CLIFFORD CHANCE

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Luxembourg Advance Pricing Arrangements

Circular LIR n°164/2 dated January 28, 2011

On 28 January 2011, the Luxembourg tax authorities issued a circular on Advance Pricing Arrangements applicable to intra-group financing transactions. This circular sets up the framework for such arrangements and the pricing documentation to be prepared by the taxpayers.

According to Luxembourg and OECD principles, any related party transaction should be performed at arm's length. In other words, remuneration should be in line with what independent third parties would have charged in a similar transaction. These transfer pricing principles apply to intra-group financings (being defined as any financing granted between companies that participate directly or indirectly in the management, control or capital of each other or have a common person doing so).

Advance Pricing Arrangements (APA)

A taxpayer may evidence and document in advance the methodology used to determine the intra-group remuneration. Auditing such documentation, the Luxembourg tax authorities may agree upon the applicable methodology knowing that this agreement would be binding on both parties for a maximum of 5 years (an agreement which could be renewed for another 5 year period upon the request by the taxpayer).The binding decision will apply unless the documentation filed were incorrect, incomplete or not in conformity with international law. Filing a formal APA request is now possible subject to several conditions linked to (a) the nature of taxpayer and (b) the request itself, both of which are described below.

Documentation and Methodology

Specific documents must be provided to the Luxembourg tax authorities including applicant information, group structure, transaction and methodology description and any other countries involved.

In respect of the methodology to be provided, the circular specifies that a comparison method has to be used, without detailing which method is to be opted for by the taxpayer (as is similarly the case in the OECD Transfer Pricing guidelines). However, the circular refers to the banking sector benchmark for similar transactions and the tax authorities recommend performing a risk analysis based on unique risk (so-called diversifiable risk) and market risk (so-called systematic risk). The transaction specifics such as the debtor balance sheet, the group structure, the financing duration and the potential security arrangements would be taken into account.

The taxpayer should conduct a comparability analysis based on the economic background, the contractual terms of the financing and the functions performed (e.g. the risks taken, the assets allocated to the financing activity, etc.). In this respect, the financing activity will have to be adequately equity financed. According to the circular, equity financing is deemed sufficient if it exceeds 1% of the financing or EUR 2 million.

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Conditions for filing an APA

In order to file an APA with the Luxembourg tax authorities, any Luxembourg tax resident company should meet the following conditions:

- majority of its directors should be Luxembourg resident or having more than 50% of their professional income taxable in Luxembourg (taxable in Luxembourg according to article 10-1 to 4 of the Luxembourg Income Tax Law);
- local directors should have the appropriate expertise and the capacity to bind the company by their decisions;
- its key management decisions should be taken in Luxembourg;
- appropriate staff should reflect the nature and volume of activity performed in Luxembourg; and
- a bank account should be opened with a Luxembourg resident bank or a Luxembourg branch of a resident bank.

According to the tax authorities view, these criteria show or demonstrate the strength of the company's local substance. It should however be noted that certain of the more restrictive criteria (i.e. majority of local resident directors or a bank account opened with local banks only) may be seen in certain circumstances as a limitation to the fundamental freedoms conferred by the European treaties (for example, if the benefit of the circular is denied to Luxembourg companies only having bank accounts opened with non Luxembourg established European banks).

In addition, the circular specifically excludes any companies which are tax resident in another country. It is not clear if local branches of any other European Union Member State company could benefit from the circular. A strict interpretation of the circular suggests that companies that are not tax resident in Luxembourg are excluded. One may then claim that such a restriction constitutes a discrimination under the European treaties between Luxembourg companies and Luxembourg branches of European head office.

It should also be noted that from a procedural point of view, the company must meet all of its direct tax filing obligations before filing an APA application.

Conclusion

The circular is a significant step forward for Luxembourg companies and practitioners as it provides clear and binding guidelines for pricing rules.

In order to receive an APA from the Luxembourg tax authorities it is necessary to perform a transfer pricing analysis based on comparable figures and a legal analysis of the contractual terms of the financing and the risks born by the Luxembourg company. Any existing security arrangements, limited recourse provisions and other similar financing arrangements are factors that would be taken into account to determine if the proposed remuneration is arm's length.

Clifford Chance can provide you with an integrated service and dedicated team who will be happy to answer your questions, to analyze the comparable figures, the contractual terms and to file the necessary request and liaise with the relevant Luxembourg authorities.

Please visit our Transfer Pricing Tax page for more information: http://www.cliffordchance.com/legal_area/tax/transfer_pricing_tax.html