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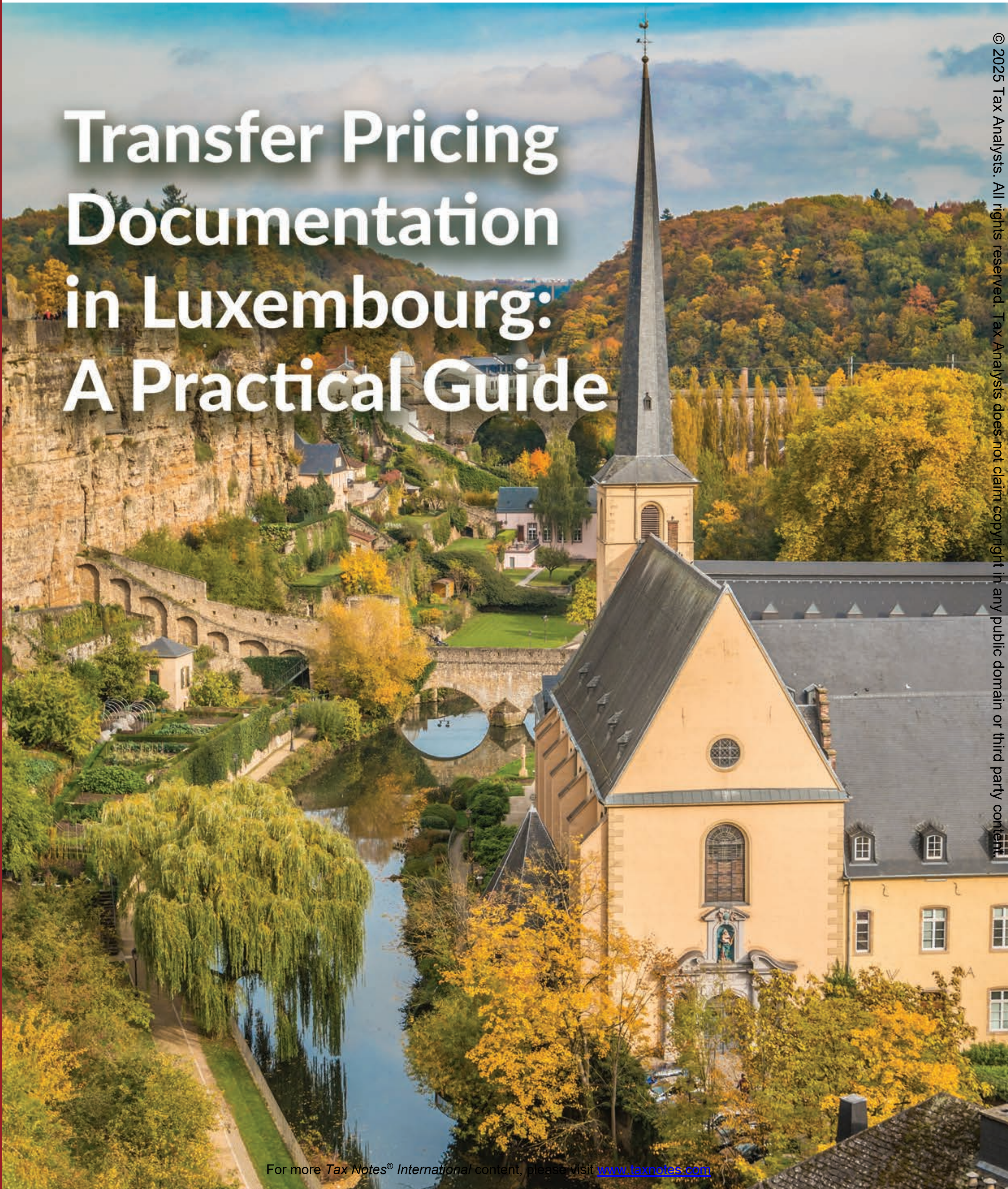

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In this article, Hoor examines the transfer pricing environment in Luxembourg, including a review of its tax law and tax history, and suggests best practices for multinationals and international investors doing business there.

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Transfer pricing documentation has become a key element of tax risk management in Luxembourg in an environment that relies less and less on tax rulings and advance pricing agreements. However, in the current international tax environment of increased transparency and scrutiny, companies would be wise to go one step further and integrate transfer pricing documentation into their broader tax strategy. This article is a practical guide to transfer pricing documentation in Luxembourg.

Introduction

Luxembourg tax law does not explicitly require specific transfer pricing documentation. However, this does not mean that taxpayers are not obligated to demonstrate the arm's-length nature of their controlled transactions through robust transfer pricing documentation.

Instead, the pressure to prepare transfer pricing documentation for Luxembourg tax purposes may come from several directions, such as the magnitude of the intragroup transaction and the associated tax risks, the rules on the burden of proof, and the ability of tax authorities to challenge the transfer pricing.

Whenever Luxembourg tax authorities can reasonably show that the transfer pricing of an intragroup transaction is not in line with the arm's-length principle, it is up to the taxpayer to disprove this rebuttable presumption. Similarly, if a taxpayer wishes to claim a downward adjustment or a hidden capital contribution, it is for the taxpayer to prove the amount.

When Luxembourg companies carry out financing activities that fall within the scope of the Luxembourg circular on transfer pricing aspects of financing activities,[1] the Luxembourg tax authorities expect the taxpayer to substantiate the arm's-length margin in a transfer pricing study.

This article:

- analyzes transfer pricing documentation requirements under Luxembourg tax law;
- considers the OECD guidance on transfer pricing documentation; and
- provides best practice recommendations regarding tax risk management and the development of an appropriate transfer pricing documentation strategy.

Transfer Pricing and the Duty of Cooperation

Opening Comments

Generally, Luxembourg tax authorities are obliged to investigate all facts and circumstances of a tax case.[2] Conversely, the taxpayer has a duty to cooperate with the tax authorities.[3] These principles go hand-in-hand and complement each other.[4]

A Luxembourg company's transfer prices are generally reviewed by tax authorities as part of the tax assessment procedure.[5] They may also be examined in the course of a tax audit covering several tax years.[6] If authorities object to statements made in the tax return, in principle they should ask the taxpayer to complete the return or provide supporting evidence.[7] Here is where the taxpayer has a duty to cooperate[8] (provide evidence of facts, circumstances, and relevant information[9]).

If the taxpayer's cooperation is insufficient, tax authorities may turn to a third party.[10] However, the third party, unlike the taxpayers themselves, may in certain circumstances lawfully refuse access to the information requested.

If none of the above is sufficient, taxpayers should be aware that, despite the limited documentation requirements, tax authorities may estimate arm's-length prices (in particular, if a Luxembourg company does not sufficiently substantiate the statements made in the corporate tax returns or fulfil its accounting obligations with due diligence).[11]

When an advance pricing agreement request is made, the transfer pricing of a controlled transaction between related parties is reviewed before the Luxembourg tax authorities decide on the case.[12]

The Taxpayer's Duty of Cooperation

Section 171 of the general tax code is the basis for the obligation of Luxembourg taxpayers to cooperate with tax authorities. Under this provision, taxpayers are required to provide evidence and information, as long as the evidence is available, reasonable for the taxpayer to have, and relevant for clarification purposes.[13] Thus, under section 171, the taxpayer is only required to obtain and provide existing documentation, not to prepare specific transfer pricing documentation.

[1] Circular L.I.R. No. 56/1 — 56bis/1 of Dec. 27, 2016.

[2] General Tax Code, section 204 (1).

[3] Section 171 General Tax Code; Tribunal Administratif, Decision of June 3, 2009, No. 24935; Tribunal Administratif, Decision of Sept. 10, 2008, No. 23544; Bundesfinanzhof (BFH), Decision of Dec. 7, 1955, V z 183/54 S, Bundessteuerblatt (BStBl.) III 1855, p. 75.

[4] BFH, Decision of Mar. 25, 1955, III 81/54 U, BStBl. III 1955, p. 133; BFH, Decision of Dec. 7, 1955, V z 183/54 S, BStBl. III 1955, p. 75; BFH, Decision of Apr. 7, 1959, I 2/58 S, BStBl. III 1959, p. 233; BFH, Decision of Oct. 29, 1959, IV 579/56 S, BStBl. III 1960, p. 26; BFH, Decision of July 13, 1962, VI 100/61 U, BStBl. III 1962, p. 428; BFH, Decision of Feb. 20, 1979, VII R 16/78, BStBl. II 1979, p. 268.

