application of the Luxembourg participation exemption), would cease to be binding. This does not seem to be in line with the intentions of the 2011 Circular, and there appears to be no particular reason why a position previously taken in regard to a different matter, for example, the application of the participation exemption, should no longer remain valid. Moreover, the scope of Circular 164/2bis clearly refers to the “tax treatment of intra-group financing transactions”, which could imply that only decisions that relate to the tax treatment of such financing transactions would lose their binding nature. More importantly, taxpayers can rely on confirmations from the tax authorities based on the general principle of “good faith”, unless the legal provisions change. The explicit requirement for a transfer pricing study and other requirements in relation to financing companies are only contained in the circular and cannot, therefore, be considered as a change in the law. Moreover, the 2011 Circulars merely clarify that general transfer pricing rules apply to intra-group financing activities and, therefore, do not as such lead to any change in law. It is, therefore, arguable that only those confirmations that are affected by Circular 164/2 directly (i.e. statements in relation to the arm’s length nature of financing activities) would cease to be binding, while other confirmations (such as confirmation in relation to the participation exemption in the example above) would continue to apply. However, unfortunately, the wording in the circular is not entirely clear in this respect.

Circular 164/2bis explicitly allows for the possibility to request a new APA from the tax authorities on the arm’s length’s character of the pricing of financing activities. To be able to obtain such an APA the requirements of Cir-

cular 164/2 will need to be met (see 3.2.). However, even though the possibility to obtain a new APA is provided by Circular 164/2bis, there is no requirement to obtain an APA and a taxpayer may simply decide to rely on his transfer pricing study. Since the remuneration for the financing activity as confirmed by such transfer pricing study is a consequence of the functions performed and risks assumed by the financing company, this will also imply the need for a certain level of substance and capital at risk, which likely may not differ substantially from the “real presence” requirements contained in Circular 164/2.

4. Practical Implications

4.1. Affected financing activities

As outlined in 3.2., the scope of Circular 164/2 only encompasses intra-group debt-funded financing, which excludes (1) any financing activities between third parties and (2) any equity-funded financing activities. For instance, the circular will not, thus, affect either genuine banking activities, where funds collected from third-party deposits are on-lent to third-party debtors, or intra-group financing companies funded by shareholder equity.

Activities falling within the scope of the circular include financing activities where a Luxembourg company predominantly borrows funds either from third parties (via issuance of interest-bearing corporate bonds on the capital markets, for example) or from other group companies and loans these funds to affiliated entities. The relevant criterion is the characterization of the financial contract as a debt instrument under Luxembourg income tax legislation. This would – in addition to any ordinary plain-vanilla loans and debt obligations – include any financial instruments of a hybrid nature, where the mix of debt and equity features leads to their characterization as debt for Luxembourg tax purposes.

In this context, it should be irrelevant in applying the 2011 Circulars whether or not a debt instrument bears interest or whether such interest has effectively been paid or accrued. In principle, the circulars, thus, include non-interest-bearing loans, any financial arrangements where interest has accrued and is only paid with reimbursement of the principal, as well as convertible loans or bonds redeemable in shares (*Obligations Remboursables en Actions*, ORAs).

Intra-group financing arrangements, such as cash pooling activities and factoring activities, are also included within the scope of the 2011 Circulars in so far as these result in receivables that are financed by payables. The circulars may also apply to structures in respect of which two or more Luxembourg companies carry out financing activities on a consolidated basis (i.e. within a tax consolidation), although, in these scenarios, the relevant functions may be assumed jointly by the consolidated entities.

Financing activities are not only carried out by Luxembourg companies but also by Luxembourg branches of foreign entities. These branches are subject to the same tax rules as Luxembourg companies, subject to some adjustments. In particular, the rules as regards the de-

termination of the business profits derived by a Luxembourg branch are generally similar to those that apply to companies. Therefore, the requirements in relation to transfer pricing studies should logically also apply to Luxembourg branches. At the same time, the circular only refers to “companies”, whereas Art. 164(3) of the LIR (in relation to which the circulars were issued) deals with hidden dividend distributions that can, in no event, be made by a Luxembourg branch (but hidden dividends could be considered paid by their head offices). Moreover, the requirements in relation to “real presence” are clearly aimed at establishing a minimum presence for Luxembourg companies since permanent establishments (PEs) do not have a board or directors. Finally, PEs would, in all circumstances, be required to have a strong link with, and presence in, Luxembourg in the form of a fixed place of business. Nevertheless, as regards the content and intentions it seems relatively clear that Luxembourg branches carrying out similar activities as those described in the 2011 Circulars would also fall within the scope of the 2011 Circulars.

4.2. Grandfathering

Advance tax clearances and/or APAs agreed to by the tax authorities after the date of Circular 164/2 should already be in compliance with the Circular. Tax clearances and APAs granted before that date should still be binding provided they meet the conditions of Circular 164/2. Should this not be the case, the APAs will cease to be binding effective 1 January 2012.

