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Vecteurs de croissance au Luxembourg

Your ticket to developing business opportunities

Chambre de Commerce Luxembourg
Issued in cooperation with Deloitte S.A.
Issue N° 1: Transfer pricing

Avant-propos

Dans un but de soutien à l'intérêt économique général et afin de développer la sensibilité à une large variété de sujets économiques, la Chambre de Commerce du Grand-Duché de Luxembourg, en collaboration avec Deloitte S.A., publie une publication technique périodique «Vecteurs de croissance au Luxembourg ». Chaque édition fournit une introduction détaillée à un sujet économique spécifique susceptible d'intéresser les entrepreneurs localisés ou désirant se localiser au Luxembourg.

Les publications de la Chambre du Commerce, en partenariat avec Deloitte S.A., visent avant tout à faciliter l'accès du grand public à ces sujets économiques spécifiques. Ainsi, ces ouvrages s'adressent tant aux entreprises non-résidentes envisageant d'investir au Luxembourg, qu'aux entreprises déjà implantées au Luxembourg ou à toute personne intéressée par les thèmes développés dans ces ouvrages.

Nous sommes fiers de vous présenter la première édition de la collection «Vecteurs de croissance au Luxembourg », dédiée aux prix de transfert. L'importance des prix de transfert dans le domaine des affaires internationales est en perpétuelle croissance. La mondialisation engendre en effet une augmentation significative des transactions transfrontalières intra-groupes. De ce fait, un certain nombre d'autorités fiscales portent toute leur attention sur cette problématique entourant les multinationales et rendent notamment les règles de prix de transfert plus strictes afin d'assurer la concordance entre les prix fixés par l'entreprise et les prix du marché. Toute réglementation plus stricte adoptée hors de Luxembourg en matière de prix de transfert impacte désormais directement, lors de transactions intra-groupes, les entités du groupe basées au Luxembourg.

Il est essentiel pour les entreprises de comprendre les principes de base des prix de transfert afin de pouvoir appliquer correctement ces règles à leurs transactions intra-groupe. Cette édition de « Vecteurs de croissance à Luxembourg » permettra aux lecteurs de mieux comprendre ce que sont les prix de transfert, leurs impacts sur l'activité ainsi que les opportunités découlant d'une stratégie efficiente en termes de prix de transfert.

Nous tenons tout particulièrement à remercier les auteurs de cette première édition, Erwan Loquet et Marc Rasch, ainsi que Gilbert Renel et Carlo Thelen pour la coordination complète de cette collection.

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Foreword

With the aim of supporting business generally and fostering greater awareness of a broad range of technical business issues, the Chamber of Commerce of the Grand Duchy of Luxembourg is publishing, in cooperation with Deloitte S.A. a new technical series under the title "Vecteurs de croissance au Luxembourg". Each edition provides a comprehensive overview of a specific business-related topic of potential interest to companies based in or contemplating a move to Luxembourg.

It is the policy of the Chamber of Commerce, together with Deloitte S.A., to make these specific business issues more accessible to the public. The technical series is thus aimed at non-resident companies considering investing in Luxembourg, resident companies in Luxembourg, and anyone else interested in these technical topics.

We are pleased to introduce the first edition of the "Vecteurs de croissance au Luxembourg" on the subject of transfer pricing. Transfer pricing has become increasingly important in international business. Globalisation has led to a significant increase in cross-border transactions between group companies with intercompany pricing set by multinationals becoming a major concern for tax authorities. Transfer pricing rules are being made stricter in many countries to ensure that intercompany pricing reflects market prices. The stricter transfer pricing rules outside Luxembourg have a direct impact on intercompany transactions involving Luxembourg-based entities.

In order to apply appropriate transfer pricing policies for their intercompany transactions, it is important for companies to understand the related basic principles. This edition of "Vecteurs de croissance au Luxembourg" will enable readers to better understand what transfer pricing is, the impact it has on their business and the potential advantages they may achieve by choosing the right transfer pricing strategy.

We thank the authors, Erwan Loquet and Marc Rasch for preparing this first edition and in particular Gilbert Renel and Carlo Thelen for the overall coordination of the technical series.

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A. Executive summary

This edition of "Vecteurs de croissance au Luxembourg" explains the basic principles of transfer pricing, its potential impact on the business, and the opportunities that transfer pricing present for their activities with a particular focus on Luxembourg.

Introduction

Section 1 of this booklet provides an introduction describing the importance of transfer pricing, its impact on the global tax burden as well as its main pillars and related trends.

Transfer pricing is the price set between two group companies for the transfer of physical goods, intangible property, services, or financing arrangements.

The transfer price for transactions between group companies has to be set so that it corresponds to the market price, taking into account the functional and risk profile and specific conditions of each of the parties (the "arm's length principle"). The reason hereof is that the tax authorities on both sides of the transaction will assess whether the transfer price for tax purposes is in accordance with the arm's length principle; an incorrect transfer price may lead to a tax reassessment issued by the tax authorities, potentially resulting in double taxation.

Luxembourg does not have specific regulatory requirements in terms of transfer pricing documentation (i.e. documentation describing and supporting related party transactions underlying transfer pricing, generally including: intercompany agreements, transfer pricing analysis, invoices and other relevant records such as minutes of meetings or brochures). However, an adequate transfer pricing policy remains important for Luxembourg corporate residents involved in cross-border transactions to reduce the risk that one or more of the different tax authorities involved, will challenge the transfer price and would adjust the related taxable basis.

Regulatory framework

Section 2 provides a description and guidance on the application of the arm's length principle. Furthermore, it describes how transfer pricing is reflected in various articles of the Luxembourg Income Tax Law and through case law. It also describes how taxpayers can deal with transfer pricing upfront, e.g. via advance tax agreements with the tax authorities, or afterwards through tax audit defence with the tax authorities.

