Transfer Pricing Forum

Transfer Pricing for the International Practitioner

Financial Transactions (Loans)

While the OECD turns its attention to the treatment of financial transactions in its Transfer Pricing Guidelines, most countries already have had to deal with intra-group financial transactions, and many countries have been independently developing views about analytical rules and principles to deal with the increased importance many see this subject having in regard to their tax bases. This issue deals with the ways in which Forum countries currently address the issue of related party loans or related party guarantee situations. Even in the absence of OECD guidelines, tax examiners see these transactions, and in some way must deal with them. In this issue, we look at the "baseline" of countries' positions, before the OECD has spoken.

1. Does your country specify permissible methods for evaluating an arm's length interest rate on related party loans? What methods does it specify – or which does it permit if it does not specify methods – (e.g., CUP, reference to interest indices, or percentage mark-ups over a base such as the national bank interest rate)? Do local tax inspectors tend to

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1. Does your country specify permissible methods for evaluating an arm's-length interest rate on related-party loans? What methods does it specify – or which does it permit if it does not specify methods – (e.g., CUP, reference to interest indices, or percentage mark-ups over a base such as the national bank interest rate)? Do local tax inspectors tend to apply particular methods over others? What methods have you found to be effective, or do you see most often used for financial transactions, and what evidence do taxpayers or the government's examiners use to establish the rate under those methods?

Article 56bis of the Luxembourg Income Tax Law (ITL) refers to the use of the five transfer pricing methods described in the OECD TP Guidelines (TPG) and provides for the selection of the method that best approximates arm's length prices in each specific case. Other methods are admissible provided that it can be shown that another method is an appropriate measure of profitability to the case at hand. The above is also the position of the Luxembourg tax authorities (LTA) in respect to transfer pricing methods. In particular, the Capital Asset Pricing Model (CAPM) method is often used for in and on-lending transactions. For related-party debt pricing, the Comparable Uncontrolled Price (CUP) method is generally applied by taxpayers and by the LTA, with or without comparability adjustments where appropriate. Furthermore, the CUP method may in principle be applied together with other corroborative methods such as financial modeling of cash flows and blended cost of finance analyses (such methods may for instance be used to substantiate the ideal loan-to-value, by way of determining at what debt-to-equity ratio the return on equity would be maximized). Other specific financial methods (e.g., Expected Loss) are also used in certain cases to approximate an at market debt-to-equity ratio for the overall financing of the taxpayer's debt investments. Both taxpayers and the LTA use data derived from publicly available sources and/or subscription based databases as evidence for market interest rates.

2. Does the country officially (or do tax inspectors in practice) express a preference for valuation methods or approaches that are different for outbound transactions (domestic lender/foreign borrower) than for inbound ones?

Neither Luxembourg legislation, administrative practice, nor case law differentiate between outbound and inbound transactions.

3. Assume a typical related-party borrowing situation in your country: a foreign member of a multinational group has lent money to a domestic affiliate. It must be established whether the borrowing is on an appropriate arm's-length basis. How are these issues dealt with in your country?

a) What factors are examined to establish the loan's "bona fides;" that an advance or a loan agreement sets out genuine debt? Is it necessary to show that the loan would have been made by an unrelated lender, absent a guarantee? Is there a separate consideration of whether the "borrowing" is in fact an equity infusion? What happens if the loan is interest-free, and what happens if there is no written agreement?

Under article 56bis of the ITL, the actual conduct of the parties must be considered when accurately delineating a transaction. Intra-group contractual arrangements should reflect the actual transaction entered into. 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. Article 56bis(7) of the ITL even provides for the non-recognition of a transaction, or parts thereof, when it lacks commercially rationality. This entails, for instance, the analysis of the commercial rationality of agreed terms and conditions, if any (e.g., the term of the intra-group debt may be revisited in light of the overall investment horizon of the assets financed).

The classification of an instrument as debt or equity under Luxembourg income tax rules is of relevance alongside transfer pricing considerations. In Luxembourg, an interest-free loan (IFL) may in specific cases be seen as either debt or equity, depending on its particular features. In this respect, some guidance may be found in Luxembourg jurisprudence, referring back to the parliamentary history of the ITL.

