Revised Guidance on Intercompany Financing

On 27 December 2016, the Luxembourg tax authorities issued revised guidance on intra-group lending activities financed by borrowings. Circular L.I.R. 56/1-56bis/1 has been aligned with Actions 8 to 10 under the OECD BEPS Project and replaces the previous Circulars L.I.R. 164/2 and 164/2 bis from 28 January 2011 and 8 April 2011 respectively.

1. Introduction

At the end of 2016, new transfer pricing law was introduced and additional guidance was issued.

On 23 December 2016, a new article 56 bis of the Income Tax Law (Loi concernant l’impôt sur le revenu, ITL) was introduced. The new law includes general principles for conducting transfer pricing analysis derived from, amongst others, Actions 8 to 10 of the OECD BEPS Project. It covers the OECD principles by applying a comparability analysis to set and test transfer prices; providing for the selection of the transfer pricing method that best approximates arm’s length prices; and – notably – providing for a non-recognition measure. This non-recognition measure provides for the possibility of the Luxembourg tax authorities to disregard (part of) an intercompany transaction if there is a lack of commercial rationale. If applied, this measure could have an impact on the taxable result in Luxembourg. However, it has been clarified that this measure will be applied only in exceptional cases.

On 27 December 2016, the tax authorities issued revised guidance on intra-group lending activities financed by borrowings, namely L.I.R. 56/1-56bis/1 (the 2017 Circular). The guidance replaces the previous Circulars L.I.R. 164/2 and 164/2 bis from 28 January 2011 and 8 April 2011 (the 2011 Circular) respectively.

Both the new law and revised guidance are effective as from 1 January 2017.

This article describes the main impact and interpretation of the new guidance on intercompany financing in Luxembourg and makes a comparison with the common practice under the 2011 Circular.

2. Scope of the Circular

2.1. Transactions in scope

The 2011 Circular applied to entities that are “principally” engaged in intra-group financing activities. The term “intra-group financing activities” refers 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. As the scope was limited to entities “principally” engaged in intra-group financing activities, in practice the 2011 Circular applied only to companies for whom financing is their main activity.

Under the 2017 Circular, there is no longer a reference to “principally”. Consequently, the scope of the 2017 Circular is much broader and includes, in principle, any intercompany financing activity employed by Luxembourg companies, i.e. borrowing funds that are either directly or indirectly on-lent to related parties. Based on further discussions with the tax authorities, it is critical to consider the relative importance of the financing transactions in comparison to the total activities employed. Where the intercompany financing activities are not considered as material in comparison with the other activities performed by an entity, the 2017 Circular should not be applicable. Consequently, it should be analysed on a case-by-case basis whether the 2017 Circular applies. For cases where the 2017 Circular does not apply, the general transfer pricing provisions under the Income Tax Law will apply. In practice, this would imply that – apart from the formal substance requirements – the transfer pricing rules should be applied in a similar way to ensure that the intercompany transactions adhere to the arm’s length principle.

Furthermore, similarly as under the 2011 Circular, the scope of the 2017 Circular applies to financing obtained from related or third parties that are on-lent to related parties. Under both Circulars, if a Luxembourg company on-lends to a third party, the Circular is not applicable.

2.2. Related party

Regarding the related party criterion, both Circulars state as follows:

Pursuant to the provisions of article 56 of the ITL, two enterprises are considered related where one of the enterprises participates, directly or indirectly, in the management, control or capital of the other, or if the same persons participate, directly or indirectly, in the management, control, or capital of both enterprises.

Under the 2011 Circular, the focus on determining what constituted a related party was on the shareholding. Under the current practice, the related party criterion is deter-
minded based on management, control and capital. Thus, the OECD principles on the related party criterion are now more strictly applied.

2.3. Main requirements

The main requirements under the 2017 Circular are the same as under the 2011 Circular, namely focusing on substance, equity at risk and arm’s length compensation. However, the requirements under the 2017 Circular have been partly aligned with Actions 8 to 10 under the OECD BEPS Project (described in detail below).