Business opportunities

While respecting the existing tax and transfer pricing regulations, transfer pricing is particularly interesting for Multinational Enterprises in optimising their intercompany flows, and by potentially reducing their global tax burden. For any international planning, transfer pricing considerations should be made in close cooperation with corporate income taxes, VAT, and customs duties. In section 3, three opportunities are discussed: (1) central entrepreneur model, (2) new intellectual property regime, and (3) opportunities in an economic downturn.

For general interest in setting-up a business in Luxembourg or developing your existing business, please refer to sections 4 and 5, which provides an overview of the Chamber of Commerce's role in business creation and development.

B. Transfer pricing - principles and business opportunities

1. Introduction

1.1 The context of transfer pricing

Transfer pricing has become a key determinant for Multinational Enterprises ("MNEs") in their overall tax strategy. Choosing the right transfer pricing policy can have a direct impact on the global payable taxes of a MNE. In the next sections, the impacts of transfer pricing on MNEs business activities are described; topics covered include (1) the importance of implementing adequate transfer pricing policies; (2) the influence of transfer pricing regulatory frameworks; and (3) opportunities available to them in Luxembourg.

1.1.1 What is transfer pricing?

Transfer pricing is the price set between two related parties for the transfer of:

(i) physical goods, e.g. purchase or sale of raw materials, inventory or finished goods;

(ii) intangible property ("IP"), e.g. sale of IP rights, licensing of IP;

(iii) services, e.g. all type of management services; or

(iv) financing arrangements, e.g. loan facilities, guarantee arrangements, cash pooling arrangements, leasing, debt factoring.

In other words, transfer pricing concerns any transaction between related parties.

According to the Organisation for Economic Cooperation and Development ("OECD")[1], two enterprises are considered to be related parties if one participates directly or indirectly in the management, control, or capital of the other, or if both are under common control.

A related party under Luxembourg Income Tax Law is broadly referred to as a special economic relationship, i.e. any relationship deviating from usual commercial relationships observed between third parties (see section 2.1.2.1 for further details).

The basis for transfer pricing is "the arm's length principle". According to this principle, transactions between related parties should be established as if they would have taken place with an unrelated party under the same circumstances, terms and conditions.

1.1.2 Historical overview

The first transfer pricing legislation goes back to early twentieth century. In 1915, the United Kingdom introduced the first transfer pricing legislation, and the United States followed shortly thereafter in 1917. Due to increasing internationalisation, the OECD released its first draft Model Tax Convention on Income and Capital providing guidelines for Double Tax Treaties ("OECD Model Convention in 1963. This draft OECD Model Convention included the arm's length principle (see section 2.1.1.1).

[1] Article 9 of the Model Tax Convention on Income and Capital providing guidelines for Double Tax Treaties

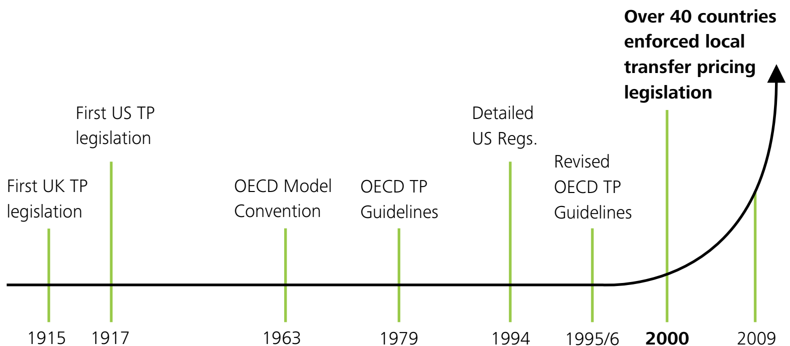
In 1979, the OECD released guidelines on transfer pricing ("OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations") - hereafter "OECD Guidelines". These OECD Guidelines, as updated from time to time, provide general guidance on how to determine arm's length pricing for intercompany transactions.

With the internationalisation and growing number of intercompany flows, transfer pricing has become increasingly important. Over the last ten years, local transfer pricing regulations have been considerably expanded, with over 40 countries enforcing local transfer pricing legislation, making transfer pricing a major tax compliance issue for multi-national businesses. Figure 1, below, provides an overview of the historical evolution of transfer pricing rules.

1.1.3 Transfer pricing in Luxembourg
Although a large number of countries have implemented transfer pricing documentation requirements describing and supporting intercompany transactions, some with specific transfer pricing penalties for non-compliance or insufficient support, Luxembourg does not have specific transfer pricing documentation regulations. However, the need to abide by the arm's length principle is reflected in various articles of the Luxembourg Income Tax Law (see section 2.1.2 for further details

1.2 Why is it important?
One of the main goals at MNEs is to maximise their profits. This goal is of course applied for transactions with third parties. While this should also apply for intercompany transactions,

Figure 1: Historical overview of transfer pricing rules



transfer prices are set within MNEs based on internal decisions, which may not necessarily correspond to the related market prices. Tax authorities are increasingly focusing on transfer pricing and raising more frequent questions regarding the transfer pricing methodologies and prices set for intercompany transactions.

Why is transfer pricing important for Luxembourg in the absence of specific documentation requirements?

First of all, an intercompany transaction should be assessed from both sides of the transaction. This is especially true for cross-border transactions, where the arm's length principle should be respected from both countries' perspectives. Due to the increasing focus by tax authorities on intercompany transactions, and the increasing number of tax audits leading to an adjustment of transfer prices, it becomes essential to have appropriate support on intercompany prices.