In case no. 38357C of 26 July 2017, the Administrative Court, citing the relevant parliamentary history, ruled that a debt instrument granted by the shareholders should be reclassified as equity, if the normal way of financing, dictated by serious economic or legal considerations, would have been to increase the capital instead and it is clear from the circumstances of the case under review that the form of a loan was chosen exclusively for tax reasons. Elements that would permit the presumption that a shareholder loan constitutes equity include uncommon characteristics of the terms and conditions of the loan, notably in relation to (i) the interest and repayment schedule; (ii) the use of the proceeds of the loan for funding a long-term fixed asset; (iii) the absence of security arrangements; (iv) the disproportion between equity and debt financing; as well as (v) the circumstances under which the loan is granted.

From these criteria it follows that both an absence of interest and an absence of a written agreement could lead to the presumption that the loan constitutes equity, although these elements are presumably not sufficient by themselves to conclude this.

b) Under the current regulatory regime and case law, should the borrower be evaluated as a stand-alone borrower, or as a member of a multinational group benefiting from passive association with its group? Is implicit support from affiliates assumed, or what factors must be identified to suggest that such support might be given? Is this viewed as an exception to the traditional arm's-length standard or as a necessary interpretation of it, or something else?

The process of estimating the credit worthiness of the borrower is complex and heavily dependent on the specific facts and circumstances. There is no specific Luxembourg guidance on factoring implicit support. Taxpayers may refer to the OECD TPG, as well as international case law (i.e. General Electric), rating agencies' documents, or Basel norms applicable to banks and financial institutions. In practice, the LTA accepts the use of the group's credit rating to the extent it can be reasonably shown that the subsidiary is core to the strategy of the multinational. This can be viewed as a necessary interpretation of the arm's-length standard, as third parties may also take implicit support into account.

c) What other factors than the borrower's position as a stand-alone entity or member of a multinational group would be taken into account in evaluating the borrower's credit worthiness?

In evaluating the creditworthiness of a borrower, relevant factors would include: the industry sector where the borrower operates or to which it is exposed; its trends as specificities; the risks of the country(ies) from where the borrower derives its revenues; its financial position and arrangements; financial balance sheet and profit and loss statement; the functional profile and position in the global value chain; any particularities of its assets; and any other elements with a potential impact that could be taken into account. As a second step, the terms and conditions of the debt instrument, namely its payment ranking (i.e. senior vs. subordinated, secured vs. unsecured); principal amount; currency; fixed vs. floating interest rates; maturity; options; repayment schedule; covenants and securities; etc. should be considered.

d) What sources of data for comparable loan benchmarking are typically referenced when undertaking an intercompany loan analysis?

Public available data from official sources (e.g., countries' bond ratings, default spreads, universities' analysis) and subscription-based databases (e.g., Bloomberg, Thompson Reuters, Moody's, etc.) are used for debt pricing.

e) What, if any, safe-harbor rates or indicative or "suggested" margins are provided? Does the tax authority have (or has it indicated) an intention to provide such guidance?

Prior to the first comprehensive administrative circulars dealing with intra-group finance issued in 2011 (i.e. circulars ITL No. 164/2 of 28 January 2011 and No. 164/2bis of 8 April 2011), administrative safe harbors were admissible in Luxembourg for a period, based on a table with interest rate brackets. Currently, there is a simplification measure under Circular ITL No. 56/1 – 56bis/1 of 27 December 2016, applicable as of January 1, 2017, that indicates that when a group financing company pursues a purely intermediary activity, it is considered that the transactions are deemed to comply with the arm's length standard if the entity receives a return of 2% after-tax on its debt investments (return on assets). According to this circular, this percentage will be regularly reviewed by LTA based on relevant market analyses. Taxpayers that wish to opt for this measure should include this option in its tax return and would not need to prepare a transfer pricing documentation report. Further, according to the 2017 Circular, as it regards undertakings comparable to financial institutions, a 10% return on equity (after tax) can be considered indicative of an arm's length compensation. Also, this percentage is to be regularly updated by the LTA, according to the circular.

f) How do you deal with negative interest rates in the context of deposits (e.g., in related financing institutions or similar situations)? How do you deal with base rates that are negative (such as Euribor, which as this is written are negative)?

Typically, to the extent that it translates into a conservative approach from a Luxembourg income tax perspective, negative floating base interest rates can be floored at zero. This is something to be evaluated on a case-by-case basis.

g) Does intra-group lending present other issues under your country's tax system, and how are those dealt with by taxpayers?

