

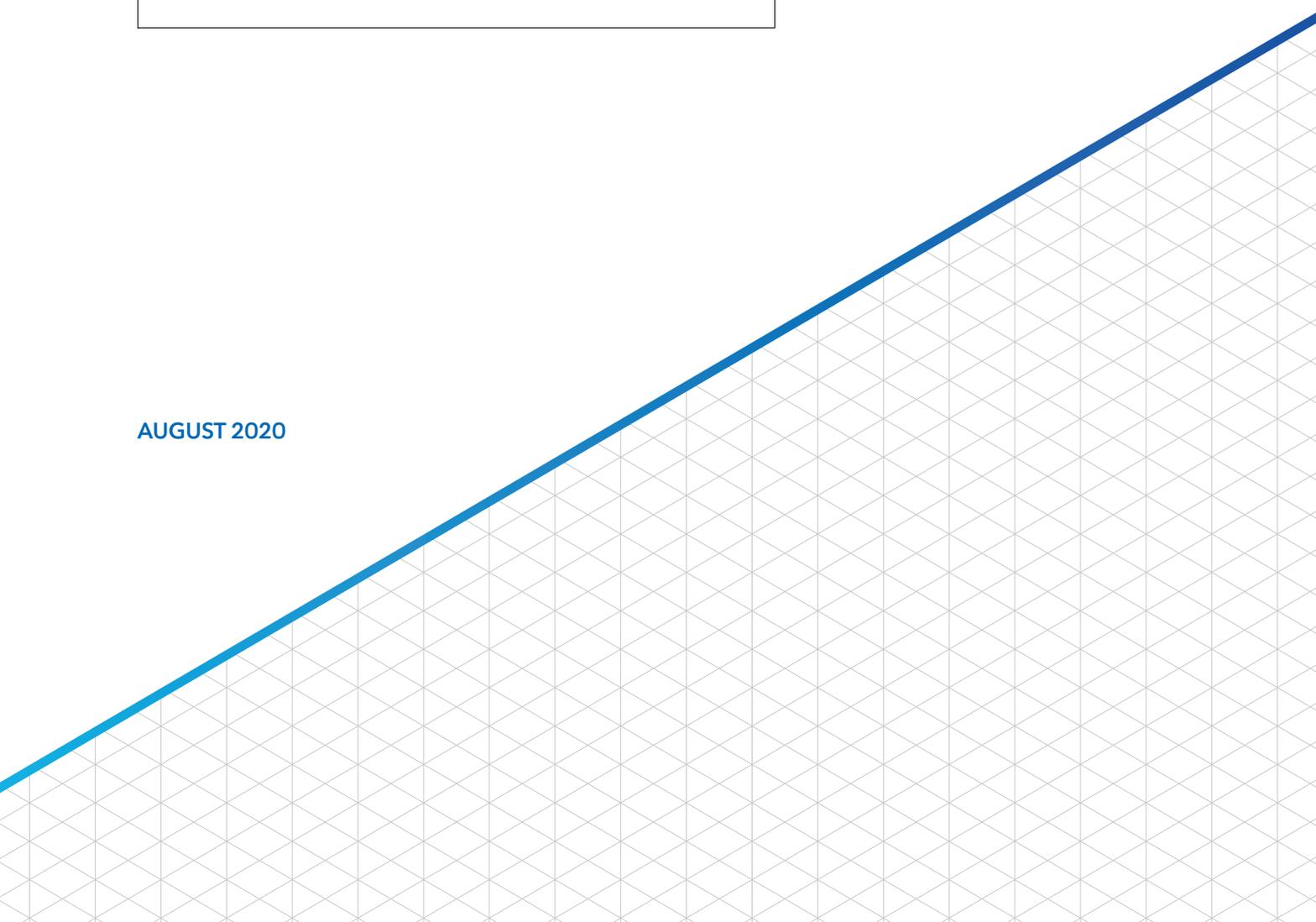
**Bloomberg
Tax**

Transfer Pricing Forum

Transfer Pricing for the International Practitioner

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Luxembourg

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1. Per the OECD, the impact of the COVID-19 pandemic on economic activity would far outweigh anything experienced during the global financial crisis in 2008-09. What similarities and differences do you see between the 2008 crisis and the current pandemic so far on the practice of transfer pricing in your jurisdiction?

Even though the arm's length principle had been part of the Luxembourg taxation system before its formal codification in 2015, the transfer pricing environment was radically different compared to today. The transfer pricing practice was not as prevalent until the release of the BEPS Action Plan, and in fact was only in its early days during the crisis of 2008-2009.

