Intra-group financing activity and arm's length principle

April 2017

Evolution of Transfer Pricing in Luxembourg

2011 — Circulars LIR n° 164/2 and 164/2bis for companies carrying out intra-group financing transactions.

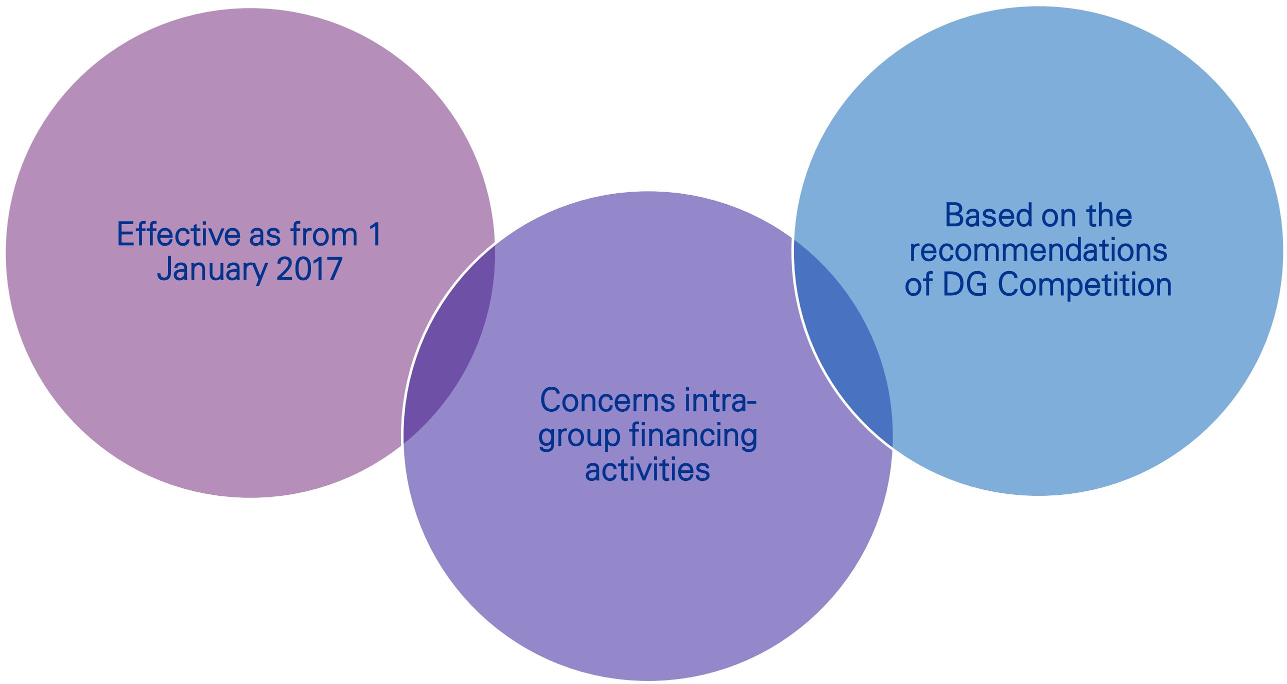
2015 — Article 56 LIR and §171 Abgabenordnung introduced formerly the «arm's length» requirement for all intra-group transactions and the need to have transfer pricing documentation.

2016 — Country-by-country reporting implementing EU Council Directive 2016/881 regarding the mandatory exchange of information in the field of taxation.

2017 — Circular from the Luxembourg tax authorities LIR n° 56/1-56bis/1 replacing the 2011 Circulars. The new Circular is applicable from 1 January 2017 to Luxembourg entities performing intra-group financing activities, as well as new article 56bis LIR on comparability analysis and the economic rationale of transactions.

This is a real game changer and new transfer pricing approaches need to be adopted in the course of 2017

The Objectives of the New Circular



Objective → being consistent with international developments in transfer pricing

Main Aspects of the New Circular

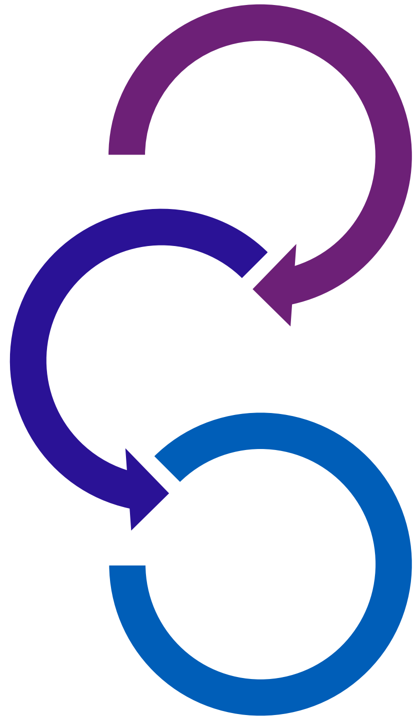
Adequate organizational substance to control the risks

Adequate economic substance to assume the risks

Arm's length remuneration in line with the functional profile

Consequences for Non-compliance

Luxembourg entities performing intra-group financing activity could be considered as **conduit entities**



Tax residency certificate for the application of double tax conventions would not be issued

Exchange of information with source jurisdictions and potentially with jurisdictions of Luxembourg lenders

Important to analyze the impact in foreign jurisdictions: beneficial ownership, withholding taxes, etc.

Changes Introduced by the New Circular

Significant increase of tax audits anticipated

Before 1 January 2017

1. **Organizational substance**

- Majority of board of managers are Luxembourg residents
- Managers are responsible for day-to-day management
- Company holds a bank account in Luxembourg
- Compliance with tax return filing obligations
- Company is considered a tax resident only in Luxembourg

2. **Economic substance**

- Credit risk covered by equity of at least 1% capped at EUR 2 million

➔ Possibility to limit credit risk contractually

3. **Advance Pricing Agreements**

- Often used

The Circular applies only to companies carrying out intra-group financing transactions (i.e. a debt financing a receivable to a group company)

After 1 January 2017

1. **Organizational substance**

- More developed substance requirements / solid governance needed
- Focus on capacity and knowledge of board of managers
- Focus on control of the risks and financial capacity to support the risks
- Qualified and knowledgeable employee needed to manage the intra-group financing activity

2. **Economic substance**

- The minimum equity threshold requirement created through contractual arrangements is not applicable anymore. Level of equity to be assessed based on the risk assumed

➔ Appropriate equity to cover the risks assumed based on the effective credit risk borne

3. **Advance Pricing Agreements**

Prior agreements are not binding upon the tax authorities as of 1 January 2017 for fiscal years following 2016

Advance Pricing Agreement are subject to automatic exchange of information

KPMG

Thank you!