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Transfer Pricing 2024

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Luxembourg: Trends & Developments

Peter Moons and Katerina Benioudaki
Loyens & Loeff

Trends and Developments

Contributed by:
Peter Moons and Katerina Benioudaki
Loyens & Loeff

Loyens & Loeff is a European independent, full-service business law firm providing integrated legal and tax advice with specialists in Dutch, Belgian, Luxembourg and Swiss law. The firm's Luxembourg transfer pricing team assists clients regarding documentation, planning and strategy, and dispute resolution. More specifically, it helps clients to assess their documentation against stringent new requirements. The team also assist clients' tax departments on the formulation of sustainable transfer pricing strategies in line with their business whilst maintaining tax efficiency. Finally, it helps clients accelerate litigation procedures and prevent double taxation. The transfer pricing team also regularly assists its clients with audits and resolves (international) transfer pricing disputes both at an administrative and court level. The team is part of a fully integrated firm with home markets in Benelux and Switzerland, and offices in all major financial centers, including London, New York, Paris and Tokyo.

Authors

Peter Moons is a partner in Loyens & Loeff's tax practice group and heads the Luxembourg transfer pricing team. He specialises in cross-border corporate tax advice for multinationals and funds, in particular private equity, private debt and real estate funds, their initiators and their investors. Peter also co-chairs the Luxembourg tax litigation team. He regularly speaks on the topics of international tax structuring, transfer pricing and tax litigation.

Katerina Benioudaki is an associate and member of the Loyens & Loeff's tax practice group in the firm's Luxembourg office. She focuses on transfer pricing-related matters and cross-border transactions. Since joining the Luxembourg tax practice group in 2022, she has advised clients on financial transactions, intragroup restructurings and operational transfer pricing.

Loyens & Loeff

18-20, rue Edward Steichen
L-2540
Luxembourg

Tel: +352 466 230
Fax: +352 466 234
Email: info@loyensloeff.lu
Web: www.loyensloeff.lu

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Law & Tax

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Introduction

As transfer pricing (TP) continues to be a hot topic domestically, at EU level and in the international scene, from Luxembourg and European Union (EU) legislation to domestic and EU case law, in this article we analyse the main TP-related developments that took place during 2023.

Public Country-by-Country Reporting

Background and timeline

Bill No 8158 transposing the provisions of directive 2021/2101 on public country-by-country reporting (CbCR) into Luxembourg domestic law was published on 22 August 2023, in the Memorial A of the Official Gazette under number 532 (the "Law"). As part of EU's initiatives to enhance corporate and tax transparency and public scrutiny, public CbCR is a global action requiring multinational enterprises (MNEs) to publicly disclose data of their tax activities to different stakeholders.

Scope of application

Who should disclose?

The Law provides for four categories of companies that are required to publish and provide certain information. These include EU-based MNEs and non-EU based MNEs conducting a business activity in Luxembourg through a subsidiary or a branch with a consolidated annual turnover at the balance sheet date of at least EUR750 million for each of the last two consecutive years.

The in-scope entities shall be covered by the EU accounting directive and should be organised under the following legal forms:

- Luxembourg public limited company (S.A.);
- Luxembourg partnership limited by shares (S.C.A.);
- Luxembourg private limited liability company (S.à r.l.); and
- Luxembourg partnerships (S.N.C. and S.C.S.), provided their direct or indirect partners, who are indefinitely liable, are organised as limited companies or similar.

Thus, any entity organised under another legal form (such as special limited partnerships – *Société en Commandite Spéciale* – SCSp) falls outside the scope of the Law.

Carve-out for banks

Considering that groups engaged in the banking sector are already required to publish a CbCR pursuant to the Capital Requirements Directive IV, the Law avoids the double reporting in this sector, by providing a general carve-out, subject to conditions.

What information to disclose?

The public CbCR for the financial year concerned should include, among others, a list of all subsidiaries included in the consolidated accounts, a brief description of the nature of their activities, the number of full-time equivalent employees, the turnover, the amount of profit or loss before tax and the amount of corporate income tax and withholding tax paid.