[5] Section 166 (1) General Tax Code.

[6] Section 162(10) General Tax Code.

[7] General Tax Code, section 205.

[8] General Tax Code, section 171 (1),(2).

[9] The taxpayer may not refuse to cooperate because the tax authorities are obliged to investigate, and the tax authorities may not remain passive because the taxpayer is obliged to cooperate.

[10] General tax Code, section 175.

[11] General Tax Code, section 217.

[12] When a Luxembourg finance company applies for an APA, the application must be based on a transfer pricing study. This is in line with a trend at the tax authority level to more systematically request transfer pricing documentation to support the arm's-length nature of intragroup pricing.

[13] BFH, Decision of Dec. 19, 1952, V z 66/53, BStBl. III 1953, p. 63; BFH, Decision of Jan. 20, 1959, I 155/57, BStBl. III 1959, p. 222; BFH, Decision of July 13, 1962, VI 100/61 U, BStBl. 1962, p. 428; BFH, Decision of July 12, 1974, III R 116/72 BStBl. II 1975, p. 25; BFH, Decision of Apr. 16, 1980, I R 75/78, BStBl. II 1981, p. 492.

Section 171 (3) explicitly extends the taxpayer's cooperation obligation to transactions between associated enterprises, although it does not contain any specific transfer pricing documentation requirements. Although this provision is merely clarifying, it confirms that authorities are placing greater emphasis on transfer pricing documentation.[14]

In general, taxpayers should endeavor to determine transfer prices for tax purposes in accordance with the arm's-length principle based on the information available at the time of determination. Taxpayers are therefore required to collect evidence at that time.[15]

The obligations of Luxembourg companies for bookkeeping and the preparation of annual accounts under Luxembourg commercial law are also requirements for tax purposes.[16] To the extent that the documentation meets the requirements of section 162 of the general tax code, it is in principle binding for Luxembourg tax purposes.[17] Financial statements and inventory records must be retained for 10 years; accounting records, business correspondence, and other information for seven years.[18] Failure to comply with minimum standards or document retention requirements may result in (partial) disregard of the accounts when determining taxable income.[19]

In addition, if values are based on estimates (rather than market values, nominal values, or payment records), section 169 of the general tax code requires that they be substantiated by facts.[20]

In a cross-border situation in which nonresident group companies are involved, Luxembourg taxpayers are under an extended duty of cooperation.[21] This measure is based on the need for Luxembourg tax authorities to respect the legal sovereignty of the foreign jurisdictions involved. Moreover, the taxpayer is often in a better position to obtain evidence from foreign jurisdictions.[22] However, as part of the duty to investigate all underlying facts, tax authorities are entitled to cross-border administrative assistance.

Burden of Proof

General

Under Luxembourg tax law, the burden of proof is generally shared between the taxpayer and the tax authorities. The burden of proof for facts and circumstances that result in an increase in the taxpayer's taxable income rests with the tax authorities, while the burden of proof for facts and circumstances that result in a decrease in the taxable income rests with the taxpayer.[23] Thus, a distinction must be made between upward and downward adjustments regarding the burden of proof for transfer pricing adjustments.

Burden of Proof for Upward Adjustments

The burden of proof that transactions in these cases are not at arm's length generally rests with the tax authorities. It is up to the administration to verify whether the transfer prices for goods and services transferred between group companies are in line with the arm's-length principle.

If the tax authorities can prove that a transfer price is not within the arm's-length range, there is a rebuttable presumption that the transaction is

[14] Section 171 (1) of the general tax code already applied to Luxembourg companies that are part of a group of companies.

[15] BFH, Decision of May 14, 1982, VI R 266/80, BStBl. II 1982, p. 772.

[16] General tax code, section 160.

[17] General tax code, section 208.

[18] General tax code, section 162 (8).

[19] General tax code, section 208.

[20] Reichsfinanzhof (RFH), Decision of Jan. 23, 1935, Reichssteuerblatt(RStBl.) 306; BFH, Decision of July 13, 1962, BStBl. III 428.

[21] RFH, Decision of Apr. 16, 1930, I A 370/29, RStBl. 1930, p. 151; RFH, Decision of Oct. 18, 1933, VI A 1683/32, Sammlung der Entscheidungen und Gutachten des Reichsfinanzhofs (RFHE) 34, 286; RFH, Decision of Jan. 9, 1934, I A 344/32, RFHE 36, 133; BFH, Decision of Apr. 7, 1959, I 2/58 S, BStBl. III 1959, p. 233; BFH, Decision of Jan. 21, 1976, I R 234/73, BStBl. II 1976, p. 513; BFH, Decision of Apr. 16, 1980, I R 75/78, BStBl. II 1981, p. 492; BFH, Decision of May 14, 1982, VI R 266/80, BStBl. II 1982, p. 772.

[22] BFH, Decision of July 15, 1986, VII R 145/85, BStBl. II 1986, p. 857; BFH, Decision of Mar. 20, 1987, III R 172/82, BStBl. II 1987, p. 679; BFH, Decision of June 19, 1985, I R 109/82, BFH/Nicht veröffentlicht (NV) 1986, p. 249; BFH, Decision of Feb. 15, 1989, X R 16/86, BStBl. II 1989, p. 462.

[23] Article 59 of the Law of June 21, 1999; BFH, Decision of June 24, 1976, IV R 101/75, BStBl. II 1976, p. 562; BFH, Decision of Apr. 11, 1984, I R 175/79, BStBl. II 1984, p. 535.

not at arm's length.[24] Overall, the burden of proving that intragroup transactions are not at arm's length is relatively low.[25]

Although the burden of proof is on the tax authorities, they can still reasonably require a Luxembourg company to provide consistent arguments regarding its transfer pricing.[26] In this regard, the company must consider that the voluntary production of documents can significantly improve the persuasiveness of its transfer pricing position.[27]

If the taxpayer is unable to justify the arm's-length nature of intragroup transactions, tax authorities may rely on the concept of hidden dividend distributions or article 56 of the Luxembourg income tax law (LITL) to make upward adjustments.[28]

Burden of Proof for Downward Adjustments

In the case of hidden capital contributions and "downward adjustments" under article 56 of the LITL, the fair market value of the advantage shifted to a Luxembourg company is deducted from the company's taxable income. It follows that the facts and circumstances underlying the advantage that has been shifted to a Luxembourg company must be proven by the taxpayer.[29]

In these situations, tax authorities may reasonably require that the value of a hidden capital contribution or the advantage that would result in a downward adjustment under article 56 of the LITL be substantiated in a transfer pricing study.

The Estimation of Transfer Prices

As a last resort, tax authorities may estimate arm's-length prices[30] for the determination of an appropriate taxable income.[31] However, it is not the amount of tax due that is estimated,[32] but rather the various elements of the taxpayer's income that are subsequently added together.[33]

The estimation is necessary when tax authorities cannot proceed otherwise, regardless of the taxpayer's wrongdoing. Estimation of transfer prices may be required when the taxpayer:

- fails to comply with bookkeeping and financial reporting requirements;[34]
- fails to meet bookkeeping standards (as set out in section 162 of the general tax code);[35]
- does not provide the necessary facts and circumstances relating to the tax position;[36] or
- does not provide a statutory declaration (*eidesstattliche Versicherung*) when requested to do so by tax authorities.[37]

The estimation usually results from a breach of the taxpayer's cooperation obligations.[38] However, if the tax authorities establish a breach of the arm's-length principle, but the taxpayer complies with its cooperation obligations, an estimate of taxable income may still be made.

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[24] The Luxembourg tax authorities may use public databases and data from comparable transactions in other cases (under certain conditions).

