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The Government of Luxembourg has introduced transfer pricing provisions in its legislation, explicitly enshrining the arm's length principle in law and establishing specific requirements with regard to transfer pricing documentation. The following article considers these changes in detail and considers the risks and implications for taxpayers.

Luxembourg Joins the Transfer Pricing Party

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Transfer pricing has become a hot topic in Luxembourg over the last four years. Domestic transfer pricing regulations aimed at intra-group financing activities introduced in 2011 [1] were followed by a 2013 transfer pricing court case [2] scrutinizing the arm's length nature of the interest rate charged by a Luxembourg company to some of its group affiliates.

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[1] Circulaire du directeur des contributions L.I.R. n° 164/2, dated 28 January 2011 and Circulaire du directeur des contributions L.I.R. n° 164/2bis dated 8 April 2011

[2] Administrative Tribunal, Case 30379, 1 July 2013.

Furthermore, the increased attention given by the Luxembourg tax authorities to transfer pricing was reiterated in 2013 by the newly formed Luxembourg government which, at that time, announced its intention to implement additional transfer pricing rules in the upcoming years.

Following the above developments, on October 15, 2014 the Luxembourg government announced in its 2015 budget Bill that a new general transfer pricing regime should take effect in 2015 to reinforce the current legislation. In this respect, the first provisions of this new transfer pricing regime were officially published on December 19, 2014 in the “Memorial – Journal Officiel du Grand-Duché de Luxembourg” and it includes changes to both the Luxembourg Income Tax Law of 1967 (“LITL”) as well as to the General Tax Law (“AO”). The main points of the transfer pricing legislation are: a restatement of the arm's length principle, a formalised transfer pricing framework, and explicit transfer pricing documentation requirements.

The new legislation entered into effect on January 1, 2015. Nevertheless, some of the practical aspects of the measures are expected to be laid out through one or more implementing Grand-Ducal Regulations or Administrative Circulars over the next years.

Based on the old Article 56 LITL, the Luxembourg tax authorities could estimate the financial result of a Luxembourg taxpayer, when a transfer of profits was made possible by the fact that a company had a specific economic relationship with a non-resident.

The proposed update of Article 56 LITL is a clarification of the arm's length principle in line with OECD Model Tax Convention, and the text reads as follows:

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 [3].

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[3] This is an unofficial English translation

The old legislation provided only a broad definition of the related parties concept (i.e. as a special economic relationship). To address this, the new provisions provide a definition of the arm's length principle that is aligned with the OECD Model Tax Convention. One effect of this new definition is that the arm's length principle is now applicable to all transactions between related parties, domestic or cross-border. Additionally, taxpayers need to consider reporting in their tax return upward/downward adjustments of profits in situations where transfer prices do not reflect the arm's length principle. The bulk of the practical aspects of the implementation of this new legislation will be made by way of one or more Grand-Ducal Regulations or Administrative Circulars.

Furthermore, until December 31, 2014 Luxembourg tax legislation contained no specific or expressive provision governing transfer pricing documentation other than the obligation to document the intra-group lending activity stemming from the transfer pricing regulations introduced in 2011 [4]. Nevertheless, the AO made it clear that all taxpayers had to be able to support the data included in their tax returns, including transfer prices, i.e. the prices set for transactions between two associated enterprises.

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[4] Circulaire du directeur des contributions L.I.R. n° 164/2, dated 28 January 2011 and Circulaire du directeur des contributions L.I.R. n° 164/2bis dated 8 April 2011

The Commentary of the Bill enacted on January 1, 2015 shows that the Luxembourg government recognizes the importance of transfer pricing documentation and considers it a key focus area for transfer pricing. To this end, the Government references the documentation chapters included in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, as well as The United Nations Practical Manual on Transfer Pricing for Developing Countries. Furthermore, the Government also makes reference to the Code of Conduct on transfer pricing documentation for associated enterprises in the European Union.

Considering the above, the new legislation amends, in addition to Article 56 LITL, paragraph 171 of the

AO, by adding a new third subparagraph. This new subparagraph clarifies that the disclosure and documentation requirements also apply to all transactions between associated enterprises. The nature and extent of the required documentation depends on the circumstances of the case under consideration. In principle, the expectations of the documentation to be provided to the LTA should be lower for straightforward corporate transactions or small business. Absence of proper transfer pricing documentation may result in a reversal of the burden of proof towards the taxpayer.

Furthermore, it is now possible that the Luxembourg tax authorities ask the taxpayer to provide all facts relevant for verifying a tax liability. To this end, the taxpayer must make available all necessary supporting documentation to facilitate the task of the Luxembourg tax authorities. The new subparagraph of the Article 171 of AO makes clear that taxpayers are obliged to fulfil this obligation in all circumstances where Luxembourg tax authorities are assessing transfer prices.

A major effect of this change applies where the Luxembourg tax authorities conclude there are facts indicating a transfer of profits (in a non-arm's length transaction scenario) and, in addition, there is no proper documentation in place from the taxpayer. In such a scenario, the tax authorities may consider the underlying economic reality of the transaction under review and reach a different conclusion than that of the taxpayer. In such a case the tax authorities are not legally obliged to justify their findings and will reverse the burden of proof towards the taxpayer.

The new legislation does not impose any explicit documentation requirements. The circumstances of an intra-group transaction will have direct impact on the extent and nature of the documentation. As a consequence, less complex transactions should give rise to documentation requirements of a matching complexity.

Furthermore, the Commentary of the law enacted on January 1, 2015 mentions that Chapter V of the OECD Transfer Pricing Guidelines—mentioned in the Commentary as being the “directing principles relating to documentation”—is being revised. Subsequently, upon the finalization of the revisions to Chapter V, Luxembourg taxpayers are expected to apply the “three-tiered” approach to documentation including the obligations laid out in Action Point 13 of the OECD's BEPS Action Plan, i.e. Country-by-Country Reporting. The September 2014 OECD report “Guidance on Transfer Pricing Documentation and Country-by-Country Reporting” lays down the new version of Chapter V. This will be finalized and become effective after the finalization of the OECD BEPS project currently scheduled for the end of 2015.

Another component of the budget bill does not specifically concern transfer pricing, but is highly relevant. For all aspects of the direct tax system, a revised and unified system for advance tax confirmations is to come into force. This system will include any form of advance pricing agreements, whether covered by the scope of the 2011 transfer pricing regulations relating to financing activities, or otherwise. The aim remains to provide taxpayers with legal certainty for their transactions, while offering a uniform and egalitarian treatment between taxpayers and, importantly, increasing the transparency of the Luxembourg tax system. Fees, of a maximum of 10,000 Euro, will apply to cover the administrative and operation expenses of the tax administration. The procedure will be further detailed in a Grand-Ducal Regulation or an Administrative Circular.

The proposed new transfer pricing legislation should be seen as an extension and clarification of the current tax law, with changes being made in order to make explicit the application within Luxembourg of the OECD concepts of transfer pricing.

In view of the attention and resourcing now increasingly being given to transfer pricing matters by the Luxembourg tax authorities, all Luxembourg taxpayers should ensure that their transfer prices are consistent with the arm's length principle, and are supported by sound transfer pricing documentation, including an economic analysis.

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