

Transfer pricing in Luxembourg

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The authors offer an authoritative guide to transfer pricing in Luxembourg

In light of the growing importance of transfer pricing and the desire for Luxembourg in-house tax departments to speak to the issues, this article offers a comprehensive overview of the elements of Luxembourg's legislative provisions on the matter. The demand for transparency in corporates' tax and transfer pricing positions has dramatically increased worldwide in recent years, elevating the arm's length principle to a new level.

I. Introduction

Recent international tax studies consistently rank transfer pricing as one of the most important tax issues for multinational enterprises worldwide. Yet transfer pricing audits are increasing, and tax authorities are willing to impose adjustments and penalties as governments are well aware that transfer pricing could be used to shift profits into low tax jurisdictions. The current economic downturn may all the more incite governments to recover shortfalls in tax revenue.

The overarching transfer pricing premise resides, in order to establish profits for tax purposes, in the application of arm's length principle. This principle enjoys general international consensus, is endorsed by the OECD and is the framework for bilateral treaties between OECD countries – including Luxembourg – and non-OECD governments. However, complexities in the application of the arm's length principle should not be underestimated. The exercise can be as much an art as a science.

Crucially, while the number of countries that devote attention to transfer pricing has soared, Luxembourg has not implemented *detailed* transfer pricing regulations. Luxembourg tax law and the related commentaries merely contain general provisions relating to transfer pricing or the allocation of profits and expenses within a group of companies.

Further, though the Luxembourg tax authorities have long-standing experience and in-depth knowledge of financial transactions and applicable market rates, Luxembourg tax law does not provide for specific documentation requirements or other obligations in relation to transfer pricing.

Luxembourg tax advisers have sought to elevate transfer pricing rules, and this article gives a tax perspective. It covers two main areas, namely the determination and documentation of transfer prices, and the tax adjustments relating to the arm's length principle.

II. Determination and evidencing of transfer prices

A. Overview

Luxembourg has not implemented detailed regulations pertaining to the determination and documentation of transfer pricing in company groups; rather, the Luxembourg law on transfer pricing is concisely expressed in the Luxembourg Income Tax Law ("LITL"), the General Tax Code (*Abgabenordnung*) and the Tax Adaptation Law (*Steueranpassungsgesetz*).

As a member of the OECD, Luxembourg adheres to the Organisation's "Transfer Pricing Guidelines for Multinationals and Tax Administrations" ("OECD Transfer Pricing Guidelines") though they are not legally binding.

Furthermore, with much of Luxembourg tax law of German origin, German jurisprudence and related interpretations may constitute a useful guideline.

B. Determination of transfer prices

Luxembourg companies that transfer goods and services to related companies must comply with the arm's length principle. That is, in order to establish profits for tax purposes, the price between connected

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parties should be the same as would have been charged between unconnected parties.

The arm's length criterion is generally based on the comparison between conditions in a controlled transaction with those in an uncontrolled transaction. This does, however, require that the economic characteristics of situations be comparable; no discrepancy should materially affect the price though reasonable adjustments may be made to eliminate potential differences.

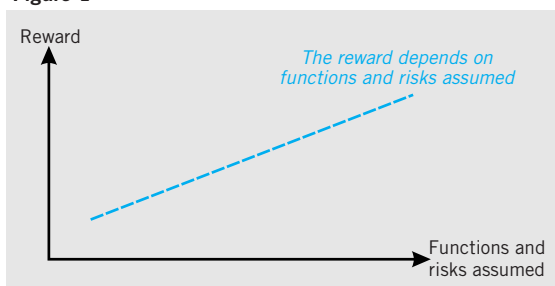
Factors to be considered when assessing the comparability of a transaction include:

- characteristics of property or services;
- analysis of functions and risks;
- contractual terms;
- economic circumstances; and
- business strategies.

The determination of transfer prices regularly begins with a 'functional analysis'. The functional analysis is a means of gathering facts about the related parties (with respect to specific transactions) by way of their functions, assets (tangible and intangible) and risks in order to identify how these characteristics are divided between the companies involved in the controlled transactions under scrutiny.

As a general principle, the reward of a party should increase proportionally to the functions and risks assumed, as demonstrated by Figure 1.

Figure 1



The findings of the functional analysis may lead directly to the application of a specific transfer pricing method. Should a given structure not be tax-efficient, adjustments may be implemented in relation to functions, assets or risks in order to justify an alternative transfer pricing structure.

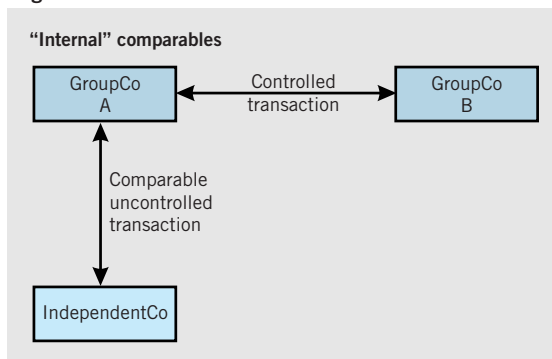
Supply chain restructuring could, however, likely raise the interest of the tax authorities involved. In this regard, the OECD recently issued a draft transfer pricing report addressing business restructurings that typically entail modifications to the business model of a multinational enterprise (e.g., the centralisation of certain risks and functions, purchasing companies).¹ The report added detail to the OECD Transfer Pricing Guidelines by addressing many of the transfer pricing issues ordinarily encountered in a business restructuring.

Once a transfer pricing method has been selected, the arm's length price should be computed. To this end, comparables are required (for example, comparable uncontrolled prices, cost plus margins) and may be sought from a variety of internal and external sources. In order to reduce the effects of business cycles and life cycles of the product, and to eliminate

development-stage companies, and to control any aberrations in a single year result, a financial analysis of comparable companies may be based on a multiple year basis (for example, three years).

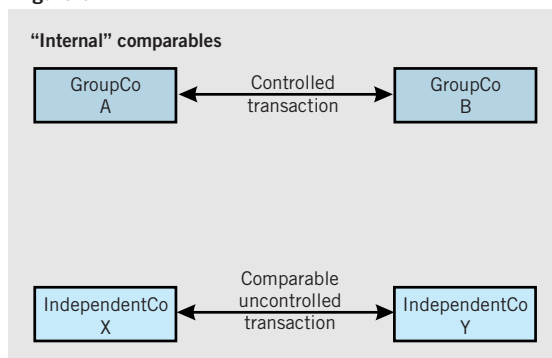
'Internal' comparables are comparable transactions made between the company (or affiliates) and third parties, demonstrated in Figure 2. These may be preferable as they are more likely to fit the analysed transaction and more information may be available.