[25] According to Luxembourg case law, to reverse the burden of proof, the tax authorities need only show that it is probable that an advantage has been shifted by the company (without having to establish a precise breach of the arm's-length principle); Tribunal Administratif, Decision of Nov. 27, 2006, No. 21033 (ID 675); Tribunal Administratif, Decision of Dec. 31, 2007, No. 22777 (ID 6149); Tribunal Administratif, Decision of June 9, 2008, No. 23324 (ID 7946); Cour Administrative, Decision of Feb. 12, 2009, No. 24642C (ID 9626); Tribunal Administratif, Decision of Feb. 16, 2009, No. 24105 (ID 9414).

[26] The taxpayer must provide consistent arguments that the arm's-length character of the transfer price is at least a probable possibility; RFH, Decision of Dec. 21, 1938, RStBl. 1939, p. 307; BFH, Decision of Apr. 7, 1959, I 2/58 S, BStBl. III 1959, p. 233.

[27] If the arm's-length character of transfer pricing is established in a transfer pricing study, the burden of proof for the non-arm's-length character of intragroup transactions should be significantly higher; *see* Oliver R. Hoor and Philippe Neefs, "TP Documentation in Luxembourg: What the Luxembourg Tax Authorities May Expect," *Tax Plan. Int'l Transfer Pricing* 26 (Dec. 2009).

[28] General tax code, section 217 (1).

[29] At the level of the shareholder, the hidden capital contribution should result in an increase in taxable income (for example, if assets are sold to the company at a sales price below market value). Thus, in the case of Luxembourg shareholders, the burden of proof that the terms of a transaction do not comply with the arm's-length principle should lie with the Luxembourg tax authorities.

[30] General tax code, section 217 (1).

[31] BFH, Decision of Jan. 19, 1993, VIII R 128/84, BStBl. II 1993, p. 594.

[32] The estimation of the amount of the tax liability would be illegitimate.

[33] BFH, Decision of Jan. 26, 1961, IV 314/58.

[34] General tax code, section 160.

[35] General tax code, section 217 (2) s. 2; a bookkeeping does not comply with the standard set out in section 162 of the general tax code if the accounting is incomplete or insufficient.

[36] General tax code, section 217 (2) s. 1 in connection with general tax code section 171.

[37] General tax code, section 217 (2) s. 1; the tax authorities do not regularly ask for such statutory declaration.

[38] General tax code, section 171.

Evidence that transfer prices in intragroup transactions do not reflect prices in comparable transactions (pricing outside the arm's-length range) should be sufficient to prove a breach of the arm's-length principle. Luxembourg tax authorities may (under certain conditions) use public databases and data from comparable transactions in other cases. Overall, the burden of proof for the non-arm's-length character of intragroup transactions should be relatively low.

If tax authorities can prove that a transfer price is not within the arm's-length range, there is a presumption that the transaction is not at arm's length, which puts pressure on taxpayers to provide transfer pricing documentation for material intragroup transactions.

If the taxpayer is unable to justify the arm's-length nature of intragroup transactions, tax authorities may use the concept of hidden dividend distribution or article 56 of the LITL to make tax adjustments.[39]

There is generally not a single arm's-length transfer price for a particular transaction[40], but rather a range of arm's-length prices. The more ambiguous the facts and circumstances of a case, the wider the range of estimates for the tax administration. It should generally apply the upper or lower end of a transfer pricing range, whichever is most favorable to the taxpayer.[41] However, the arm's-length range can be further narrowed by statistical means (for example interquartile range).

In some cases, tax authorities may proceed to tax adjustments with reference to the "prudent business manager" test (*ordentlicher und gewissenhafter Geschäftsleiter*). This test is based on hypothetical assumptions about the behavior of a prudent manager and may allow the tax authorities to develop their own theories about third-party dealings without reference to third-party transactions.[42]

Moreover, a prudent manager would generally not choose a price at the less favorable end of the arm's-length range if it was not profitable. Therefore, if a Luxembourg company has been making losses (or has not been profitable) for many years, tax authorities may narrow the transfer pricing ranges, for example by using statistical means[43] or the cost-plus method.[44] (See figure.)

Country-by-Country Reporting

General

With the law of December 23, 2016, the Luxembourg legislation transposed the provisions of EU directive 2016/881 of May 25, 2016, into Luxembourg tax law, extending administrative cooperation in tax matters to country-by-country reporting.

Scope of Country-by-Country Reporting

Multinational enterprise groups with a consolidated turnover exceeding €750 million are required to prepare a CbC report. If the €750 million threshold is exceeded in fiscal year N, the report must be prepared in fiscal year N+1.

The reporting entity of the group is either the Luxembourg resident ultimate parent company of the MNE group or, under certain circumstances, another reporting entity (a Luxembourg subsidiary or a Luxembourg permanent establishment) as defined in annex 2 of the law.

Notification Procedure

Luxembourg entities that are members of an MNE group are required to notify the Luxembourg tax authorities of the identity and tax residence of the reporting entity (whether this reporting entity is the Luxembourg entity itself or another entity of the group) no later than the last day of the MNE group's reporting fiscal year.

While the EU CbC reporting directive gave EU member states the option to extend the reporting deadline to the date of filing of the relevant tax return, Luxembourg law makes no reference to an extension.

[39] General tax code, section 217 (1); the presumption that transfer prices do not comply with the arm's-length principle (after proof by the Luxembourg tax authorities) is a precondition for the estimation of transfer prices if Luxembourg companies comply with their cooperation duties.

[40] Where there is a market price (for example quoted shares), there would be no arm's-length range but only one market price.

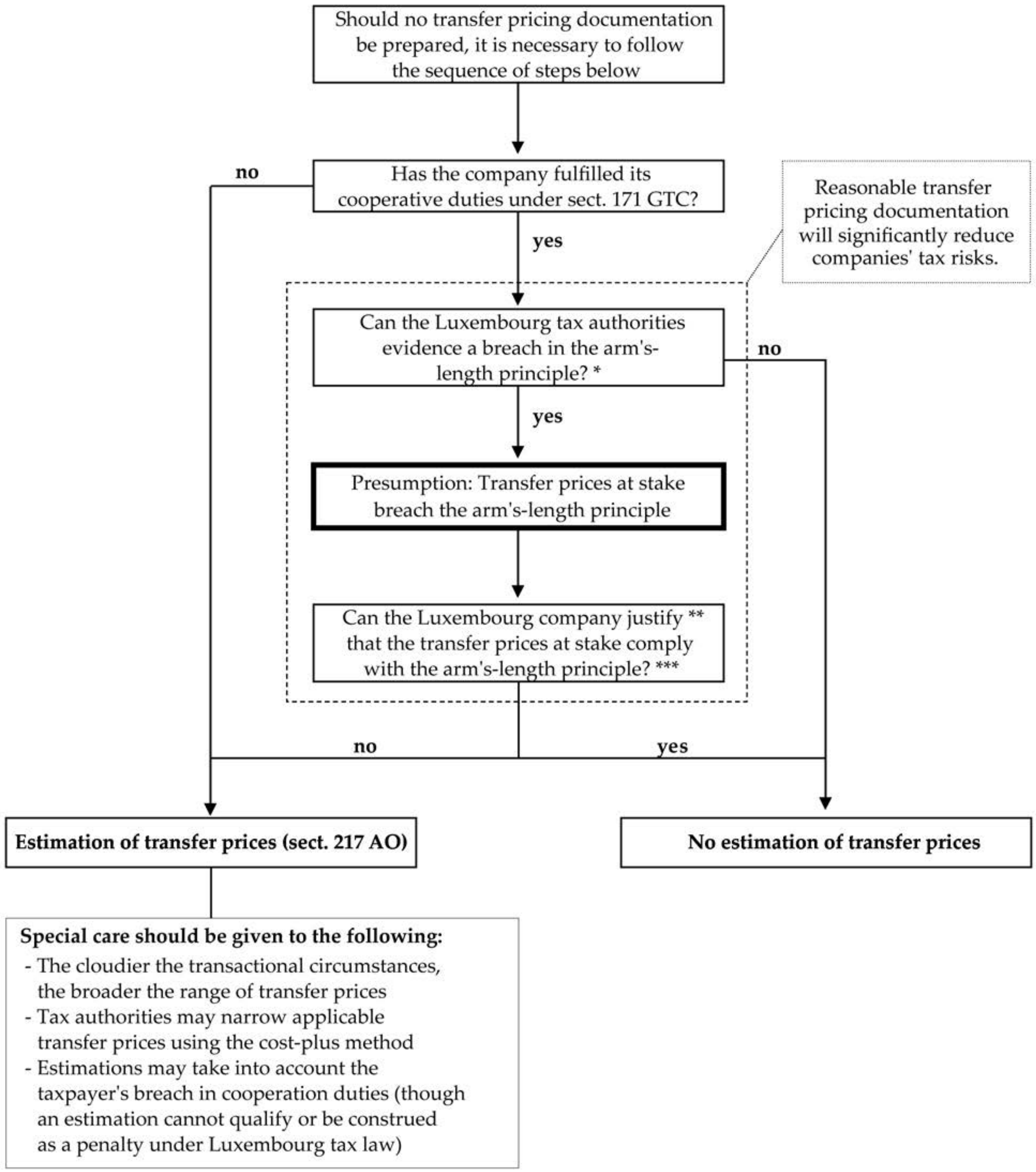
[41] BFH, Decision of Oct. 17, 2001, I R 103/00, BFH/NV 2002, 134.

