

FUND MANAGEMENT SERVICES: CONSIDERATIONS FROM A (LUXEMBOURG) TRANSFER PRICING PERSPECTIVE¹

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I. INTRODUCTION

Luxembourg is the largest domicile for investment funds in Europe and the second largest fund centre worldwide (after the United States). Investment funds can be defined as collective investment vehicles which are created for the purpose of gathering investors' capital and investing that capital in a portfolio of assets.

Investment funds may be divided into two broad categories:

- Undertakings for collective investment in transferable securities ("UCITS") which invest into financial instruments such as stocks, bonds and other securities; and
- Alternative investment funds ("AIF") which are created for different types of investments such as Private Equity, Venture Capital, Real Estate and Infrastructure investments.

All funds have in common that they are managed in one way or another by an investment manager. However, the organisation of fund management services may vary significantly from one case to another and involve two or more related parties (management companies, advisory companies, etc.).

When fund management services involve controlled transactions between related parties, it is crucial that the parties to these transactions are remunerated at arm's length. Given that the overall amount of fees for fund management services typically ranges between 1% and 2% of the assets under management (or commitments as the case may be), fund management services are frequently material transactions. Therefore, it is not surprising that the transfer pricing of fund management services is increasingly more in the focus of the Luxembourg tax authorities.

II. FUND MANAGEMENT SERVICES

Fund management services cover a wide range of elements including fund and portfolio management (investment

advice, investment performance monitoring, investor relations, etc.), risk management (supervision, portfolio risk management, internal audit, etc.), marketing, valuation and fund administration (accounting, investor administration, depository, reporting, etc.).

In practice, fund management services might be rendered by one single management company or by several companies which might be members of the same group or third parties. While Luxembourg funds are generally managed by a Luxembourg management company, certain aspects of the fund management services may be outsourced to other management or advisory companies resident in Luxembourg or abroad.

The way fund management services are organised depends on a number of factors such as the particular organisation of the investment manager, the size of the investment manager and the type of investment fund (UCITS vs AIF).

III. WHEN DOES THE ARM'S LENGTH PRINCIPLE APPLY?

The transfer pricing analysis of fund management services frequently begins with the mapping of the different transactions. In a second step, it has to be analysed whether transactions are arm's length transactions between third parties or controlled transactions between related parties.

When fund management services involve transactions between related parties, the arm's length character of the remuneration earned by the parties to those transactions has to be substantiated for tax purposes.

In contrast, transactions between third parties do not have to be tested from a transfer pricing perspective. As such, it can be assumed that the overall fund management fee is arm's length since the investors in the fund are third parties to the investment manager that have accepted the quantum of fund management fees as detailed in the

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fund's prospectus. Likewise, the fees of third-party service providers such as a third-party Alternative Investment Fund Manager ("AIFM"), a depositary bank or an auditor are deemed to be arm's length.

When the parties to a controlled transaction are resident for tax purposes in Luxembourg and one or more foreign jurisdictions, the transfer pricing analysis has to satisfy not only the Luxembourg requirements but also, at the same time, the requirements in the foreign jurisdiction(s) involved. Thus, it is important to develop a sound approach which is consistent with the arm's length principle. Otherwise, there would be a risk of economic double taxation and disputes between taxpayers and the tax authorities of the relevant jurisdiction(s) (i.e. when tax authorities perform unilateral transfer pricing adjustments). However, in general, it is possible to rely on the OECD Transfer Pricing Guidelines for Multinationals and Tax Administrations (the "OECD Transfer Pricing Guidelines") which reflect the international consensus towards the interpretation of the arm's length principle.

IV. HOW TO ESTABLISH ARM'S LENGTH TRANSFER PRICES?

The determination of arm's length prices relies on the application of transfer pricing methods. The OECD Transfer Pricing Guidelines provide for five different methods which are categorised as traditional transaction and transactional profit methods.

