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Luxembourg Tax Alert

New TP Guidance inspired by BEPS action 8-10 published in Budget law 2017 on October 12, 2016

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Background

Last Wednesday, 12 October 2016, the Luxembourg Minister of Finance presented the 2017 budget and the related draft bill to the parliament. Among social, environmental, and investment provisions, tax professionals and taxpayers spotted the tax section introducing a new set of rules for transfer pricing practice, in the form of the new Article 56 bis LITL with new guidance and clarification on transfer pricing regulations in Luxembourg.

After having introduced the basic principle of arm's length into Article 56 ITL based on Article 9 of the OECD Model Convention back in January 2015, this new article intends to add further guidance on how to practically apply this principle based on the latest version of Section D of Chapter I of the OECD Transfer Pricing Guidelines.

Purpose

In the Declaration of Intent, the government intends to incorporate some conclusions *("des conclusions tirées dans le cadre des actions BEPS 8-10")* and basis criterions *(des critères de base à respecter)* drawn by the OECD under its BEPS initiative (action 8-10) into domestic law.

Highlights / what's new

The draft bill introduces a more granular functional and risk analysis based on the latest Transfer Pricing Guidelines for MNE's and Tax Authorities (hereafter OECD Guidelines) with a focus on the comparability analysis and the new tests as revised per the BEPS initiative to delineate controlled transaction.

Once the definitions are set in §1, it is worth mentioning that §2 §3 and §4 introduce commonly applied concepts of comparability analysis into the law. It therefore confirms that:

- Should a related transaction not observable between independent parties does not mean this transaction does not comply with arm's length principle.
- Conditions between controlled transaction and transaction between third parties should be comparable, and economical characteristics should be comparable.
- When adjustments are required for comparability purposes, these should be reasonably reliable in order to eliminate the impact on the pricing.
- Taxpayers should identify the transactions and determine the economically significant characteristics and conditions in order to delineate the controlled transaction and then compare them to the open market.

More practically speaking, it lists two key aspects for the comparability analysis:

1. identify the commercial or financial relations between the associated enterprises and the conditions and **economically relevant circumstances** attached to those relations so that the controlled transaction is **accurately <u>delineated</u>**; and
2. to compare the conditions and the economically significant circumstances of the controlled transaction as accurately delineated with those between independent parties.

The delineation process is further detailed under §5 through a series of steps, again largely inspired by the words of the OECD under BEPS action 8-10:

1. the contractual terms of the transaction;
2. the functions performed by each of the parties to the transaction, considering assets used and risks managed and assumed;
3. the characteristics of the transaction;
4. the economic circumstances of the parties and of the market in which the parties operate;
5. the business strategies pursued by the parties.

Finally, once the transaction adequately delineated, the choice of the method (being any method detailed under chapters 2 and 3 of the OECD Guidelines) should allow the best approximation of the arm's length price.

Last but certainly not least, the new §7 introduces a general anti-abuse measure specifically for transfer pricing purposes. In the event a controlled transaction, or a part of it, does not embed valid business rational, taxpayers/tax authorities should disregard it to determine the arm's length price.

Conclusions and take aways

The proposed article 56bis strengthens the Luxembourg TP rules and practice as it gives clarifications of the methodologies available to reach conclusions on the arm's length price when testing or setting prices in a related party context.

Taking into account the latest works under the BEPS initiative, it will also introduce an anti-abuse rule specifically for TP purposes.

Regarding the specific point of documentation as laid-down under action 13 of the BEPS initiative, one may expect further regulations introducing local and master file requirements while a draft law on CbC Reporting is already available.

Taxpayers should therefore be prepared as from FY 2017 and upon request of the tax authorities, to sustain their controlled transactions (including valid business rationale behind such transaction or series of transactions) through TP documentation based on a more granular functional and risk analysis.

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