[42] *Id.*

[43] Statistical means include, in particular, the interquartile range and the median.

[44] BFH, *supra* note 41.

Checklist: The Importance of Transfer Pricing Documentation for Tax Purposes



* Tax authorities may look to public databases and data of comparable transactions experienced in other cases (under certain conditions).

** The Luxembourg company has to provide consistent arguments that the transfer price could reasonably comply with the arm's-length principle.

*** Transfer prices may be reviewed several years after transactions take place. Sound transfer pricing documentation is all the more important amid increasing difficulties in tracing back relevant facts and circumstances of intragroup transactions.

Information to Be Reported

The CbC report follows the OECD recommendations in Chapter V of the OECD transfer pricing guidelines and must include:

- the amount of income, profit, or loss before income tax, and income tax paid or accrued, registered capital, undistributed profits, number of employees, and tangible assets other than cash or cash equivalents; and
- an identification of each entity that is a member of the MNE group, indicating the jurisdiction of tax residence of each entity and the nature of its principal business activities.

Reporting Deadline

A distinction can be made between the deadline for the filing of the CbC report by a reporting Luxembourg entity and the deadline by which the Luxembourg tax authorities must share this information with other tax authorities:

- Step 1: The reporting entity must file the CbC report with the Luxembourg tax authorities within 12 months of the last day of the reporting fiscal year of the MNE group.
- Step 2: The Luxembourg tax authorities must exchange the CbC report with any other EU member state and any other country that has signed the OECD multilateral competent authority agreement on exchange of CbC reports in which, on the basis of the information contained in the report, one or more entities of the MNE group are either resident for tax purposes or subject to tax on the business carried on through a PE. The exchange must take place within 15 months of the last day of the fiscal year of the MNE group to which the CbC report relates.

Use of Information

The information contained in the CbC reports is to be used by the Luxembourg tax authorities to assess high-level transfer pricing risks and other risks related to base erosion and profit shifting, including the assessment of the risk of noncompliance with applicable transfer pricing rules by members of the MNE group and, where appropriate, for economic and statistical analysis.

Transfer pricing adjustments by the receiving member state's tax authorities may not be based on the information contained in the CbC report. However, the information exchanged between countries may be used for further inquiries into the MNE group's transfer pricing arrangements or other tax matters as part of a tax audit, which may result in transfer pricing adjustments.

Penalties

A fine of up to €250,000 may be imposed for failure to file, late filing, incomplete or incorrect filing of the CbC report, and failure to comply with filing requirements (including the obligation to notify the tax authorities of the identity and tax residence of the reporting entity).

OECD Guidance on Transfer Pricing Documentation

Opening Comments

Chapter V of the OECD transfer pricing guidelines provides guidance on transfer pricing documentation. In its 2017 revision, Chapter V was replaced by new guidance on transfer pricing documentation developed by the OECD in relation to action 13 of the BEPS project (transfer pricing documentation).

The revised guidance sets out a three-tiered approach to transfer pricing documentation that includes a master file, a local file, and a CbC report (all three reports are collectively referred to as the CbC reporting package).

Luxembourg is a member of the OECD and as such takes into account the organization's transfer pricing guidelines. Therefore, transfer pricing documentation that complies with the OECD guidelines should be accepted by Luxembourg tax authorities.

Transfer Pricing Documentation Requirement Objectives

The three-tiered standardized approach to transfer pricing documentation has three main objectives:

- to ensure that taxpayers give appropriate consideration to transfer pricing requirements when setting prices and other terms for transactions between their controlled entities, and when reporting the income from these transactions in their respective tax returns;

- to provide tax administrations with the information necessary to make an informed assessment of transfer pricing risks; and
- to provide tax administrations with useful information for conducting an appropriately thorough examination of the transfer pricing practices of taxable entities in their jurisdiction, although it may be necessary to supplement the documentation with additional information as the audit progresses.[45]

Each of these elements is addressed below.

Taxpayer Compliance With the Arm's-Length Principle

The intention of requiring MNEs to articulate transfer pricing positions in transfer pricing documentation is the creation of a culture of compliance. Well-prepared documentation will give tax administrations assurance that the taxpayer thoroughly considered its (transfer pricing) positions reported in tax returns and the available comparable data.[46]

Tax administrations can support this culture by:

- requiring reasonable documentation be prepared contemporaneously;
- rewarding timely and accurate documentation; and
- creating incentives for timely consideration of the taxpayer's positions.[47]

Transfer Pricing Risk Assessment

Because tax administrations operate with limited resources, the OECD transfer pricing guidelines emphasize the importance of effective tax administration risk identification and assessment. This involves selecting appropriate cases for transfer pricing audits and focusing audits on the most important issues.[48] Accordingly, early access to sufficient, relevant, and reliable information is an important consideration when designing transfer pricing documentation rules.[49]

Transfer Pricing Audit

A third objective of transfer pricing documentation is to provide tax administrations with useful information for conducting a thorough transfer pricing audit. Transfer pricing audit cases are fact-intensive, involving the assessment of the comparability of several transactions and markets. The availability of adequate information from a variety of sources during an audit is critical to facilitate a proper assessment of the controlled transaction.[50]

However, the OECD transfer pricing guidelines recognize that it would be unduly burdensome and inefficient for transfer pricing documentation to attempt to anticipate all information that may be required for a full audit. They also explicitly state that if a jurisdiction requires certain information to be retained for transfer pricing audit purposes, those requirements should strike a balance between the tax administration's need for information and the compliance burden on taxpayers.[51]

If the documentation required for a transfer pricing audit is located outside the country's borders, it is essential that the tax administration is able to obtain the information it needs, either directly from the MNE or through information exchange mechanisms.[52]

Three Tiers of Documentation

OECD transfer pricing guidelines state that countries should adopt a standardized approach to transfer pricing documentation consisting of:

- a master file containing standardized information relevant for all MNE group members;

[45] *See* OECD, "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations," Ch. V, para. 5.5 (2022).

[46] *See* paragraph 5.7 in Chapter V of the OECD transfer pricing guidelines.

[47] *See* paragraph 5.8 in Chapter V of the OECD transfer pricing guidelines.

[48] *See* paragraph 5.10 in Chapter V of the OECD transfer pricing guidelines.

[49] *See* paragraph 5.11 in Chapter V of the OECD transfer pricing guidelines.

[50] *See* paragraph 5.13 in Chapter V of the OECD transfer pricing guidelines.

[51] *See* paragraph 5.14 in Chapter V of the OECD transfer pricing guidelines.

[52] *See* paragraph 5.15 in Chapter V of the OECD transfer pricing guidelines.

