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Transfer Pricing Forum

Transfer Pricing for the International Practitioner

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1. Briefly describe the transfer pricing documentation and tax return disclosure requirements in your jurisdiction.

Since 2015, transfer pricing documentation has been explicitly identified as documentation that the Luxembourg tax authorities ("LTA") may request.[1] Accordingly, taxpayers may be required to substantiate, within a reasonable timeframe, the exactness of their tax returns (including with regard to transfer pricing) upon request.

According to Article 56 of the Luxembourg Income Tax Law ("LIR"),[2] any related party transaction should be priced in accordance with the arm's length principle. Article 56*bis* LIR elaborates on the content of the transfer pricing analysis to be reflected in the transfer pricing documentation. The substantiation of the arm's length nature of the intercompany dealings should be based on, *inter alia,* functional and comparability analyses (see further details in the response to question 4).

Since fiscal year 2017,[3] the form for the direct tax returns includes the following yes/no questions on transfer pricing:

- "Did the company engage in transactions with related parties (Articles 56 and 56*bis* LIR)?"
- "Did the company opt for the simplification measure in section 4 of the Circular of the Director of the Tax Administration LIR 56/1–56*bis*/1 as of December 27, 2016?"

The first question does not differentiate between domestic and cross-border transactions nor between different types of transactions. The second question relates to taxpayers engaging in purely intermediary financing activities and meeting the substance requirements in the Circular. The simplification measure deems the company to be in compliance with the arm's length principle if it earns a remuneration of at least 2% after tax (the percentage to be regularly revisited by the LTA), calculated over the financed assets. As the tax impact of the simplification measure is generally substantially higher than what is commonly found in the market, it is expected that the simplification measure will not be opted for often.

Country-by-Country ("CbC") reporting has been implemented in Luxembourg in accordance with the relevant EU Directive.[4] The ultimate parent entity controlling the MNE group with a total consolidated turnover of at least EUR 750 million should file the CbC report. The Luxembourg entity, regardless of whether it is the ultimate parent, should file a notification indicating which entity in the group will submit the CbC report.

Currently, there are no Master File or Local File requirements. As the government stated that it would follow the OECD's recommendations, it is foreseen that such requirements will be introduced in Luxembourg in the future.

2. In recent years, have the tax authorities changed or modified their audit approach? (e.g., increase in staffing and/or increase in funding with respect to the transfer pricing audit function; use of risk assessment tools or data mining tools to identify audit targets; use of joint or coordinated audits, etc.). If risk assessment tools are used, what factors are typically analyzed?

In 2018, the head of the APA committee within the LTA internally moved to the tax audit department. The LTA informally communicated that the administration will increase its scrutiny of transfer pricing in tax audits.

In 2016 and 2017, the LTA's staff grew in numbers. With the 2017 tax reform, it was announced that LTA personnel would be increased. The exact number of new hires for 2018 has not yet been published; however it was confirmed that the number of civil servants in the tax administration is expected to continue to increase.

3. Do the tax authorities focus on certain types of transactions? (e.g., intangibles, financing transactions, commodities, etc.).

All intragroup transactions should follow the arm's length principle. As Luxembourg is a key jurisdiction for funds, holding companies, and financing companies, the emphasis is on financial transactions. The tax administration published Circular LIR 56/1–56*bis*/1 of 27 December 2016 on the tax treatment of

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companies carrying out intragroup financing transactions. This guidance applies to companies involved in granting related-party loans which are financed with debt.

4. Do the tax authorities rely on BEPS-related concepts during its audits? (e.g., DEMPE analysis, new approach for hard-to-value intangibles, expanded use of profit splits, use of risk assessment framework, etc.).

Articles 56 and in particular 56*bis* LIR embrace the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the "OECD TPG"). If an intercompany controlled transaction does not meet the arm's length principle, the LTA may make adjustments. The parliamentary documents expressly refer to the OECD TPG and, due to the authoritative value given to parliamentary documents, the OECD TPG constitutes a good source for the determination of an arm's length price in intragroup transactions.

Article 56*bis* LIR provides that the determination of an arm's length price is based on a comparability analysis. The controlled transaction is compared to uncontrolled transactions with similar economic characteristics. Further, the provision states that a transaction is sufficiently comparable if there are no material differences that could have a substantial influence on the determination of arm's length prices under a given methodology or when reasonable adjustments can be made to neutralize the effect of minor comparability differences.

The comparability analysis is two-fold:

(i) The commercial and financial relationships between the related parties should be identified, and the conditions and economically significant circumstances attached to those relationships (i.e., conduct aligned with contractual arrangements) should be determined in order to accurately delineate the controlled transactions.

(ii) The economically significant circumstances and conditions of the controlled transactions are then compared to uncontrolled transactions found on the market.

The economically significant circumstances and conditions that should be identified "globally"[5] include the following:

- The contractual terms;
- The functions performed by each party to the transaction, taking into account their assets used and risks assumed;
- The characteristics of the asset transferred, the services, or the contract concluded;
- The economic circumstances of each party and the market where the activity is exercised; and
- The parties' strategies.

The law also states that the fact that a given transaction cannot be found between independent parties does not necessarily mean that the transaction itself does not conform to the arm's length principle. While this provision may provide some leeway, the extent to which it applies is not certain. In particular, Article 56*bis* LIR ends with the possibility for the LTA to ignore part of a transaction that bears no valid commercial reason.

Transfer pricing documentation should therefore contain all of the above. The selection of the appropriate method should also be corroborated.

5. Do transfer pricing penalties apply in your jurisdiction? If so, what can be done to mitigate these penalties?

There are no specific sanctions applicable to transfer pricing in Luxembourg. To the extent the pricing of a transaction is not at arm's length, the LTA may adjust the taxable basis either upward or downward.

The LTA may levy administrative penalties in cases of culpable intent to reduce the tax liability (*fraude fiscale simple*) or culpable negligence (*fraude fiscaleinvolontaire*). The penalty for the former is set to a maximum of half of the tax due or the reimbursement unduly obtained and cannot be lower than 10% of the unpaid tax or the reimbursement unduly obtained. For the latter, the fine can be up to EUR 125,000, although it cannot exceed 25% or be less than 5% of the tax due or the reimbursement unduly obtained.

A discretionary maximum penalty of up to EUR 250,000 can be levied in case of: a late filing or non-filing of the CbC report/notification; disclosure of inaccurate or incomplete information; or failure to inform the LTA that the ultimate parent entity refused to supply the necessary information under the secondary mechanism.

6. Please describe any challenges taxpayers face in preparing their transfer pricing documentation in light of these changes in the audit process.

There is little guidance in this regard. Currently, taxpayers are facing uncertainty after having historically enjoyed certainty through the extensive Luxembourg tax ruling practice.

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NOTES

[1] § 171(3) of the General Law of Taxation of 22 May 1931 (*Abgabenordnung vom 22 Mai 1931*).
[2] *Loi du 04 décembre 1967 concernant l'impôt sur le revenu*.
[3] As of this writing, the 2018 tax return form was not yet available to taxpayers.
[4] Directive 2016/881/EU of 25 May 2016.
[5] "Globally" is the term used in Article 56*bis* LIR.