Figure 2



Alternatively, arm's length prices may be determined based on 'external' comparables, demonstrated in Figure 3. Information on such comparable third party transactions may, for instance, be obtained from government sources, industry associations or special databases.² Due to the limited number of potential Luxembourg comparables, it could be relatively difficult to find local comparables. However, though adjustments may be necessary, comparable third party transactions conducted in European neighbour countries may be used as a basis.

Figure 3



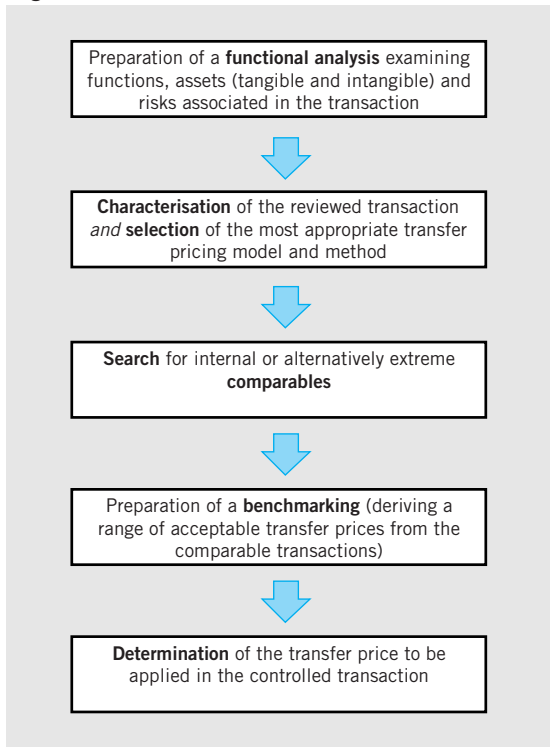
As transfer pricing is not an exact science, the analysis of comparable transactions in the frame of a benchmarking should result in a range of arm's length transfer prices rather than in the identification of a single arm's length price. Ultimately, the arm's length price of the controlled transaction has to be chosen from a range of arm's length prices.

Summary: 'Determination of transfer prices'

See Figure 4.

Importantly, Luxembourg companies may obtain an advance tax agreement from the Luxembourg tax authorities regarding the compatibility of their transfer pricing systems with the arm's length principle.

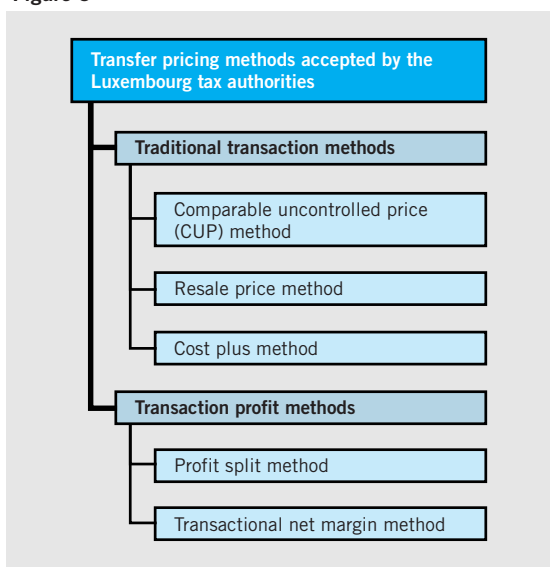
Figure 4



C. Accepted transfer pricing methodologies

Luxembourg has not implemented specific rules regarding the use and application of accepted transfer pricing methods. However, with reference to the OECD Transfer Pricing Guidelines, the transfer pricing methods shown in Figure 5 should in general be accepted by the Luxembourg tax authorities:

Figure 5



1. Traditional transaction method

The following standard conventional methods may be applied in Luxembourg:

- **Comparable uncontrolled price (CUP) method**
This method is potentially the most reliable in arriving at arm's length prices. The CUP method compares the price charged for property or services in a controlled transaction with the price charged in a

comparable uncontrolled transaction.

This comparison provides that where a company has sold goods and services to related parties, the same prices should be applied for the sale of those goods and services to unrelated parties in comparable circumstances. If no such transaction exists, an arm's length price may be found by looking for similar transactions between completely independent parties. Though the 'direct' price comparison does not require absolute comparability, compared business transactions must, essentially, be identical; in particular with regards to the transferred goods or services that significantly influence the price. In practice, this method is often difficult to apply as it is unusual for multinationals to have access to sufficient details of appropriate comparable third party transactions.

If the direct price comparison method – in the absence of comparable transactions – cannot be applied, reference may be made to transactions of a different kind (e.g., prices charged for comparable products) if the influence of differing factors may be eliminated via adjustments (so-called 'indirect' method of price comparison).

- **Resale price method**

The resale price method determines an arm's length price by deducting an appropriate gross margin from the actual resale price. The resale price method may only be applied where a product is sold by an associated enterprise to another, itself reselling it to an unrelated third party. The crux of this method lies in the application of an arm's length gross margin (reflecting functions and risks assumed by the interposed reselling associated company) that should be derived from comparable uncontrolled transactions.

- **Cost plus method**

Under the cost plus method, an arm's length price is determined by applying an appropriate gross mark-up on costs incurred for goods or services. A gross mark-up should be added to this to give the supplier a profit appropriate to the functions carried out and market conditions. The profit element should be calculated by reference to the cost plus mark-up earned in comparable uncontrolled transactions. The cost-plus method is most useful where semi-finished goods are transferred between related parties (a manufacturing company selling to a distributing affiliate. . .), or where the controlled transaction involves the provision of services.

2. Transactional profit methods

Since the three conventional methods are difficult to apply where goods are delivered, services rendered, or licenses granted amongst associated enterprises for which no comparable market exists, arm's length prices may be determined on the basis of transactional profit methods.

- **Profit split method**

The profit split method determines the share of profits that independent enterprises would expect to realise under circumstances similar to the transaction under review. The profit split method calculates the profit from the controlled transactions and splits that profit based on the contribution of each entity

and is therefore consistent with what would have occurred at arm's length. The contribution of each entity is determined by performing a functional analysis and valued, if possible, with reference to reliable external market data.

■ *Transactional net margin method*

The transactional net margin method (TNMM) examines the net profit from controlled transactions as a percentage of an appropriate base (e.g., costs, sales, assets). Ideally, the net margin should be established by reference to net margins earned by the same taxpayer in comparable uncontrolled transactions. If that is not possible, the TNMM refers to comparable transactions between independent entities. Comparability between controlled and uncontrolled transactions is established by way of a functional analysis.