3. Substance Requirements

3.1. Control of risks

In respect of a group financing company, the 2017 Circular focuses on the control of risk, stating as follows:

A group financing company controls risk if it has the decision-making power to enter into a risk-bearing commercial relationship, if it has the ability to deal with such risk, and if it actually performs such decision-making functions. A financing company can outsource daily risk-mitigation activities. It must, however, be able to determine the objectives of the activity outsourced, to decide to use the services of a risk-mitigating provider, to assess whether objectives are properly being met and, if necessary, to decide to amend or terminate the contract with the service provider and perform these functions itself.\(^5\)

3.2. Actual presence in Luxembourg

In order to control the risks, a group financing company must have an actual presence in Luxembourg. The substance requirements under the 2017 Circular deviate to some extent from the requirements under 2011 Circular. Three main conditions must now all be met. First:

The majority of members of the board of directors, directors or managers having the ability to bind the group financing company, are either residents or non-residents carrying out a professional activity in Luxembourg that falls within one of the first four categories of net income referred to in article 10 of the ITL and are taxable in Luxembourg on account of at least 50% of the total of such income. In a case where a member of the board of directors is a legal person, it must have its registered office and central administration in Luxembourg.\(^6\)

This implies active and qualified members of the board. The members of the board must be actively involved and included in the flow of information relating to the financing activities, i.e. from the moment of entering into a new financing activity, monitoring, and upon exit. Furthermore, the members of the board must have professional qualifications in terms of knowledge related to financing. It is expected that the activities of the members of the board will be closely monitored by the tax authorities. Such monitoring can take place through, for instance, functional interviews or requesting supporting documentation such as a curriculum vitae from each of the members of the board. Therefore, it is essential to verify the current governance of the board, and have supporting documentation in place to demonstrate the activities performed by the members of the board.

Second, the company must have personnel who are qualified to control the transactions performed.\(^7\) The company may nonetheless subcontract functions that do not have a significant impact on risk control. Key decisions concerning the management of the company must be taken in Luxembourg. In addition, for companies for which corporate law provides for general meetings, at least one general meeting per year must be held, in principle at the place indicated in the articles of association.

An adequate number of employees is required with regard to managing the financing activities on a daily basis. Although functions may be outsourced, it should be considered which functions should remain with the financing company. Generally, where there are more financing activities in terms of the number of financing arrangements or regular movements in positions, the adequate level of employees is expected to be higher. In line with the expectations to have an adequate level of employees, office space should also be available.

Third, the company must not be considered a tax resident of another state.

Going forward, financing companies should assess whether their current substance in Luxembourg is in line with these new requirements.

4. Equity at Risk

A group financing company assumes the risk when it has the financial capacity to bear such risk if it occurs. The 2017 Circular states that:

Specific economically significant risks related to financing transactions, the functions relating to or influencing the risk management or impact of risk, as well as the parties that assume such risk, should be assessed based on the facts and circumstances of each individual case. A group financing company is generally considered to assume risk if it has the financial capacity to manage it and to bear the financial consequences if it arises. The financial capacity to manage the risk can be defined as having access to funding necessary in order to assume or avoid the risk, to pay for risk-mitigation actions, and to bear the consequences if the risk arises.\(^8\)

Under the 2011 Circular, a minimum threshold was applied with regard to the equity at risk that a financing company should assume. The minimum equity at risk had to be at least 1% of the loans granted or EUR 2 million, whichever is less. The 2017 Circular no longer makes reference to the minimum equity at risk. Therefore, and based on the functional and risk profile, the 2017 Circular makes a distinction where a financing company bears effectively no risks, or assumes a (full) risk. If no risks are borne, the financing company is characterized as a mere service provider. In such case, the financing activities may not be compliant with the 2017 Circular, leading to a potential exchange of information (see section 6). Conversely, in a full risk situation, it should be further analysed to what

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5. 2017 Circular, art. 20.
6. 2017 Circular, art. 21 (internal citations omitted).
7. 2017 Circular, art. 21.
8. 2017 Circular, art. 18.
extrem the risks should be borne by the Luxembourg fin-
ancing company.

5. Arm’s Length Compensation

5.1. Functional profile

The starting point for determining an arm’s length remu-
neration is a functional analysis. The 2017 Circular refers
to financial institutions for the functions performed, stating as follows:

The functions assumed in connection with granting loans or
cash advances to related enterprises are basically comparable
to the functions assumed by independent financial institutions
subject to the supervision of the Commission de Surveillance
du Secteur Financier (CSSF). More precisely, important func-
tional differences can be observed where financing transactions
are undertaken by related entities not subject to regulations
imposed by the CSSF. Functional analysis focuses on the actual
activity of the parties, and on the competences they deploy. The
functions analysed include decision-making, in particular in
terms of corporate strategy and risks. In this context, the legal
rights and obligations of each party must be determined to the
greatest extent possible when performing such functions.

