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Transfer Pricing Forum

Transfer Pricing for the International Practitioner

The Arm's Length Nature of Intercompany Financing Transactions

The Arm's Length Nature of Intercompany Financing Transactions The OECD's recent publication Discussion Draft on Financial Transactions addresses the Report on Actions 8-10 of the BEPS Action Plan, which includes transfer pricing guidance for related party financial transactions. The goal of this forum is to identify the current status of the country's specific rules, best practices, and court cases applicable to determining and supporting the arm's length nature of intercompany financing transactions (including the terms of the instrument and the pricing of the transaction) and the potential impact of the discussion draft.

1. How does your country identify and adjust related party financing transactions? What is you country's approach to determining whether the debt arising from a related party financing transaction should be properly characterized as debt?
2. What rules or guidance exist in your country to determine the arm's length interest rate for a related party financing transaction?

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3. Besides the determination of whether a transaction's interest rate is at arm's length, what other factors does your country consider in deciding whether the related party financing is arm's length and acceptable overall? Examples of additional factors may include: contractual terms, functions of the companies involved, characteristics of the companies' financial products or services, economic circumstances, or business strategies.
4. If it is determined that any part of a related party transaction should not be characterized as debt, what are the consequences to both the borrower and the related lender?
5. Are there any relevant court cases or tax rulings in your country dealing with the transfer pricing of intercompany financing transactions?

THE TRANSFER PRICING FORUM is designed to present a comparative study of typical transfer pricing issues by Country Panelists who are distinguished transfer pricing practitioners in major and emerging industrial countries. Their discussions focus on practical questions posed by guidance, case law and practice in their respective jurisdiction, with practical recommendations whenever appropriate.

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1. How does your country identify and adjust related party financing transactions? What is you country's approach to determining whether the debt arising from a related party financing transaction should be properly characterized as debt?

Article 56 of the Luxembourg Income Tax Law (**ITL**) defines "related parties" as those who participate directly or indirectly in the management, control, or capital of the other, or if the same person(s) participate directly or indirectly in the management, control, or capital of both enterprises. The article does not specify a percentage threshold. Despite the bill of law implementing the provisions of the EU Directive 2016/1164 on anti-tax avoidance (ATAD) in Luxembourg, establishing a 25% threshold,[1] such a threshold is not expected to alter the aforementioned broad-spectrum related parties' definition, which is relevant for transfer pricing.

Effective as of January 1, 2017, a new article 56bis LIR lays down the basic principle that a transfer pricing analysis must comply with the OECD Transfer Pricing Guidelines (**TPG**) and actions 8-10 of the BEPS Action Plan. Circular LIR n° 56/1 – 56bis/1 of 27 December 2016 (the **"Circular"**) clarifies the Luxembourg tax authorities' interpretation of articles 56 and 56bis LIR regarding intragroup financing activities.

According to the Circular, intragroup financing activities comprise all interest-bearing lending to related companies, funded with financial instruments from within or outside the group. The guiding principles in the Circular are that intragroup financing companies need to have the financial capacity to assume risks and the ability to control and manage such risks. With respect to financial capacity, the previous 2011 circulars (LIR n° 164/2 and 164/2bis) generally considered the adequate minimum amount of equity at risk to be the lower of either 1% of the intragroup financing amount or EUR 2 million. The Circular, however, states that the appropriate amount of equity at risk should be determined on a case–by-case basis.

As a result, until 2017, a debt-to-equity ratio of 99:1 had often been applied to financing transactions. As of 2017, such a determination should be based on the computation of the equity at risk, which is highly dependent on the facts and circumstances of the case (i.e., the borrower' credit rating, the terms and conditions of the loan, etc.). For holding activities, a maximum debt-to-equity ratio of 85:15 has been the established practice of the Luxembourg tax authorities (**LTA**).

In addition to the above, the general principle of substance over form applies. In this regard, a reference is made to the parliamentary documents on article 97 ITL, which establish the following:

[A] loan is to be considered a participation where the normal financing mode, dictated by serious economic or legal considerations, would have been a capital increase and where it clearly results from the circumstances such that the form of the loan could not have been chosen for a purpose other than tax evasion. The absence of the usual legal form(s) of a loan, namely the fixing of the interest rate and repayment terms, the allocation of funds lent to long-term fixed assets, the lack of guarantees,]and] the disproportion between the share capital and the funds lent provide . . . presumptions of the existence of a disguised participation in the form of the loan. It is also important to consider the circumstances under which the loan is granted."[2]

Thus, for Luxembourg tax purposes, the qualification of an instrument as debt or equity is not bound by its legal form, accounting treatment, or characterization provided by another country. Instead, the substance over form principle prevails, and the relevant facts and circumstances are considered in order to classify an instrument as debt or equity for tax purposes. In court case no. 38357C of 26 July 2017, the administrative court applied these criteria to a loan granted by a Luxembourg shareholder to its Dominican subsidiaries and added that the loan should qualify as equity to the extent that it had no fixed maturity or periodical interest and its remuneration was based on capital gains realized upon the disposal of certain assets held by these subsidiaries. According to the court, a global analysis – rather than a limited analysis – should be made. In other words, all the terms, conditions, facts, and circumstances need to be reviewed together, instead of focusing on a single element.