Since 2008, a lot has changed. First, the Luxembourg tax authorities ("LTA") published a transfer pricing circular in 2011,¹ which in essence provided that Luxembourg companies involved in intra-group financing activities were considered as assuming the credit risks related to their intra-group financing activities if the capital was higher than 1% of the nominal amount of the loans assets or the equivalent of EUR 2 million or higher. In 2015, the legislature explicitly codified the arm's length principle into the law.² In addition, transfer pricing documentation has explicitly been mentioned as supporting evidence that the LTA may request.³ Then in December 2016, the legislature introduced a new provision⁴ that elaborates on the content of the transfer pricing analysis in line with BEPS Actions 8-10 and the OECD Transfer Pricing Guidelines ("TPG").⁵ The LTA took the opportunity to replace the 2011 circular with a new one that provides some guidance on the transfer pricing requirements for intra-group financing companies (the "TP Circular").⁶ The parliamentary documents to the introduction of the new transfer pricing provision explicitly refer to the TPG. In February 2020, the OECD released new transfer pricing guidelines on financial transactions ("TPG FT"),⁷ which will likely be followed by the LTA in transfer pricing cases.

There are not many similarities to the transfer pricing practice itself between 2008 and 2020, due to the development of transfer pricing itself rather than the effect of an economic crisis. That being said, the

nature and origin of the COVID-19 economic crisis is also completely different than the financial crisis of 2008. While it may *prima facie* be considered a solution to use 2008-2009 data for pricing new loans due to the lack of current data reflecting the crisis, the comparability of the data would not seem appropriate. Luxembourg law provides that the economic characteristics of the transactions taken into account in the analysis should be sufficiently comparable. Transactions are sufficiently comparable when there are no material differences between the compared transactions that could have a significant impact from the methodological point of view on the price determination or when reasonable adjustments can be made to eliminate the differences (e.g., currency). The COVID-19 economic crisis is not driven by a weak financial sector but rather by government-induced halt in economic activities and supply chains. Like the previous financial crisis, there are many temporary and permanent interest waivers sought by MNEs. However, the general responses seen by MNEs and the circumstances are also different from 2008-2009. Hence, in our view, the data from 2008-2009 may be used as an indicator for information purposes only but should not be relied upon during a benchmark or transfer pricing analysis.

2. Business performance as a result of the COVID-19 pandemic:

a. What do you see as the impact of the COVID-19 pandemic on low-risk entities (which typically bear limited risks, and record limited profit margin when the principal entity incurs a loss) in your jurisdiction? Do you see your jurisdiction accepting that such entities can lose money during this unusual economic downturn?

Generally, a company remunerated on the basis of the TNMM, such as a limited risk distributor, is regarded as performing a more routine function (as opposed to the "main entrepreneur" in centralized models). Routine entities generally perform limited functions, bear limited risks, or hold assets that are not core or essential to the group.

The remuneration of a low-risk entity could be based on a benchmark using comparables derived from publicly available financial tools. The data retrieved from such databases are generally based on historical data or multi-year comparables. Hence it is often seen that year-end remuneration computations are based on the data from the previous year-end. Despite the current reorganization and/or refinancing of some MNEs, the transactions made between independent enterprises are not immediately available in databases. Intermediary solutions may need to be sought until the comparable data are available. Even then, the selection of comparables may differ due to new factors that were not prevalent before (e.g., government support).

In centralized business models, low-risk entities are generally guaranteed to receive a positive remuneration and may end-up with a positive taxable basis while the group as a whole is incurring losses. Under extraordinary circumstances, such as a pandemic crisis, the question arises whether there is room to change the transfer pricing approach or to allocate part of the group losses to the low-risk entities. The answer depends on the facts and circumstances of the company and the group itself (e.g., industry), and the analysis should be done on a case-by-case basis. Low-risk entities are not synonymous with no-risk entities.

Another aspect that should not be overlooked is the contractual arrangement that the parties agreed to. Although not prevalent in most intra-group agreements, it should be verified whether the intra-group contract contains a force majeure clause or the possibility of a price adjustment that could be triggered by a defined event. Such a clause could provide a basis to revise the remuneration of the low-risk entity. In the absence of a contractual provision (prevalent in intra-group transactions), a change could be considered in line with what is seen on the market between independent enterprises. However, care should still be applied so that the adjustment reflects the change in circumstances and does not become an opportunity that could be challenged by tax authorities. Any change in method or approach should in any case be thoroughly documented.