- a local file referring to material transactions of the local taxpayer; and
- a CbC report containing certain information relating to the global allocation of the MNE's income and taxes paid together with certain indicators of the location of economic activity within the MNE group.[53]

This approach is meant to provide tax administrations with relevant and reliable information to perform an appropriate risk assessment. It will also provide MNEs with a means and incentive to meaningfully consider and describe their compliance with the arm's-length standard in their material intragroup transactions.[54]

Master File

The master file should provide a high-level overview of the MNE group's business, including the nature of its global business operations, its overall transfer pricing policy, and its global allocation of income and economic activity, in order to assist tax administrations in assessing the existence of significant transfer pricing risks. The master file should include lists of significant agreements, intangibles, and transactions. Taxpayers should use prudent business judgment to determine the appropriate level of detail for the information provided. The requirements could be satisfied by cross-references to other documents.[55]

The information provided in the master file should provide a "blueprint" of the MNE group. The information can be grouped into five categories:

- organizational structure;
- description of the MNE business;
- intangibles;
- intercompany financial activities; and
- the MNE's financial and tax position.[56]

The information to be provided in the master file is set out in Annex I to Chapter V of the OECD transfer pricing guidelines:

- Organizational structure: a chart illustrating the MNE's legal and ownership structure, as well as the geographic location of operating entities.
- A description of the MNE's businesses, with written description of the MNE's business including:
  - important drivers of business profit;
  - a description of the supply chain for the group's five largest products and service offerings by turnover, plus any other products and services amounting to more than 5 percent of group turnover — the required description could take the form of a chart or diagram;
  - a list and brief description of important service arrangements between members of the MNE group, other than research and development services, including a description of the capabilities of the principal locations providing important services, as well as transfer pricing policies for allocating service costs and determining prices to be paid for intragroup services;
  - a description of the main geographic markets for the group's products and services that are referred to in the second item of description above;
  - a brief written functional analysis describing the principal contributions to value creation by individual entities within the group, that is, key functions performed, significant risks assumed, and key assets used; and
  - a description of important business restructuring transactions, acquisitions, and divestitures occurring during the fiscal year.
- The MNE's intangibles (as defined in Chapter VI of the updated OECD transfer pricing guidelines):
  - a general description of the MNE's overall strategy for the development, ownership, and exploitation of intangibles, including the location of principal R&D facilities and R&D management;

[53] *See* paragraph 5.16 in Chapter V of the OECD transfer pricing guidelines.

[54] *See* paragraph 5.17 in Chapter V of the OECD transfer pricing guidelines.

[55] *See* paragraph 5.18 in Chapter V of the OECD transfer pricing guidelines.

[56] *See* paragraph 5.19 in Chapter V of the OECD transfer pricing guidelines.

- a list of intangibles or groups of intangibles of the MNE group that are significant for transfer pricing purposes, and which entities legally own them;
- a list of important agreements among identified associated enterprises related to intangibles, including cost contribution arrangements, principal research service agreements, and license agreements;
- a general description of the group's transfer pricing policies related to R&D and intangibles; and
- a general description of any important transfers of interests in intangibles among associated enterprises during the fiscal year concerned, including the entities, countries, and compensation involved.

- The MNE's intercompany financial activities, including:
  - a general description of how the group is financed, including important financing arrangements with unrelated lenders;
  - identification of any members of the MNE group that provide a central financing function for the group, including the country under the laws of which the entity is organized and the place of effective management of those entities; and
  - a description of the MNE's general transfer pricing policies related to financing arrangements between associated enterprises.
- The MNE's financial and tax positions, consisting of:
  - the MNE's annual consolidated financial statement for the fiscal year concerned, if otherwise prepared for financial reporting, regulatory, internal management, tax, or other purposes; and
  - a list and brief description of the MNE group's existing unilateral APAs and other tax rulings relating to the allocation of income among countries.

Local File

In contrast to the master file, which provides a high-level overview as described above, the local file provides more detailed information on significant intercompany transactions involving the local subsidiary and associated enterprises in other countries. This information includes relevant financial data on these transactions, a comparability analysis, and the selection of the most appropriate transfer pricing method.[57]

Information to be included in the local file is set out in Annex II to Chapter V of the OECD transfer pricing guidelines:

- Management structure and strategy:
  - a description of the management structure of the local entity, a local organizational chart and a description of the individuals to whom local management reports, and the countries in which those individuals maintain their principal offices;
  - a detailed description of the business and business strategy pursued by the local entity, including whether the local entity has been involved in or affected by business restructurings or transfers of intangibles in the present or preceding year, as well as an explanation of those aspects of such transactions affecting the local entity; and
  - key competitors.
- Controlled transactions: for each material category of controlled transactions in which the entity is involved:
  - a description of the material controlled transactions (for example procurement of manufacturing services, purchase of goods, provision of services, loans, financial and performance guarantees, and licenses of intangibles) and the context in which those transactions take place;
  - the amount of intragroup payments and receipts for each category of controlled transactions involving the local entity (for example payments and receipts for products, services, royalties, interest), broken down by the tax jurisdiction of the foreign payer or recipient;
  - an identification of associated enterprises involved in each category of controlled transactions and the relationship among them;
  - copies of all material intercompany agreements concluded by the local entity;

[57] *See* paragraph 5.22 in Chapter V of the OECD transfer pricing guidelines.

  - a detailed comparability and functional analysis of the taxpayer and relevant associated enterprises addressing each documented category of controlled transactions, including any changes compared with prior years;
  - an identification of the most appropriate transfer pricing method with regard to the category of the transaction and the reasons for selecting that method;
  - an indication of which associated enterprise is selected as the tested party, if applicable, and why;
  - a summary of the important assumptions made in applying the transfer pricing method;
  - if relevant, an explanation of the reasons for performing a multiyear analysis;
  - a list and description of selected comparable uncontrolled transactions (internal and external), if any, and information on relevant financial indicators for independent enterprises relied on in the transfer pricing analysis, including a description of the comparable search method and the source of such information;
  - a description of any comparability adjustment performed, and an indication of whether adjustments have been made to the results of the tested party, the comparable uncontrolled transactions, or both;
  - a description of the reasons for concluding that relevant transactions were priced arm's length, based on the application of the selected transfer pricing method;
  - a summary of financial information used in applying the transfer pricing method; and
  - a copy of any existing unilateral, bilateral, and multilateral APAs and other tax rulings to which the local tax jurisdiction is not a party and which are related to controlled transactions described above.
- Financial information:
  - annual local entity financial accounts for the fiscal year concerned; if audited statements exist, they must be supplied, and if not, existing unaudited statements are to be supplied;
  - information and allocation schedules showing how the financial data used in applying the transfer pricing method may be tied to the annual financial statements; and
  - summary schedules of relevant financial data for comparables used in the analysis and the sources from which those data were obtained.

CbC Report

The OECD transfer pricing guidelines provide that MNE groups should be required to submit a CbC report, which should be made available to the tax administrations of the countries in which they operate. A model template for the CbC report, together with accompanying instructions, is set out in Annex III to Chapter V.

The CbC report requires MNEs to report their income, taxes paid, and certain indicators of the location of economic activity (for example, employment, and capital and tangible assets in each tax jurisdiction) across the tax jurisdictions in which the MNE group operates.[58] The purpose of the report is to provide data for a high-level transfer pricing risk assessment by the tax authorities involved.[59]

The OECD transfer pricing guidelines state that the CbC report should not be used as a substitute for a detailed transfer pricing analysis of individual transactions and prices based on a full functional analysis and a full comparability analysis. Moreover, the OECD transfer pricing guidelines emphasize that:

- the information in the CbC report on its own does not constitute conclusive evidence as to whether transfer prices are appropriate; and
- the CbC report should not be used by tax administrations to propose transfer pricing adjustments based on a global formulary apportionment of income.[60]

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[58] *See* paragraph 5.24 in Chapter V of the OECD transfer pricing guidelines.

[59] *See* paragraph 5.25 in Chapter V of the OECD transfer pricing guidelines.

[60] *See* paragraph 5.25 in Chapter V of the OECD transfer pricing guidelines.

