

CIRCULAR LIR N°56/1 – 56BIS/1 PUBLISHED ON 27 DECEMBER 2016 BY THE LUXEMBOURG TAX AUTHORITY ON THE TAX TREATMENT OF ENTITIES CARRYING OUT INTRA-GROUP FINANCING ACTIVITIES.

1. DEFINITIONS

1. An entity carrying out intra-group financing activities (hereafter a 'group finance company') is an entity conducting intra-group financing transactions. For the purpose of the previous sentence, activities related to the holding of participations are not taken into account.

2. An Intra-group financing transaction is any activity involving the making of interest bearing loans or fund advances to associated enterprises, financed by any means, including by way of public offerings, private placements, cash advances or bank loans. Under article 56 LIR, two enterprises are deemed associated when one enterprise participates, directly or indirectly, in the management, control or share capital of the other, or if the same persons participate, directly or indirectly, in the management or share capital of both enterprises.

2. GENERAL INFORMATION

3. The arm's length principle, as set forth in article 9 of the OECD Model Tax Convention, is an international norm adopted by OECD countries that must be used for the determination of transfer prices between associated enterprises conducting cross-border transactions. To support the proper application of this principle, the OECD has developed and regularly updates guidelines on the application of the arm's length principle for multinational companies and tax authorities to observe in determining the transfer price of transactions carried out between associated enterprises.

4. Article 56 LITL incorporates the arm's length principle into Luxembourg domestic tax law. It provides for the adjustment of profits declared by the enterprise when transfer prices differ from those applied between independent enterprises for comparable transactions carried out between third parties in comparable circumstances.

5. For intra-group financing transactions, as for other types of intra-group transactions, one should ascertain whether, given the economic nature of the transaction, the agreed pricing is at arm's length, i.e. a price reflecting one that would be agreed and charged between independent enterprises in comparable circumstances. In order to determine whether transactions between independent enterprises are comparable to transactions between associated enterprises, one has to conduct a comparability analysis.

6. New article 56bis LIR, introduced by article 3, number 2 of the law dated 23 December 2016 concerning the 2017 State budget (due to enter into force on 1 January 2017) provides the principles to apply when conducting a transfer pricing analysis. This new article addresses new factors to consider in the context of a comparability analysis. It sets out issues pertinent to the implementation and application of the arm's length principle.

7. In accordance with paragraph 171 of the of the Luxembourg General Tax Law, a taxpayer needs to be able to support the data reported in its tax returns, including the transfer prices of controlled transactions, i.e. transactions between associated enterprises.

3. APPLICATION OF THE ARM'S LENGTH PRINCIPLE TO INTRA-GROUP FINANCING TRANSACTIONS

3.1. COMPARABILITY ANALYSIS

8. According to article 56bis (4) LITL, there are two aspects in a comparability analysis:

- a) The identification of the commercial or financial relations between the associated entities and the conditions and economically relevant circumstances attaching to those relations in order that the controlled transaction is accurately delineated;
- b) The comparison of the conditions and the economically relevant circumstances of the controlled transaction as accurately delineated with those of comparable transactions between independent enterprises.

3.1.1. IDENTIFICATION OF BUSINESS OR FINANCIAL RELATIONS BETWEEN ASSOCIATED ENTITIES AND DETERMINATION OF CONDITIONS AND ECONOMICALLY RELEVANT CIRCUMSTANCES

9. In order to delineate a controlled transaction and to determine the arm's length remuneration, it is important to describe the role of each entity taking part in the controlled transaction in the context of the commercial and financial relations of the group. Therefore, it is often useful to understand the structure and the organization of the group and the extent to which they influence the modus operandi of the group. Likewise, it might be useful to understand the interdependencies between the functions performed by the enterprises taking part in the controlled transactions and the rest of the group, the contribution of the associated enterprises to the value creation of the group and the extent to which this contribution influences the arm's length remuneration of each entity taking part in the controlled transactions. Indeed, the economically relevant characteristics of a transaction are related to the economic circumstances in which the transaction takes place.