With article 56bis of ITL, in force as from January 1, 2017, Luxembourg incorporated into its domestic law

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important aspects of actions 8 to 10 of the BEPS G20/OECD Report which emphasize the relevance of the functions performed by people. In this regard, Luxembourg intra-group financing companies which lack organizational and economic substance (e.g. active and qualified managers capable of controlling risks) could be considered as 'conduits' and, thus, not entitled to the interest income. This analysis is made alongside other considerations in regard, for instance, to beneficial ownership under tax treaties. In these cases, the LTA may exchange information. Against this background, some taxpayers are reviewing and reorganizing their operations accordingly, especially where treaty benefits are intended to be claimed.

4. In light of BEPS Action 2 (Hybrid Mismatch Arrangements) a number of countries during the last year have been enhancing, modifying, or adopting rules that affect transfer pricing of financial transactions. If changes have recently been made to your country's rules, what changes are those, and when do they take effect?

Luxembourg implemented the amendments to the Parent-Subsidiary Directive or PSD (2014/86), so that as from January 1, 2016 dividend income can only be tax exempt to the extent that the payment was not deductible at the level of the distributing subsidiary. This rule is limited to EU subsidiaries. Even though Luxembourg does not yet have a bill of law for implementing the Anti-Tax Avoidance Directive (ATAD) 1 and the ATAD 2, it is expected that the Directives will be implemented and enter into force as from January 1, 2019 and January 1, 2020, respectively. It is not expected that Luxembourg will go beyond those Directives.

5. How do your country's rules for attribution of income to a permanent establishment work with the rules on debt financing? In particular does the "distinct and separate enterprise" view of a PE's income calculation permit (or require) separate entity evaluation of the PE?

Luxembourg endorses the Authorized OECD Approach (AOA) for the Attribution of Profits to Permanent Establishments and thus, such guidance should apply in this respect.

6. If a foreign affiliate provides an explicit loan guarantee, when do your country's rules or your country's practice indicate that a guarantee fee must be accounted for? (If it must, when can it be an adjustment to the interest rate, or when must a separate guarantee fee be deemed to be paid to the foreign affiliate?). How is the appropriate charge for a guarantee determined?

Luxembourg follows the guidance of the OECD TPG in this regard. To the extent that third parties in comparable circumstances would have paid for the guarantee, this should be reflected in the intra-group setting as well (whether a separate guarantee fee is paid or an adjustment to the interest rate is performed). There are several ways to determine the benefit of the guarantee and price guarantee fees, including analysis based on Credit Default Swap (CDS) spreads, the cost of the guarantee for the guarantor, and the benefit of the guarantee for the borrower.

7. If your country has adopted interest deduction limits, such as the OECD's suggested ratio or group ratio approach, what are those measures? Do you expect that those measures will reduce the need for strict enforcement of transfer pricing in regard to related-party loans, by making it less tax-efficient to erode the domestic tax base through interest charges? Do thin capitalization or other specific limits such as debt vs. equity rules limit the operation of transfer pricing more generally? If so, how do these affect decisions that companies might make?

At present, there are no thin capitalization rules in Luxembourg law. The LTA in practice observes a debt-to-equity ratio of 85:15 for holding companies, so that interest expenses on debt exceeding such ratio could be denied by the LTA and such interest reclassified as a hidden dividend distribution. In addition, interest expenses may be non-deductible if incurred in connection with assets which have generated accrued tax-exempt income or to the extent such interest expenses exceed arm's length interest rates in the case at hand. Luxembourg currently does not have interest deduction limitation rules as advanced by the G20/OECD's BEPS Project. This will change with the ATAD 1, expected to enter into force by January 1, 2019. We don't expect that this will reduce the need to enforce transfer pricing in regard to related-party debt. The arm's length standard should apply in determining the taxable profits of Luxembourg taxpayers prior to the application of any interest deduction limitation rules. The debt-financing bias may remain namely by way of withholding tax-free cash repatriation, as currently interest is not subject to Luxembourg withholding tax while dividends are subject to withholding tax at a rate of 15%. Moreover, Luxembourg financing companies borrowing and lending intra-group would not be targeted by ATAD 1, to the extent interest income and expenses closely match.

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