The traditional transaction methods include the comparable uncontrolled price ("CUP") method, the cost-plus method and the resale price method. The transactional profit methods include the transactional net margin method ("TNMM") and the profit split method which might be applied in different ways.

Each of these methods has its strengths and weaknesses and cannot be applied in every case. Therefore, the most appropriate method has to be determined on a case-by-case basis, considering the functional analysis (that is the analysis of the functions performed, risks assumed, and assets owned by the parties to the controlled transaction).

The transfer pricing methods which are generally most appropriate with regard to fund management services include the CUP method, the cost plus method and the profit split method. The CUP method may, for example, be applicable when one of the entities has a functional profile comparable to that of a management company

which offers services to third parties (here, one may rely on external comparables). Moreover, when a management company renders services to related parties and similar services to third parties, these internal comparables may be used to establish the arm's length price.

In other cases, a cost plus remuneration might be most appropriate in the absence of comparable data which would enable the application of the CUP method. The cost plus method is often applied for determining an arm's length remuneration regarding functions performed by a Luxembourg general partner on behalf of a Luxembourg fund. A cost plus remuneration may further be appropriate in case of administrative services.

However, in practice, fund management services may be highly integrated and rendered by several parties that render highly specialised services and contribute valuable intangibles. In these circumstances, the determination of an arm's length remuneration may often rely on the application of the profit split method.

The profit split method may either rely on a contribution or a residual analysis. Under a contribution analysis, the combined profits (i.e. the total profits from the controlled transactions under examination) are divided between the associated enterprises based on a reasonable approximation of the division of profits that independent enterprises would have expected to realise from engaging in comparable transactions.

A residual analysis is appropriate where the contributions of the parties to the combined profits include contributions which can be directly and reliably valued by reference to comparables. A residual analysis divides the combined profits from the controlled transactions under examination into two stages:

- In the first stage, each party engaged in the controlled transactions is allocated an arm's length remuneration for the categories of contributions which can be directly valued; typically, routine contributions for which reliable comparables can be found. Ordinarily this initial remuneration would be determined by applying one of the traditional transaction methods (i.e. the CUP or the cost plus method) to identify the remuneration of comparable transactions between independent enterprises.
- In the second stage, any residual profit (or loss) remaining would be allocated among the parties. Typically, this allocation would be based on the relative value of the second category of contributions of the parties in a manner similar to the contribution analysis outlined above.

V. THE IMPORTANCE OF TRANSFER PRICING DOCUMENTATION

As a matter of principle, the arm's length character of material intra-group transactions should be substantiated in sound transfer pricing documentation. Despite the fact that Luxembourg tax law does not specifically require the preparation of transfer pricing documentation, taxpayers are under a duty to co-operate with the Luxembourg tax authorities and have to evidence facts and provide information in regard to statements made in the tax returns.

When the Luxembourg tax authorities can reasonably evidence that the transfer pricing of an intra-group transaction does not adhere to the arm's length principle, it is the responsibility of the taxpayer to disprove this rebuttable presumption. Another factor to be considered is that transfer prices may be reviewed several years after a transaction takes place. This makes it more and more difficult from a practical perspective to trace back relevant facts and circumstances of the transaction as well as data on comparable transactions. All these factors evidently exert pressure on Luxembourg companies to develop and apply appropriate transfer pricing policies for risk mitigation purposes.

Moreover, since the creation of a new tax audit division, tax audits are now performed more systematically by the Luxembourg tax authorities. As tax assessments in Luxembourg may generally be revised for a period of five years, potential tax risks may span several years, which requires an appropriate and active tax risk management function.

Experience shows that transfer pricing is frequently put under the microscope during tax audits. Tax authorities can more easily challenge transfer pricing when no transfer pricing documentation has been prepared: how could taxpayers take informed decisions if no transfer pricing analysis was performed before the pricing of intra-group transactions was determined? Therefore, transfer pricing should always be considered before agreements are concluded.

