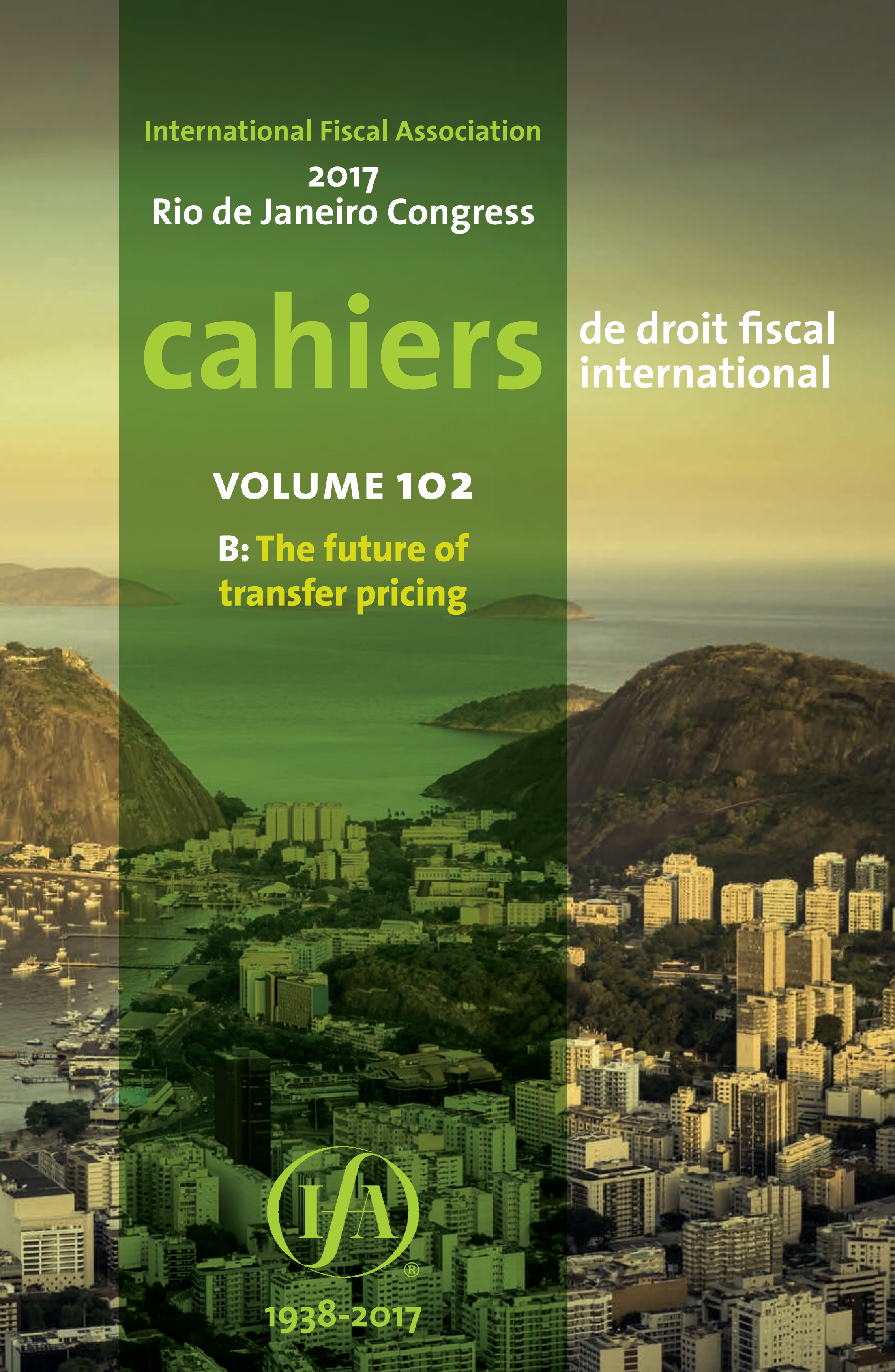
International Fiscal Association

2017
Rio de Janeiro Congress

cahiers de droit fiscal international

VOLUME 102

B: The future of transfer pricing



1938-2017

Branch Reporters
Nicolas Gillet*
Antonio A. Weffer**

Summary and conclusions

Luxembourg being a founding member of the OECD, the Luxembourg tax authorities have referred to the OECD transfer pricing (TP) guidance in applying domestic TP principles. Reference to the OECD TP guidelines for assessing the arm's-length character of intercompany transactions has been made since 2011 and has covered intra-group financing transactions.