These statements in the OECD transfer pricing guidelines address concerns of businesses that tax administrations may use the information to selectively apply some form of formulary apportionment where it appears to be more advantageous from a tax revenue perspective. In particular, the simultaneous application of the arm's-length principle and formulary apportionment is likely to result in double taxation and long-lasting disputes with the tax administrations involved.[61]

Given the significant compliance burden and costs that CbC reporting imposes on companies, the OECD transfer pricing guidelines provide that there should be an exemption for MNE groups with annual consolidated group revenues of less than €750 million in the preceding fiscal year.[62] It is estimated that this threshold should exempt between 85 and 90 percent of MNE groups from the requirement to prepare a CbC report.[63]

However, no special industry exemption should be provided such as a general exemption for investment funds.[64] Thus, alternative investment funds (real estate, private equity, venture capital, etc.) structured in Luxembourg may, under certain conditions, fall within the scope of CbC reporting. In the case of private equity or venture capital funds investing in companies, CbC reporting may also be required for individual portfolio groups of companies.[65]

Interestingly, countries participating in the OECD BEPS project agree that the use of the CbC reporting will be subject to:

- confidentiality;[66]
- consistency in application of requirements;[67]
- appropriate usage in conducting examinations and making proposed adjustments;[68] and
- a framework for the exchange of the CbC report, consistent with the implementation package developed in the BEPS project.[69]

Therefore, the information provided under the CbC report should be available to the tax authorities involved, but confidentiality remains a top priority because this is sensitive information that may be useful to competitors.

It is ironic, however, that shortly after the introduction of CbC reporting, the European Commission began to push for "public" CbC reporting in the EU. This effort resulted in directive (EU) 2021/2101 on the disclosure of income tax information by certain companies and branches.[70] A public CbC report is an additional MNE CbC report requirement that, according to the European Commission, is intended to increase corporate transparency and public scrutiny of corporate taxes paid by MNEs operating in the EU. The reporting requirement under directive (EU) 2021/2101 is similar to the CbC reporting requirement, the report needs to be made publicly available and applies to groups with a total consolidated revenue of at least €750 million. The directive had to be transposed into national law by June 22, 2023, and was implemented in Luxembourg by a law dated August 15, 2023.

[61] Despite the strong statement by OECD member countries that the arm's-length principle should be the sole standard for pricing intragroup transactions, it cannot be ruled out that the tax authorities of some countries may base transfer pricing adjustments on the information provided in the CbC report.

[62] *See* paragraph 5.52 in Chapter V of the OECD transfer pricing guidelines.

[63] *See* paragraph 5.53 in Chapter V of the OECD transfer pricing guidelines.

[64] *See* paragraph 5.55 in Chapter V of the OECD transfer pricing guidelines.

[65] This would assume investments into large businesses exceeding on their own the consolidated group revenue threshold of €750 million.

[66] According to the OECD transfer pricing guidelines, jurisdictions should have in place and enforce legal protections of the confidentiality of the reported information; *see* paragraph 5.57 in Chapter V of the OECD transfer pricing guidelines. This statement is in stark contrast to the implementation of public CbC reporting in the EU.

[67] Jurisdictions should adopt a legal requirement that the ultimate parent company of MNE groups resident in their jurisdiction prepares and files the CbC report (unless exempted because of the €750 million consolidated turnover threshold). In addition, jurisdictions should require exactly the information contained in Annex III to Chapter V of the OECD transfer pricing guidelines, no more and no less; *see* paragraph 5.58 in Chapter V of the OECD transfer pricing guidelines.

[68] Tax administrations should not use the information provided in the CbC report to apply some kind of formulary apportionment; see paragraph 5.59 in Chapter V of the OECD transfer pricing guidelines.

[69] Jurisdictions should require the timely filing of CbC reports by the ultimate parent company of MNE groups resident in their jurisdiction. *See* paragraph 5.60 in Chapter V of the OECD transfer pricing guidelines.

[70] Directive (EU) 2021/2101 of the European Parliament and of the Council of Nov. 24, 2021, amending Directive 2013/34/EU as regards disclosure of income tax information by certain undertakings and branches.

The appendix to Chapter V of the OECD transfer pricing guidelines provides the following templates for the CbC report. (See tables 1 and 2.)

Compliance Issues

The OECD transfer pricing guidelines further provide guidance about certain compliance issues.

Contemporaneous Documentation

Associated enterprises need to adhere to the arm's-length standard when doing business with other members of the group. Arm's-length pricing is to be established based on information reasonably available at the time of the transaction. Accordingly, taxpayers should normally consider the arm's-length character of the terms and conditions of controlled transactions before pricing and confirm the arm's-length result when filing tax returns.[71]

However, the OECD transfer pricing guidelines state that taxpayers should not be expected to incur disproportionate costs and burdens in producing documentation. Therefore, tax administrations should balance requests for documentation against the expected cost and administrative burden to the taxpayer of producing the documentation. If a taxpayer can reasonably demonstrate that either no comparable data exists or that the cost of searching for it would be disproportionate to the amounts at stake, taxpayers should not be required to incur the costs of searching for the data.[72]

Time Frame

There are different practices regarding the timing of the preparation of transfer pricing documentation. It is recognized that these different timing requirements for the provision of information may lead to difficulties for taxpayers in prioritizing and providing information in a timely manner.[73]

With regard to the master file and the local file, the OECD transfer pricing guidelines suggest that taxpayers prepare or update documentation by the time the tax returns are due to be filed.[74] Given the difficulties in obtaining some of the information for the CbC report, the deadline for completing it is extended to one year after the last day of the fiscal year of the ultimate parent company of the MNE group.[75]

Materiality

The OECD transfer pricing guidelines emphasize that tax administrations should only require controlled transactions that are sufficiently material to be covered by full documentation in the local file. Tax administrations have an interest in ensuring that MNEs are not so overwhelmed by compliance requirements that they fail to consider and document the most important issues.[76] Various measures of materiality may be considered, either relative (transactions not exceeding a percentage of revenue or a percentage of costs) or absolute (transactions not exceeding a certain fixed amount).[77]

The guidelines also state that small and medium-size enterprises should not be required to provide the same level of documentation as would be expected from larger companies, except in relation to significant cross-border transactions, at the request of the tax administration.[78]

Retention of Documents

Transfer pricing documentation should be retained for a reasonable period in accordance with domestic law, either at the level of the parent company or at the level of the local entity. However, tax administrations should be mindful of the difficulties in locating documentation for prior years and should limit requests to cases in which they have a good reason, in relation to the transaction under examination, to review the

[71] *See* paragraph 5.27 in Chapter V of the OECD transfer pricing guidelines.

[72] *See* paragraph 5.28 in Chapter V of the OECD transfer pricing guidelines.

[73] *See* paragraph 5.29 in Chapter V of the OECD transfer pricing guidelines.

[74] *See* paragraph 5.30 in Chapter V of the OECD transfer pricing guidelines.

[75] *See* paragraph 5.31 in Chapter V of the OECD transfer pricing guidelines.

[76] *See* paragraph 5.32 in Chapter V of the OECD transfer pricing guidelines.

[77] *See* paragraph 5.32 in Chapter V of the OECD transfer pricing guidelines.

[78] *See* paragraph 5.33 in Chapter V of the OECD transfer pricing guidelines.

Model Template for the Country-by-Country Report

Table 1. **Overview of allocation of income, taxes and business activities by tax jurisdiction**

Name of the MNE group:
Fiscal year concerned:
Currency used:

Tax Jurisdiction	Revenues			Profit (Loss) before Income Tax	Income Tax Paid (on Cash Basis)	Income Tax Accrued – Current Year	Stated Capital	Accumulated Earnings	Number of Employees	Tangible Assets other than Cash and Cash Equivalents
	Unrelated Party	Related Party	Total							

Table 2. **List of all the Constituent Entities of the MNE group included in each aggregation per tax jurisdiction**

Name of the MNE group:
Fiscal year concerned:

Tax Jurisdiction	Constituent Entities Resident in the Tax Jurisdiction	Tax Jurisdiction of Organisation or Incorporation if Different from Tax Jurisdiction of Residence	Main Business Activity(ies)												
			Research and Development	Holding or Managing Intellectual Property	Purchasing or Procurement	Manufacturing or Production	Sales, Marketing or Distribution	Administrative, Management or Support Services	Provision of Services to Unrelated Parties	Internal Group Finance	Regulated Financial Services	Insurance	Holding Shares or Other Equity instruments	Dormant	Other[1]
	1.														
	2.														
	3.														
	1.														
	2.														
	3.														