However, taxpayers should not consider the preparation of transfer pricing documentation as a compliance exercise. Instead, in the current international tax environment of heightened transparency and scrutiny, Luxembourg companies would be wise to take it one step further and to integrate the documentation of transfer prices in their wider tax strategy, using it as a means to reflect the business rationale behind their investment structures and intra-group transactions.

Transfer pricing policies should further not be disregarded after their implementation. As a matter of best practice, taxpayers should review their transfer pricing documentation at least once a year in order to assess whether the fact pattern is still consistent with reality and to determine whether an update might be necessary.

VI. SELECTED CASE STUDIES

A. *Opening comments*

The way fund management services are organised by asset managers may vary significantly from one case to another. Therefore, the transfer pricing analysis generally starts with the identification of the entities involved (both related parties and third-party service providers) and the mapping of the relevant transactions.

While transactions between third parties are by nature arm's length transactions, the remuneration earned by related parties in controlled transactions has to adhere to the arm's length standard. The transfer pricing analysis of fund management services is outlined in the following case studies.

B. *Case study 1: the real estate fund*

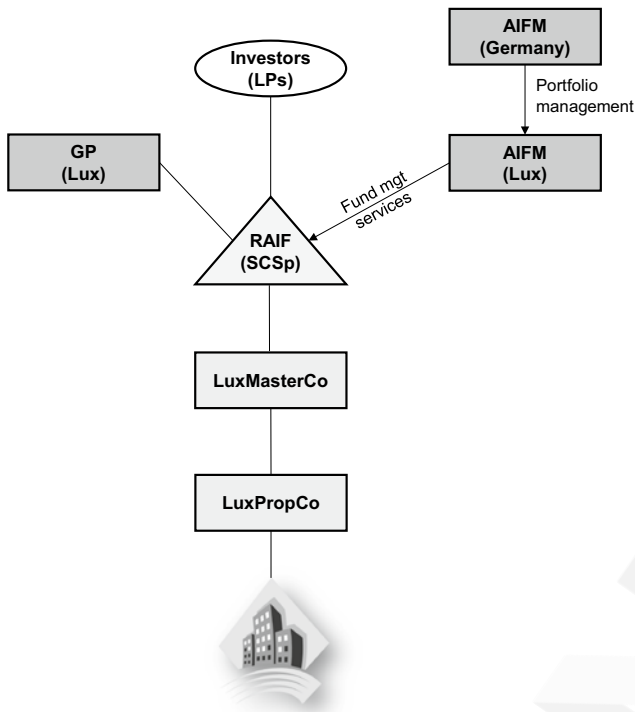
A Luxembourg real estate fund established as a Reserved Alternative Investment Fund ("RAIF") in the legal form of a limited partnership (*société en commandite simple*, "SCS") is managed by a Luxembourg limited liability company (*société à responsabilité limitée*, "S.à r.l.") which is the general partner ("Lux GP") of the SCS. The international investors in the fund are limited partners ("LPs") of the SCS.

Lux GP appointed a Luxembourg alternative investment fund manager ("AIFM (Lux)") and a German AIFM ("AIFM (Germany)"), both group companies of the asset manager, to perform fund management services. The RAIF pays fund management fees corresponding to 1.5% of the assets under management.

It is assumed that the functional profile of AIFM (Lux) corresponds to that of a Luxembourg third-party AIFM, whereas AIFM (Germany) performs most of the high value-adding functions such as portfolio management, fund raising, marketing and others.

Some functions such as accounting, tax compliance and investors administration are outsourced to third-party service providers.

The Luxembourg investment platform and the way the fund management services are organised are depicted in the following chart:



Transfer pricing analysis

The percentage of the overall fund management fees has been agreed between third parties (i.e. between the investors in the fund and the asset manager) and does not need to be tested from a transfer pricing perspective. Rather, the 1.5% fund management fee is arm's length by nature.

Likewise, the fees paid to third-party service providers are arm's length by nature.

