Circular L.I.R. n° 164/2 – Tax Treatment of Entities Carrying Out Intra-Group Financing Activities

Circular issued by the Luxembourg direct tax authorities
Luxembourg Income Tax Law (LITL) 164/2 dated 28 January 2011*

1. Definitions
Entities carrying out intra-group funding activities ("group finance companies") should be taken to refer to entities which principally conduct intra-group financing transactions. For the purpose of the previous sentence, activities related to the holding of participations are not taken into consideration.

The term “intra-group funding transactions” should be taken to refer to any activity consisting of granting loans or cash advances to related companies, refinanced by funds and financial instruments such as public offerings, private loans, cash advances or bank loans.

Two enterprises are deemed to be related where one enterprise participates directly or indirectly in the management, control, or in the share capital of the other; or if the same persons participate directly or indirectly in the management or in the share capital of both enterprises.

2. General Information
The arm’s length principle, as set forth in Article 9 of the OECD Model Tax Convention, is the internationally accepted principle that OECD member countries have agreed must be used for the determination of transfer prices between related entities conducting cross-border transactions. In order to ensure the implementation of this principle, the OECD has developed regularly updated guidelines on the use of the arm’s length principle which are to be observed by multinational companies, and by tax authorities for the determination of transfer prices between related enterprises carrying out cross-border transactions.

Under Article 164 (3) of the Luxembourg Income Tax Law (LITL), a hidden profit distribution arises when a shareholder, a member or an interested party receives, either directly or indirectly, an advantage from a company or an association which he normally would not have received had he not been a shareholder, a member or an interested party. This article provides that such a profit distribution is to be included in the taxable base of the company or association, and establishes the arm’s length principle in domestic law.

An intra-group service (including an intra-group funding transaction) has been rendered if, in comparable circumstances, an independent enterprise would have been willing to pay another independent enterprise for such activity, or if it would have performed such activity itself. Where an intra-group service has been rendered, as for other types of intra-group transfers, one should ascertain whether an arm’s length price is charged for such service, i.e. a price corresponding to the price which would have been charged and agreed to by independent enterprises in comparable circumstances.

In order to determine whether transactions between independent enterprises are comparable to transactions between related enterprises, a comparability analysis must be conducted. Characteristics of “comparability factors” which might be important for the evaluation of the degree of comparability include the characteristics of the goods or services being transferred, the functions performed by the parties involved, the terms and conditions of the contract, the economic circumstances of the parties and the business strategies pursued by those parties.

In general, the remuneration of each enterprise which is party to a given transaction corresponds to the functions it performs (taking into account assets used and risks borne). Thus, it is important to identify and compare economically significant activities and responsibilities as well as the assets used and risks assumed by the parties to the transactions. Therefore, it is often useful to understand the structure and organization of the group to which the related enterprises belong.

In accordance with paragraph 171 of the General Tax Code (“Abgabenordnung” / “loi générale des impôts”), taxpayers must be in a position to support the data presented in their tax returns, including the transfer pricing of controlled transactions, i.e. transactions between related enterprises.

3. Determination of the arm’s length price in the hands of intra-group finance companies
As regards intra-group finance companies, the functions that they perform when they grant loans to group entities are, in substance, comparable to the functions performed by independent financial institutions subject to the supervision of the Commission de Surveillance du Secteur Financier (CSSF’). In this case, the arm’s length


1. Editor’s note: CSSF is Luxembourg’s financial regulatory authority.
price for the functions performed (taking into account the assets used and risks borne) should be based on the price charged by those financial institutions for comparable credit transactions.

Before granting a loan or a cash advance, financial institutions perform an analysis of the risks incurred. As part of their analysis, notably they review the financial statements of the borrower in order to evaluate the financial risk related to the transaction. They verify the existence of guarantees, and examine the purpose of the loan, as well as its term, in order to evaluate borrower risk. An analysis of the industry sector in which the borrower operates enables the lender to evaluate borrower risk. Structural risk is calculated based on ratings provided by independent rating agencies.

Independent financial service providers determine the expenses relating to granting loans by applying additional charges to the base financing cost. Such additional costs take into account, among other things, additional expenses generated by solvency requirements, additional expenses related to credit risk, processing fees or additional expenses related to foreign exchange risk.

Credit risk is to be determined based on the terms and conditions of the loan agreement, and on the outcome of the risk analysis. The terms of the loan agreement may have an effect as to the degree of foreign exchange risk. In general, independent financial service providers set their price based either on the loan amount or on the actual market value of the assets under management.

The additional element related to solvency requirements may be based on the lender’s solvency or on the solvency of another group entity which acts as guarantor, as in the latter case, the guarantor’s capital is exposed to risk. In the former case, the additional cost is the arm’s length price for the capital that the lender must retain in order to be able to carry out the transaction. In the latter case, the enterprise which acts as guarantor would, in principle, receive remuneration for putting its equity at risk. The additional fee charged by the lender should at least correspond to the cost of the guarantee.

Following the example of independent service providers, intra-group finance companies should prepare a risk analysis before granting loans to a related undertaking. They should also take into consideration any other factor which may influence the determination of their transfer prices.