10. For example, a group finance company may make loans or cash advances to associated entities for different commercial reasons:

- Financing of fixed assets
- Financing of current assets
- Long-term strategic financing
- Other miscellaneous financing.

11. The above list is not exhaustive. However, the economically relevant characteristics of a financing transaction are closely linked to the commercial relations between associated enterprises and to the business strategy of the parties.

12. As part of the process to delineate a controlled financing transaction, it is important to identify the characteristics of a transaction, including the terms of the transaction, the functions

performed, the assets used and the risks assumed by the parties to the transaction. The extent to which one of the comparability factors is economically significant for a particular transaction depends on the extent to which independent entities would consider such a factor when evaluating the terms of the same transaction were they to enter into it.

3.1.1.1. CONTRACTUAL ARRANGEMENTS

13. A transaction is the expression of a commercial relationship between parties. For the purpose of the comparability analysis, it is not relevant whether the transaction has been formalized in a written document. It is the behavior of the parties to the transaction that it is essential to identify and to delineate in relation to the controlled transaction. Therefore, even if a formal written contract exists, in the event that the actual behavior of the parties deviates from what has been contractually agreed, the actual behavior of the parties has to be considered when delineating the true nature of the transaction undertaken.

3.1.1.2. FUNCTIONAL ANALYSIS

14. The purpose of the functional analysis is to identify the economically significant activities, responsibilities and functions as well as the assets used or provided, and the risks assumed by the parties to the

transactions. The functions assumed when making loans or cash advances to group entities are in principle substantially comparable to the functions assumed by independent financial institutions supervised by the "Commission de Surveillance du Secteur Financier" ('CSSF'). However, it is important to point out that significant functional differences can be found when financing transactions are carried out between associated enterprises not supervised by the CSSF. The functional analysis focuses on what the parties actually do and the capabilities they deploy. Those functions include decision-making, in particular regarding the strategy of the company and in relation to risk. In this context, it is important to determine as far as possible the legal rights and obligations of each party when exercising those functions.

15. Without being exhaustive, the following functions might be undertaken by entities carrying out intra-group financing activities:

a) Origination of the transaction • Marketing of the transaction (client identification, product proposal ...)

- Negotiation (decisions made in relation to the terms of the contract, risk assessment in relation to the loan, ...)

- Decision on the financing

- Monitoring of the compliance with the contractual terms prior to the conclusion of the transaction (value of guarantees, solvability analysis ...).

b) Transaction management • Administration of the transaction

- Monitoring of the credit risk (review of guarantees and risk)

- Management of the refinancing.

16. Identification of the functions performed and assets used is essential in order to determine the risks of the transaction.

3.1.1.3. RISK ANALYSIS IN FINANCIAL RELATIONS

17. Before making a loan or a cash advance, a financial institution, or any other person engaged in the provision of credit, performs an analysis of the risk to which it is exposed. As part of this analysis, it notably reviews the financial statements of the borrower in order to assess the financial risk related to the

transaction. It verifies the existence of guarantees and examines the purpose of the financing, its terms and any other significant factor, in order to evaluate the risk. Usually, in the open market, the assumption of increased risk would be compensated by an increase in the expected reward. The ability to assume that risk and the ability to manage it are economically relevant characteristics to be identified in order to delineate the controlled financing transaction.

18. Based on the facts and circumstances of each individual case, it is essential to evaluate the specific risks that are economically significant in relation to the financing transaction, the functions performed that relate to (or affect) the assumption or impact of the risks, and which party or parties to the transaction assume these risks. Usually, a group finance company will be considered to assume lending risk when it has the financial capacity to assume that risk and to bear its financial impact when that risk materializes. Financial capacity to assume risk can be defined as access to funding to take on or to lay off the risk, to pay for risk mitigation functions and to bear the consequences of the risk if it materializes.