Lux GP is in charge of the management and corporate governance of the RAIF and should be remunerated at arm's length for both the functions performed and the amount of equity at risk. When it is not possible to apply the CUP method (e.g. in the absence of comparable data), the cost-plus method will likely be the most appropriate transfer pricing method for determining an arm's length remuneration for the functions performed. Given that Lux GP has an unlimited liability for the obligations of the RAIF, Lux GP should further earn an arm's length remuneration for the equity at risk.

Based on the assumption that AIFM (Lux) has a functional profile which is similar to that of third-party AIFMs, the CUP method might be the most appropriate method to determine an arm's length remuneration. In this case, the residual fund management fee (after payment of third-party service providers, Lux GP and AIFM (Lux)) should be attributed to the German AIFM which performs most of the high value-adding services.

C. Case study 2: the real estate fund II

As a variation to the previous case, it is assumed that the fund management services performed by AIFM (Lux) and AIFM (Germany) are highly integrated and the functional profile of AIFM (Lux) is much more comprehensive than that of third-party AIFMs.

Transfer pricing analysis

The percentage of the overall fund management fees has been agreed between third parties (i.e. between the investors in the fund and the asset manager) and does not need to be tested from a transfer pricing perspective. Rather, the 1.5% fund management fee is arm's length by nature.

Likewise, the fees paid to third-party service providers are arm's length by nature.

Lux GP is in charge of the management and corporate governance of the RAIF and should be remunerated at arm's length for both the functions performed and the amount of equity at risk. When it is not possible to apply the CUP method (e.g. in the absence of comparable data), the cost-plus method will likely be the most appropriate transfer pricing method for determining an arm's length remuneration for the functions performed. Given that Lux GP has an unlimited liability for the obligations of the RAIF, Lux GP should further earn an arm's length remuneration for the equity at risk.

As regards the remuneration of the AIFMs, the application of the CUP method based on external comparables looking at third-party AIFMs might not be appropriate. Instead, given the comprehensive functional profile of both AIFMs and the high level of integration of the fund management services, the profit split method should be the most appropriate transfer pricing method to attribute an arm's length remuneration to both AIFMs.

The application of the profit split method requires a detailed analysis of the value chain and the functions performed by the parties to the controlled transaction.

The following matrix is assumed to reflect the functions performed by the AIFMs:

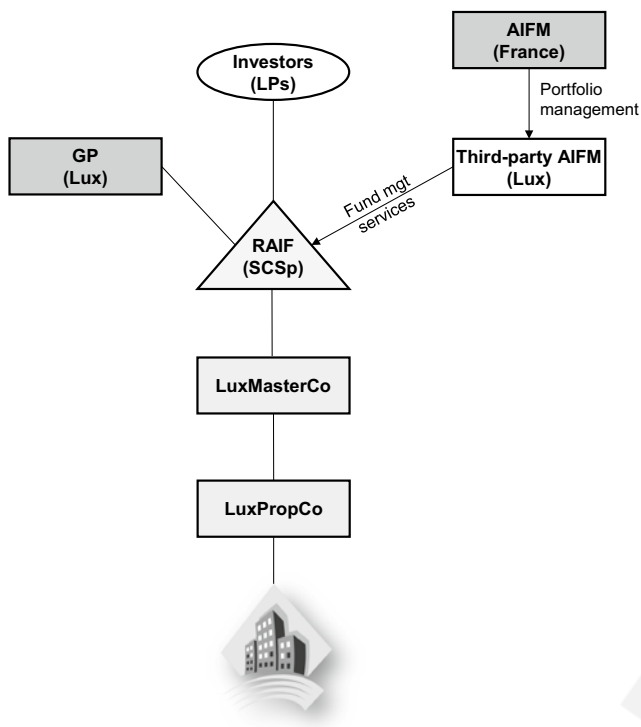
Functional comparative analysis			
Functions	Service providers	GermanAIFM	LuxAIFM
Fund and portfolio management			
Investment advice		●	
Negotiate and execute investment transactions		●	○
Investment performance monitoring		●	○
Investor relations		●	○
Support services		●	○
Risk management			
Supervision			●
Organisational risk management			●
Portfolio risk management			●
Internal audit	●		○
Compliance and risk monitoring			●
Marketing			
Marketing		●	
Promotion		●	
Ancillary		●	
Valuation			
Supervision			●
Valuation		○	●
Review of valuation		○	●
Fund administration			
Accounting	●		○
Investors administration	●		○
E-filing	●		
Depositary	●		
Percentage of functions performed		67.5%	32.5%