In this respect, it is clear that a group finance company must have sufficient equity in order to assume the risks connected with its business were those risks to materialize. Therefore, the nature and extent of the risks assumed, and whether the group finance company has the appropriate level of equity to assume such risks, must be determined based on the facts and circumstances of each individual case.

4. Information Which Is Binding on the Direct Tax Authorities

4.1. Principles

Apart from Article 27 of the Grand-Ducal Regulation dated 27 December 1974 (as amended) addressing the procedure for withholding taxes from wages and pensions, the direct tax authorities are not required to provide taxpayers or their agents with any information regarding specific cases which would be binding on the direct tax authorities as regards the tax that will be applied for one or more tax years.

Where group finance companies are concerned, information which is effectively binding on the direct tax authorities will be provided only if the companies concerned have real substance in Luxembourg and if they assume the risks in connection with the granting of loans.

A group finance company will be considered to have real substance in Luxembourg if notably it satisfies all of the following requirements:

- A majority of the members of the board, the directors or managers who have the authority to bind the group finance company are either Luxembourg residents, or non-residents who carry on a professional activity in Luxembourg falling under the scope of Article 10 (1 to 4) of the LITL, and who are liable to tax in Luxembourg on at least 50 per cent of that aggregate 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.

- Board members, directors and managers who live in Luxembourg or derive at least 50 per cent of the aggregate income referred to above from Luxembourg (for individuals), or who have their registered office and central administration in Luxembourg (for corporate entities), need to have the professional knowledge required to fulfil their duties. Furthermore, they must at least have the authority to bind or otherwise incur liability for the company and to ensure that all transactions are properly executed. The group finance company must have qualified personnel (being either the company’s own employees or outside personnel) capable of executing and recording the transactions being carried out. The company must be capable of supervising the work performed by such personnel.

- Key decisions concerning the company’s management must be made in Luxembourg. In addition, for entities for which the Company Law requires the holding of general shareholders’ meetings, at least one meeting per year must be held at the place specified in the articles of association.

Art. 10 LITL:

The following shall be taken into consideration only for the determination of total net income within the meaning of Article 7 (2):

1. commercial profit;
2. profit from agricultural and forestry sources;
3. profit from the practice of a profession;
4. net income from employment;
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The group finance company must have at least one bank account in its own name either at a financial institution established in Luxembourg, or at a Luxembourg branch of a financial institution registered outside Luxembourg.

When the company submits a request for information which is effectively binding on the tax authorities, it must have met all its filing requirements. This applies to returns relating to taxes applied and collected by the direct tax authorities.

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

The company should maintain an adequate level of equity with regard to the functions performed (taking into account assets used and risks assumed).

In general, a group finance company will be considered to assume the risks related to granting loans if its equity is at least equal to either 1 per cent of the nominal value of the loan(s) granted or EUR 2 million. Specifically, a group finance company is considered to assume the risks related to its lending activity, so long as it is able to demonstrate that it is effectively required to use its equity if the risks associated with the transactions materialize.

4.2. Content of the request for information which is effectively binding on the direct tax authorities in terms of transfer pricing in the context of a group finance company

Depending on the facts and circumstances of each individual case, all requests for information should at least include the following information:

1. specific information on the requestor (name, domicile, file number if available) and on the entities or branches which are party to the transactions or arrangements referred to in the request;
2. a detailed description of the transactions, arrangements or legal acts referred to in the request, including the background and purpose of the legal position taken by the requestor;
3. any other country or countries affected by such transactions or arrangements;
4. a presentation of the group’s legal structure, including information concerning the beneficial owner of the requestor’s capital;
5. the tax years to be covered by the request;
6. a transfer pricing report in line with OECD Transfer Pricing Guidelines and notably including a detailed description of the proposed methodology, as well as detailed information and analysis in support of this methodology, including, for instance, an identification of comparables and the expected range of results;
7. a general description of market conditions;
8. a review of any pertinent ancillary tax issues raised by the proposed methodology;
9. the requestor must confirm that the information needed to assess the facts is complete and truthful.

4.3. Validity period

Where the direct tax authorities respond to a request for transfer pricing information from group finance companies, how long the authorities’ decision is valid will depend on the facts and circumstances of each individual case. However, the decision by the relevant tax office will not be binding upon the direct tax authorities for a period exceeding five (5) tax years. At the end of this period, the relevant tax office will decide, when a request has been submitted by the company, whether a new decision can be given under the same conditions. That new decision cannot bind the direct tax authorities for more than another period of five (5) tax years.

Based on the good faith principle, the decision shall be binding on the direct tax authorities for the period agreed, except where it appears that:

– the situation or the transactions described were incomplete or inaccurate,
– the key elements of the actual transactions differ from the description provided in the request,
– the decision is not in conformity with the provisions of international law.

The decision will no longer be enforceable if the legal provisions (domestic or international) on which it was based are modified, or if one of the key characteristics of any transaction is altered.

Luxembourg, 28 January 2011

Le Directeur des Contributions