3. Preferred order of methods

The selection of a transfer pricing method should solely aim at finding the most appropriate method for a particular transaction. However, since the utility of the different methods tends to vary with the different goods and services involved, an overall order of preference cannot reasonably be established.

However, should necessary data be available, the comparable uncontrolled price method should invariably be given precedence over the resale price, cost plus and transactional profit methods. Moreover, and insofar as this may be possible, the traditional transaction methods should be given precedence over the transactional profit methods.³

In practice, the Luxembourg tax authorities frequently accept the cost plus method if it can be justified that this method leads to appropriate results reflecting market conditions.

4. Specific Luxembourg tax rules

But for the above general rules that are mainly based on the OECD Transfer Pricing Guidelines, the following cases are given specific treatment in Luxembourg:

a. *Financing activity*

In the framework of intra-group financing activities, a minimum arm's length margin should be realised by a Luxembourg finance company or permanent establishment. Further, the interest rates applicable on such loans must remain at arm's length.⁴

In this respect, the LIR Circular Letter 120 of July 14, 1989 stipulates that a margin of 0.25 percent applied on the financing volume should be acceptable for Luxembourg tax purposes provided that the financing volume exceeds €2.5m; should the amounts involved remain below that threshold, a margin as high as 0.5 percent would have to be realised. Should the financing activity, however, significantly exceed €2.5m, progressive reduced margins may be applied provided that specific guarantees be given and the arm's length principle be respected. Importantly, should the margins realised accounting-wise exceed the arm's length margin, the entire accounting margin would be subject to Luxembourg taxation.

Though the aforementioned circular letter was repealed on February 20, 1996, the application of the cost plus method on financing activities contained therein remains valid. According to current administrative practice of the Luxembourg tax authorities, the margin to be realised on financing activities merely depends on the amounts involved, the level of credit risk, foreign exchange risks and potential guarantees. Notably, financing margins may be agreed with the Luxembourg tax authorities.

b. *Luxembourg thin capitalisation rules*

Luxembourg tax law does not provide for a specific debt/equity-ratio to be respected by Luxembourg companies. Therefore, shareholders are in principle free to finance their company either with (shareholder) debt or equity.⁵ This freedom of financing is limited twofold, first by a debt/equity-ratio –exclusively – applicable to holding activities and, second, by the concept referred to as “*verdecktes Stammkapital*”.

■ *Financing of holding activities*

Luxembourg companies are obliged to respect a debt/equity-ratio of 85:15 with regards to the financing of participations. This ratio is not provided for in Luxembourg tax law but exclusively based on administrative practice. This requirement applies irrespective of whether a particular participation qualifies for the Luxembourg participation exemption regime.

To the extent that the financing of participations exceeds the above ratio, interest on the exceeding debt portion may be recast into hidden dividend distributions. The latter are not tax deductible and in principle subject to Luxembourg dividend withholding tax (see section III.A.2, below).⁶ Since the debt/equity-ratio merely aims at limiting interest expenses, it is under certain conditions possible to further increase the debt financing of participations. While participations may only be financed up to 85 percent with interest-bearing shareholder loans (bearing interest at an arm's length rate), additional debt may for instance be injected in the form of interest-free loans without triggering tax adjustments.⁷

■ *“Verdecktes Stammkapital”*

The freedom of shareholders in the financing of companies is further limited – though seldom applied – by the concept “*verdecktes Stammkapital*” (hidden share capital) aiming at re-qualifying shareholder loans into equity on the basis of their economic substance. The concept has been shaped by German case law and is based on the principles laid down in § 5 StAnpG (sham transactions) and § 6 StAnpG (abuse of law).

Interest on loans qualified as “*verdecktes Stammkapital*” is recast into hidden dividend distributions that are not tax deductible and in principle subject to Luxembourg dividend withholding tax (see section III.A.2, below). Crucially, the tax consequences deriving from this concept go further than those deriving from the debt/equity-ratio applicable to holding activities. While the latter exclusively aims at re-qualifying interest payments, the former

aims at re-qualifying (parts of) shareholder loans into equity for both Luxembourg income tax and net wealth tax purposes. Consequently, such shareholder loans are not deductible within the computation of the company's unitary value (the taxable basis for net wealth tax purposes).⁸

The scope of "verdecktes Stammkapital" has been, however, limited by German jurisprudence to exceptional cases in which additional equity financing was constrained under legal and economical circumstances; that is, on the basis of the arm's length principle. The burden of proof lies with the Luxembourg tax authorities.⁹

c. Disposal of shares in non-listed companies

According to Luxembourg tax law, the disposal of participations in non-listed companies to other group companies has – like any other transfer – to be made at fair market value.¹⁰

Should such participations, however, not be evaluated in the frame of a transfer pricing analysis, and the fair market not be derived from the terms and conditions of recent disposals between unrelated parties, the Luxembourg Valuation Law (*Bewertungs-gesetz*) provides for a specific method referred to as "Stuttgarter Verfahren" for the determination of the fair market value of such participation. In short, this method considers the subsidiary's net equity and its earning prospects based on previous years. This method, whilst emphasising more on the company's net equity than on its future growth potential, should permit to keep values as low as possible.¹¹

D. Luxembourg documentation requirements

Since Luxembourg has not implemented specific provisions relating to the preparation of transfer pricing documentation, the documentation requirements prevailing for transfer pricing may exclusively be based on the general provisions of the Luxembourg tax law. Reference may also be made to the OECD Transfer Pricing Guidelines.

1. Luxembourg bookkeeping obligations

As a rule, the obligations of Luxembourg companies relating to bookkeeping and the preparation of financial statements as required by Luxembourg commercial law are extended as obligations for tax purposes.¹² These obligations clearly do not specify special documentation requirements for transfer pricing purposes.

Provided that such documentation fulfils the requirements set out in § 162 AO, it is in principle binding for Luxembourg tax purposes.¹³ Notably, relevant documentation need to be retained for 10 years for financial statements and inventory recordings, and seven years for accounting records, business correspondence and other documentation.¹⁴ Where the minimum standards or document retention requirements have not been met, information deriving from accounting may be (partly) disregarded for Luxembourg tax purposes.¹⁵

Furthermore, the determination of values other than nominal amounts, payments and market values as well as relevant facts needs to be evidenced by the Luxembourg taxpayer.¹⁶ In particular in cross-border situations, the Luxembourg tax authorities are dependent on the information provided by the taxpayer.¹⁷ Therefore, the Luxembourg tax authorities need to be in a position to verify whether the transfer pricing for goods and services exchanged with other group companies fulfil the arm's length criterion.