Omission from disclosure

Luxembourg chose to permit in-scope entities to defer, under certain conditions, the disclosure of commercially sensitive information. In cases where the disclosure of one or more of the required pieces of information would constitute a serious prejudice to the commercial position of the reporting entity, their temporary omission is allowed. Any omission shall be clearly indicated in the CbCR and accompanied by an explanation. Nevertheless, any omitted information shall be published in a subsequent CbCR within a maximum period of five years from the date of its initial omission.

To date there is no administrative guidance as to which information is considered commercially sensitive capable of constituting a serious prejudice to the commercial position of the reporting entity. It remains to be seen whether the Luxembourg Tax Administration (LTA) will issue a guidance and the Luxembourg courts will take position in their judgements.

How to disclose?

In-scope entities shall file and publish the public CbCR with the Luxembourg Trade Register (RCS) and make available its content in one of the official EU languages on their website free of charge for a minimum period of five consecutive years. Entities are exempt from publication on their website provided that the CbCR is accessible to the public free of charge. The entities shall also inform the public by including on their website the reasons for the exemption and by making reference to the RCS website.

Sanctions

Failure to comply with the provisions of the Law may lead to fines of between EUR500 and EUR25,000. A distinction is drawn between the responsibility of the administrative, management and supervisory bodies of UPEs and standalone undertakings, which are required to prepare and publish the public CbCR in accordance with the Law, and the responsibility of the administrative, management and supervisory bodies of subsidiary undertakings and branches, which are expected simply to ensure, to the best of their knowledge and ability, that the public CbCR is prepared and published.

Auditor's statement

Statutory auditor(s) or approved audit firm(s) auditing financial statements shall state in their audit report whether the taxpayer was required by the Law to publish a public CbCR for the financial year preceding the financial year being audited and whether the public CbCR was indeed prepared and published.

Entry into force

The Law will be applicable to financial years starting on or after 22 June 2024. The public CbCR shall be published within 12 months of the closing of the financial year for which it is drawn up. For entities whose financial year follows the calendar year, the reporting obligation will only start with respect to the financial year 2025 and the public CbCR shall be published by 31 December 2026 at the latest.

Conclusion

The public CbCR will be a supplementary obligation for MNEs besides the existing CbCR reporting that is applicable since 23 December 2016. Given the publication of the information and the managers' personal liability, a timely review might be necessary to determine whether an adoption of a data capture processes is required.

Master File and Local File Obligations

On 28 March 2023, the Luxembourg government presented a bill of law as well as the related project of grand-ducal regulation (the "Grand-Ducal Regulation"), to reform certain tax administrative and procedural aspects, as well as TP documentation requirements.

The draft Grand-Ducal Regulation on TP documentation provides that there will be a Local File and Master File obligation for Luxembourg "constituent entities" as defined in the Luxembourg CbC law. Therefore, Luxembourg constituent entities that are part of an MNE group having a consolidated revenue exceeding EUR750 million shall prepare a Local File describing the TP analysis of their transactions with related parties.

An additional threshold is also foreseen for the Master File obligation. Luxembourg resident constituent entities with a net turnover of at least EUR100 million or with a balance sheet total of at least EUR400 million, shall prepare a Master File type of documentation.

Both the Local File and the Master File shall be available to the LTA at all times.

The Grand-Ducal Regulation is in line with OECD's BEPS Action 13 and the OECD TP Guidelines for Multinational Enterprises and Tax Administrations (the "OECD Guidelines") and provides a list of information as well as the content of the Local File and the Master, which overall is in line with the OECD Guidelines.

The bill of law has not been voted yet. To date, the legislative proposal has faced much criticism, both from stakeholders and the *Conseil d' Etat*. It remains to be seen whether the proposal will be adopted, or it will undergo any amendments. In any case, the intention to align TP documentation with the BEPS Action 13 Report is set and taxpayers should make sure that all controlled transactions are supported by ad hoc TP documentation.

Advanced Pricing Agreements (APAs)

Under the same legislative proposal, the government also proposed a draft Grand Ducal regulation introducing a new bilateral and multilateral APA (BAPA or MAPA) procedure, based on the provisions of Article 25(3) of the OECD Model Tax Convention. A BAPA or a MAPA is concluded between the competent tax authorities. While it is already possible to request a BAPA or a MAPA, following this draft regulation, the procedure would be formalised and the application would be subject to a fee ranging from EUR10,000 to EUR20,000.