Secondly, MNEs operate in different countries where their transfer prices may have an impact on the taxable bases. Using the right transfer pricing policy can help reduce the global tax burden, while ensuring compliance with existing tax and transfer pricing regulations.

1.2.1 Practical business impact

The following example illustrates the impact of a change in the transfer pricing between two (related) parties on their global tax burden. :
Company A, located in country A, renders a service (e.g. IT service) for € 80 to its related party Company B, located in country B. Company B renders the IT service for € 100 to a third party and is subject to restriction on its input VAT recovery, i.e. part of the VAT paid related to services received is non-deductible.

Company A generates a net profit before tax of € 15, after deducting its costs of goods sold for € 20 and operating expenses of € 45. Company B generates a net profit of € 10, after deducting its cost of goods sold for € 80 (i.e. purchase price paid to Company A), expenses of € 5, and non-deductible VAT expenses over the purchase price of € 5. The combined total net profit

Example:

Table 1: Assumptions

	Country A	Country B
VAT/CIT tax rate	40%	20%
Partly non-deductible VAT	-	30%

before tax for these two companies is € 25. The combined effective tax burden in this situation will be € 8.[2]

Now let us assume that the transfer price between Company A and B is lowered from € 80 to € 70. The net profit before tax for Company A will now be lowered from € 15 to € 5, whereas Company B will generate a net profit before tax of € 21 instead of 10 in the previous situation. This is due to a lower CIT rate and lower non-deductible VAT expense resulting from a lower purchase price. The combined total net profit before tax for these two companies is € 26. The combined effective tax burden in this situation will be € 6.[3]

In addition to the higher net profit before tax resulting from a lower non-deductible VAT expense, the overall effective tax rate is lower when Company B receives the services for a lower price. Based on the lower corporate tax rate in Country B and the lower non-deductible VAT expenses, the global tax burden has been substantially reduced from € 13 to € 10.[4] Table 2 below provides a detailed computation of our illustration.

From the example below it can be observed that a mere change in the transfer price can result in a significant reduction of the effective as well as on the actual global tax burden. However, tax authorities understand the impact of setting transfer pricing and consequently they have increased their focus on the determination of transfer prices. In the absence of a proper transfer pricing policy supported by economic analyses, the tax authorities of Country A in the example above may reject the new transfer price and reassess the taxpayer. To avoid lengthy discussions with the tax authorities on how an intercompany price is set (even for a transfer price that remains unchanged), the transfer pricing policy should be properly documented, preferably

Table 2: Business impact on global tax burden - detailed illustration

	Country A	Country B	Country A	Country B
Revenues	80	100	70	100
Cost of goods sold	20	80	20	70
Gross margin	60	20	50	30
Non-deductible VAT (30%)	-	5(a)	-	4(d)
(Operating) expenses	45	5	45	5
Net profit before tax	15	10	5	21

Table 2: Continuation

	Country A	Country B	Country A	Country B
Tax rate	40%	20%	40%	20%
Effective tax burden	6(b)	2(c)	2(e)	4(f)
Global tax burden(X)	X=(a)+(b)+(c):	13	X=(d)+(e)+(f):	**10**

Legend:
(a) / (d) : 30% non-deductible VAT * costs of goods sold *20% VAT rate
(b) / (c) / (e) / (f): Net Profit Before Tax * CIT rate

supported by an economic study on the profit margins of both sides of the transaction. Provided that a proper transfer pricing strategy is put into place, the change in transfer price as presented in the example above can be envisaged.

1.2.2 Main pillars

From the sections above it can be concluded that with regard to transfer pricing two main pillars can be identified:

- **Optimisation:** the right transfer pricing policy can result in an optimisation of existing intercompany flows;
- **Risk reduction:** proper transfer pricing documentation reduces the risk that a given intercompany price is rejected by the relevant tax authorities.

1.3 Who is concerned?

An intercompany transaction between related parties should meet the arm's length standard on **both sides** of the transaction. Therefore, transfer pricing concerns all (corporate) taxpayers, with particular concern for those involved in cross-border intercompany transactions.

1.4 Trends

Over the last ten years, we have experienced an escalation of local transfer pricing rules, with or without specific local transfer pricing documentation requirements. It is expected that this trend will continue in the coming years, whereby more countries will implement detailed transfer pricing legislation.

At the same time, some countries provide specific tax/transfer pricing incentives to attract certain business activities to their jurisdiction. With respect to IP, a number of countries have implemented specific incentives for attracting IP to their jurisdiction. As of 1 January 2008, Luxembourg is one of these countries that have implemented a favourable IP regime (see section 3.2.2 for further details).

[2] 40% CIT rate * 15 + 20% CIT rate * 10 = 8
[3] 40% CIT rate * 5 + 20% CIT rate * 21 = 6
[4] Effective tax burden 8 + non-deductible VAT expense 5 = 13

2. Regulatory framework

2.1 Overview of regulatory framework

2.1.1 General

2.1.1.1 Arm's length principle

The arm's length principle is the international standard and basis for transfer pricing analyses. The arm's length principle can be found in Article 9 of the OECD Model Convention, stating:

"Where […] conditions are made or imposed between ... two [related] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."

In other words, if the arm's length principle is not respected for transactions between related parties, the transfer price and consequently the taxable basis can be adjusted by the relevant tax authorities.

The application of the arm's length principle is further described in the OECD Guidelines, as explained hereafter.