2. Practical recommendations

When dealing with transfer pricing, companies must find the right balance between a comfortable level of security, and the significant costs involved in the preparation of in-depth transfer pricing documentation. While insufficient documentation may result in complex tax consequences, involving increased taxable income, double taxation, penalties and in particular uncertainty, the examination of intra-group transactions and their tax risks is key.

In practice, companies should identify significant inter-company transactions in order to screen the latter for material tax risks. Thereafter, companies have to focus on developing transfer pricing policies to manage such risks.

In cross-border situations, though Luxembourg does not require particular transfer pricing documentation, other jurisdictions may require substantial evidence. In such cases, Luxembourg tax authorities may accept a transfer pricing analysis based on a transfer pricing documentation prepared for the foreign country.

Despite transfer pricing being generally referred to as cumbersome, the hidden vantage points of transfer pricing should not be underestimated. The implementation and monitoring of transfer pricing systems may provide additional benefits beyond direct taxation. The improved information basis may serve as a controlling tool and additionally give indications for value chain management.

Since arm's length transfer prices need in any case to be determined for Luxembourg tax purposes, it is recommended to record the circumstances considered evidencing records in order to adhere to the 'prudent business management principle'.

Based on the OECD Transfer Pricing Guidelines, it is advised that the following should, at least, be regularly documented:

- information regarding the group structure (including group and organisational charts as well as information on the legal and operative structure);
- information pertaining to the relevant transactions (including terms and conditions and in particular functions performed and risks assumed by the different parties);
- relevant legal documentation such as agreements, price lists, and information deriving from the financial controlling;
- transfer pricing computations indicating compliance with the arm's length principle.

From a practical perspective, it should be considered that transfer prices may be reviewed several years after transactions have been completed. Considering that tracing back the relevant circumstances of intra-group transactions will become increasingly difficult with time, it is advised to document relevant facts in a timely manner.

Importantly, a sound transfer pricing policy statement can have considerable power and significantly reduce transfer pricing risks.

A transfer pricing policy may not be established once and disregarded thereafter. Practice shows that companies in some cases do not comply with their transfer pricing policies. However, should documentation have any value for the company, it must be regularly reviewed on an ongoing basis; particularly when the group business is restructured and new types of transactions are contemplated.

E. Review of transfer pricing

The transfer pricing of Luxembourg companies is generally reviewed by the Luxembourg tax authorities as part of the corporate tax returns in the tax assessment procedure.¹⁸ Transfer pricing may further be reviewed in the frame of a tax audit spanning several fiscal years.¹⁹ In terms of timing, the Luxembourg tax authorities generally assess the amount of income and net wealth tax to be paid within five years following the end of the year in which the corporate tax returns have been filed.²⁰

In principle, Luxembourg companies have to file corporate tax returns by May 31 of each year following a fiscal year end. The Luxembourg tax authorities may, however, grant extensions where necessary.²¹ Should a taxpayer exceed a deadline, a penalty amounting to a maximum of 10 percent of the final tax liability may be levied for late filing.²² Furthermore, a penalty payment of a maximum of €1,250 may be imposed where a request from the Luxembourg tax authorities (e.g., a request requiring the filing of corporate tax returns) is disregarded by the taxpayer; such penalty has to be communicated beforehand.²³ Last but certainly not least, interest amounting to 0.6 percent per month may be levied on both the amount of tax assessed and penalties for late payment.²⁴

Luxembourg tax authorities are obliged to verify the statements in the corporate tax returns, including those relating to transfer pricing.²⁵ In the frame of these investigations, the Luxembourg tax authorities have far-reaching competences to request – either orally or in writing – information from the taxpayer that are mirrored by the obligation of the taxpayer to clarify uncertainties.²⁶ Should the tax authorities have objections concerning the statements made in the tax returns, they should in principle ask the taxpayer to complete the tax returns or to provide additional evidence; not least to accelerate the assessment procedure and to avoid eventual disputes.²⁷ Importantly, the taxpayer has no right to deny tax authorities' information requests; rather, the taxpayer should provide the tax authorities with consistent information evidencing the correctness of his statements.²⁸

Should the tax authorities' investigations not succeed with the help of the taxpayer, these may revert to third parties for their support.²⁹ Under certain circumstances, however, third parties – and in contrast to the taxpayer – may have the right to deny the Luxembourg tax authorities access to requested information.

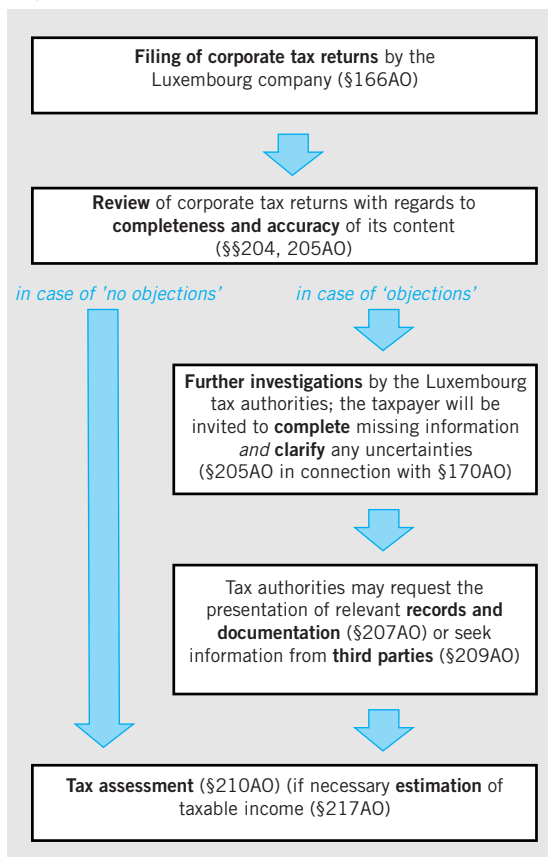
The Luxembourg tax authorities need to inform the taxpayer beforehand should they wish to significantly vary from the tax returns so as to allow the latter to substantiate relevant aspects.³⁰

As a mean of last resort, the Luxembourg tax authorities may have to estimate (parts of) the taxable income of a Luxembourg taxpayer;³¹ particularly if a Luxembourg company does not provide sufficient information evidencing the statements made in its corporate tax returns or does not duly fulfil its bookkeeping obligations. Notably, since the arm's length price is generally not a certain amount but rather a certain range of acceptable prices, the tax authorities may only estimate the taxable income within such range; all amounts within this range comply with the arm's length principle. It follows that the more unclear the situation of the taxpayer is, the broader the tax authorities' scope of estimation.