The TPG provide that associated enterprises, just like independent enterprises, can incur *genuine losses* (even though the group is in a profit-making situation) due to “heavy start-up costs, unfavourable economic conditions, inefficiencies, or other legitimate business reasons.”⁸ The COVID-19 pandemic should constitute “unfavourable economic conditions;” however, this alone may not justify the use of related entities’ losses. Group losses could be shared to low-risk entities to the extent that third parties would agree to share losses. Under the current market conditions, voluntary price adjustments not based on contractual agreements are also seen between third parties. Nevertheless, in most cases it may be disputed for a routine and low-risk entity to accept a price adjustment to the extent that such entity will be in a loss-making position, unless the continuity of the group is in jeopardy or the adjusted pricing will give the routine entity a higher potential upside in future years.

The TPG provide that an “entity may agree to a restructuring as a better option than going out of business altogether,”⁹ which may not give rise to compensation.¹⁰ All the options realistically available (“ORAs”) should be assessed when performing adjustments or a restructuring.

b. Are there MNEs in your country who are experiencing or likely to experience increased or expanded business opportunities despite the current pandemic? What strategies should these entities be mindful of with regards to their transfer pricing models?

While the majority of have businesses suffered from the COVID-19 crisis, with the tourism and airline sectors among the worst impacted, some other sectors, such as technology, have proved to be resilient or even benefited from the pandemic. In Luxembourg some MNEs have seen new demands created.¹¹

Luxembourg companies are, for the majority of MNEs, holding and financing companies. Many Luxembourg companies raise debt on behalf of the group, generally guaranteed by the ultimate parent company, and on-lend the funds to related companies. There may be liquidities brought in by other group companies to cope for intra-group borrowers that may not be able to serve their debts.

Luxembourg is a key jurisdiction for (alternative) investment funds. The current COVID-19 crisis should provide new prospects for investment funds, and in particular funds investing in distressed debt. At the beginning of the crisis, fund managers called upon the capital commitment of their investors in anticipation of potential new investment opportunities created by the pandemic. The transfer pricing models of funds structures depend on their investment business structure and is generally different from that of MNEs. Generally the models factor in the expected internal return. Valuation methods of the assets may be reconsidered.

c. How are MNEs in your jurisdiction addressing comparability issues, or how would you advise them to address comparability issues? How should they treat loss-making comparables, to ensure that any adjustments factor in the current global epidemic and adequately reflect economic reality?

Benchmarking studies generally rely on historical data, which can be relied upon in a stable economic environment. During a time of crisis, the (historical) data should likely not be used as comparables, as it does not take into account the latest economic downturn. For limited risk entities in particular, the financial data of comparable companies are not available until after the closing of the financial year. Using pre-crisis data may result in non-arm’s length pricing.

Where available, MNEs may use internal comparables (e.g., a third-party loan) as a basis for adjustments for pricing intra-group transactions. In the absence of internal comparables, the benchmarking strategy should factor in differences in comparables. Different approaches may be used to improve the quality of the comparables or the reliability of the adjustments made, the availability of which depends on a case-by-case basis.

By way of example, search criteria in the benchmarking process of consumer-facing sectors may be expanded to include companies with similar sale declines. Companies which did not face economic hardship may be excluded from the results.

For financial transactions, MNEs may need to move liquidities across the group in order to meet their external debt obligations. Parent guarantees or cross-guarantees may be called

upon. Large MNEs have their credit ratings periodically reviewed by the Big Three Agencies which may be available at the time of the transfer pricing review/benchmark. If, on the other hand, the intra-group pricing relied on a historical credit rating, such a choice may need to be reviewed. The choice of relative importance and the implicit support available to the company within the group should be tested.

Data on debt issuances below investment grade are often not as widely available. Companies facing severe financial difficulties may struggle to find financial comparables. Any decision taken in the benchmarking study should be substantiated in the transfer pricing documentation in anticipation of discussions with tax authorities, which may consider the data selection and adjustments to be motivated by reasons other than reaching an arm's length result.

d. How likely are the tax authorities in your jurisdiction to consider "economic circumstances" as a relevant comparability factor?

To date,¹² the Luxembourg government and tax administration have enacted some measures as a response to the COVID-19 crisis,¹³ but none related to transfer pricing. The OECD Secretariat announced in its last webcast¹⁴ that the Inclusive Framework is exploring the option to develop additional transfer pricing guidance due to the new transfer pricing issues created by the COVID-19 crisis. Such guidance, if available, would not be published until late 2020 or early 2021. It is likely that the LTA would align its position to the recommendations of the OECD in terms of transfer pricing guidance.

Luxembourg law textually provides that as part of the comparability analysis of a transfer pricing study, the significant economic circumstances should first be determined, which are relevant to the identified commercial or financial relations under the tested transaction in order to accurately delineate the controlled transaction, then compared to those between independent enterprises.¹⁵ In addition, Luxembourg transfer pricing rules generally embrace the guiding principles embodied in the TPG. As such, the LTA must consider "economic circumstances" as a relevant comparability factor.