Source: OECD (2022), *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022*, OECD Publishing, Paris, https://doi.org/10.1787/0e655865-en.

documentation in question.[79] The method of storage should be at the discretion of the taxpayer, as long as relevant information can be made available promptly.[80]

Frequency of Documentation Update

Transfer pricing documentation should be reviewed periodically to determine whether the functional and economic analysis is still accurate and to confirm the validity of the transfer pricing method used. While it is recognized that in many situations, the business descriptions, functional analysis, and description of comparables may not change significantly from one year to the next, best practice dictates that transfer pricing documentation should generally be reviewed and updated annually.[81]

Language

The OECD transfer pricing guidelines encourage countries to permit the filing of transfer pricing documentation in commonly used languages (for example, English), as the translation of key documentation is time consuming and costly. Translations into local languages should only be required in specific cases, and taxpayers should be given sufficient time to prepare them.[82]

Penalties

Many countries have introduced documentation-related penalties to ensure the effective operation of transfer pricing documentation requirements, designed to make noncompliance more costly than compliance. Penalty regimes are governed by the laws of each country and vary widely.[83]

Another way to encourage taxpayers to comply with transfer pricing documentation requirements is to introduce compliance incentives such as penalty protection or a shift in the burden of proof.[84]

Confidentiality

The OECD recognizes the importance of confidentiality to businesses. In this respect, the OECD transfer pricing guidelines state that tax administrations should take all reasonable steps to ensure that confidential information (business secrets, scientific secrets, etc.) and other commercially sensitive information contained in the documentation package (master file, local file, and CbC report) are not disclosed to the public. In addition, tax administrations should assure taxpayers that the information contained in the transfer pricing documentation will remain confidential.[85]

Local vs. Regional Comparables

According to the OECD transfer pricing guidelines, local comparables rather than regional comparables should be used if reasonably available.[86] However, practical experience shows that in some cases, there are not enough local comparables, so it is necessary to extend the search to other countries in the same geographical region, provided the markets are comparable.

OECD Transfer Pricing Guidelines in Luxembourg

Because Luxembourg is an OECD member, Luxembourg tax authorities generally follow the guidance provided in the organization's transfer pricing guidelines for MNEs and tax administrations.

Article 56bis of the LITL aligns with several fundamental axioms concerning the arm's-length principle, as delineated in Chapter I of the OECD transfer pricing guidelines. This affirmation underscores the standing of the OECD transfer pricing guidelines within Luxembourg's legal framework.

[79] *See* paragraph 5.35 in Chapter V of the OECD transfer pricing guidelines.

[80] *See* paragraph 5.36 in Chapter V of the OECD transfer pricing guidelines.

[81] *See* paragraph 5.37 in Chapter V of the OECD transfer pricing guidelines.

[82] *See* paragraph 5.39 in Chapter V of the OECD transfer pricing guidelines.

[83] *See* paragraph 5.40 in Chapter V of the OECD transfer pricing guidelines.

[84] *See* paragraph 5.43 in Chapter V of the OECD transfer pricing guidelines.

[85] *See* paragraph 5.44 in Chapter V of the OECD transfer pricing guidelines.

[86] *See* paragraph 5.46 in Chapter V of the OECD transfer pricing guidelines.

In 2023 the Luxembourg legislation published a draft règlement (draft regulation) that would require MNEs with an external turnover of at least €750 million to prepare transfer pricing documentation that follows the master file and local file approach included in Chapter V of the OECD transfer pricing guidelines. However, the draft regulation has not been adopted, and it remains unclear if it will be. The content requirements for both the master file and local file were found to be consistent with those stipulated in Chapter V of the OECD transfer pricing guidelines, as described above in the "Three Tiers of Documentation" section.

Today Luxembourg tax authorities do not require the creation of a local file as provided for in Chapter V of the OECD transfer pricing guidelines. Instead, taxpayers may prepare separate transfer pricing reports for material intragroup transactions.

While Luxembourg tax law also does not require the preparation of a master file, many countries in the EU and around the world have introduced this requirement when certain conditions are met (for example, a certain turnover is achieved). Therefore, despite the absence of a requirement under Luxembourg tax law, large MNE groups present in Luxembourg can be expected to prepare a master file.

Best Practice Recommendations

Opening Comments

In recent years, transfer pricing and related documentation have become the hot topic in Luxembourg taxation in an environment that relies less and less on tax rulings and APAs. This means that MNEs and international investors need to develop a solid transfer pricing (and related documentation) strategy in order to mitigate tax risks.

This trend has been accompanied by the introduction of new transfer pricing legislation,[87] a circular on the tax treatment of finance companies,[88] and new reporting obligations regarding intragroup transactions[89] that place more emphasis on transfer pricing.

But for which transactions should transfer pricing documentation be prepared? Does it make a difference when transfer pricing documentation is prepared? How often should transfer pricing documentation be reviewed? Is transfer pricing a focus of tax audits, leading to disputes between taxpayers and tax authorities? All these questions are analyzed in this section.

Screening Intragroup Transactions

Transfer pricing inevitably forces taxpayers to strike a balance between a comfortable level of certainty and the cost of preparing the relevant documentation. In practice, Luxembourg companies should review major intragroup transactions to identify issues that may raise the suspicion of tax authorities and to assess the level of tax risk involved. On this basis, taxpayers can perform a cost-benefit analysis and weigh the cost of transfer pricing documentation against the level of potential tax risks.

If Luxembourg tax authorities can reasonably demonstrate that the transfer pricing of a controlled transaction is not in line with the arm's-length principle, it creates a rebuttable presumption that the transaction is not in line with the arm's-length principle. It is then incumbent on the taxpayer to provide rebuttal evidence. In these circumstances, transfer pricing

[87] A new version of article 56 of the LITL was introduced in 2015, which incorporates the arm's-length principle and serves as the basis for upward and downward adjustments in the case of non-arm's-length conditions. In addition, a new article 56bis of the LITL was introduced in 2017, which incorporates some of the key transfer pricing principles set out in Chapter I of the OECD transfer pricing guidelines and complements article 56 of the LITL. Moreover, a third paragraph was added to section 171 of the general tax code, which explicitly extends the taxpayer's cooperation obligations to associated enterprises. Finally, on December 13, 2016, the Luxembourg parliament passed a law implementing the CbC reporting requirements for Luxembourg companies that are part of an MNE (whose consolidated group turnover exceeds €750 million). The latter was the implementation of Council directive (EU) 2016/881 of May 25, 2016 (DAC IV), concerning the mandatory automatic exchange of information in the field of taxation.

[88] Circular L.I.R. N° 56/1 — 56bis/1 of Dec. 27, 2016.

[89] Some disclosures on intragroup transactions must be made in the corporate tax returns.

documentation is of immense value. Overall, the burden of proof for the non-arm's-length character of intragroup transactions should be relatively low.

Sound transfer pricing documentation may further be necessary to justify the value of a hidden capital contribution or a downward adjustment under article 56 of the LITL.

However, transfer pricing documentation requirements may not only arise from a Luxembourg tax perspective. Several countries in Europe and around the world have introduced an obligation to prepare a master file[90] and a local file[91] in accordance with Chapter V of the OECD transfer pricing guidelines. Therefore, there may be more cases in which Luxembourg companies have to prepare a master file because of foreign tax requirements (for example, private equity and real estate funds investing in pan-European assets may have to prepare master files because of the requirements in the investment jurisdictions).

Preparing Appropriate Transfer Pricing Documentation

There is no one-size-fits-all approach to preparing adequate transfer pricing documentation. Instead, taxpayers would be wise to adopt a risk-based approach that considers both the level of risk and the cost of transfer pricing documentation.

As a general rule, transfer pricing of all significant intragroup transactions that give rise to significant tax risks should be detailed in comprehensive transfer pricing documentation. This should reduce tax risks to an acceptable level.

> **Example: The Luxembourg Finance Company**
>
> A Luxembourg company carries out financing activities with a volume of €100 million. If the Luxembourg tax authorities successfully challenge the financing margin, the relevant tax base would increase by €100,000 (per year) for every 10 basis points of tax adjustment. The tax risks would only increase over time because the transfer pricing could be reviewed after several years. Given the materiality of this transaction, the Luxembourg company should substantiate the arm's-length nature of the financing margin in a full transfer pricing report.

On the other hand, the transfer pricing of immaterial transactions may be based on reasonable assumptions (for example, choosing a reasonable cost-plus markup for services with a low value).