Summary: 'Review of transfer pricing within the tax assessment procedure'

Illustrated in Figure 6

Figure 6



F. Burden of proof

The burden of proof that transfer prices do not comply with the arm's length principle generally lies with the Luxembourg tax authorities. Therefore, the tax authorities must be in a position to verify whether the transfer prices of goods and services exchanged within a company group are in line with the arm's length principle; not shifting advantages between affiliates.³²

Though the Luxembourg tax law does not contain any obligation to prepare a special transfer pricing documentation, the taxpayer has to demonstrate all the business (and other) considerations motivating him to conclude a certain contract.³³ Hence, the taxpayer needs to present all relevant facts including functions performed and risks assumed by the different parties. This is justified by the fact that only the taxpayer himself knows the circumstances under which a certain price has been negotiated. This is all the more valid in cases where the tax authorities have difficulties to gather all relevant facts.³⁴

Notably, § 169 AO determines that where values do not derive from market values, nominal values or payments, but are the result of estimates, facts need to be presented substantiating such estimates. The requirements are more numerous where transactions involve Luxembourg non-residents since the Luxembourg tax authorities' powers of investigation are not as wide-ranging.³⁵

III. Tax adjustments relating to the arm's length principle

In Luxembourg, the arm's length principle is realised by applying several domestic tax rules. These may be limited to the extent of applicable double tax treaties concluded by Luxembourg.

A. Luxembourg domestic tax law

1. Overview

Luxembourg companies are subject to corporate income tax and municipal business tax at the current aggregate rate of 28.59 percent (for Luxembourg City). The taxable income of companies comprises the results of business relationships with third parties and related parties.

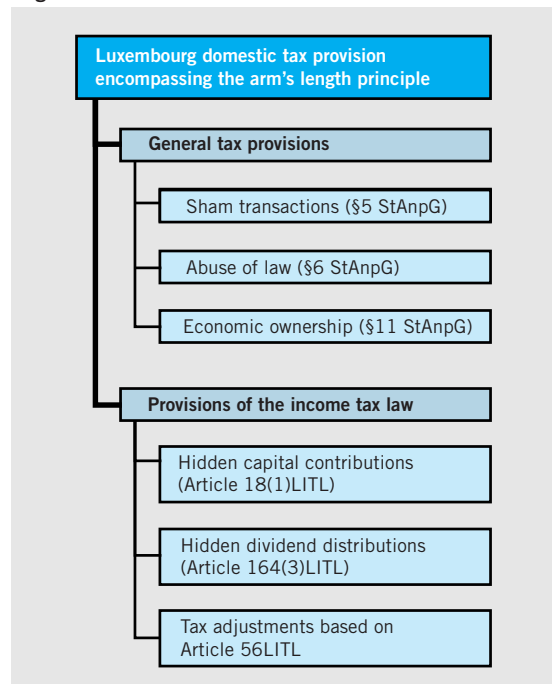
While unrelated parties have no interest in shifting advantages between each other, related parties may – in the absence of a divergence of interests – intend to shift advantages so as to realise a lower aggregate tax burden. Luxembourg tax law therefore provides for the severance of the realm of the company – that is itself subject to tax³⁶ – from that of its shareholder(s) (*Trennungsprinzip*) via adherence to the arm's length principle by means of the following tax provisions:

- hidden dividend distributions (including Luxembourg thin capitalisation rules);
- hidden capital contributions;

- tax adjustments according to Article 56 LITL in case of special economic relationships with Luxembourg non-resident taxpayers.

Crucially, the general tax principles given in § 5 StAnpG regarding sham transactions (*Scheingeschäfte*), § 6 StAnpG regarding abuse of law (*Gestaltungsmisbrauch*) and § 11 StAnpG regarding economic ownership (*wirtschaftliches Eigentum*) take precedence over the above mentioned tax adjustments (see Figure 7). Moreover, the deduction of expenses may be denied where the taxpayer does not disclose the name of the recipient of related payments.³⁷

Figure 7



2. Hidden dividend distributions

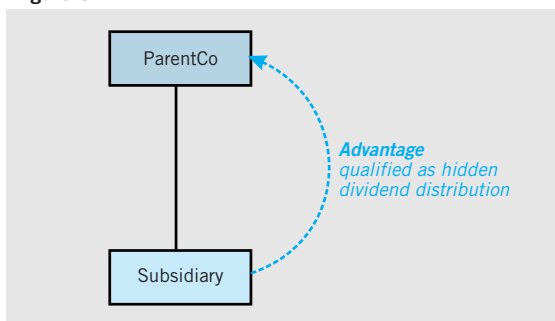
Hidden dividend distributions are advantages shifted – motivated by the shareholding relationship – by a company to its shareholder(s) (or to a related party of the shareholder) leading to a decrease – or averted increase – of the company's net equity while decreasing the company's income.³⁸ Should an unrelated party not have granted the same advantage, it is considered that the advantage was motivated by the shareholding relationship; in short, this criterion is verified with the arm's length principle.

By contrast to hidden capital contributions (see section III.A.3, below), any advantage – including services granted without valuable consideration – may qualify as hidden dividend distribution, see Figure 8.

For Luxembourg tax purposes, hidden dividend distributions are reintegrated to the taxable income of the company; the basis for the calculation of corporate income tax and municipal business tax.

Furthermore, hidden dividend distributions, considered income in accordance with Article 97 (1) No. 1 LITL, are in principle subject to Luxembourg dividend withholding tax at a rate of 15 percent.³⁹ Nonetheless, alike regular dividend distributions, they may – under certain conditions – be exempt from Luxembourg dividend withholding tax.⁴⁰ Alternatively, the

Figure 8



Luxembourg withholding tax rate may be reduced based on an applicable tax treaty.

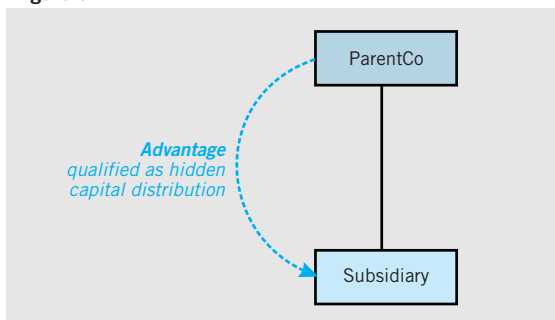
At the level of the shareholder, hidden dividend distributions may – if certain conditions are met – benefit from the Luxembourg participation exemption regime.⁴¹ Consequently, the Luxembourg tax treatment of hidden and regular dividend distributions is identical.