2.1.1.2 OECD Transfer Pricing Guidelines

The OECD Guidelines provide guidance on how to apply the arm's length principle for intercompany transactions. As part of this guidance, the OECD Guidelines describe different methods to evaluate whether the conditions of commercial and financial relations in the context of cross-border transactions between related parties are in accordance with the arm's length standards. The selection of the appropriate transfer pricing method is generally based on a functional analysis describing the functions performed, risks borne and assets utilised by each of the parties to the transaction. The OECD Guidelines make a distinction between two general categories of methods:

(1) Traditional transaction methods

Traditional transaction methods compare the prices or the (gross) margins from controlled transactions[5] to those of transactions between or with independent parties. Under the transaction methods, detailed information is required to compare controlled transactions with uncontrolled transactions. The OECD Guidelines describe three types of transfer pricing methods under this category:

Figure 2.1: Internal CUP - comparison of "€ X?" **with** independent parties

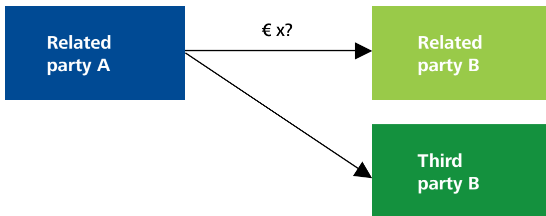
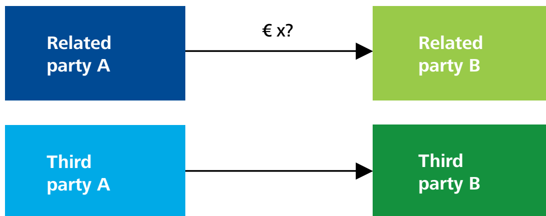


Figure 2.2: External CUP - comparison "€ X?" **between** independent parties



- **Comparable Uncontrolled Price method ("CUP"):** the CUP method compares the price charged in a controlled transaction to the price charged in a comparable uncontrolled transaction under very similar circumstances. In other words, the price set in a related party transaction is compared to the price set in a comparable transaction between unrelated parties. There are two types of CUPs, internal and external ones. An internal CUP compares prices in controlled transactions to those in uncontrolled transactions **with** independent parties, whereas an external CUP compares prices in controlled transactions to those in uncontrolled transactions **between** independent parties.[6] Figures 2.1 and 2.2 illustrate an internal and external CUP.

The OECD Guidelines state that an uncontrolled transaction is a reliable comparable for purposes of the CUP method if: "(1) none of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions could materially affect the price in the open market, or (2) reasonably accurate adjustments can be made to eliminate the material effects of such differences."[7]

Although the CUP is the most direct way to establish whether the prices in controlled transactions are at arm's length, in practice it will often be difficult to identify a good CUP due to the lack of detailed information on the external comparables (i.e. unrelated comparable companies).

[5] Prices set internally at intercompany level
[6] Paragraph 2.6 OECD Guidelines
[7] Paragraph 2.7 OECD Guidelines

Figure 3: Resale Price Method

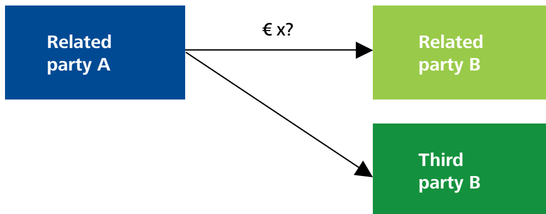
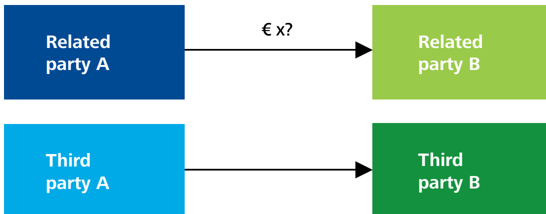


Figure 4: Cost Plus Method



- **Resale Price Method ("RPM"):** the RPM makes reference to the gross margin realized in comparable uncontrolled transactions to determine whether the price in a controlled transaction is at arm's length. This method is primarily used for distributors reselling products.
- **Cost Plus method ("CP"):** the CP method starts with the costs incurred in a controlled transaction for property transferred or services provided to a related purchaser. An appropriate cost plus mark up is then added to these costs in order to achieve an appropriate profit in relation to the functions performed and the market conditions. What is arrived at after adding the cost plus mark up to the initial costs may be regarded as an arm's length price for the original controlled transaction.[8] This method is often used for manufacturing and services activities.

Although the OECD Guidelines do not describe any hierarchy in the methods to be used, it has a preference for the use of the traditional transaction methods described above. Only when these methods cannot be reliably applied, the profit based methods, as described in part (2) of this section, should be used to come to an approximation of the arm's length conditions.[9]

(2) Traditional profit methods
Traditional profit methods examine the profits that arise from a particular controlled transaction when compared to those of an uncontrolled transaction. Profit methods assess the overall profitability earned by related parties, against those earned by independent parties performing similar functions and bearing similar risks. Under the profit methods, less detailed information is required in terms of functions, risks and assets than under the transaction methods.

The OECD Guidelines describe two main types of transfer pricing methods under this category:

- **Profit Split Method ("PSM"):** The PSM is applied for transactions that are very interrelated, and cannot be evaluated on a separate individual basis. This method splits the overall profit between the related parties based on an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length.[10] This method can, for example, be applied for joint contribution of the creation of intangibles.
- **Transactional Net Margin Method ("TNMM"):** The TNMM examines the net profit margin of transactions relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realizes from a controlled transaction against that of the financial results of comparable unrelated parties performing similar functions and incurring similar business risks.[11] This method is mainly used if the other (transaction) methods do not result in an arm's length result.