The functions performed by financing companies in Lux-
embourg may be considered only broadly comparable, as most
financing companies will not be subject to regula-
tory requirements. However, the functions assumed by
independent financial institutions provide an appropri-
ate reference to the functions performed by Luxembourg
financing companies. In this regard, the 2017 Circular
includes the following non-exhaustive list:

– originating the transaction;
– commercializing a transaction (e.g. identifying
  clients, offering products);
– negotiating (e.g. setting the contractual terms,
  assessing the credit risks linked to granting the
  financing);
– identifying the financing structure linked to the
  financing activity; and
– before the transaction is concluded, evaluating
  the likely respect of contractual commitments
  (e.g. valuing guarantees, analysing solvency); and
– managing the transaction;
– managing the financing transaction;
– credit-risk monitoring (reviewing transaction
  risks and guarantees); and
– managing the financing for the transaction.

5.2. Return on equity

Whereas under the 2011 Circular the arm’s length remu-
neration was, amongst other things, established by a
reward for functions and a risk premium, under the 2017
Circular reference is made to the return on equity. The
2017 Circular states that:

For companies performing functions similar to those performed
by regulated financing and treasury companies, namely compa-

Going forward, the return on equity will be one of the
approaches to determining the arm’s length compensa-
tion. Alternatively, the arm’s length compensation can be
determined using the difference between the interest
expense and interest income, i.e. based on an interest
benchmarking analysis. In both cases, it is still essential
to determine the appropriate equity at risk.

5.3. Simplification measure

The 2017 Circular provides for a simplification measure
in terms of equity at risk in case it meets the substance
requirements as outlined in section 3.2. above.

When a group financing company that meets the criteria set
out [substance requirements]... pursues a purely intermediary
activity; granting loans or cash advances to related entities that
are themselves financed by loans or cash advances granted by
related entities, it is considered that, in view of the risks asso-
ciated with the transactions analysed, for the sake of simplifi-
cation, the transactions are deemed to comply with the arm’s
length principle if the entity analysed receives, in relation to its
controlled transactions being analysed, a minimum return of
2% after tax on assets. This percentage will be regularly reviewed
by the Administration des contributions directes based on
relevant market analyses.

The purely intermediary character of such an activity is not
affected by the number, amount, nature, maturity or other char-
acteristics of the loans or cash advances in question.

This simplification measure is an option, and a specific
section will be included in the tax return for taxpayers
that wish to opt to apply this simplification measure. The
simplification measure reduces the burden of preparing a
transfer pricing analysis and putting (sufficient) equity at
risk. However, the minimum compensation to be left, i.e.
2% after tax on the assets, which is close to 300 bps before
tax, can be regarded as very high. In addition, the 2017
Circular states that opting for the simplification measure
will be subject to an exchange of information (see section
6). Considering the latter two consequences, it is expected
that, in practice, most taxpayers will not opt for the sim-
plification measure.

For intermediary financing companies that do not comply
with the minimum substance requirements, the simplifi-
cation measure is not applicable without a transfer pricing
analysis. Thus, also in these cases, the simplification measure
will, in practice, likely not be applied.

5.4. Commercial rationale

Based on article 56 bis of the ITL and the 2017 Circular,
the commercial rationale must be described as part of the
transfer pricing documentation. As an example, it is men-
tioned that a group financing company might grant loans

9. Similarly to the 2011 Circular.
11. 2017 Circular, art. 15.
15. 2017 Circular, art. 30.
or advances to related entities for various commercial purposes, including:
- financing of fixed assets;
- financing of current assets; and
- long-term strategic financing; or other types of financing.

In line with article 56 bis of the ITL, the 2017 Circular specifies the treatment of transactions without commercial rationale. It states as follows:

It should be noted that during comparability analysis and the accurate delineation of one or more controlled transactions, it may turn out that such transactions not only cannot be observed on the open market, but are also devoid of any commercial rationale to the extent that independent parties would not have agreed to conclude these transactions under the same conditions. In this case, such transaction or transactions, together with the associated tax consequences, must be disregarded to ensure compliance with the arm's length principle.16

Consequently, in exceptional cases where an intercompany transaction is disregarded, it may lead to a higher taxable result for the Luxembourg financing company.