3. Hidden capital contributions

Contributions may be made in the form of regular contributions as provided for in the Luxembourg Commercial Law or in the form of hidden capital contributions. Luxembourg tax law provides for neither a legal definition of regular contributions, nor the concept of hidden capital contributions (*verdeckte Einlagen*).

Hidden capital contributions are advantages granted – motivated by the shareholding relationship – by a shareholder (or a related party of the shareholder) to a company. Should an unrelated party not have granted the same advantage, it is considered that the advantage was motivated by the shareholding relationship (see Figure 9); in short, this criterion is verified with the arm's length principle.

Figure 9



Essential to the qualification as hidden capital contribution, those advantages must be mirrored in the company's balance sheet; leading to either an increase in assets or a decrease in liabilities. The advantages referred to above may also be contributed in the frame of regular capital contributions (in exchange for shares or in the share premium of the company). Thus, the concept of hidden capital contribution solely relates to those contributions that remain undisclosed in agreements entered into by the shareholder and the receiving company. These are considered 'hidden' to the extent that they relate to

contributions, though not necessarily labelled as such, that purport to shape an agreement entered into by unrelated parties (for example, a purchase agreement) while (partly) not determining a valuable consideration.

Crucially, services granted by the shareholder to the company without valuable consideration (*Nutzungseinlagen*) such as interest-free loans may not qualify as hidden capital contributions. Thus, only the assets themselves but not their use may be contributed to the company.

Regular contributions increase the company's share capital or share premium while remaining profit-neutral. In contrast, hidden capital contributions are often treated as income in the accounting profit and loss account. However, only income connected with the company's business activities should be subject to Luxembourg corporate income tax and municipal business tax. Therefore, an increase in the accounting profit that is related to – hidden capital – contributions must be deducted from the taxable basis of the company.⁴² Consequently, the Luxembourg tax treatment of regular and hidden capital contributions should correspond.

4. Adjustments based on Article 56 LITL

According to Article 56 LITL, the taxable income of a Luxembourg resident taxpayer may be adjusted by a tax official appointed by the tax director where it has been decreased due to a 'special economic relationship' – be it directly or indirectly – with a Luxembourg non-resident taxpayer. In other words, the taxable income of a resident taxpayer may be increased in order to reflect arm's length conditions in certain transactions between related parties.

Different from hidden dividend distributions, Article 56 LITL only aims at increasing the taxable income while the advantage itself is not considered dividend income⁴³ subject to Luxembourg withholding tax. Furthermore, Article 56 is solely applicable in case the beneficiary of the advantages is a Luxembourg non-resident taxpayer whereas Article 164 (3) LIR applies irrespective of the residence of the shareholder. Therefore, Article 56 LITL is debatable in an EU context as it contains potentially discriminatory provisions.

However, Article 56 should only apply where tax adjustments may not be given effect on the basis of the concepts of hidden dividend distributions or hidden capital contributions. Therefore, the scope of Article 56 is in intra-group transactions limited to cases where a Luxembourg shareholder grants services without valuable consideration (e.g., interest-free loans) to foreign subsidiaries. Such transactions may not be qualified as hidden capital contributions as they are not reflected in the company's balance sheet. However, in practice Article 56 is seldom applied.

B. International tax law

Tax adjustments according to Luxembourg domestic tax law may be restricted by applicable tax treaties. Most tax treaties of Luxembourg's treaty network follow the OECD Model Convention treaty ("OECD-MC").

1. Taxation of associated enterprises

Whereas profits derived by an enterprise are in principle exclusively taxable in the contracting state of residence (Article 7 (1) OECD-MC), Article 9 (1) OECD-MC provides – under certain conditions – for the possibility to perform profit adjustments on the basis of the arm's length principle. Article 9 (1) OECD-MC allows the state of residence to depart from these general rules by adjusting the profits accruing to a domestic enterprise associated with a foreign enterprise, to the extent that the business profits concerned were affected by (commercial) terms and conditions differing from those that would have been made between unrelated enterprises.

Notably, Article 9 OECD-MC does not create any legal basis for a rewriting of accounts but solely restricts domestic law to the extent that the latter provides for profit adjustments between associated enterprises beyond those permissible under the arm's length rule. The application of Article 9 OECD-MC is not conditional to the enterprises wilfully attempting to avoid tax.

Crucially, while the legal form in which the enterprise is organised is irrelevant, Article 9 OECD-MC remains inapplicable where one or both parties to a business relationship fail to carry on an enterprise or the income concerned is not classified as business income.

2. Interest and royalties

With regards to interest and royalties, Articles 11 (6) and 12 (4) OECD-MC take precedence over Article 9 OECD-MC. According to these provisions, the application of the (distributive) tax treaty rules relating to interest⁴⁴ and royalties⁴⁵ is restricted to the amount considered not to be excessive as a result of a 'special relationship' between the parties. The term 'special relationship' is wider than the criteria generating an association of enterprises under Article 9 OECD-MC.

Both aforementioned provisions solely apply, however, to 'excessive' interest or royalties. Consequently, an adjustment of interest or royalty payments below the arm's length price is permissible only if the conditions of Article 9 OECD-MC are met.

3. Non-discrimination rules

The non-discrimination principle laid down in Article 24 OECD-MC is also applicable to associated enterprises.⁴⁶ According to Article 24 (5) OECD-MC, interest, royalties, and other disbursements paid to residents of the other contracting state shall be deductible under the same conditions as if they had been paid to a resident enterprise. The same rule shall fur-

ther apply with regards to the deductibility of debts when determining taxable capital (for net wealth tax purposes).

The legal basis for tax adjustments and for the deductibility of expenses lies – even in the context of a tax treaty – exclusively with domestic tax law. Tax adjustments relating to the profits of enterprises controlled by an enterprise of the other contracting state are, however, restricted twofold; firstly to the arm's length criterion under Article 9 OECD-MC, secondly to eventually more restrictive adjustments rules applied – within the limits of the arm's length principle – to domestically controlled enterprises.⁴⁷

4. The relation between treaty rules and domestic tax law

The relationship between treaty rules corresponding to Article 9 OECD-MC and domestic tax law is characterised by the fact that tax treaties merely restrict, rather than generate, domestic tax law. Therefore, Article 9 OECD-MC cannot serve as a legal basis for Luxembourg tax adjustments.