In the present case, the functional analysis is assumed to result in an allocation of 67.5% of the residual fund management fees (after payment of third-party service providers and Lux GP) to AIFM (Germany), whereas the remaining 32.5% of the residual fund management fees should be allocated to AIFM (Lux).

Notably, the analysis of the value chain of fund management services requires an estimation of the relative contribution of each function when determining the overall contribution of the parties.

D. Case study 3: real estate fund with a third-party AIFM

As a variation to case study 1, it is assumed that the fund management services are performed by a Luxembourg third-party AIFM ("Third-party AIFM (Lux)") and a French AIFM which is a major asset manager. While Third-party AIFM (Lux) performs risk management functions the French AIFM performs fund and portfolio management, marketing and valuation functions.



is managed by a Luxembourg limited liability company (*société à responsabilité limitée*, "S.à r.l.") which is the general partner ("Lux GP") of the SCS. The international investors in the RAIF are limited partners ("LPs") of the SCS.

Lux GP appointed a Luxembourg alternative investment fund manager ("AIFM (Lux)") which is a member of the asset manager's group. The RAIF pays fund management fees corresponding to 1.5% of the assets under management.

Some functions such as accounting, tax compliance and investors administration are outsourced to third-party service providers.

The Luxembourg investment platform and the way the fund management services are organised are depicted in the following chart:

Transfer pricing analysis

The percentage of the overall fund management fees has been agreed between third parties (i.e. between the investors in the fund and the asset manager) and does not need to be tested from a transfer pricing perspective. Rather, the 1.5% fund management fee is arm's length by nature.

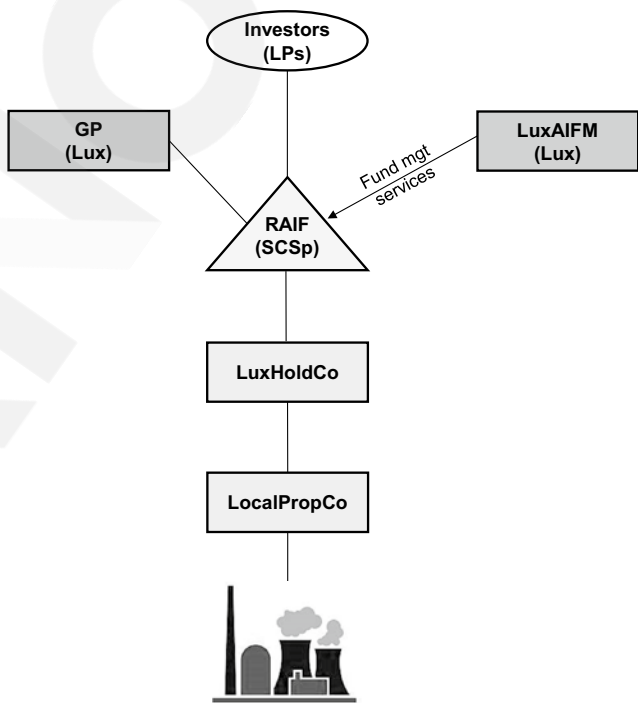
Likewise, the fees paid to third-party service providers are arm's length by nature.