Luxembourg companies that carry out financing activities will have to analyse whether or not they are covered by the scope of Circular 164/2, i.e. whether or not they carry out intra-group financing activities as defined by Circular 164/2. If they do, they should review their existing transfer pricing documentation to determine whether or not it is in line with the requirements of the Circular. If not, or if only an incomplete transfer pricing analysis was carried out at the time the loans were granted by the financing company, a new or more thorough transfer pricing analysis may have to be prepared. This study will have to be based, in principle, on the situation prevailing at the time when the loan in question was granted. As collecting past data may, however, be a challenging exercise, it should be possible, in the authors' view, to rely on current data if past comparables are overly difficult or burdensome to determine.

In addition, intra-group finance companies would have to review their organizational substance, as well as their equity structure, to determine whether or not they would meet the “real presence” and “equity at risk” tests of Circular 164/2. Strictly speaking, meeting the conditions of the Circular will only be required if the company wants to apply for a new APA after the end of the grandfathering period. Since having an APA is not a requirement, but merely an option, the company could also decide to rely on its transfer pricing documentation as a basis for the remuneration earned from its financing activities. A review of the functions of the entity and the equity at risk will still

have to be carried out, in order to determine whether or not they are in line with the facts and conclusions of the transfer pricing study. Moreover, in order to qualify as a Luxembourg tax resident, a company would also need to have a certain presence in Luxembourg.

Companies that prefer having their remuneration confirmed in an APA might have to inject additional capital and/or amend the composition of their boards or carry out other changes to their organizational substance. Since organizational substance involves a “facts and circumstances” test, the requirements listed in the circular will have to be met on an ongoing basis and not only at the time a new APA is requested. However, companies may also decide not to comply with the organizational substance criteria. This could, for instance, be the situation in relation to the criterion surrounding board composition. In line with international tax principles, companies that have highly-qualified board members that regularly physically meet in Luxembourg where they take true business decisions will, in principle, be considered as being effectively managed from Luxembourg even if the majority of board members is not resident or professionally resident in Luxembourg.

Companies that do not have the required transfer pricing documentation and analysis, whether or not the analysis was confirmed in an APA, will likely face tighter scrutiny of their tax returns, which may eventually lead to an increase in their tax burden. In addition, as a result of discussions at the G20 and OECD level, Luxembourg has, in recent years, amended many of its tax treaties to include a more complete exchange of information clause. As a result, information on the tax base of a Luxembourg financing company may be more frequently exchanged with the tax authorities of other countries concerned, particularly Member States.

4.3. Determination of appropriate remuneration of intra-group financing activities

Remuneration typically reflects the functions that a company performs, taking into account assets used and risks assumed. Therefore, in determining the appropriate remuneration of intra-group financing activities, the functions carried out by a specific company, the risks assumed, as well as the assets employed by such a company will have to be analysed in order to identify and compare the economically significant activities and responsibilities undertaken, assets used and risks assumed by the parties to the transactions with those assumed by independent parties in uncontrolled transactions. The typical risks assumed by an intra-group financing company include credit default risks, operational risks, withholding tax risks, market risks and foreign exchange risks.

The functional analysis that has to be carried out will typically cover the functions performed both during the process of creating a new financial asset, as well as the subsequent activities performed over the lifetime of the financial asset. Functions involved in creating a new financial asset (i.e. a new receivable) would typically include: sales functions (for example, negotiating contrac-

tual terms with the borrower, deciding whether or not to advance monies and, if so, on what terms, as well as evaluating credit, currency and market risks related to the transaction), trading functions (for example, raising funds and capital, taking deposits, raising funds on the most advantageous terms and making the funds available) and sales support functions (for example, checking draft contracts and completing the contract formalities, resolving any outstanding legal issues, checking any collateral offered, signing the contract, recording the asset in the books and disbursing the proceeds of the financing contracts).

The functions involved in managing an existing financial asset or financing activities typically include: finance contract support (for example, administering finance contracts, collecting and paying interest and other amounts when due and monitoring repayments), monitoring risks assumed as a result of entering into financing contracts (for example, reviewing the creditworthiness of the final borrower(s), monitoring interest rate and position risk, analysing the profitability of the finance contracts and return on capital employed), managing risks initially assumed and subsequently borne as a result of entering into financing contracts (for example, deciding whether and, if so, to what extent, various risks should continue to be borne by the lender, such as transferring credit risk to a third party by means of (credit) derivatives or deciding to write-off debts for non-performing loan contracts), managing the funding position (for example, dealing with the funding of deficits or investing surpluses in the market, including managing the interest rate risk and liquidity risk exposure and matching the duration of borrowing with lending) and sales/trading functions (for example, refinancing, deciding to sell or securitize receivables, pricing, negotiating contractual terms of sale and completing sales formalities).