Accordingly, profit adjustments between associated enterprises may only be based on Luxembourg domestic tax law. Should domestic provisions not be applicable, Luxembourg has no possibility to adjust the taxable income of resident companies. On the contrary, Article 9 OECD-MC may restrict adjustments according to domestic tax law.

C. Dispute settlement

1. Domestic dispute settlement process

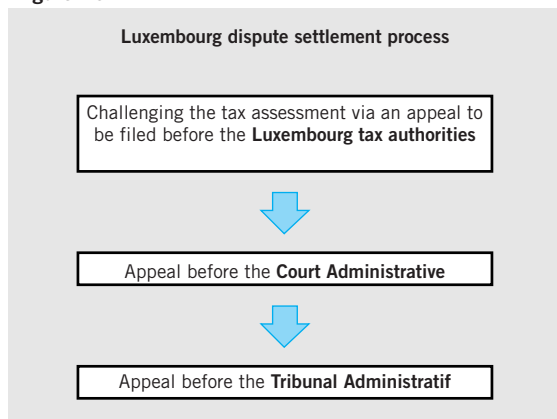
The tax assessment procedure relating to corporate tax returns is closed with the assessment of corporate income tax, municipal business tax and net wealth tax to be paid by the Luxembourg companies.⁴⁸ Such tax assessment may either consider the statements given in the corporate tax return or be based on modified assumptions (e.g., adjusted transfer prices). Should the taxpayer not agree with a certain tax assessment, he may challenge it via filing an appeal with the Luxembourg tax authorities within three months following its receipt.⁴⁹

The appeal has to define the claimant, the relevant tax assessment and the extent to which it is challenged.⁵⁰ It is recommended to file an appeal in writing though it is alternatively possible to put it on record at the tax authorities' offices by fax or by phone.⁵¹ Furthermore, the taxpayer should specify which aspects he challenges and, importantly, provide sufficient documentary evidence.⁵² The Luxembourg tax authorities are obliged to review the appeal.⁵³ Crucially, filing an appeal does not suspend the effect of the tax assessment.⁵⁴

Should a taxpayer disagree with the appeal decision of the Luxembourg tax authorities, he may challenge such decisions by filing an appeal before the Luxembourg Administrative Court. As a measure of last resort, the taxpayer may file an appeal against the de-

cision of the Administrative Court before the Administrative Tribunal, illustrated in Figure 10.

Figure 10



2. Double tax treaties

According to Article 9 (2) OECD-MC, the increase in profits in one contracting state shall be balanced by a corresponding change in the other contracting state ('matching adjustment'). Thereby it is the only treaty provision designed to avoid economic double taxation (taxation of the same taxable income in both contracting states in the hands of different persons that economically constitute one entity). The only possible generating factor for a matching adjustment is a profit adjustment between associated enterprises within the meaning of Article 9 (1) OECD-MC.

On the contrary, Articles 23 A and 23 B OECD-MC aim at avoiding double taxation in the hands of the same person (so-called 'legal double taxation'); they may therefore not be considered a supplementary means in cases where Article 9 (2) OECD-MC applies.

While the contracting state making an adjustment under Article 9 (1) OECD-MC implements a measure against a resident enterprise based on its own domestic law, a matching adjustment according to Article 9 (2) OECD-MC requires consensus between the two contracting states with regards to both the circumstances justifying the profit adjustment and the appropriate amount thereof (i.e., the arm's length price). Hence, the other contracting state is only committed to make a matching adjustment where the two contracting states come to the conclusion that the initial adjustment was justified.

A matching adjustment becomes necessary whenever the result of the initial adjustment is sustained. Should the contracting State that made the initial adjustment adhere to its measure without the approval of the other contracting state, the latter will refuse a matching adjustment and therefore economic double taxation will continue.

In order to reach a consensus, the competent authorities of the contracting states shall if necessary consult each other in the frame of a mutual agreement procedure under Article 25 OECD-MC. The obligation to make a matching adjustment under Article 9 (2) OECD-MC is conditional to a consensus reached on

the adjustment. However, no obligation to realise such a condition can be gleaned from the text of the provision.

It follows that the contracting states involved will not easily agree on matching adjustments to their disadvantage. Therefore, in order to avoid long-lasting procedures, risks pertaining to transfer pricing should be mitigated as far as possible.

3. EU Arbitration Convention

The EU Arbitration convention relating to transfer pricing is designed to apply in situations where profits are taxed in two EU Member States as a result of tax adjustments made in non-arm's length transactions. The convention further provides for relief in case losses are disallowed twice.

Businesses that can benefit from the Convention are those that constitute 'an enterprise of a contracting state,' including permanent establishments. Further, the Convention does not only apply to corporations but also to other forms of business that are subject to tax on profits.

Should double taxation not be eliminated between the two countries concerned, the remaining provisions of the Convention may be used to provide relief.

IV. Conclusion

Tax authorities around the world are increasingly aware that the transfer pricing of transactions between connected parties can affect their tax yield, particularly where the parties to a transaction are subject to different tax rules and rates.

Currently, the bulk of relevant Luxembourg tax legislation may be less far-reaching than in other jurisdictions in cases of international transfer pricing transactions. The current economic downturn could, however, incite the Luxembourg tax authorities to undertake more stringent transfer pricing reviews. The importance of compliance with documentation requirements for the avoidance of a reversal in the burden of proof thereby cannot be understated.

Ultimately, and all the more amid the financial turmoil, the filing of an advance pricing agreement before the Luxembourg tax authorities remains a virtually unrivalled shield for security and flexibility in transfer pricing matters.

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NOTES

¹ OECD, Discussion Draft on the Transfer Pricing Aspects of Business Restructurings of 19.9.2008.

² BFH, Decision of 17.10.2001, I R 103/00, BStBl II 2004, p. 171.

³ On 25 January 2008, the OECD issued a discussion draft on the use of transactional profit methods. Whereas in the current OECD Transfer Pricing Guidelines the transactional profit methods are considered as methods of 'last resort', the discussion draft considers elevating them to globally acceptable methods.