2.1.1.3 EU Joint Transfer Pricing Forum

The European Union has endorsed the OECD framework via its working group "EU Joint Transfer Pricing Forum" that was set-up in 2001. This Forum was set-up as a consequence of the different interpretations given to the OECD Guidelines, which often give rise to cross border transfer pricing disputes. The Forum, consisting of a group of experts from the tax administrations of each Member State and experts from the business, works within the framework of the OECD Guidelines and provides practical recommendations and guidelines on different transfer pricing topics. The outcome of the Forum should be considered as a political commitment, but it will not be binding to the Member States.[12]

[8] Paragraph 2.32 OECD Guidelines
[9] Paragraph 3.1 OECD Guidelines
[10] Paragraph 3.5 OECD Guidelines
[11] Paragraph 3.26 OECD Guidelines
[12] http://ec.europa.eu/

2.1.2 Local

2.1.2.1 Statutory rules

Luxembourg reflects the arm's length principle in different articles of the Income Tax Law ("ITL"). Article 56 ITL provides the core provision on transfer pricing. This Article allows the Luxembourg tax administration to estimate the profit of a taxpayer in case of a possible transfer of profits out of Luxembourg that is due to a special economic relationship with a non-resident company, either directly or indirectly. The definition of a related party ("special economic relationship") is therefore very broadly defined as a relationship that differs from a normal commercial relationship, which allows for a potential transfer of profits.[13]

Article 164 ITL allows for a reclassification of hidden distributions with regard to (non-resident) shareholders receiving direct or indirect advantages from a taxpayer in Luxembourg, which they would not have received if they were unrelated parties. The burden of proof, however, remains first with the Luxembourg tax administration to demonstrate that there is effectively an advantage received by a (non-resident) shareholder. Based on Luxembourg case law,[14] however, the burden of proof may be shifted to the taxpayer who needs to demonstrate that no reduction of Luxembourg profit has taken place.[15]

2.1.2.2 Circulars

Circulars are instructions from the director of the tax authorities applicable to the Luxembourg tax administration on how to apply/interpret the articles to which they refer.[16]

In relation to Article 164 ITL, two circulars have been issued.[17] These circulars refer to shareholder's accounts and provide for the definition and examples for when a transaction results in a hidden distribution of profits. Furthermore, it provides an indication on the interest rate and the way it can be computed.

2.1.2.3 Case law

There is relevant case law in Luxembourg relating to transfer pricing, although it is still relatively limited. Current case law shows that the Luxembourg tax administration regularly puts forward the argument of hidden profit distributions. Therefore, in particular for intercompany transactions between parent companies and their subsidiaries, it is recommended that taxpayers ensure that the transfer pricing complies with the arm's length principles and have proper documentation in place to support it.

2.1.2.4 Documentation requirements

Luxembourg does not have specific transfer pricing documentation requirements, but in anticipation of a tax audit in, or outside of Luxembourg, taxpayers on both sides of the intercompany

transaction should maintain proper documentation relating to its transfer pricing policy. Such documentation generally includes intercompany agreements, transfer pricing analysis (e.g. functional analysis, selection of transfer pricing method, economic analysis), invoices and other relevant records such as minutes of meetings or brochures.

2.1.2.5 Agreements with tax authorities

Taxpayers may, on a case-by-asis, discuss their transfer pricing methodologies with the Luxembourg tax administration and obtain advance tax agreements. In contrast to other countries, Luxembourg has not issued any formal Advanced Pricing Agreement ("APA") procedure. In absence of such formal procedure, we have not seen any bilateral or multilateral APAs negotiated with Luxembourg.

2.1.2.6 Dispute resolution

There is not much information available on transfer pricing disputes in Luxembourg. In the case of a dispute between a taxpayer and the Luxembourg tax administration that cannot be solved, there are different routes available to a taxpayer to come to a solution within prescribed deadlines.

Local remedies
A taxpayer may utilise local remedies provided by domestic law to come to satisfactory solutions.

Mutual agreement procedure
Alternatively, a taxpayer may, based on the applicable article of the Double Tax Treaty ("DTT"), file a Mutual Agreement Procedure ("MAP").[18] The filing of such request is done in the country where the taxpayer is a resident and, in some cases also in the country where it is a national. Luxembourg included in all its DTTs a MAP, which can be filed in Luxembourg with the International Division of Direct Taxation ("La Division des Relations Internationales").

Under the MAP, the competent authorities should make an effort to resolve the case for the taxpayer, but there is no obligation for the competent authorities to arrive at a satisfactory solution.

[13] LOQUET Erwan / RASCH Marc, IBFD country analysis, Transfer pricing database 2009, Par. 2.2
[14] Administrative Court of Appeal, No. 11318 C, 1 February 2000
[15] LOQUET Erwan / RASCH Marc, IBFD country analysis, Transfer pricing database 2009, Par. 2.9
[16] LOQUET Erwan / RASCH Marc, IBFD country analysis, Transfer pricing database 2009, Par. 2.5
[17] Circular ITL N.S. N° 164/1, dated 9 June 1993; Circular ITL N° 164/1, dated 23 March 1998
[18] Most MAP in DTTs are based on article 25 of the OECD Model Tax Convention

European Arbitration Convention
Besides the local remedies and the MAP, a taxpayer may also opt for the European Arbitration Convention (90/436/EEC) on the elimination of double taxation in connection with the adjustment of profits of associated enterprises. Under this Convention, which applies to European Member States that have ratified it, there is an obligation, unlike the lack of obligation under the MAP, to resolve the dispute and eliminate the double taxation for the taxpayer from a transaction that resulted in an adjustment to the taxable base.

2.1.3 International

2.1.3.1 Importance of transfer pricing outside of Luxembourg
OECD members as well as most other countries have adopted or tend to follow the arm's length principles and transfer pricing methodologies as described in the OECD Guidelines. Furthermore, an increasing number of countries have implemented local transfer pricing documentation requirements, some with additional transfer pricing penalties.