Further, given the introduction of art. 56bis (7) ITL, the reclassification of an instrument may also be made on the basis of an "irrational transaction." An irrational transaction occurs when the form is consistent with the substance, but the arrangements or elements of the transaction differ from those which would have been adopted by independent enterprises

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behaving in a commercially rational manner, making a significant impact on the determination of the arm's length price. Compared to substance over form cases where an all-or-nothing approach is applied, in irrational transaction cases, certain parts or conditions of controlled transactions may be disregarded.

2. What rules or guidance exist in your country to determine the arm's length interest rate for a related party financing transaction?

Article 56bis of the ITL refers to the use of the five transfer pricing methods described in the TPG and provides for the selection of the method that best approximates arm's length prices in each specific case. 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). 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. 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.

The starting point in determining an interest rate is the credit rating of the borrower. For such purposes, projected cash flows and pro-forma financials (or past data in the absence of present-day and projected data) may be used. Factors such as relevant industries and countries where the borrower operates are also taken into account. Then, the features of the instrument, e.g., its payment ranking, maturity, specific terms and conditions, etc., are considered when assessing the credit rating of the instrument.

In addition to the above, the Circular indicates that when a group financing company pursues a purely intermediary activity, 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 (i.e., return on assets). As for undertakings comparable to financial institutions, a 10% return on equity (after tax) can be considered indicative of an arm's length compensation. Also, according to the Circular, this percentage is to be regularly updated by the LTA.

3. Besides the determination of whether a transaction's interest rate is at arm's length, what other factors does your country consider in deciding whether the related party financing is arm's length and acceptable overall? Examples of additional factors may include: contractual terms, functions of the companies involved, characteristics of the companies' financial products or services, economic circumstances, or business strategies.

Under articles 56 and 56bis ITL, the actual conduct of the parties is decisive in accurately delineating a transaction. Notably, the five comparability factors described in detailed in the TPG may be used to assess whether a borrower would have been able to attract debt under the given terms and, correspondingly, whether the lender would have agreed to lend under those terms. Should the answer be negative, article 56bis (7) ITL provides for the non-recognition of a transaction, or parts thereof, when it lacks commercial rationality. Because this provision is effective as of January 1, 2017, no concrete examples of the application of this provision are available to date although, in financing transactions, tax authorities have laid special emphasis on the contractual terms.

4. If it is determined that any part of a related party transaction should not be characterized as debt, what are the consequences to both the borrower and the related lender?

If a related party financing transaction is recharacterized, in whole or in part, from debt to equity, the consequences for a Luxembourg borrower are that:

a. the interest will not be deductible from the corporate income tax base (and therefore not from the municipal business tax base either); and

b. the debt will not be deductible from the net wealth tax base.

For a foreign lender, the interest received may be subject to a 15% Luxembourg dividend withholding tax, unless the conditions required for the application of the dividend withholding tax exemption are met. As for a Luxembourg lender, the proceeds received under the instrument in question may be exempt if the conditions required for the application of the participation exemption are met.

5. Are there any relevant court cases or tax rulings in your country dealing with the transfer pricing of intercompany financing transactions?

There are court cases and tax rulings dealing with the transfer pricing of intercompany financing transactions. In the few court cases, the main discussion is about the imputation of a notional interest on debt instruments such as interest-free loans, on the basis that third parties behaving in a commercially rational manner would not lend for free. For example, see Luxembourg Administrative Court 22 July 2015, n° 34190C.

The LTA have been issuing tax rulings in many individual cases. Regarding intragroup financing activities, the Circular establishes that tax rulings dealing with the arm's length principle based on the rules applicable before the entry into force of article 56bis ITL no longer bind the LTA as of January 1, 2017. Companies that wish to be covered by a new decision in this respect are required to submit a new request that is compliant with the requirements set out in the Circular, which includes, among other factors, the accurate delineation of the transaction including the details of the parties and countries involved, as well as one of the five comparability factors; the list of comparables searched, rejected, and selected; the projections of the profit and loss accounts for the years covered by the request; etc. Thus, taxpayers seeking an advance pricing confirmation for their intercompany financing transactions in Luxembourg should observe the OECD TPG incorporating the BEPS recommendations, which have been incorporated in the law through article 56bis of the ITL and regulated under the Circular.

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NOTES

[1] Article 164ter in the proposed wording is expected to enter into force on January 1, 2019.

[2] Parliamentary Document n° 571/04 on the former article 114 ITL, p. 180.

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