The existing TP framework was formalized with effect from 1 January 2015, to demonstrate the alignment of Luxembourg TP rules with internationally accepted TP guidelines and regulations. To this end, further to the formalization of the Luxembourg TP legislation, profits of associated enterprises, entering into transactions (irrespective of transaction type), should meet the arm's length principle.

Luxembourg, as an OECD and EU member, actively follows and supports the OECD base erosion and profit shifting (BEPS) action plan as well as EU measures taken to fight BEPS. Luxembourg has always been extremely efficient when implementing EU directives, so that it can be expected that any measure taken or to be taken by the EU (or at OECD level) will be implemented in Luxembourg within the required time frame.

1. Current TP regulation and practice in Luxembourg

Luxembourg being a founding member of the OECD, the Luxembourg tax authorities have referred to the OECD TP guidance in applying domestic TP principles. Indeed, reference to the OECD TP guidelines for assessing the arm's length character of intercompany transactions has been made since 2011 in Circular No. 164/2 about intra-group financing transactions. In addition, the commentaries regarding TP matters between related parties in the 2015 Budget Law also refer to the OECD TP guidelines as designed to be observed by multinational companies (MNEs) and by tax authorities.

In practice, prior to January 2015, domestic regulations enabled the Luxembourg tax authorities to adjust the taxable income of a Luxembourg enterprise via

* Tax Partner – Transfer Pricing, EY Luxembourg
** Tax/TP Director – TP Country Leader Baker & McKenzie, Luxembourg

tax assessments, for example if the profit allocation between related parties did not reflect the economic reality of the transaction or when the allocation was not under arm's length terms.

As indicated above, back in 2011, the Luxembourg tax authorities released two circulars providing guidance on the tax treatment applicable to companies carrying out intra-group financing activities, including all types of financing arrangements, covering bonds and potentially certain cash pooling activities. Circular No. 164/2 clarifies that the arm's length remuneration of transactions, falling in its scope, has to be determined using article 9 of the OECD model. Moreover, it explains the two main requirements, namely the minimum equity at risk and the minimum substance requirements, and defines the procedure to follow to obtain written confirmation from the Luxembourg tax authorities. Circular No. 164/2 *bis* clarifies the effect of Circular No. 164/2 on intra-group financing transactions set up prior to its issuance.

The existing TP framework was formalized with effect as from 1 January 2015, to demonstrate the alignment of Luxembourg TP rules with internationally accepted TP guidelines and regulations. To this end, further to the formalization of the Luxembourg TP legislation, profits of associated enterprises entering into transactions (irrespective of transaction type) should meet the arm's length principle. Therefore prices for the transfer of goods, services or financial arrangements should be determined according to third parties' open market conditions and taxed accordingly. Hence, both upward and downward TP adjustments in the context of domestic and cross-border transactions are possible. The arm's length principle is applicable to all taxpayers, regardless of the legal form under which they exercise their activities in Luxembourg (including tax opaque collective undertakings and tax transparent partnerships, and also individuals carrying on business activities and collective undertakings without legal form). Indeed, the amended legislation defines the arm's length principle in line with the concept provided in the OECD model article 9(1).

With the view to implementing the guidance for the application of the arm's length principle as set out in Actions 8–10, on 12 October 2016, the Luxembourg government proposed the introduction of a new TP article in the Luxembourg tax legislation. The new article contains the basic principles to be respected in the framework of a TP analysis, indicating the comparability analysis as the starting point for any TP exercise. If adopted in the proposed form, the new article will offer more clarity on the tools and approaches to be considered by taxpayers when applying international TP guidance and standards under Luxembourg law.

2. The impact of the BEPS project on TP

2.1. Introduction

Luxembourg has stated its willingness to be fully compliant with the new international framework, and in particular the TP guidelines in the BEPS Actions Plan, as well as with the OECD's and EU's exchange of information requirements for rulings. Some of the most important recent changes reflected in the Luxembourg tax legislation relate to TP and transparency matters.