Whereas most countries have the possibility to agree on the transfer pricing methodology in advance with the local tax authorities, a number of countries have implemented (contrary to Luxembourg) a formal APA procedure that allows for a bi- or multi-lateral agreement between the different tax authorities.

2.1.3.2 Trends
The trend over the last ten years has been the escalation and enforcement of local transfer pricing rules, often including specific transfer pricing documentation requirements and/or penalties.

It is expected that this trend will continue in the coming years, whereby countries with or without little local transfer pricing legislation will implement documentation requirements and specific local transfer pricing rules.

Over the last years, tax authorities have been increasingly focusing on transfer pricing, which is evidenced by the surge in tax audits challenging transfer pricing policies.

3. Business opportunities

3.1 Overview

3.1.1 Tool for international tax planning

Transfer pricing is an important tool for international tax planning. For any international tax planning, transfer pricing considerations should be made in close cooperation with income taxes, VAT and customs duties. Any approach focusing only on one of these factors is likely to give rise to considerable risk. Not giving adequate consideration to the other tax regimes will lead to the creation of exposures instead of opportunities. As explained in section 1.2.1, applying the right transfer pricing strategy may reduce the overall tax burden.

3.1.2 Basic principles

3.1.2.1 Characterisation of activities

In order to optimise and align the right transfer pricing policy to arrive at an arm's length compensation for each party to the (intercompany) transaction, it will be important to perform a transfer pricing analysis. The starting point is a functional analysis in which the functions performed, risks borne and assets utilised in the intercompany transaction(s) are described. The outcome of the functional analysis provides a functional and risk profile (characterisation) for each of the parties.

The more functions, risks and assets are attributed to a specific party, the more profits (or losses) should be allocated.

3.1.2.2 Selection of transfer pricing method

Based on the outcome of the functional analysis, an appropriate transfer pricing method can be selected. The transfer pricing method is generally selected based on the so-called "tested party", the party to the transaction with the lower functional and risk profile. The reason hereof is that the tested party's functions and risks borne will be compared with transactions between or with unrelated parties performing similar functions and bearing similar risks. Conversely, it would be difficult to test a transaction with complex functions and risks with an unrelated party as the increased complexity can create too many comparability issues. The tested party performing the least complex functions generally receives a routine compensation for its activities, whereas the counterparty of the transaction performing often the more complex functions and risks would receive the residual profit. On the other hand, if a wrong transfer pricing method is selected, the profit margin for the tested party may show significant fluctuations during the financial year. The example below illustrates the impact of choosing the correct tested party and transfer pricing method.

Figure 5: Selection of tested party

In the figure above, the manufacturer performs the routine activities and is selected as the tested party. The distributor performing the most complex functions and bearing the main risks is eligible for the residual profit. In this example, the manufacturer has a cost basis of € 100. The market price to the third parties fluctuates from € 150, € 170 to € 130.

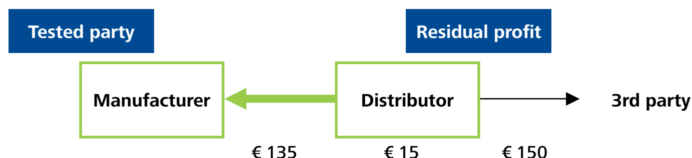
Under the application of an arm's length cost plus 10% for the manufacturer, it will charge to the distributor a transfer price of € 110, receiving net compensation of € 10. The distributor will receive, based on the fluctuating market price, a gross compensation of € 40 (€ 150 - € 110), € 60 or € 20, respectively. If a resale price is applied as the transfer pricing method, the resale price margin at the level of the distributor will constantly fluctuate depending on the market price to still provide the manufacturer with a cost plus of 10%. In the example below, the resale price margin would fluctuate between 15.4% and 35.3%.

The example below shows that the fluctuation in the market price is a risk for the distributor, whereby the manufacturer receives routine compensation. On the contrary, if the manufacturer were entitled to the residual or excess profit and the distributor to a routine profit, the appropriate transfer pricing method should be based on a resale price method instead. In that case, the routine profit margin for the distributor would be based on, for instance, a percentage of the third party sales. This is depicted in figure 6 below, whereby we assume a market price of € 150 and a routine profit margin for the distributor of 10% (€ 15) on net sales.

Table 3: Impact of transfer price

	Cost price manufacturer	Manufacturer Cost plus 10%	Distributor Residual	Distributor resale margin	Market price
1	€ 100	€ 10	€ 40	26.7%	€ 150
2	€ 100	€ 10	€ 60	35.3%	€ 170
3	€ 100	€ 10	€ 20	15.4%	€ 130

Figure 6: Distributor as tested party



3.2 Inbound tax/transfer pricing opportunities

3.2.1 Central entrepreneur model

3.2.1.1 Overview

MNEs are often engaged in a broad range of activities, resulting in numerous intercompany flows that may include products, services, IP and/or financing. Certain activities, such as research and development ("R&D") activities, may be performed in one or more jurisdictions. Under a central entrepreneur model, the key functions and key risks related to such activity will be centralised and performed by one central entrepreneur.