> **Example: The Small Service Fee**
>
> A Luxembourg company, which is part of a MNE group, has incurred costs of €5,000 for services provided to another Luxembourg group company, which should be charged on a cost-plus basis. Consideration should be given to choosing an appropriate cost-plus markup for the activities performed (for example, 5 percent or 10 percent depending on the nature of the services). In this case, a tax adjustment of 10 percent on the cost-plus markup would result in an increased tax base of only €500, which does not justify the preparation of detailed transfer pricing documentation. Of course, if there are many services provided to other group companies that add up to significant amounts, transfer pricing documentation may be required.

If the intragroup transactions are not insignificant, but still reasonably small, companies may consider focusing on the economic analysis rather than preparing a full transfer pricing report. The economic analysis should outline the transfer pricing method used (that is, the selection of the most appropriate transfer pricing method and the application of the method to the case) and include screenshots of the database searches.

Should the Luxembourg transfer pricing authorities question the transfer pricing analysis in the future, it would then be possible to prepare

[90] In the master file, MNEs would be required to provide tax administrations with high-level information regarding their global business operations and transfer pricing policies.

[91] In the local file, MNEs would be required to provide more transactional transfer pricing documentation, identifying relevant related-party transactions, the amounts involved in those transactions, and the company's analysis of the related arm's-length character of the transfer pricing.

a full transfer pricing analysis that is consistent with the economic analysis prepared in parallel with the implementation of the transaction. As a result, the Luxembourg tax authorities will not be able to accuse the taxpayer of having prepared the transfer pricing documentation (long) after the implementation of the transaction.

Example: The Interest-Bearing Loan

A Luxembourg company grants a loan of €2 million to another group company. If the Luxembourg tax authorities successfully challenge the interest rate, the relevant tax base would increase by €20,000 (per year) for every 1 percentage point of tax adjustment. The tax risks would only increase over time because the transfer pricing could be reviewed after several years. However, the tax risk does not justify the preparation of a full transfer pricing report. Here, the Luxembourg company may decide to prepare a transfer pricing analysis that focuses on the economic analysis (which can be completed in the event of a challenge).

Timing Aspects

For Luxembourg tax purposes, taxpayers should adhere to transfer prices that are consistent with the arm's-length principle based on the information reasonably available at the time of determination (that is, at the time of the transaction or upon a subsequent review of the transfer pricing documentation). Therefore, a taxpayer should normally consider whether its transfer prices are appropriate for tax purposes before setting them. This may or may not involve the preparation of transfer pricing documentation (depending on the size of the transaction and the tax risks involved).

Importantly, transfer prices may be reviewed several years after a transaction has taken place. From a practical point of view, this makes it increasingly difficult to trace back the relevant facts and circumstances of the transaction, as well as data on comparable transactions. This puts pressure on Luxembourg companies to develop appropriate transfer pricing policies for risk mitigation purposes.

Further, experience shows that transfer pricing documentation prepared for use in the event of a challenge by Luxembourg tax authorities (possibly years after the transaction has taken place), or for litigation purposes, is of much less value and can be more easily challenged by tax authorities. After all, it could be considered suspicious if the transfer pricing analysis confirms the transfer price set when the transaction was carried out, but no transfer pricing analysis was carried out at that time.

Review and Update of Transfer Pricing Documentation

It is important that transfer pricing policies are not neglected once they have been implemented. This means that transfer pricing documentation should be reviewed and updated regularly to reflect the actual facts of the situation, particularly in the event of corporate restructurings and if new transactions are contemplated.

As a best practice, transfer pricing documentation should be reviewed annually to ensure that it still reflects the correct facts and circumstances and the actual conduct of the parties to the controlled transactions.

Taxpayers should not consider the preparation of transfer pricing documentation as a mere compliance exercise. Rather, in the current international tax environment of increased transparency and scrutiny, it would be prudent for Luxembourg companies to adopt a more comprehensive approach by integrating transfer pricing documentation into their overall tax strategy. This would allow them to reflect the underlying business rationale behind their investment structures and intragroup transactions.

A large part of the controlled transactions involving Luxembourg companies are financial transactions and intragroup services. The arm's-length pricing (fixed rate, variable rate, etc.) for financial instruments should be determined before implementation. The interest rate of a financial instrument does not normally need to be changed during the term of the debt instrument, unless the terms of the financial instrument provide for the possibility of adjusting the remuneration from time to time.

However, a new interest rate may also need to be set if there is a significant change in the financial instrument (for example, a significant increase in the principal amount if the financial instrument does not include a facility, the extension of the loan at the end of the term).

When a Luxembourg company carries out financing activities (that is, a Luxembourg company grants debt instruments to related parties, which are financed with debt instruments granted by related parties or third parties), the arm's-length remuneration to be realized by the Luxembourg company should be determined before carrying out the activity.

If the financing activities change from one year to another, this should be reflected in the transfer pricing documentation. If the facts do not change, it may be possible to rely on OECD guidance, which suggests that taxpayers should be able to amend long-term intragroup arrangements after a maximum of three years.[92] Therefore, if no changes are made, taxpayers may be able to rely on the arm's-length financing margin for three years.

Similarly, when Luxembourg companies provide (or receive) intragroup services, the arm's-length remuneration (where the cost-plus method will often be the most appropriate transfer pricing method) should be reviewed after three years. However, if the nature of the services can be classified as low value-adding intragroup services within the meaning of Chapter VII of the OECD transfer pricing guidelines, a cost-plus markup of 5 percent should be appropriate (without the need to change the transfer pricing analysis over time).

Transfer Pricing Audits and Disputes

Following the creation of a new tax audit department, tax audits by Luxembourg tax authorities have become more systematic. Because tax assessments in Luxembourg can generally be reviewed for a period of five years[93], potential tax risks can extend over several years, requiring an appropriate and active tax risk management function.

Based on experience, transfer pricing is often scrutinized during tax audits. Tax authorities can more easily challenge transfer pricing if no transfer pricing documentation has been prepared: How can taxpayers make informed decisions if no transfer pricing analysis has been carried out before the pricing of intragroup transactions? Therefore, transfer pricing should be considered before agreements are entered into.

With the increased focus on transfer pricing, disputes between companies and tax authorities are becoming more common. However, transfer pricing disputes are most likely to arise when companies have not prepared adequate transfer pricing documentation for material intragroup transactions. Conversely, the preparation of sound transfer pricing documentation is generally an effective defense against challenges by tax authorities.

Ideally, taxpayers should take a proactive approach to transfer pricing and, when appropriate, prepare documentation at the time a controlled transaction is entered into, rather than waiting until a transaction is identified during a tax audit. Although transfer pricing documentation may be prepared at the time of a tax audit, the level of scrutiny in terms of assumptions, transfer pricing approach, and benchmarking is likely to be much higher.

Conclusion

The transfer pricing of Luxembourg companies must comply with the arm's-length principle. If Luxembourg tax authorities can reasonably demonstrate that the transfer pricing of an intragroup transaction does not comply with the arm's-length principle, it is the taxpayer's responsibility to rebut this presumption.

[92] Paragraph 5.38 in Chapter V of the OECD transfer pricing guidelines provides useful guidance: "In order to simplify compliance burdens on taxpayers, tax administrations may determine, as long as the operating conditions remain unchanged, that the searches in databases for comparables supporting part of the local file be updated every three years rather than annually."

[93] If the tax authorities issue preliminary tax assessments in accordance with the information provided by the taxpayer in the corporate income tax returns, the tax authorities have the right to review these tax returns within five years (General Tax Code, Section 100a (1), (3)). This should speed up the tax assessment process and allow the tax authorities to review a company's corporate income tax returns for several years at once.

It is therefore recommended that taxpayers adopt a risk-based approach when screening intragroup transactions. If the transfer pricing of controlled transactions presents significant tax risks, sound transfer pricing documentation is an effective means of mitigating these risks.

Transfer pricing documentation has become a key element of tax risk management. In the current international tax environment of increased transparency and scrutiny, companies would be wise to go one step further and integrate transfer pricing documentation into their broader tax strategy, using it to reflect the business rationale behind their corporate structure and intragroup transactions.

Ultimately, the best practice recommendations set out in this article should help Luxembourg companies to adopt a sensible approach to transfer pricing and related documentation requirements. ■