

### NEW CIRCULAR N°56/1 – 56BIS/1 ON THE TAX TREATMENT OF COMPANIES ENGAGED IN INTRA-GROUP FINANCING TRANSACTIONS

*Following the introduction of the new article 56bis LIR which lays down the basic principles that a transfer pricing analysis must comply with OECD Transfer Pricing Guidelines and actions 8-10 of the BEPS Action Plan, the Luxembourg Tax Authorities have published on 27 December 2016 the new Transfer Pricing Circular (the Circular) clarifying the Transfer Pricing rules for companies engaged in intra-group financing transactions (“Circulaire du directeur des contributions L.I.R. n° 56/1 – 56bis/1 du 27 décembre 2016”) and replacing the 2011 Transfer Pricing Circulars.*

#### **Definition of intra-group financing transactions**

According to the Circular, intra-group financing activities basically comprise all cases where a Luxembourg company provides interest bearing financing to related companies financed out of financial instruments like shareholder loans, bank loans, cash advances or public offerings.

#### **Comparability analysis**

The Circular states that the comparability analysis is the basis for the arm’s length principle’ application and this analysis should be carried out as follows:

- An identification of the commercial and financial relations between affiliated enterprises and determination of the significant economic circumstances of those relations to clearly define the scope of the controlled transaction; and
- A comparison of the conditions and the economically significant circumstances applicable between controlled entities with those applicable under comparable transactions entered into by non-related parties.

The comparability analysis entails a (i) functional analysis to identify the activities, liabilities, the significant economic functions, the assets used and risks assumed by each party involved in the transaction and (ii) a risk analysis to ensure that the financing company has sufficient equity in relation to its functions (in line with the risks assumed).

Should the comparability analysis conclude that a controlled transaction would not have been entered into by non-related parties under the same conditions, such controlled transaction should be disregarded.

#### **Equity at risk**

The previous circular considered a minimum amount of equity at risk equal to the lower of either 1% of the intra-group financing amount or EUR 2 million as “safe harbor”. Under the new Circular, the appropriate amount of equity at risk should be determined on a case by case basis. Intra-group financing companies that can be compared to regulated financial undertakings are considered to have

sufficient equity if they meet the solvability requirements as set out in EU Regulation 575/2013 (Basel III) on prudential requirements for credit institutions and investment firms (a regulated financial undertaking). A typical Luxembourg financing company does not seem to be comparable to credit institutions or investment firms. In such case, a different methodology should be used to determine the equity at risk (the new Circular does not further elaborate on the methodology to be used, however, a model such as LossCalc may be acceptable and typically results in a lower equity at risk level than under Basel III).

The risk as such should be controlled and managed by the Luxembourg financing company. In order to substantiate that the Luxembourg financing company controls these risks, the following minimum substance requirements should be met pursuant to the Circular:

- key decisions should be taken in Luxembourg;
- the company should have qualified personnel which can manage and control the transactions carried out (under the 2011 Circulars, it was sufficient that the group as such had qualified personnel, however, under the new Circular, it seems the Luxembourg financing company must have the personnel on its pay roll);
- the company should have a majority of Luxembourg resident board members;
- at least one annual shareholder meeting should be held in Luxembourg; and
- the company should not be tax resident in another jurisdiction.

To summarize the above, the financing company needs to have the financial capacity to assume risks and the ability to control and manage such risks.

### Safe harbors

The following safe harbors are provided for in the new Circular:

- An after-tax return on equity of 10% could reflect an arm's length compensation for financing and treasury functions for companies with a functional profile similar to that of a regulated financial undertaking. This percentage will be regularly reviewed and updated by the Luxembourg direct tax authorities. As mentioned above, a typical Luxembourg financing company does not seem to be comparable to a regulated financial undertaking.
- For intra-group financing companies performing a pure intermediary activity, transactions will be considered to respect the arm's length principle if a minimum after-tax return of 2% on the amount of the financing activity is reported (the so-called simplified regime). There is no definition of intermediary activities in the Circular). Companies opting for the simplified regime will be subject to exchange of information.

### APAs/rulings

It is still possible to file an Advance Pricing Agreement (APA) with the Luxembourg tax authorities. The

Circular lists the following information which must be included, in addition to the information which already had to be provided by the law, in the APA:

- the qualification and functions of relevant employees;
- the countries affected by the financing transactions;
- information on the parties involved in the controlled transaction; and
- a detailed transfer pricing analysis.

The Circular furthermore states that all rulings and other individual administrative decisions “in relation to the arm’s length principle” will no longer be binding on the Luxembourg tax authorities as from 1 January 2017 for tax years starting after 2016. Presumably, this only refers to APAs, however, this is not specifically stated as such. For what it’s worth, the legal basis for this comment is unclear as the APAs are approved on the basis of existing laws and regulations which cannot simply be set aside by the new Circular.

### Going forward

The new Circular will have an immediate impact on the equity at risk level maintained by Luxembourg financing companies engaged in an intra-group financing activity.

As most Luxembourg financing companies are arguably not comparable to regulated undertakings, it does not seem appropriate in these cases to use Basel III as basis to determine the appropriate level of equity at risk. Other methods (LossCalc) may be more appropriate in this respect and will typically result in a lower equity at risk level.

Furthermore, the simplified regime seems to result in a higher tax burden than what typically has to be reported if a transfer pricing analysis is performed. As such, it seems advisable not to opt for the simplified regime, however, to perform a transfer pricing analysis to determine the appropriate arm’s length margin on the relevant financing activity.

HVK Stevens is more than happy to assist clients in performing the Transfer Pricing analysis and to further assess the impact of the new Circular on existing and new intra-group financing structures.

Should you wish to learn more about this subject, please contact:

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