BEPS Action 5 contains two measures that have had considerable impact on the Luxembourg tax environment: the substantial nexus rules for patent box regimes and the automatic exchange of information on tax rulings. The patent box measure laid down in Action 5 was partially reflected in Luxembourg by the abolition of the existing Luxembourg intellectual property (IP) regime (as of 1 July 2016, with a grandfathering period of five years). Meanwhile, the government also announced the introduction, at a later stage, of a new regime which would be in line with the nexus approach.[1]

Furthermore, in the context of Action 5, Luxembourg enables automatic exchange of information related to tax matters. In addition, the existing ruling procedures have been complemented with advance tax clearances and advance pricing agreements requests, which are subject to fees and applications reviews by the Tax Ruling Commission.

Actions 8–10 and 13 have encouraged the Luxembourg tax authorities to proceed towards the formalization of TP requirements in the Luxembourg tax legislation since 1 January 2015. The reworded arm's length principle aligns Luxembourg regulations with EU law, but also with the OECD guidance, by introducing TP regulations applicable to companies of any legal form and engaged in any type of transaction, either domestic or foreign. Luxembourg will also be implementing country-by-country reporting requirements in line with related OECD guidance and EU-related directives.

In addition, the guidance for applying the arm's length principle set out in Actions 8–10 is intended to be reflected in the Luxembourg TP legislation through the introduction of a new article, which aims at reinforcing that the methods to be used for the determination of the appropriate arm's length compensation must take into account the OECD comparability factors and be coherent with the nature of the accurately delineated transactions.

Within the Luxembourg TP environment, Actions 2, 4, and 6 are also of particular importance, due to the fact that they affect the main related party transactions occurring in Luxembourg. In fact, Luxembourg has adopted the revised EU Parent–Subsidiary Directive, restricting intra-EU use of hybrids, effective as of 2016 and the EU Anti-Avoidance Directive that will be enforced prior to its deadline in 2019.[2]

2.2. Challenges of transactions with intangibles

Increasing awareness has been noted among Luxembourg tax practitioners, taxpayers and tax authorities in the area of transactions involving intangibles. Taxpayers and tax practitioners have become more focused on aligning their business purpose with their economic presence, due to increasing demands from the tax authorities' side when scrutinizing such transactions.

[1] Written answer provided by the Luxembourg Ministry of Finance on 4 February 2016 further to parliamentary question no. 1673.

[2] Extended deadlines may apply for certain matters, e.g. interest deductibility, exit tax.

2.2.1. Definition of intangibles

The concept and categorization of intangible assets are not specifically depicted in the Luxembourg tax and TP legislation.

Particular reference to IP categories can be found in the context of the IP regime introduced in Luxembourg on 1 January 2008 (abolished in 2016) and further guidance on its interpretation is mentioned through Circular No. 50*bis*/1 dated 5 March 2009. The circular defines the legislative framework, which outlines the qualifying types of IP, and also indicates the OECD model article 12 as an additional source of guidance. In particular, software copyrights are indicated as being regulated by the Luxembourg Copyright Law of 18 December 2001 and derive from the initial development of computer software, excluding changes in programming language. Moreover, patents are regulated by the Luxembourg Patents Act (Law of 20 July 1992), qualifying them as new inventions, which in turn implies a creative activity that can also be applied at the industrial level.

Trademarks, designs and models are regulated by the Benelux Convention on IP (signed in The Hague, on 25 February 2005), to which Luxembourg has adhered. Within the Benelux provisions, designs and models represent the appearance of products, to which specific features are attributed. While individual trademarks are referred to as denominations, designs, seals, letters, numbers or other signs which can be graphically represented and which distinguish the products/services of a company, collective trademarks are signs used by an organization to distinguish itself geographically and also by means of other features. Even though domain names are not specifically regulated by a legal provision, they are identified by Circular No. 50*bis*/1, dated 5 March 2009, as a personalized electronic address, corresponding to a website in the virtual environment.

The IP regime specifically excludes certain types of IP: knowhow (meaning unregistered or non-patentable professional knowledge and expertise), copyrights (other than computer software) and other rights such as original literary and artistic works, plans, formulae and secret processes and the leasing of industrial, commercial or scientific equipment.