6. Exchange of Information

To the extent that taxpayers do not comply with the substance and/or equity at risk requirements under the 2017 Circular, the tax authorities may exchange information with foreign jurisdictions.17 The information to be exchanged is not clear, but may include an explanation that the taxpayer in question does not comply with the Circular. More importantly, the exchanged information may state that it lacks substance and/or lacks sufficient equity to assume and control the related risks.

It will depend on the foreign jurisdiction how such exchange of information will be treated. Some jurisdictions may question, based on, for example, the applicable income tax treaty, whether the Luxembourg financing company is not considered the beneficial owner of the interest income. The consequence may be a denial of reduced withholding taxes on interest, where applicable. Thus, it is expected that most taxpayers will become compliant with the 2017 Circular.

7. Alignment of Existing Financing Structures with 2017 Circular

Most financing structures that were compliant under the 2011 Circular may need to be modified in order to comply with the 2017 Circular. The main question concerns how to align existing financing structures. Based on the requirements of the 2017 Circular, the main changes can be summarized as follows.

7.1. Substance

Similarly to the 2011 Circular, there is a minimum substance required. It is vital to reconsider the governance of the board to ensure the members are well informed and qualified. In practice, the substance requirements in terms of board, employees and office space are often already met and compliant with the 2017 Circular.

7.2. Equity at risk

Luxembourg financing companies bearing limited risk in line with the 2011 Circular should now consider a (full) equity at risk. This requires an analysis of how much the equity at risk should be. One of the questions concerns whether the contractual arrangement should not prevail above the actual conduct. Whereas the tax authorities under the 2011 Circular focused on a more legal approach, under article 56 bis of the ITL and the 2017 Circular, the actual conduct must be considered. The 2017 Circular states in this regard that:

A transaction is the expression of a commercial relationship between the parties. For comparability analysis, it irrelevant whether this transaction is formalised in writing or not. The conduct of the parties is paramount for the identification and accurate delineation of the controlled transaction. Therefore, even when a contract is formalised in writing, if the actual conduct of the parties differs from what was contractually agreed, it is the actual conduct of the parties that must be taken into account in delineating the transaction.18

Whereas for purposes of applying the 2017 Circular no amendments to the contractual arrangements may be required, for accounting purposes it is important that there be an alignment of the contractual arrangements with the actual conduct, as it follows strictly the contractual arrangements. A misalignment may lead to potential discussions as to which entity should bear the losses or capital.

7.3. Arm’s length compensation

Under the 2017 Circular, the remuneration will be limited to a return on equity,19 i.e. a reward for functions will no longer be required.

A last significant point to consider is the timing of the implementation of the 2017 Circular. Taxpayers should be compliant as from 1 January 2017, even though the guidance was issued on 27 December 2016. The tax authorities have clarified that the implementation may be effectuated during 2017. However, the application of the implementation should be effective as from 1 January 2017.

In 2018, the tax authorities will start auditing the application of the 2017 Circular. It is therefore essential to implement any necessary changes during 2017.

8. Advance Pricing Agreements

8.1. Advance pricing agreements under 2017 Circular

Similar to the 2011 Circular, the 2017 Circular allows taxpayers to request an advance pricing agreement (APA). The requirements to request an APA are specified in detail in the 2017 Circular.20 However, due to the international context (e.g. exchange of information), it is expected that

17. 2017 Circular, art. 31.
20. 2017 Circular, art. 32.
few taxpayers will continue to request unilateral APAs in future.

8.2. Advance pricing agreements under 2011 Circular

The 2017 Circular has clarified that any individual decision relating to the arm’s length principle that was made prior to the implementation of article 56 bis of the ITL, as from 1 January 2017, will no longer be binding. As a consequence, existing APAs prior to 1 January 2017 cease to have effect.


9. Conclusion

The 2017 Circular replaces the 2011 Circular describing the tax treatment of intercompany financing for Luxembourg companies. Whereas the requirements are similar to those under the 2011 Circular, the application under the new guidance is stricter. In particular, in terms of substance, there is a higher level of presence required, and in terms of risks, the minimum risk mitigation is no longer applicable.

The Circular leaves a number of questions unresolved, but it is expected that these will be clarified in the near future.