1. Tax authority and law

The Luxembourg tax administration is the Administration des Contributions Directes (ACD). Luxembourg tax law does not provide for integrated transfer pricing legislation. Instead, transfer pricing adjustments aimed at restating arm’s length conditions can be made on the basis of different tax provisions and concepts applicable under Luxembourg domestic tax law.

The arm’s length principle is, however, firmly ingrained in Luxembourg tax law and explicitly stated in article 56 of the Luxembourg Income Tax Law (LITL). Article 56 of the LITL does not only serve as a legal basis for upward adjustments but also for downward adjustments when a Luxembourg company receives an advantage from an associate enterprise. In addition, the concepts of hidden dividend distributions (article 164(3) of the LITL) and hidden capital contributions (article 18(1) of the LITL) play a vital role in ensuring that associated enterprises adhere to the arm’s length standard.

Luxembourg is a member of the OECD and the ACD adheres to the organization’s Transfer Pricing Guidelines which reflect the consensus of OECD Member countries towards the application of the arm’s length principle as provided in article 9(1) of the OECD Model Tax Convention. Furthermore, article 9 of the OECD Model Tax Convention is generally used in the tax treaties that Luxembourg concludes with other states.

2. Regulations and rulings

2.1. Regulations, rulings and guidelines

In addition to article 56 of the LITL, the concepts of hidden dividend distributions and hidden capital contributions are cornerstones of Luxembourg’s transfer pricing rules.

On 28 January 2011, the Luxembourg tax authorities issued a Circular on the tax treatment of companies carrying out intra-group financing activities. Under this transfer pricing regime, Luxembourg finance companies are required to have genuine substance, run economic risks and report an arm’s length remuneration on their financing activities in conformity with the OECD Transfer Pricing Guidelines.
Guidelines. The arm’s length margin should generally be documented in a transfer pricing study.

2.2. Arm’s length principle

Even before the amendment of article 56 of the LITL (as from 1 January 2015), Luxembourg companies had to comply with the arm’s length principle. However, the new version of article 56 of the LITL formalizes the application of the arm’s length principle under Luxembourg tax law.

Article 56 of the LITL provides a legal basis for upward and downward adjustments where the terms and conditions agreed between associated enterprises deviate from what third parties would have agreed upon.

Where a Luxembourg company shifts an advantage to its shareholder, such advantage may be classified as a hidden dividend distribution. Hidden dividend distributions bear the following characteristics:

– there is a decrease (or averted increase) in the company’s net equity;
– it is motivated by the shareholding relationship;
– it impacts the company’s taxable income (i.e. either in the form of expenses or income that has been abandoned); or
– it is not a regular dividend distribution (under Luxembourg commercial law).

Hidden dividend distributions may not decrease a company’s taxable income and are subject to Luxembourg withholding tax at a standard rate of 15%, unless a domestic tax exemption or a reduced (or zero) withholding tax rate applies under a tax treaty concluded by Luxembourg.

In contrast, where a shareholder grants an advantage to a company, such advantage may be classified as a hidden capital contribution. Hidden capital contributions bear the following characteristics:

– they are granted by a shareholder or a related party of the shareholder;
– the grants are motivated by the shareholding relationship;
– there is an advantage to the company that may be reflected in the balance sheet (i.e. either an increase in assets or a decrease in liabilities insofar as the shareholder does not receive an arm’s length compensation); and
– the contribution is not a regular contribution (under Luxembourg commercial law).

Hidden capital contributions may require complex tax adjustments at the level of the company and the shareholder and need to be analysed on a case-by-case basis. In general, income realized accounting-wise by the company in relation to the hidden capital contribution should be excluded from the company’s taxable income. At the level of the shareholder, the book value of the participation in the company receiving the advantage should be increased by the fair market value of

5. In this regard, tax adjustments should be made in the company’s tax return.

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the contribution and deemed income corresponding to the amount of the hidden capital contribution should be considered when determining the taxable income.

Article 56 of the LITL and the concepts of hidden dividend distributions and hidden capital contributions operate independently of one another and may apply concurrently when controlled transactions do not comply with the arm’s length principle. In case of an overlap, however, the concepts of hidden dividend distributions and hidden capital contributions should take precedence over article 56 of the LITL. This is because the only tax consequence of article 56 of the LITL is an adjustment of the taxable income of the company (in order to restate arm’s length conditions), whereas the concepts of hidden dividend distributions and hidden capital contributions may require additional tax adjustments at the level of both the company and the shareholder.