Luxembourg generally accepted accounting principles (Lux GAAP) do, however, provide useful guidance, while attempting to shape the current concept of IP for Luxembourg tax and TP purposes and considering the broad principle applicable in Luxembourg legislation, based on which the fiscal balance sheet should in principle follow the accounting one. The Lux GAAP identify intangible assets as items without physical substance, composed of research and development expenses, concessions, patents, licences, trademarks and similar rights and goodwill.

In line with the OECD nexus approach developed in Action 5, the Luxembourg government has abolished the IP regime as of 1 July 2016 (with a grandfathering period of five years). It is anticipated that new measures will apply to specifically defined categories of intangibles.

As such, apart from the inherent changes to be brought forward by the introduction of new IP measures, there have been no specific comments by the Luxembourg tax authorities to define the concept of intangibles in a uniform manner, as a consequence of the BEPS recommendations. Nevertheless, Luxembourg will implement in its legislation the guidelines or directives related to this matter issued by organizations to which it belongs.

2.2.2. Transactions with intangibles

The general principle, by means of which the fiscal balance sheet should follow the accounting one, is generally also applied by tax practitioners in identifying embedded intangibles for Luxembourg TP purposes. A specific intangible is identified for tax and TP purposes, if it has previously been labelled as such for accounting purposes. As per the Lux GAAP, intangible fixed assets are recognized when the control (generally the property rights) is transferred for valuable consideration.[3]

In identifying embedded intangibles for TP purposes, careful consideration should be given to certain provisions of the 2009 Circular clarifying the application of the IP regime. According to this guidance, there may be situations in which contracts involving IP licensing also include the provisions of additional services or rights, which do not fall in the scope of the IP regime. In such a case, emphasis is placed on the necessity of splitting the revenue streams, in order to identify the eligible income.

In the past, a common approach was that the ownership of an intangible was attributed prima facie to the legal owner; however, further analysis was often performed to ensure alignment with economic ownership. Nevertheless, the guidance on the partial exemption of income, derived from qualifying IP rights under the Luxembourg IP regime, clearly refers to the situation in which the legal and economic ownership of the IP rights do not belong to the same person. The guidance notes that, even though in most cases legal and economic ownership generally coincide, an asset should be allocated for taxation purposes to the person who behaves in such a manner as to remove all possibility of the legal owner disposing of this asset.[4] Consequently, the economic owner has to be considered as the owner of the IP, for the purposes of applying the IP regime, and thus only the beneficial owner can claim the benefits of the IP right. In practice, the OECD guidance is also referred to in these situations. This approach is reflected also in IP related case law which refers to the Luxembourg Tax Adaptation Law to highlight that the facts and legal circumstances of a transaction should be analysed according to economic criteria.

In line with the current attempts of the Luxembourg tax authorities to impose stricter conditions, including on IP companies, the OECD TP standards are also applied in the case of transfers of intangibles, irrespective of the jurisdiction to which the IP is being transferred.

2.2.3. "Substance-over-form" approach toward intangibles

Certain anti-abuse regulations as regards transactions involving intangibles are specifically identified in the Luxembourg legislation.

Inter alia, with the goal of preventing abusive use of the IP regime, Luxembourg legislation provides that taxpayers should evaluate qualifying IP, as well as income paid thereon, by reference to general TP standards. The purpose of this rule is to prevent a transfer of IP to Luxembourg for a below market value, as well as to prevent the overcharging of royalties to the benefit of the Luxembourg taxpayer,

3 Art. 55 of the Accounting Law, December 2002.
4 Court Case no. 36612C dated 25 February 2016 of the Luxembourg Administrative Court.

with a view to eroding the basis at the level of the payer in a foreign jurisdiction and to benefiting in Luxembourg from an 80 per cent exemption. In addition, various other conditions were stipulated for the regime to apply, such as the acquisition or constitution date of the IP right being after 2007, acquisition not to be made from a directly related party, as well as recapture of expenses incurred to develop the IP right.