19. When the comparability analysis reveals that the profile of the group finance company is comparable to that of an entity subject to Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, and that the equity of the group finance company meets the solvency requirements provided by the Regulation, the equity of the group finance company is considered as sufficient to bear the financial consequences when the risk materialises. When the comparability analysis reveals significant differences in the functional profile (assets used and functions performed) of a group finance company compared to that of an entity subject to the Regulation, the level of equity required to assume the risks must be determined using other methods - in particular, by using credit risk analysis models developed by recognised professionals. Those methods are based on the analysis of balance sheet items, and market and other relevant factors to evaluate the risk associated with a financing activity.

20. A group finance company controls risk to the extent to which it has the capability to make decisions to enter into commercial relations in relation to which that risk arises and if it has the capability to make decisions on whether and how to respond to those risks, together with the actual performance of that decision-making function. A finance company may outsource the day-to-day risk mitigation. In this case, the finance company must have the capability to determine the objectives of the outsourced activities, to decide whether to hire the provider of those risk mitigation functions, to assess whether the objectives are being adequately met and, where necessary, to decide to adopt or terminate the contract with that provider, together with the performance of such assessment and decision-making.

21. A group finance company must, therefore, have a real presence in Luxembourg in order to support the fact that it controls the risks pertinent to its activity. A group finance company will be considered as having a real presence in Luxembourg if notably, it satisfies all of the following requirements:

- A majority of the members of the board, the directors or the managers who have the authority to engage the group finance company are either Luxembourg residents or non-residents who carry on a professional activity in Luxembourg (from which income falls under the one the first 4 categories of income of article 10 LIR3) and who are liable to tax in Luxembourg on at least 50% of that income. Where a corporate entity is a member of the board of directors, its registered office and its central administration must be located in Luxembourg
- The group finance company must have qualified personnel who have the skills necessary to control the transactions it undertakes. The company may, however, outsource functions that do not have a significant impact on the control of the risk. Key decisions concerning the

management of the company have to be made in Luxembourg. In addition, for entities for which company law requires shareholders' meetings, at least one of such meetings has to be held every year at the place specified in the articles of association

- The company should not be considered to be a tax resident of another country.

3.1.2. COMPARISON OF THE CONTROLLED TRANSACTION, CLEARLY IDENTIFIED, WITH COMPARABLE TRANSACTIONS BETWEEN INDEPENDENT ENTITIES AND THE DETERMINATION OF AN ARM'S LENGTH REMUNERATION

22. In order to determine the arm's length remuneration, it is essential to compare the precisely delineated controlled transaction with comparable transactions in the open market.

23. The arm's length remuneration is the remuneration which would have been agreed upon between third parties in the open market under similar conditions. Therefore, in order to be able to determine such remuneration, it is important to identify comparable transactions. The process to identify potential comparables must be transparent, systematic and verifiable. The search for potential comparables must use all information sources available at the time the transaction is implemented.

24. Features and practices of the specific sector must also be taken into account. In the event that an entity performs functions similar to the ones of a regulated financing or treasury company, i.e. an entity covered by paragraph 19 of section 3.1.1.3, an after tax return on equity of 10% can be observed in the market and can be considered as reflecting an arm's length remuneration for financing or treasury functions at the time of publication of this circular. The Luxembourg tax authority will regularly revise this percentage based on the relevant market analysis.

25. Comparability adjustments should be made in accordance with internationally recognized standards in this field (if they are necessary to improve the reliability and the quality of the comparability analysis).

3.1.3. TRANSACTIONS WITH NO COMMERCIAL RATIONALITY

26. When undertaking a comparability analysis or when accurately delineating the actual transaction, it may be apparent that the transaction is not seen between independent parties and that it lacks commercial rationality. As a result, independent parties would not have agreed to enter into the transaction under the same conditions. In that event, this transaction (as well as the related tax consequences) must be disregarded to ensure that the arm's length principle is respected.