As a result of this analysis, there needs to be sufficient equity to cover the risks incurred in relation to the activities performed. This equity should, at least, meet the conditions in relation to “equity at risk” mentioned in Circular 164/2, i.e. the equity at risk should at least be the lesser of EUR 2 million or 1% of the loan volume. Where the transfer pricing analysis carried out leads to the conclusion that a higher level of equity is required to arrive at an adequate remuneration, the equity of the financing company would have to be in line with the requirements of the transfer pricing study.

When choosing a transfer pricing method, taxpayers are required to select the transfer pricing method that provides the most reliable results. These methods include transactional methods, such as the Comparable Uncontrolled Price (CUP), Resale Price and Cost Plus methods, as well as profit-based methods, such as the Transactional Net Margin method and Profit Split methods, which may also be used if they provide a better result than the transactional methods. Clearly, the preferred method is the CUP method, provided that the required comparables are available.

Generally, adequate remuneration for financing activities will consist of two elements, an adequate return on equity and an appropriate handling fee to cover the operational risks. The return on equity should provide the shareholders with the return they would expect from engaging in the financing transaction, taking into account the credit risk incurred if the loan granted by the financing company is not reimbursed. Since shareholders carry more risk than creditors, the return on the equity at risk needs to be higher than the return on a debt instrument to reflect the inherent subordination of equity to debt.

In addition to the return on equity, a financing company would typically earn an annual fee to cover the operational risks and to provide adequate remuneration for the financial management and maintenance activities. There are various ways to determine what an appropriate handling fee would be, such as different quantitative approaches, benchmarking analyses of annual fees charged by banks for the management of similar loans or a cost plus method. Again, the preferred method is the CUP method, provided that the required comparables are available.

5. Conclusion and Outlook

The most positive aspect of the 2011 Circulars is, undoubtedly, the legal security they bring for companies operating financing activities in Luxembourg, as the conditions under which existing financing structures may be continued and under which new activities may be implemented are now clearly outlined. As mentioned in 2., although transactions between Luxembourg companies and other members of its group had to be carried out at terms comparable to those prevailing in regard to third-party transactions prior to the 2011 Circulars, this had not previously been expressly stated in a domestic provision. The 2011 Circulars close a gap in the Luxembourg tax system by now making specific reference to OECD transfer pricing rules.

This first-time reference to OECD standards in relation to transfer pricing may lead to considerations to introduce general comprehensive Luxembourg transfer pricing legislation applicable to intra-group transactions in general. This would hopefully also include clearer guidelines on the related exchange of information with foreign tax authorities.

The minimum economic and organizational substance requirements laid down in Circular 164/2 strengthen the corporate governance of Luxembourg companies, despite the fact that the condition regarding the majority of board members that have to be resident or professionally resident in Luxembourg does not seem to add much value. In view of the application of tax treaties, similar substance has already been required in the past to ensure Luxembourg companies are considered

resident under the relevant tax treaties. More substance may be necessary based on the facts and circumstances of a particular case. Moreover, substance and possibly higher equity at risk strengthen the beneficial ownership analysis in light of international case law.¹³ Against this background, the 2011 Circulars may present an opportunity to look, in more detail, at the level of economic substance that should generally be required in order for a company to qualify as a Luxembourg tax resident.

Finally, this may also represent an opportunity for the legislator to take a step further and lay down more detailed rules governing the general procedure to request tax clearances, as well as the conditions

under which such clearances would be binding. The possibility to obtain a binding tax clearance under Luxembourg tax practice has been confirmed both by the Ministry of Finance,¹⁴ as well as by tax courts. Nevertheless, there is no specific provision in the tax code that provides for detailed procedural rules and conditions for their validity. Since Circular 164/2 now establishes a set of requirements to apply for an APA, as well as conditions for the validity of such APAs, it would make sense to establish a framework for tax clearances in general. As a result, despite the rather narrowly defined scope of the 2011 Circulars, they may have implications that go far beyond their original scope in dealing with intra-group debt-funded financing companies.

-
13. For example, Court of Appeal, 2 March 2006, *Indofood International Finance Ltd v. JP Morgan Chase Bank NA, London Branch*, (2006) 8 ITLR 653; [2006] STC 1195.
 14. For example, the response by Minister of Finance Luc Frieden to parliamentary question No. 354 (7 January 2010).

BOOK

Transfer Pricing and Dispute Resolution

Aligning Strategy and Execution

Transfer Pricing and Dispute Resolution addresses the complexity, valuation and administrative nuances, and cultural impacts of resolving this significant cross-border issue when tax disputes arise.

Contents

- Foreword
- Introduction
- Dispute Channels
- International Developments
- Country chapters
- Case Study



IBFD, Your Portal to Cross-Border Tax Expertise

Editors: Anuschka Bakker and Marc M. Levey
Date of publication: July 2011
ISBN: 978-90-8722-100-3
Type of publication: Book
Number of pages: ± 750
Terms: Price includes delivery
Price: € 145 | \$ 195 (VAT excl.)

To view detailed contents or to order, visit www.ibfd.org. Alternatively, contact our Customer Service Department via info@ibfd.org or +31-20-554 0176.

Scan with your mobile



030TPDR/A02/H