Proposal on a TP Directive

Introduction

As part of the BEFIT package, on 12 September 2023, the European Commission (EC) presented the proposal for a Directive that integrates key TP principles into EU law (the "TP Directive"). The draft TP Directive aims to increase tax certainty, reduce compliance costs, mitigate the risk of double (non) taxation and harmonise TP rules throughout the EU with the adoption of the arm's length principle into EU law and the clarification of the role and status of the OECD Guidelines. To ensure a common application of the arm's length principle, the latest version of the OECD TP Guidelines will be binding when applying it and a common definition of what should be considered a controlled company has been included in the TP Directive.

TP methods

The TP Directive provides the five TP methods already included in the OECD Guidelines. The arm's length prices shall be determined by applying the most appropriate method and any other valuation method or technique can be applied only if it can be demonstrated that (i) none of the approved methods can be reasonably applied, and (ii) such other method produces a result consistent with that which would have been achieved by independent enterprises. Hence, the draft TP Directive is more restrictive than the OECD Guidelines and the current practice in many member states with respect to the obligation to apply the most appropriate TP method and the burden of proof in applying other methods.

Arm's length ranges

Further, the TP Directive contains rules on the application of the comparability analysis and the arm's length ranges. According to the TP Directive, a taxpayer is not subject to adjustment if its

results fall within the interquartile range, unless it can be proven that a different point within this range is justified by the underlying facts and circumstances. If the result of a controlled transaction falls outside the arm's-length range, it shall be adjusted to the median of the range unless it can be proven that another point in the range provides an arm's length price. This contradicts with the OECD Guidelines, which state that any point within the range (ie, not just the interquartile range) is arm's length.

TP documentation

Pursuant to the TP Directive, member states shall ensure that taxpayers avail of sufficient information and analysis to prove that their controlled transactions respect the arm's length principle. The TP documentation requirements will apply to all taxpayers in the absence of a revenue threshold. The EC can also supplement the TP documentation prerequisites by adopting common templates, language requirements, defining the type of taxpayer to abide by these templates and the deadlines to be respected.

TP adjustments

The TP Directive also provides for a mechanism enabling member states to make a corresponding adjustment when a primary adjustment is made in another EU or treaty country. More precisely, member states may not limit the granting of such corresponding adjustments only in the context of a double tax treaty or a mutual assistance procedure (MAP). Pursuant to the TP Directive, member states will have at their disposal a "fast-track" procedure when there is no doubt that the primary adjustment is well founded, or in case such adjustment results from a joint audit. Such "fast-track" procedure shall be concluded within 180 days, without the need to open a MAP. Compared to MAPs, a term of 180 days would be a tremendous improvement. Hence, this fast-track procedure is a very welcome but also ambitious development.

In the absence of a primary adjustment, member states are allowed to perform a downward adjustment provided that an amount equal to the downward adjustment shall be included in the profit of the associated enterprise in the other jurisdiction and that such downward adjustment shall be communicated to the tax authorities of the other jurisdiction.

The TP Directive also provides strict conditions under which EU member states should recognise a compensating adjustment, which is initiated by the taxpayer and differs from the price that is actually charged between the associated enterprises.

Entry into force

If passed, member states shall adopt and publish the necessary laws to comply with the TP Directive by 31 December 2025 at the latest, which shall apply as from 1 January 2026.

On 14 November 2023, it was proposed to amend the TP Directive, among others, by shortening the deadline for its adoption to 31 December 2024 and subsequently its entry into force to 1 January 2025 instead of 2026 (the "Draft Report"). The Draft Report was adopted by the European Parliament's Economic and Monetary Affairs Committee on 22 February 2024. The European Parliament's plenary will vote on the Draft Report on 11 April 2024, which will then pass to the European Council for consideration. However, the European Parliament's opinion is not binding for the European Council.

It remains to be seen how member states will respond to the content of the TP Directive. Provided the TP Directive has formally been

approved, member states would have to include the provisions of the TP Directive in their domestic legislation, and both tax authorities and taxpayers may have to adjust their TP practices, which may impact their support to the TP Directive.