In a broader TP context, the draft law introduced to Parliament on 12 October 2016 provides for situations in which related party transactions (and thus also transactions involving intangibles) may be disregarded for TP purposes. The determining factors for assessing such situations would be the commercial rationality of a transaction's elements and the impact of such elements on determining the arm's length price of the transaction. If adopted in the current form, the draft law would implement in the Luxembourg tax legislation the recommendations laid down in the guidance for applying the arm's length principle set out in Actions 8–10.

2.2.4. Comparability and group synergies

In the light of the legislative reference made to the OECD guidance in the area of TP, the OECD principles are also referred to for the identification of such synergies. No specific measures have been indicated at this stage by the Luxembourg tax authorities further to the BEPS guidance in the area of group synergies and their impact on comparability.

2.2.5. Hard-to-value intangibles

Luxembourg TP legislation does not provide for a specific valuation methodology to be followed in cases involving transactions with intangibles. However, the tax legislation indicates that under the IP regime, when dealing with transactions between related parties, the remuneration must be computed bearing in mind the arm's length principle. Consequently, any commonly used valuation method for valuing IP rights can be used for this purpose.

In practice, when dealing with hard-to-value intangibles, the valuation tools used in compliance with international valuation standards are of great help. Indeed, the preparation of a tax valuation report to determine the fair market value of such hard-to-value intangibles, in order to best reflect their arm's length price, allows the taxpayer to gather many factors, such as parties purchases' strengths, risks assessment, synergies, location savings, innovation and SWOT elements present in open market transactions.

In the absence of other specific valuation methodology indicated for intangibles, the general valuation legislation in Luxembourg can also be applied while analysing transactions involving intangibles from a TP perspective. In this respect, Luxembourg tax legislation[5] distinguishes between fixed assets (which can be depreciated) and others (land, shareholding and current assets). The general valuation rule for the other assets provides that they should be valued at acquisition price or production cost, with certain exceptions being applicable. Luxembourg legislation does not provide for specific regulations as regards hard-to-value

[5] Art. 21 of the Income Tax Law.

intangibles and, at this stage, no immediate measures are envisaged further to the BEPS guidance.

2.2.6. Cost contribution agreements (CCAs)

In light of the legislative clarifications introduced in the Luxembourg tax legislation in the area of TP, as of 1 January 2015, reference can be made to the OECD guidance on CCAs. In addition, in the absence of particular guidance in this respect, differences are not expected to surface while analysing the TP aspects of a CCA compared to other related party arrangements.

At this stage, no specific measures have been announced by the Luxembourg tax authorities further to the BEPS guidance in the area of CCAs.

2.3. Risk and capital

As of the preparation date of the present survey, no tax bill or corresponding draft involving TP measures, aligned with the Actions 8–10 report, to control the return on capital or the compensation for the assumption of risk have been released.

However, back in December 2014, the Luxembourg Parliament approved the draft law on the implementation of the first part of the "Package for the Future", under which article 56 of the Luxembourg Income Tax Law makes explicit reference to the arm's length principle, as found in article 9(1) of the OECD model:

> "When an enterprise participates, directly or indirectly, in the management, control or capital of another enterprise, or where the same individuals participate, directly or indirectly, in the management, control or capital of two enterprises and where, in either instance, the two enterprises are, within their commercial or financial relations subject to conditions made or imposed which differ from those which would be made between independent enterprises, the profits of these enterprises are to be determined under conditions prevailing between independent enterprises and taxed in consequence."

Hence, as of 1 January 2015, by law, the recommendations of the OECD TP guidelines to control the return on capital or the compensation for the assumption of risks should have been properly depicted within the TP documentation of Luxembourg taxpayers, in order for enterprises to justify their intra-group transactions and determine their arm's length taxable income in Luxembourg. However, even before 2015, the Luxembourg authorities applied OECD TP guidance. As mentioned above, back in 2011, the Luxembourg tax authorities released Circular No. 164/2 on the determination of the arm's length compensation to be performed by Luxembourg companies involved in intra-group financing transactions, wherein explicit provisions to control the return on capital and the entity's compensation for the assumption of risk were stated.[6]

6 "Intra-group financing transactions refer to any activity consisting of granting loans or cash advances to associated enterprises, refinanced by funds and financial instruments, such as public offerings, private loans, cash advances, or bank loans." The term "associated enterprises" is defined in accordance with art. 9(1) of the OECD model (2010).