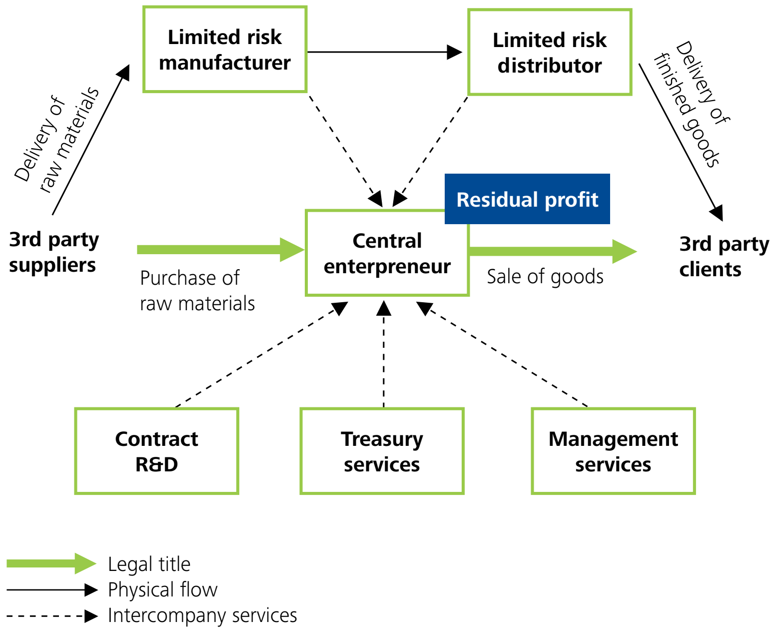
In the case of an R&D activity, the key functions, e.g. strategic decisions, will be made at the level of the central entrepreneur, and the latter will also bear the main entrepreneurial risks. However, the operational R&D activities can remain at the level of the R&D company. Figure 7, provides an example of activities that can be centralised through the use of a central entrepreneur model.

3.2.1.2 Benefits

There are a number of benefits for implementing a central entrepreneur model. First of all, the overall business is managed and controlled centrally, which may lead to higher efficiency and a reduction in operational costs. Additionally, for performing the key functions and bearing the key risks, the excess profit should also be allocated to the central entrepreneur. If the entrepreneur is located in a tax beneficial jurisdiction, the overall tax burden can be further reduced.

Luxembourg is regarded as an attractive jurisdiction to set-up a central entrepreneur model as, amongst other advantageous conditions, tax efficient profit repatriation can be achieved without withholding tax consequences. Furthermore, Luxembourg is attractive for its low effective VAT and corporate tax rates. Several MNEs have already implemented one of more of these structures, with the aim of a lower global tax rate in Luxembourg.

Figure 7: Central entrepreneur model



3.2.1.3 Potential considerations

When an optimisation of the supply chain is envisaged, whereby key functions and/or risks are shifted from one jurisdiction to another one, it will be important to consider the potential consequences. From an operational perspective, it may require the real-location of a number of key employees to another jurisdiction, which may not always be obvious in practice. Furthermore, from a tax perspective, there may be exit charges for transferring certain rights or assets. An exit charge is a payment to tax authorities for the transferred rights or other assets that carry profit/loss potential and should be remunerated at arm's length "loss of profit potential".[19] Moreover, as a result of a change in functions and risks for the intercompany transactions, the transfer price should be adjusted.

In order to minimise the risks that local tax authorities would argue that there is an exit charge, or that the applied transfer price is not correct, the taxpayer

should have proper transfer pricing documentation and an economic study supporting the new transfer price. Such transfer pricing analyses are compulsory in most (European) countries, irrespective of whether there is a change in the actual activities, functions and/or risks.

3.2.2 Intellectual property regime

3.2.2.1 Overview

Luxembourg has implemented a beneficial tax regime (applicable as of 1 January 2008) for income derived from IP rights. The IP regime provides an exemption of 80% of net income related to "qualifying IP rights".[20] The qualifying IP rights are copyrights on software, patents, trademarks (including service marks and domain names), designs and models acquired or created after 31 December 2007.

Taxpayers that own self-developed IP for their own business may benefit from a notional deduction that amounts to 80% of the net positive income that they would have earned if they had licensed the right to use the patents to a third party.

3.2.2.2 Benefits

The main advantages of the new Luxembourgish IP regime are the following:

- The royalty expenses should be tax deductible in most countries where a licence payment is made for the use of the IP rights, whereas in Luxembourg a total of 80% of the licence income is tax exempt;
- There is 80% exemption on the capital gains when the IP is sold;
- Potential significant reduction or elimination of foreign withholding taxes on royalties received for Luxembourg tax resident companies which can benefit from EU directives and from the extensive network of DTTs concluded by Luxembourg. To the extent there is foreign withholding taxes on royalties paid, it can under certain conditions be credited against the Luxembourg corporate income tax;
- The qualifying IP is fully exempt from Net wealth tax (the general annual rate is 0.5% on the net asset value at the beginning of the year);
- Based on the applicable corporate tax rates for 2009, licence income under the IP regime would be subject to an effective tax rate of 5.71%, (for companies based in Luxembourg city) which is considered to be (one of) the lowest in Europe.

[19] OECD draft business restructuring, page 24
[20] Article 50bis ITL

3.2.2.3 Potential considerations
It will be important that the royalty payments made by the foreign licensees are in line with the arm's length standard. Therefore, it is highly recommended that there are proper transfer pricing documentation and intercompany agreements in place.

3.2.3 Opportunities in an economic downturn

3.2.3.1 Overview
In an economic downturn being characterised by a decrease in demand, resulting in lower sales and subsequent lower production volumes, companies take steps to secure their going concern and often initiate cost-cuttings. The current downturn combines a credit crunch with decreased demand, resulting in companies facing even more challenges in managing their day-to-day business.

3.2.3.2 Benefits
A downturn is often viewed as unfavourable, but it may also create business opportunities where transfer pricing can play an important role.

There are short-term and medium- to long-term transfer pricing opportunities as described below.