Case Law

In 2023, there has been further progress in the judicial review of significant cases involving tax rulings dealing with TP matters.

Interest-free loans case law

Administrative Court No 48125C of 23 November 2023

In 2016, a Luxembourg company financed its subsidiary with an interest-free loan (IFL). The involved companies imputed notional interest applying TP rules, leading to a deduction at borrower level and a corresponding income at the level of the lender. The LTA initially denied the deduction and requalified the IFL into equity. LTA's decision was confirmed by the administrative tribunal but was annulled on appeal on 23 November 2023.

Case law in recent years has consistently listed a range of criteria, largely derived from parliamentary documents and doctrine, to classify a financial instrument for Luxembourg tax purposes, but also the need for a holistic assessment of the transaction and its economic circumstances, stressing that no single feature of the loan is determining. The transaction should rather be analysed according to its economic conditions (substance over form). In the case at hand, the court applied these criteria to an IFL granted to a debtor by its sole shareholder. The key takeaways are the following.

- Considering that the formalities of loan documentation are more flexible than those of a capital increase, documenting a loan after the funding, although not ideal, can be acceptable. As such, a delay in documenting the funding, while not desirable is not indicative of equity or debt classification.
- When the debt-to-equity ratio is lower than the maximum 99/1 debt-to-equity ratio prevailing based on the circular on intragroup financing activities that was applicable until 2017, the borrower shall not be considered as having a disproportionate debt-to-equity ratio. Moreover, to assess the debt-to-equity ratio, only the actual drawdowns should be considered rather than the total commitment under a facility. Note that nowadays the debt-to-equity ratio should be substantiated.
- The criteria of the absence of a right to participate in profits and liquidation proceeds and the absence of voting rights need to be assessed in respect of the lender's capacity, by examining the terms and conditions of the financial instrument. These criteria shall not be considered met just because of the mere fact that the lender is also the borrower's shareholder.
- A maturity of eight to ten years shall not be considered so long that it would be indicative of equity classification, while actual (p)repayments on the IFL confirm the debt nature of the instrument.
- The limited recourse clause transfers risk to the lender but does not annul ex ante the repayment obligation. As such, the limited recourse clause shall not be a feature to support the equity classification of the IFL.
- Considering that a bank would typically ask for its loans to rank senior to shareholder debt, the subordination of shareholder loans to third-party debt shall not be held as an equity feature, where such subordination is standard.

This decision offers valuable clarifications regarding the classification of financial instruments as debt or equity and is pertinent for evaluating the tax implications not only of IFLs but also various other financial instruments used in Luxembourg. It also offers useful guidance for analysing specific criteria which remained largely open to interpretation.

Administrative Court No 48127C of 21 September 2023 and No 47754C of 14 November 2023

In its decision 48127C of 21 September 2023, the Administrative Court of Appeal criticised LTA's position in its attempt to reverse the burden of proof regarding the level of interest rates (that should be) charged on interest free shareholder loans. The LTA referred to its 1998 circular that basically prescribes an interest rate of 5% to shareholders' current accounts. However, the court found that the mere demonstration of the existence of a hidden distribution of profits (due to the shareholder loan in the case at hand being interest free) should not entail a reversal of the burden of proof as otherwise, the LTA would be free to impose any interest rate, however unreasonable. In cases of hidden distribution of profits, to determine whether the transaction was carried out in accordance with the arm's length principle, the LTA shall accurately define the transaction it intends to requalify and also has the burden of determining the amount of hidden distribution, and cannot merely refer to the rate stated in the 1998 circular, which is not binding on taxpayers. The court applied the interest rate sustained by transfer pricing analyses submitted by the taxpayer, that it analysed as adequate.

Similarly to the above, the Court confirmed these principles for an interest-bearing loan in its decision No 47754C.