Thus, the scope of article 56 of the LITL should be limited to cases where advantages shifted between related companies may not be classified as a hidden dividend distribution or a hidden capital contribution. Article 56 of the LITL may, for example, serve as a basis for downward adjustments in accordance with the arm’s length principle when a Luxembourg company receives an interest-free loan or free services from an associated company.

2.3. Meaning of control and associated persons

According to Article 56 of the LITL, enterprises are associated if:

- one enterprise participates, directly or indirectly, in the management, control or capital of another enterprise; or
- the same taxpayer participates, directly or indirectly, in the management, control or capital of two enterprises.

The ACD can apply transfer pricing adjustments in the case of vertical affiliation as well as in the case of horizontal affiliation. Moreover, article 56 of the LITL applies not only to entities subject to the LITL but also to foreign taxpayers with a permanent establishment in Luxembourg.

3. Methodologies

3.1. Prescribed methods

While there is no detailed guidance regarding the application of the arm’s length principle under Luxembourg tax law, the ACD relies on the OECD Transfer Pricing Guidelines and accepts the application of the following methods (where appropriate):

- comparable uncontrolled price (CUP) method;
- cost-plus method;
- resale price method;
- transactional net margin method (TNNM); and
- transactional profit split method.
3.2. Priority of methods
In accordance with the OECD Transfer Pricing Guidelines, the selected transfer pricing method should be the “most appropriate method” for a particular case. This implies that there is no single method considered suitable in every situation.

Traditional transaction methods are regarded as the most direct means of establishing whether the pricing of controlled transactions complies with the arm’s length principle. When a traditional transaction method and a transactional profit method can be applied in an “equally reliable manner”, the traditional transaction method is to be preferred. Moreover, the CUP method is preferred to another transfer pricing method where it can be applied in an “equally reliable manner”.

Different transfer pricing methods may provide different results when applied in practice. Therefore, taxpayers must select the method that provides the best estimate of an arm’s length price for a particular transaction. This, however, does not mean that all the transfer pricing methods should be analysed in depth or tested in each case when selecting the most appropriate method. Nevertheless, the ACD expects the taxpayer to substantiate the reason for selecting the chosen transfer pricing methodology.

4. Comparability analysis
4.1. Comparable data
In the absence of detailed guidance under Luxembourg tax law, the ACD will rely on Chapter III of the OECD Transfer Pricing Guidelines that provides guidance on comparability and the actual process of conducting a comparability analysis.

A comparability analysis involves two independent but related analytical steps:
– first, an examination of the economically significant characteristics of the controlled transaction and the respective roles of the parties to the controlled transaction; and
– second, a comparison between the conditions of the controlled transaction and the conditions of uncontrolled transactions taking place in comparable circumstances (i.e. comparable uncontrolled transactions).

Controlled and uncontrolled transactions are considered comparable if the economically relevant characteristics of the transactions being compared and the circumstances surrounding them are sufficiently similar to provide a reliable measure of an arm’s length result. The degree of comparability is typically determined on the basis of the following five comparability factors:
– characteristics of the property or services;
– functions performed by the parties to the transactions (taking into account assets used and risks assumed);
– terms and conditions of the contract;
– economic circumstances; and
– business strategies.
Controlled and uncontrolled transactions are comparable when:

- there are no differences between the transactions that would materially affect the price in the open market; or
- if there are material differences, reliable adjustments can be made to eliminate the material effects of such differences.

4.2. Foreign comparables

Given the size of Luxembourg, it will be difficult to base a comparability analysis on mere domestic comparables. Therefore, the ACD will generally accept pan-European comparables to the extent that the markets from which these comparables are derived are not completely different from the market conditions prevailing in Luxembourg.

4.3. Secret comparables

Luxembourg law does not make any reference to secret comparables.

4.4. Use of ranges

In line with the OECD Transfer Pricing Guidelines, the ACD accepts that transfer pricing is not an exact science. The application of a transfer pricing method commonly results in a range, rather than one arm’s length price.

When the comparability of comparables is high, all points in the range should be considered to be arm’s length. In contrast, when the comparability of comparables is low, the range should be narrowed down by means of using a statistical method (for example, the interquartile range).

5. Disclosure/documentation requirements

5.1. Tax return disclosures

In general, there is no requirement to provide the tax authorities with transfer pricing documentation when filing a tax return. Nevertheless, the tax authorities may request additional information or, as the case may be, transfer pricing documentation to substantiate the statements in relation to intra-group transactions in the corporate tax returns.