- *Short-term opportunities*
  In an economic downturn, the demand generally decreases, resulting in lower sales and subsequent lower production volumes. A decline in the overall profit margin may, based on the applicable transfer pricing policy at MNEs, result in local losses whereas other entities remain profitable. In particular during an economic downturn, it should be considered whether the supply chain risks can be partly shared (e.g. risks translating into losses). Moreover, where prices with third parties are revised, the question is whether the existing intercompany pricing continues to appropriately reflect the economic reality? A short-term business opportunity may be to adapt the transfer pricing to appropriately reflect the economic reality. Such change in intercompany pricing may potentially lead to a better allocation of profits and losses, contributing to an overall lower tax burden. The determination of an arm's length transfer price can be determined on the basis of economic analyses. Another example relates to intercompany loan facilities. If the borrower no longer has the same credit worthiness, i.e. the same credit rating, it should be analysed whether the current interest rate should be adjusted upwards or downwards for the related increase or decrease in credit worthiness.
- *Medium to long-term opportunities*
  Cost reductions are one of the first protective measures that are taken during an economic downturn. However, cost reductions should

always be considered in relation to the optimisation of revenues in order to avoid long-term detrimental effects for when the economy recovers. Appropriate cost management may lead to further centralisation of functions within a MNE. In addition to analysing such centralisation from an operational perspective, the tax and transfer pricing aspects should also be considered to achieve the adequate tax optimisation.

In a downturn, there may be losses within the group and/or the value of the IP may have been reduced. In such a period, it should be considered if an optimisation of the entire supply chain can create additional tax advantages. With regard to losses, it should be assessed whether these (temporary) losses are located in the proper jurisdiction. If not, converting the loss-making entities into limited risk entities should be considered, leaving them with a future routine compensation instead. The excess profit (or losses) will then be attributed to the central entrepreneur (see section 3.2.1).

In case of a reduction in IP value, it may be the right moment to transfer the IP to a jurisdiction with a beneficial IP regime, e.g. to Luxembourg.
In particular, if the IP value is low, the acquisition price should also be lower.

3.2.3.3 Potential considerations

When adjusting the transfer pricing, it is recommended to base the adjustment on an economic analysis (e.g. benchmarking study), with the support of appropriate transfer pricing documentation. This is particularly true as tax authorities are increasingly focusing on intercompany pricing. An economic analysis consists of a search for comparable companies or loan facilities performing similar functions and risks. When adjusting the intercompany price, it is important to review the existing intercompany agreements to understand whether an adjustment to the pricing can be made during the term or whether it is appropriate to renegotiate the terms and conditions in consideration of the economic downturn.

One of the main considerations in the conversions above is that the new transfer price should continue to be in line with the arm's length principle. Depending on the way the conversion is performed and the value of the transferred activity, an exit charge may be due.

3.3 What is the right transfer pricing opportunity to pursue?

To determine what is the right transfer pricing policy for them and which transfer pricing model would fit their particular business operations, MNEs generally perform a feasibility study, whereby both operational, tax and transfer pricing aspects are considered.

4. How can the Chamber of Commerce help you?

The Chamber of Commerce is a public institution encompassing all sectors of activity other than agriculture and the skilled-craft industry. Today, the Chamber of Commerce has some 40,000 affiliated members, representing 80% of GDP and 75% of total employment. The plenary assembly of the Chamber of Commerce consists of 25 elected members representing 6 sectors of activity: trade and other trade related activities; financial participations companies (Soparfi); industry, small and medium-sized industries; banking and other financial activities; insurance; the hotel, restaurant and bar business.

Guardian of wealth creation …
The rationale behind the Chamber of Commerce is simple: all wealth is created through companies. Thus, the Chamber of Commerce fulfils its role as guardian of the interests of Luxembourg companies by assuming the following tasks:

Promotion of the general economic interest – The primary task of the Chamber of Commerce is to express and represent the general economic interest. On this basis, the Chamber of Commerce promotes an open, dynamic and competitive economy in order to enable companies to benefit from unrestrained development. It also supports the promotion of Luxembourg companies and products abroad and encourages foreign investment.

An independent mouthpiece for the market economy and critical voice responding to national, European and international policy-making

As an accredited and independent mouthpiece for the market and its players, the Chamber of Commerce defends company interests and supports their development and expansion at national, European and international level.

Involvement in the legislative procedure – The task of promoting the interests of companies requires the participation of the Chamber of Commerce in the legislative procedure. Within this context, the government has the duty to request the opinion of the Chamber of Commerce regarding any bill or Grand-Ducal Regulation related to the sectors of activity represented by the Chamber. In addition, the Chamber of Commerce is entitled to submit bills to the government, to be transmitted to the Chamber of Deputies.

Service provider to business and the general public – Today, the Chamber of Commerce is also primarily a service provider for Luxembourg citizens and all those interested in setting up any commercial, financial or industrial activity in Luxembourg.

Five departments at your service
The Chamber of Commerce comprises five departments that offer a wide range of services:

- Department of Business Creation and Development
- Department for Legal Affairs
- Department of Economics
- Department of International Affairs
- Department of Education and Training

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Abbreviations

APA	Advanced Pricing Agreement
CP	Cost Plus
CUP	Comparable Uncontrolled Price
DTT	Double Tax Treaties
IP	Intellectual property
ITL	Income Tax Law
MAP	Mutual Agreement Procedure
MNEs	Multinational Enterprises
OECD	Organization for Economic Cooperation and Development
OECD Guidelines	OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations
OECD Model Convention	Model Tax Convention on Income and Capital providing guidelines for Double Tax Treaties
PSM	Profit Split Method
R&D	Research & Development
RPM	Resale Price Method
TNMM	Transactional Net Margin Method

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