Administrative Court No 48281C of 26 September 2023

The Administrative Court, in its decision No 48281C of 26 September 2023, dealt with payments under a total return swap (TRS) paid by a Luxembourg corporate taxpayer (the "LuxCo") to its non-resident individual shareholder (the "Individual"). LuxCo's subsidiary in fiscal unity (the "Subsidiary") distributed to Russia and Kazakhstan pharmaceutical products manufactured in France through Russian and Kazakh related entities, respectively. The group's beneficial owner was the Individual. The Subsidiary's role in the chain was administrative, involving the receipt of orders from the Russian and Kazakh companies and their transmission to the manufacturer, as well as the import of the pharmaceuticals into the aforementioned countries. This particular distribution activity that had a high margin for the Subsidiary was not possible without the central role performed by the Individual.

The TRS on the one hand entitled the Individual to 85% of the net profits of the Subsidiary, and on the other hand LuxCo to a small annual amount and possibility to borrow interest free. LuxCo claimed that the TRS arrangement was at arm's length, remunerating the Individual for his central role and leaving the Subsidiary/fiscal unity with a return that was commensurate or in excess of usual margin as a low-risk distributor.

The court recognised that the margin made by the Subsidiary on the distribution activity seemed high in light of the functions it performed. However, the overall margin on the distribution activity realised by the three related entities in Luxembourg, Russia and Kazakhstan should be allocated among them in an arm's length manner, and not between them and the Individual, that was not employed by and had not entered into any services agreement with these entities.

Instead, the Individual benefitted in an indirect way from the high margin activity of the group, namely as shareholder. Absent any indication of the Russian and Kazakh margin being challenged in Russia and Kazakhstan, there should be no reason to doubt the remaining margin realised by the Subsidiary. The obligations of LuxCo under the TRS being in no proportion with its entitlements under the TRS, the court sided with the LTA and confirmed the latter's treatment of the payments to the Individual as hidden dividends.

Transfer pricing-related state aid case law

Amazon case law

The case concerned the arm's length nature of royalties paid by a Luxembourg operating company (the "LuxOpCo") to a Luxembourg partnership for the use of certain intangibles.

In a tax ruling issued in 2003, the LTA confirmed the arm's length nature of the deductible royalty payments. LuxOpCo provided supporting TP analysis determining its arm's length remuneration for the provision of the royalties. The EC argued that LuxOpCo's tax base was unduly reduced and made its own calculation to determine the appropriate amount of the royalty charge using a different TP method, thus arriving at a lower royalty charge. The General Court then annulled the EC's decision.

The CJEU, with its decision No 985/2023 of 14 December 2023, confirmed the General Court's conclusions, albeit on different grounds. In line with its landmark Fiat judgment of November 2022, the CJEU repeated that in the absence of EU harmonisation, taxation remains within the authority of member states, which shall exercise their discretion within the framework of EU rules, including those regarding state aid. CJEU stressed member states' exclusive right to choose their own tax policy and their own standards, and that the OECD Guidelines are not legally binding if not incorporated into domestic law.

As such, CJEU ruled that the OECD Guidelines could not form part of the "reference framework", leading to the annulment of the EC's decision due to an error of law. The CJEU finally noticed that, although the General Court also relied on a wrong reference framework, it results in a correct outcome. The CJEU, thus, ruled in final instance and dismissed EC's decision.

Impact on other cases and taxpayers

The Fiat and Amazon judgments confirmed that the EC, under the legal framework, is not entitled to enforce the non-binding OECD Guidelines to the extent they are not implemented in national law. Instead, it should focus on the arm's length principle as implemented in the domestic law of the member states. Note that Luxembourg has implemented part of the OECD Guidelines in article 56bis of the LIR.

The TP Directive discussed above may come to fill in the gap of the binding nature of the OECD Guidelines.

Developments on TP-related audits

Over the past few years, TP has become the main point of attention in Luxembourg taxation. The decrease of tax rulings and APAs has resulted in an increased scrutiny on behalf of the LTA, which has started more systematically questioning taxpayers' intercompany transactions and the application of the arm's length principle.

While in most cases the LTA limits itself in requesting the supporting TP documentation for intragroup financing activities, cash pooling and services, some tax inspectors have not hesitated

to review in detail and challenge the methodology applied and the underlying calculations performed.

Experience shows that the LTA can challenge easier taxpayers' intercompany transactions when no TP documentation is prepared. In an environment where more and more tax scrutiny is observed, taxpayers should make sure that all controlled transactions are duly documented and supported by ad hoc TP documentation.

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