5.2. Transfer pricing documentation requirements

Article 171 of the General Tax Code (Abgabenordnung) is the basis for Luxembourg taxpayers’ duty to cooperate with the tax authorities. According to this provision, taxpayers are under an obligation to evidence facts and provide information, assuming the evidence is (i) available, (ii) reasonable for the taxpayer to have, and (iii) relevant for clarification purposes. Thus, in accordance with article 171 of the General Tax Code, the taxpayer merely has to obtain and to provide already existing documents, and does not have to prepare special transfer pricing documentation.
Article 171(3) of the General Tax Code explicitly extends a taxpayer’s duty of cooperation to transactions between associated enterprises although no specific transfer pricing documentation requirements are detailed therein. While the new provision is merely there for clarification purposes, it confirms that the Luxembourg tax authorities are increasingly relying on transfer pricing documentation. In this regard, Chapter V of the OECD Transfer Pricing Guidelines provides useful guidance for what documentation should reasonably be produced.

Transfer pricing inevitably exerts pressure on taxpayers to find a balance between a comfortable level of security and the costs of preparation of sound transfer pricing documentation. In practice, Luxembourg companies should screen major intra-group transactions in order to identify issues that could raise suspicion on the part of the Luxembourg tax authorities and assess the magnitude of related tax risks.

Where the Luxembourg tax authorities can reasonably evidence that the transfer pricing of a controlled transaction does not adhere to the arm’s length principle, it is for the taxpayer to disproof this rebuttable presumption. However, transfer prices may be reviewed several years after a transaction takes place which, from a practical perspective, makes it increasingly difficult to trace back relevant facts and circumstances of the transaction as well as data on comparable transactions. This evidently exerts pressure on Luxembourg companies to develop appropriate transfer pricing policies for risk mitigation purposes amid an international tax environment that elevates transparency in tax matters to a new level.

Sound transfer pricing documentation may also be necessary in order to justify the value of a hidden capital contribution or a downward adjustment under article 56 of the LITL. Moreover, the Luxembourg tax authorities may require transfer pricing documentation when a company files a request for advance certainty (advance tax clearance or advance pricing agreement).

In the case of cross-border transactions, foreign tax authorities may be more demanding in terms of transfer pricing documentation than their domestic counterparts. In these circumstances, the Luxembourg tax authorities generally accept transfer pricing documentation prepared for foreign tax purposes as long as the documentation is based on the OECD Transfer Pricing Guidelines.

It is expected that the ACD will issue a Circular in the second half of 2015 in order to provide guidance on transfer pricing documentation requirements.

5.3. Other disclosures

There is currently no legal obligation to update transfer pricing documentation within a certain period of time. It is, however, highly recommended to perform periodic reviews of the facts and circumstances on which transfer pricing documentation is based (for example, as part of the preparation of the corporate tax returns) in order to ensure that it still reflects the reality.
6. Mutual agreement procedures (MAPs)

While Luxembourg has not implemented any specific legislation or guidance on the application of MAPs, Luxembourg companies may rely on the remedies provided in tax treaties concluded by Luxembourg and, in an EU context, on the EU Arbitration Convention.

Article 25(1) of the OECD Model Convention (OECD-MC) grants taxpayers a right to raise issues relating to the appropriate application of a tax treaty with the competent authorities of their residence state. If that state is not able to satisfactorily resolve the issue, article 25(2) and (3) of the OECD-MC foresee that the two competent authorities will endeavour to reach a mutual agreement that eliminates the taxation which is asserted by the taxpayer not to be in accordance with the treaty (i.e. a “mutual agreement procedure”). Where unresolved issues have prevented the competent authorities from reaching a mutual agreement within 2 years, article 25(5) of the OECD-MC provides that the issues which are preventing them from reaching an accord will, at the request of the taxpayer who presented the case, be solved through an arbitration process. However, the arbitration provision provided for in paragraph 5 of article 25 of the OECD-MC has only been included in the 2008 update to the OECD-MC and is therefore not included in every bilateral tax treaty.

In an EU context, Luxembourg companies may further rely on the EU Arbitration Convention that establishes a two-phase procedure to resolve cases of international double taxation resulting from transfer pricing adjustments (i.e. upward adjustments). The scope of the EU Arbitration Convention is, however, restricted to transactions between enterprises of different Member States of the EU. The EU Arbitration Convention is not applicable in the case of non-EU enterprises even if they are doing business through a permanent establishment situated in one of the Member States.

The EU Arbitration Convention provides for mandatory arbitration in cases where Member States cannot reach mutual agreement on the elimination of double taxation within 2 years of the date on which the case was first submitted to one of the competent authorities of the Member States involved.

Following this 2-year period, an advisory commission is convened (by the competent authorities) which has to deliver an opinion within a 6-month period. Thereafter, the competent authorities may either adhere to the opinion of the advisory commission or benefit from an additional 6-month period to seek another agreement to eliminate double taxation. If the competent authorities do not reach an agreement within 6 months, they must conform to the opinion of the advisory commission.

