

Luxembourg direct tax authorities issue a new Circular on transfer pricing

A couple of months ago, Luxembourg direct tax authorities issued the Circular 164/2 of 28 January 2011 (hereinafter, Circular) on the tax treatment of intra-group financing transactions. This Circular was seen as a very positive step forward in the clarification of transfer pricing rules applying to Luxembourg companies.

Luxembourg companies carrying out intra-group financing activities were already required to comply with the arm's length principle. After the introduction of the Circular, the question of whether or not financing transactions implemented before the issuance of the Circular would have to be revisited was unclear. For instance, were Luxembourg companies required to observe the new minimum equity requirements provided under the Circular?

The prevailing interpretation was that Luxembourg companies would have to be very prudent with any changes in the characteristics of their financing activities. In principle, any modifications to the characteristics of the intra-group financing would bring the Luxembourg company into the net of the Circular and its guidelines would have to be observed.

Latest developments - Luxembourg direct tax authorities' Circular 164/2bis of 8 April 2011

Now, the Luxembourg direct tax authorities' Circular 164/2bis of 8 April 2011 (hereinafter, Circular/Bis) clarifies that Luxembourg companies carrying out intra-group financing activities covered by a confirmation on the arm's length character of their financing transaction(s), obtained in front of the Luxembourg direct tax authorities, prior to 28 January 2011, may rely on it until 1 January 2012.

Hence, Luxembourg companies concerned and willing to confirm their tax position onwards may request an Advance Pricing Agreement under the Circular of 28 January 2011 - please see below in further detail.

The Advance Pricing Agreement framework - Luxembourg direct tax authorities' Circular 164/2 of 28 January 2011

On 28 January 2011, Luxembourg direct tax authorities issued a Circular on transfer pricing rules applicable to Luxembourg companies carrying out mainly intra-group financing activities.

Intra-group financing activities are defined as any activities of granting loans or advancing funds to related companies financed with financial instruments such as bank loans, private loans and public loans. Shareholding activities are therefore excluded from the scope of the Circular.

The companies are deemed related to the extent one of them participates directly or indirectly in the management, capital or control of the other, but also if the same persons participate directly or indirectly in the management, capital or control of the two entities.

This new set of rules confirms Luxembourg adherence to OECD transfer pricing principles, introduces minimum substance and equity requirements and foresees the Luxembourg Advance Pricing Agreement procedure.

The Circular refers to the arm's length principle of the OECD Model Tax Convention. Associated enterprises are required to conform their transactions with the dealing conditions applying between unrelated parties. The assessment of such arm's length dealing conditions is based on a comparability analysis further to the characteristics of goods and services, the functions performed, contractual terms and economic context. Under the Circular, in-scope Luxembourg companies are to be compared with independent regulated financial institutions. Basically, the remuneration earned by the concerned Luxembourg company should be comparable to the one realized by an independent regulated financial

institutions in similar circumstances.

Luxembourg Advance Pricing Agreements are available provided the Luxembourg companies have real substance in Luxembourg and assume the risks related to the financing transaction.

Substance requirements:

- The majority of directors/managers of the Luxembourg company must be resident or professionally domiciled in Luxembourg,
- The key decisions concerning the management of the Luxembourg company must be taken in Luxembourg and at least once a year the shareholders meeting is held in Luxembourg,
- The Luxembourg company must operate through an account with a Luxembourg bank or Luxembourg branch of foreign bank,
- The Luxembourg company must not be a dual resident company,
- The Luxembourg company must have observed all requirements with respect to the filing of its tax returns, and
- The Luxembourg company must be adequately capitalized.

Equity requirements:

- The Luxembourg company is considered to assume the financing activity risk where its equity (hedging the transaction(s) risk(s)) amounts to at least 1% of the nominal amount of the loan(s) granted or EUR 2 million.

The request for an Advance Pricing Agreement to be filed in front of the Luxembourg direct tax authorities must include the following information (i) Name, address and taxpayer number (if available); (ii) Detailed description of the transactions; (iii) Overview of the legal structure, including information of the beneficial owner(s); (iii) Tax years concerned by the request; (iv) Transfer pricing study in line with OECD principles and guidelines; (v) Description of the industry and market context; (vi) Analysis of the relevant tax issues linked to the methodology; and (vii) Confirmation that the information provided is complete and gives an accurate view of the transaction(s).

The Advance Pricing Agreements granted by the Luxembourg direct tax authorities will be binding, according to the principle of good faith, for 5 years in cases there are no substantive changes in the characteristics of the transaction(s).

How can we help

CMS tax professionals assist companies seeking Advance Pricing Agreements before Luxembourg direct tax authorities. Furthermore, international tax specialists within CMS network can help you reviewing, on each side of the transaction, the transfer pricing documentation supporting cross-border financing activities.

For further information on this tax analysis and thought, please contact:

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