3. How do you see the pandemic affecting APAs? What adjustments are MNEs making – or what adjustments should they make – to ensure that they will be considered to be in compliance with their agreements? Are companies looking to amend (or should they look to amend) their APAs, or are they just documenting changes in anticipation of possible future amendments?

Since the publication of the TP Circular, the number of APAs submitted and decided by the LTA dropped significantly from 118 in 2016 (pre-TP Circular) to just 29 in 2017. The trend continued with only 6 APAs decided in 2018 (of which 3 did not confirm the taxpayer's request) and 3 in 2019 (of which 2 were not obtained).¹⁶ Hence, it is not expected that the COVID-19 crisis will either affect or increase the number of APAs decided by the LTA.

In most instances, APAs did not cover extraordinary circumstances that could have a severe impact on the transfer pricing

computation of a local company or on the transfer pricing policy of the group, which in turn would impact the local transfer pricing. Unless expressly stated in the APA request or confirmation letter, the COVID-19 pandemic should not have an impact on a confirmed APA for the tax authorities.

If a taxpayer decides to perform adjustments compared to the approach used in its initial APA, the change in approach and the reasoning behind it should be carefully documented, especially if it leads to a decrease in the taxable basis. Taxpayers with a valid APA could, as a transparency measure, inform the LTA of its intention to perform adjustments or change its approach due to the COVID-19 crisis.

APAs can be a useful tool in providing taxpayers with legal certainty on the pricing and related tax treatments of intra-group transactions. The LTA has not to date made any communication on the potential impact of the COVID-19 crisis on transfer pricing documentation or APAs.

4. Do you think there is a "silver lining" or bright spot about this economic situation that MNEs should be mindful of? What are possible opportunities that otherwise would not be sustainable in the absence of an economic crisis? Reset possibilities? Location-specific advantage?

A Luxembourg company is deemed to realize all its assets and liabilities at fair market value upon exit, and it is deemed to realize any asset transferred at fair market value. Some groups may consider transferring their IP out of Luxembourg while the inherent fair market value has been negatively affected by the crisis, effectively reducing taxes on latent gains.

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NOTES

¹ Circular 164/2 on the tax treatment of companies carrying out intra-group financial transactions (*circulaire n°164/2 du 28 janvier 2011 sur le traitement fiscal des sociétés exerçant des transactions de financement intra-groupe*).

² Article 56 of the Luxembourg Income Tax Law (*loi du 04 décembre 1967 concernant l'impôt sur le revenu*).

³ § 171(3) of the General Law of Taxation (*Abgabenordnung vom 22. Mai 1931*)

⁴ Article 56bis of the Luxembourg Income Tax Law (*loi du 04 décembre 1967 concernant l'impôt sur le revenu*)

⁵ The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD: Paris, July 2017.

⁶ Circular 56/1-56bis/1 on the tax treatment of companies carrying out intra-group financial transactions (*circulaire n°56/1-56bis/1 du 27 décembre 2016 sur le traitement fiscal des sociétés exerçant des transactions de financement intra-groupe*)

⁷ OECD, *Transfer Pricing Guidance on Financial Transactions — Inclusive Framework on BEPS: Actions 4, 8-10*, OECD, Paris, February 2020.

⁸ Para. 1.129 TPG.

⁹ Para. 9.71 TPG.

¹⁰ Para 9.78 TPG.

¹¹ E.g., Cargolux with the supply of medical equipment.

¹² On the basis of information available up to 15 June 2020.

¹³ Examples of measures taken include financial help to SMEs, waiver of the corporate income tax and municipal business tax advances due for the first two quarters of 2020 if the Luxembourg company faces liquidity difficulties, deferral of payment for other tax liabilities without late interest payment accrual, or the extension of the filing deadline for the annual accounts 2019 or a claim against a decision of the LTA. For further information, see <https://impotsdirects.public.lu/fr/formulaires/contribuables.html> and <https://coronavirus.gouvernement.lu/en.html>.

¹⁴ OECD Tax Talks of 4 May 2020, available on <https://www.oecd.org/ctp/tax-talks-webcasts.htm>.

¹⁵ Articles 56bis(4) and 56bis(5) of the Luxembourg Income Tax Law (*loi du 04 décembre 1967 concernant l'impôt sur le revenu*).

¹⁶ Annexes to the *Annexes du Rapport d'Activité du Ministère des Finances—Exercice 2019*, p. 130.