4. SIMPLIFICATION MEASURE

27. When a group finance company meeting the requirements of section 3.1.1.3., paragraph 21 and acting as a pure intermediary, makes loans or fund advances to associated enterprises which are refinanced by loans or fund advances from associated enterprises⁴, given the risks related to this transaction, it is accepted for the purposes of simplicity to assume that the transaction respects the arm's length principle when the company derives from the controlled transaction a minimum after tax return of 2% on the financed assets. The Luxembourg tax authorities will regularly update this after-tax return based on the relevant market analysis.

28. It should be noted that this minimum return on financed assets for pure intermediaries with limited functions cannot be applied without a transfer pricing analysis in order to determine the arm's length remuneration for intra-group financing activities other than those described in this section.

29. In order to benefit from this simplification measure, the enterprise must inform the Luxembourg tax authorities of its use in the relevant section of the tax return.

30. A deviation from the minimum return set in the first paragraph is accepted only in exceptional circumstances and must be supported by a transfer pricing analysis.

31. Taxpayers that have opted to apply the simplification measure will be subject to exchange of information as foreseen by one of the following legal frameworks:

- Law of 29 March 2013 on administrative cooperation in the field of taxation, as modified
- Tax treaties that are in force
- Law of 26 May 2014 ratifying the OECD multilateral convention on mutual assistance in tax matters and its protocol of amendment (signed in Paris on 29 May 2013) amending the Luxembourg General Tax Law.

5. CONTENT OF AN INFORMATION REQUEST HAVING A BINDING EFFECT ON THE LUXEMBOURG TAX AUTHORITIES REGARDING TRANSFER PRICING ASPECTS OF A GROUP FINANCE COMPANY

32. Based on the facts and circumstances of each particular case, a request for an advance tax agreement submitted to the Luxembourg tax authorities in accordance with the procedure foreseen by paragraph 29a of the Luxembourg General Tax Law should contain at least the following information and documents:

1. Detailed information (name, domicile, file number if available) relating to the applicant as well as the entities or branches which are parties to the transactions or arrangements referred to in the request.
2. A detailed description of all intra-group financing transactions of the company as well as the arrangements or legal documents which are referred to in the request, including a detailed statement of the legal position taken by the applicant.
3. Qualifications of the relevant employees as well as a description of their functions.
4. Country or countries to which the transactions or arrangements relate.
5. Presentation of the legal structure of the group including information regarding the beneficial owner of the applicant's equity.
6. Fiscal years covered by the request.
7. Transfer pricing study meeting the requirements outlined in the previous sections and as recommended by the OECD, which includes notably:
 - A description of the computation method applied to determine the required amount of equity necessary to assume the risks
 - A description of the group and a description of the interdependence between the functions performed by the enterprises taking part to the controlled transactions and the rest of the group, as well as a broad description of the value creation at the level of the group by the enterprises involved in the transaction(s)
 - An accurate delineation of the analyzed transactions
 - A complete list of researched comparables
 - The matrix of the rejected potential comparables, as well the reason they have been rejected

- The final list of the selected comparables based on which the enterprise determined the arm's length remuneration applied to the accurately defined intra-group transaction(s)
- A general description of the market conditions
- A review of all relevant ancillary tax issues triggered by the proposed methodology
- A list of all APAs obtained in other countries relating to the transaction(s) under review
- A list of all advance tax agreements relating to the enterprise under review that is still valid at the time the request is submitted.
- Forecasts (profit and loss account) for the years covered by the APA.

8. Confirmation that the information necessary to assess the facts is complete and accurate.

6. DECISION TAKEN BY THE LUXEMBOURG TAX AUTHORITIES BEFORE THE ENTRY INTO FORCE OF ARTICLE 56BIS LITL

33. As from 1 January 2017, all administrative decisions relating to the arm's length principle that were based on rules applicable before the entry into force of article 56bis LITL, no longer bind the tax authority.

34. Companies wishing to benefit from a new decision have to introduce a new request meeting the requirements described in chapter 5 of this Circular.