- ⁴ Circulaire LIR No. 164/1 of 23.3.1998; Cour administrative, Decision of 21.1.2008, 23053C.
- ⁵ RFH, Decision of 19.9.1933, I A 272/31, RStBl 1933, p. 1220; RFH, Decision of 30.8.1938, I 271/38, RStBl 1938, p. 901; RFH, Decision of 30.8.1938, I 272/38, RStBl 1938, p. 902; RFH, Decision of 29.9.1942, I 129/42, RStBl 1942, p. 1075; BFH, Decision of 7.11.1950, I 20/50 U, BStBl III 1951, p. 12; BFH, Decision of 20.8.1954, I 130/53 U, BStBl III 1954, p. 336; BFH, Decision of 11.10.1955, I 117/54 U, BStBl III 1956, p. 11; BFH, Decision of 20.3.1956, I 178/55 U, BStBl III 1956, p. 179; BFH, Decision of 28.10.1964, I 198/62 U, BStBl III 1965, p. 119; BFH, Decision of 10.12.1975, I R 135/74, BStBl II 1976, p. 226.
- ⁶ Article 164 (3) LITL, Article 97 (1) No. 1 LITL in connection with Article 146 (1) No. 1 LITL.
- ⁷ See Warner, Philip J.: „Luxembourg in international tax planning”, IBFD 2004, p. 271.
- ⁸ See Winandy, Jean-Pierre: „Fiscalité et comptes annuels des entreprises”, Portalis Editions 2005, p. 535; BFH, Decision of 15.5.1953, III 103/52 S, BStBl III 1953, p. 208; Döllerer, Georg: „Verdeckte Gewinnausschüttungen und verdeckte Einlagen bei Kapitalgesellschaften”, 2nd Edition, Verlag Recht und Wirtschaft GmbH, Heidelberg 1990.
- ⁹ RFH, Decision of 19.9.1933, I A 272/31, RStBl 1933, p. 1220; RFH, Decision of 30.8.1938, I 271/38, RStBl 1938, p. 901; RFH, Decision of 30.8.1938, I 272/38, RStBl 1938, p. 902; RFH, Decision of 29.9.1942, I 129/42, RStBl 1942, p. 1075; BFH, Decision of 7.11.1950, I 20/50 U, BStBl III 1951, p. 12; BFH, Decision of 20.8.1954, I 130/53 U, BStBl III 1954, p. 336; BFH, Decision of 11.10.1955, I 117/54 U, BStBl III 1956, p. 11; BFH, Decision of 20.3.1956, I 178/55 U, BStBl III 1956, p. 179; BFH, Decision of 13.1.1959, I 44/57 U, BStBl III 1959, p. 197; BFH, Decision of 28.10.1964, I 198/62 U, BStBl III 1965, p. 119; BFH, Decision of 10.12.1975, I R 135/74, BStBl II 1976, p. 226.
- ¹⁰ Article 27 (1) LITL, § 10 (1) Bewertungsgesetz.
- ¹¹ § 13 (2) Bewertungsgesetz in connection with § 69 - 72 Bewertungsgesetz; see Lauterbour, Paul: „Etudes fiscales – Evaluation des biens” (1980), p. 246.
- ¹² § 160 Abgabenordnung.
- ¹³ § 208 Abgabenordnung.
- ¹⁴ § 162 (8) Abgabenordnung.
- ¹⁵ § 208 Abgabenordnung; BFH, BStBl III 1956, p. 82.
- ¹⁶ § 169 Abgabenordnung.
- ¹⁷ RFH, Decision of 24.12.21, Kartei AO § 205 R. 2; RFH, Decision of 23.1.35, RStBl 1935, p. 306; BFH, Decision of 13.7.1962, BStBl III 1962, p. 428.
- ¹⁸ On 17 December 2008, the Luxembourg Chamber of Representatives gave assent to a law permitting the direct tax authorities to assess the amount of tax due by Luxembourg companies on the basis of the corporate tax returns filed, without the requirement of a previous review of the latter. Importantly, the tax authorities may verify the tax returns including transfer pricing afterwards and readjust –if necessary– the taxable basis. A tax assessment becomes, however, fully definitive after a five-year period.
- ¹⁹ § 162 (10), (11) Abgabenordnung.
- ²⁰ § 144 (1) Abgabenordnung (the period is extended to ten years in case of tax fraud); departing from the general rule, § 145 (2) No. 1 Abgabenordnung stipulates that the five-year period starts at the latest three years following the year-end in which the tax was due.
- ²¹ § 167 (3), (4) Abgabenordnung.
- ²² § 168 (2) Abgabenordnung; such penalty is according to Article 12 No. 4 LITL not deductible for Luxembourg tax purposes.
- ²³ § 202 (1) Abgabenordnung; such penalty is according to Article 12 No. 4 LITL not deductible for Luxembourg tax purposes.
- ²⁴ Article 155 LITL.
- ²⁵ § 204 Abgabenordnung.
- ²⁶ § 205 (2) Abgabenordnung and § 171 Abgabenordnung, respectively.
- ²⁷ § 205 Abgabenordnung; Court Administrative, Decision of 15.2.2000, No. 11578C.
- ²⁸ § 171 and § 174 Abgabenordnung.
- ²⁹ § 175 Abgabenordnung.
- ³⁰ § 205 (3) Abgabenordnung.
- ³¹ § 217 (1) Abgabenordnung.
- ³² Article 59 of the Law of 21 June 1999.
- ³³ BFH, Decision of 26.8.1993, I B 25/93, BFH/NV 1994, p. 268.
- ³⁴ BFH, Decision of 12.7.1962, BStBl III, p. 522.
- ³⁵ RFH, Decision of 23.1.1935, RStBl 306; BFH, Decision of 13.7.1962, BStBl III 428.
- ³⁶ Article 159 LITL.
- ³⁷ § 205a (2), (3) Abgabenordnung, Court Administrative, Decision of 6.11.2007, No. 23068C.
- ³⁸ According to Article 164 (3) LITL, hidden dividend distributions are considered where a shareholder receives –directly or indirectly– an advantage from the company due to his capacity as shareholder.
- ³⁹ Article 146 (1) No. 1 LITL in connection with Article 148 (1) LITL.
- ⁴⁰ Article 147 LITL.
- ⁴¹ Article 166 LITL.
- ⁴² Article 18 (1) LITL.
- ⁴³ Income within the meaning of Article 97 (1) No. 1 LITL.
- ⁴⁴ Article 11 OECD-MC.
- ⁴⁵ Article 12 OECD-MC.
- ⁴⁶ Article 24 (2) (b) OECD-MC.
- ⁴⁷ Article 24 (6) OECD-MC.
- ⁴⁸ § 210 Abgabenordnung.
- ⁴⁹ § 328 (2) first sentence Abgabenordnung in connection with § 236 (1) Abgabenordnung.
- ⁵⁰ § 238 (1), (3) Abgabenordnung.
- ⁵¹ § 238 (1) Abgabenordnung.
- ⁵² § 238 (3) Abgabenordnung.
- ⁵³ § 246 Abgabenordnung in connection with § 204 Abgabenordnung.
- ⁵⁴ § 242 (1) Abgabenordnung.