Indeed, the circular states that a company falling within its scope should have sufficient equity to assume the connected inherent risks, i.e. mainly credit risk, market risk and operational risk. Such equity should be effectively used as soon as the risk related to its financing activities has materialized.

2.4. High-risk transactions

2.4.1. Comparable uncontrolled price (CUP) and quoted prices for cross-border commodity transactions

The Luxembourg tax authorities have not yet provided any specific TP guidance related to commodity transactions. In the Actions 8–10 report preference is shown for the CUP method, which should thus prevail. However, given Luxembourg's size and market, it would be difficult to base a comparability analysis on mere domestic comparable uncontrolled arrangements.

Therefore, in accordance with the code of conduct on TP documentation for associated enterprises in the European Union, the Luxembourg tax authorities generally accept pan-European comparable uncontrolled arrangements, to the extent that the markets these selected comparables relate to are reasonably similar to the market conditions prevailing in Luxembourg. The aim of any TP analysis, based on the CUP method, is for its result to represent a reliable approximation of a market-based outcome, in line with the arm's length principle.

Additionally, the Luxembourg tax authorities also use the following sources for interpretation purposes (a) foreign doctrine of EU Member States, (b) relevant ECJ case law decisions, and (c) the OECD final reports/pertinent guidelines, among other legal sources. Therefore, it is reasonable to believe that the OECD TP guidelines 2016 and further revisions, which will comment on transactions with commodities, should be used for the interpretation of the case at hand by the Luxembourg tax authorities, as long as they do not create any distortions in connection with domestic or international binding laws or arrangements signed by Luxembourg.

2.4.2. Intra-group services

The Luxembourg TP practice for intra-group services follows the OECD TP guidelines, under which the selected TP method should be the "most appropriate method" for a particular case.

In practice, the Luxembourg tax authorities also follow the latest developments of the EU Joint Transfer Pricing Forum on low value intra-group services, and as a matter of domestic administrative policy, all TP documents must have a comprehensive economic comparability analysis/benchmark, in line with the nine-step approach, suggested in paragraph 3.4 of the OECD TP guidelines. Therefore, acknowledging that Actions 8–10 and 13 of the BEPS project have been inserted with the 2016 revised version, the reporters believe that the outcomes of other actions of the BEPS project could also be inserted in the upcoming revisions of the OECD TP guidelines (e.g. 2020). This should have an impact on such treatment, in line with the Luxembourg tax authorities' use of foreign doctrine and OECD TP guidelines, for interpretation on a case-by-case basis.

Moreover, pursuant to the Directorate-General for Competition of the European Commission's working paper on state aid and tax rulings dated 3 June 2016, the Luxembourg TP treatment of intra-group services needs to reflect a reliable approximation of a market-based outcome, in line with the arm's length principle, regardless of the TP method used. The approximate nature of the arm's length principle cannot be used to justify a TP analysis that is either methodologically inconsistent, or based on an inadequate selection of comparables. There are cases where identifying a market outcome is not straightforward and requires the use of an approximation. According to the Commission, this is not a concern as such, as long as the approximation is as precise as it can be under the circumstances.

In closing, the search for a "reliable approximation of a market-based outcome" means that any deviation from the best estimate of a market-based outcome must be limited and proportionate to the uncertainty inherent in the TP method chosen, or the statistical tools employed for that approximation exercise.

2.4.3. Profit splits in the context of value chains

Luxembourg does not yet possess any special guidelines concerning the application of TP rules to MNEs' value chains.

In practice, the Luxembourg tax authorities welcome the use of the profit split method as a mechanism to allocate profits across the value chain, as long as it is based on an analysis comprising sound risks and which is properly documented by the parties involved in the intra-group transaction or dealing.

Therefore, it is reasonable to argue that the OECD's work on profit splits will be taken into account by Luxembourg when drafting TP domestic regulations or informally adopting them, for instance when dealing with sophisticated value chain analyses or complex financial transactions that involve physical and virtual teams to generate enterprise economic value. This could be either by making reference to the 2016 revised version of the OECD TP guidelines or by officially adopting the profit split mechanism while applying Luxembourg TP rules.[7]

2.5. TP documentation

2.5.1. CbCR

Luxembourg is a valuable, implicated and driven player, in pursuit of greater transparency concerning tax matters. Indeed, since January 2015 Luxembourg has been promoting the introduction of the automatic exchange of information for tax purposes as a global standard and has implemented the automatic exchange of information on the basis of the European Savings Taxation Directive.