7. Advance pricing agreements (APAs)

Luxembourg companies may request for advance certainty on the arm’s length nature of the terms and conditions agreed upon in transactions with associated enterprises. Since 1 January 2015, the rules regarding the APA process have been formalized.

The request for an APA must, in particular, include the following information:
- a detailed description of the taxpayer requesting the APA (name, address, tax number), as well as details of the other parties involved;
- a detailed description of the contemplated operation(s);
- a transfer pricing study including a functional analysis and an economic analysis with a benchmarking of the transaction under review; and
- a confirmation that the information provided to analyse the request is complete and accurate.

A fee ranging between EUR 3,000 and EUR 10,000 will be levied by the Luxembourg tax authorities for requests for advance certainty. The amount of the fee depends on the complexity of the APA request and the amount of work required. In the case of APAs, the fee should in general be at the upper end of the range. The fee is payable within a 1-month period.

The APA may be valid for a period of maximum 5 tax years to the extent that the facts and circumstances described in the request for the APA are accurate and remain in line with reality. Where Luxembourg, EU or international tax law is changing, the confirmation provided in the APA may quite naturally no longer be valid.

8. Safe harbour provisions

There are no safe harbour provisions in Luxembourg.

9. Transfer pricing audits

9.1. Burden of proof

Under Luxembourg tax law, the burden of proof is generally split between the taxpayer and the Luxembourg tax authorities. For facts and circumstances resulting in an increase in the taxpayer’s taxable income, the burden of proof is on the Luxembourg tax authorities, while the taxpayer has to prove those facts and circumstances that entail a reduction in the taxable income. Thus, with regard to the burden of proof in case of transfer pricing adjustments, upward and downward adjustments have to be distinguished.

Burden of proof in case of upward adjustments

The onus to prove that transactions do not adhere to the arm’s length principle is generally on the Luxembourg tax authorities. It is for the administration to verify whether transfer prices for goods and services transferred between group compa-
Luxembourg

nies adhere to the arm’s length criterion. If the tax authorities can prove that a transfer price is not within the range of arm’s length prices, this raises a rebuttable presumption that the transaction does not comply with the arm’s length principle. Overall, the burden of proof for the non-arm’s length character of intra-group transactions should be relatively low.

Although the burden of proof is on the tax authorities, they may still reasonably oblige a Luxembourg company to provide consistent arguments for its transfer pricing. In this regard, the company must take into consideration that the voluntary production of documents can significantly improve the persuasiveness of the company’s approach to transfer pricing before the tax authorities. If the taxpayer is unable to justify the arm’s length character of intra-group transactions, the tax authorities may rely on the concept of hidden dividend distributions or article 56 of the LITL to perform upward adjustments (article 217(1) of the General Tax Code).

Burden of proof in case of downward adjustments

In case of hidden capital contributions and “downward adjustments” under article 56 of the LITL, the fair market value of the advantage shifted to a Luxembourg company is deducted from the company’s taxable income. It follows that the underlying facts and circumstances regarding the advantage to be shifted to a Luxembourg company should be evidenced by the taxpayer. In certain circumstances, the Luxembourg tax authorities may reasonably require that the value of a hidden capital contribution or, respectively, the advantage that would result in a downward adjustment under article 56 of the LITL is substantiated in a transfer pricing study.

9.2. Statute of limitation

The time limit for the ACD to perform transfer pricing adjustments is closely linked to the tax assessment procedure. 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 Luxembourg companies. Such tax assessment may either be in line with the statements made in the corporate tax return or be based on modified assumptions (for example, adjusted transfer prices). The Luxembourg tax authorities are, however, entitled to issue a tax assessment notice based on the tax return filed by Luxembourg companies for acceleration of the assessment process, a procedure which is commonly applied by the Luxembourg tax authorities. In this case, the preliminary tax assessment notice is not final and may be amended within a 5-year time frame. The Luxembourg tax authorities are not required to provide the taxpayer with a final assessment upon request. It follows that the taxpayer will have to wait up to 5 years to be certain that the amount of taxes fixed temporarily will indeed be the definitive amount of tax liability.

In case of transfer pricing manipulations that amount to tax fraud, the ACD may perform tax adjustments within a 10-year period.
9.3. Desk and field audits

The ACD may perform tax audits in accordance with the General Tax Code. The focus of a tax audit is generally on the general tax position of a taxpayer. However, it may be expected that in future transfer pricing and related documentation will increasingly be the focus of such audits.

10. Penalties

No specific transfer pricing penalties apply in Luxembourg.