On 27 January 2016, ministers and top tax officials from 31 countries, including those from Luxembourg, signed the Multilateral Competent Authority Agreement, in order to facilitate the automatic exchange of CbCR called for in Action 13 of the OECD/G20 BEPS project. Consequently, Luxembourg is fully involved in the amended Accounting Directive (Directive 2013/34/EU), as approved by the

[7] Revised guidance on profit splits was published on 4 July 2016.

European Parliament and the Council on 12 May 2016 and 25 May 2016 respectively, in order to implement BEPS Action 13 on CbCR within the EU.

On 2 August 2016, the Luxembourg government submitted the draft bill no. 7031 to the Luxembourg Parliament aiming at transposing the EU Directive 2016/881 dated 25 May 2016 which imposes on Member States the implementation into their domestic laws of mandatory CbCR obligations for MNE groups. If the draft bill is adopted, Luxembourg tax resident entities qualifying as "reporting entities" will have to comply with the CbCR requirements for financial years starting 1 January 2016 and onwards.

The CbCR has a three-tier design:

(a) a master file provides a high-level overview of an MNE's global operations and TP policies, and is provided to the tax administrations of all the countries concerned;
(b) a local file covers detailed information concerning specific inter-company transactions; and
(c) a separate CbCR, based on a common template, gives all countries a broad picture of how a company operates, including aggregate information on income, taxes paid, total employment, retained earnings and tangible assets in each jurisdiction.

This contextual information will have to be disclosed for every EU country in which a company is active and will remain available for five years.

The implementation will certainly be enacted by Luxembourg soon. Indeed, the deadline for Member States is set on 4 July 2017, thus enabling the preparation for CbCR to commence as from the first fiscal year starting after 1 January 2016.

2.5.2. Master and local files

The Luxembourg government has always highlighted the need to promote a coordinated implementation of the BEPS actions at the international level, to ensure a level playing field worldwide.

Therefore, based on the above directive and the commentary to the law, which refers to chapter V of the 2016 OECD TP guidelines, Luxembourg is likely to include master and local files in the TP documentation requirements, in its upcoming comprehensive tax reform.

2.5.3. Compliance costs

The visibility on this matter is limited since the administrative burden of Action 13 cannot be measured yet.

2.6. TP-related measures in other BEPS actions and other measures against BEPS

Luxembourg, as an OECD and EU member, actively follows and supports the OECD BEPS Action Plan as well as EU measures taken to fight BEPS. Luxembourg has always been extremely efficient when implementing EU directives, so that it can be expected for any measure taken or to be taken by the EU (or at OECD level) to be implemented as such in Luxembourg within the required time frame.

Luxembourg and several other EU Member States and non-EU Member States have adopted or announced the adoption of TP-related measures into their domestic law, and the integration of those rules into double tax treaty conventions.

2.7. Can BEPS work in favour of MNEs?

The automatic exchange of information in the field of taxation is already in place, thus obtaining pieces of information that are necessary for Luxembourg domestic compliance is already a reality.

3. What is the future of TP?

In a general fashion, the future of TP in Luxembourg will most certainly be in line with any legislation, guidelines or directives issued by a body it is part of. An important piece of BEPS-related draft legislation was published on 21 June 2016, which resulted from the political agreement which was reached between all EU Member States on the draft Anti-Tax Avoidance Directive which covers the interest limitation rule, exit taxation, the general anti-abuse rule, the controlled foreign company (CFC) rule and hybrid mismatches.

Subsequently, on 13 July 2016, the Luxembourg government adopted tax reform plans for the year 2017. The last point of the reform states that "international developments will be monitored, particularly the concretization of the implementation of BEPS rules in the EU, to consider the necessary adjustments in the interest of the competitiveness of Luxembourg".

International Fiscal Association

ISBN 978 90 12 40001 5

Sdu