Lux GP is in charge of the management and corporate governance of the RAIF and should be remunerated at arm's length for both the functions performed and the amount of equity at risk. When it is not possible to apply the CUP method (e.g. in the absence of comparable data), the cost-plus method will likely be the most appropriate transfer pricing method for determining an arm's length remuneration for the functions performed. Given that Lux GP has an unlimited liability for the obligations of the RAIF, Lux GP should further earn an arm's length remuneration for the equity at risk.

The remuneration of Third-party AIFM is by nature an arm's length transaction. The residual fund management fee (after payment of third-party service providers, Lux GP and AIFM (Lux)) should be attributed to French AIFM.

E. Case study 4: the infrastructure fund

A Luxembourg infrastructure fund established as a Reserved Alternative Investment Fund ("RAIF") in the legal form of a limited partnership (*société en commandite simple*, "SCS")



Transfer pricing analysis

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Likewise, the fees paid to third-party service providers are arm's length by nature.

Lux GP is in charge of the management and corporate governance of the RAIF and should be remunerated at arm's length for both the functions performed and the amount of equity at risk. When it is not possible to apply the CUP method (e.g. in the absence of comparable

data), the cost-plus method will likely be the most appropriate transfer pricing method for determining an arm's length remuneration for the functions performed. Given that Lux GP has an unlimited liability for the obligations of the RAIF, Lux GP should further earn an arm's length remuneration for the equity at risk.

Given that all fund management services are rendered by AIFM (Lux), the residual fund management fees (after payment of third-party service providers and Lux GP) should be allocated to AIFM (Lux).

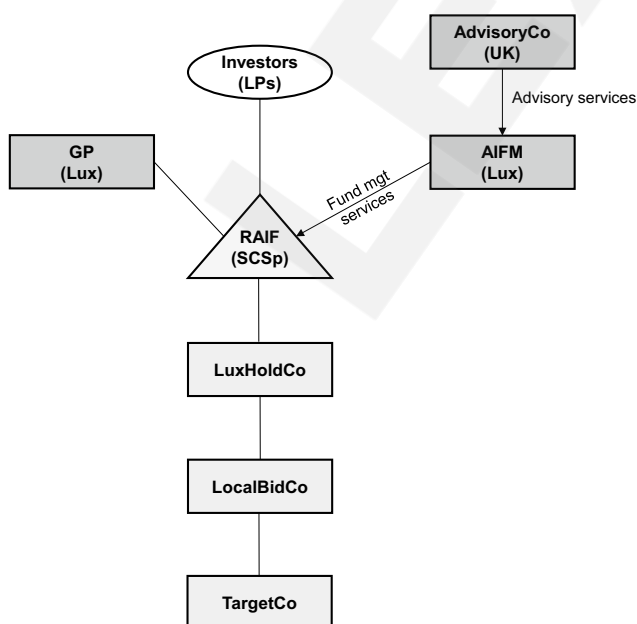
F. Case study 5: the private equity fund

A Luxembourg private equity fund established as a Reserved Alternative Investment Fund ("RAIF") in the legal form of a limited partnership (*société en commandite simple*, "SCS") is managed by a Luxembourg limited liability company (*société à responsabilité limitée*, "S.à r.l.") which is the general partner ("Lux GP") of the SCS. The international investors in the RAIF are limited partners ("LPs") of the SCS.

Lux GP appointed a Luxembourg AIFM ("AIFM (Lux)") which outsourced certain supervision and management functions to a UK advisory company ("AdvisoryCo (UK)") which is a member of the asset manager's group. The RAIF pays fund management fees corresponding to 1.5% of the assets under management.

Some functions such as accounting, tax compliance and investors administration are outsourced to third-party service providers.

The Luxembourg investment platform and the way the fund management services are organised are depicted in the following chart:



Transfer pricing analysis

The percentage of the overall fund management fees has been agreed between third parties (i.e. between the investors in the fund and the asset manager) and does not need to be tested from a transfer pricing perspective. Rather, the 1.5% fund management fee is arm's length by nature.

Likewise, the fees paid to third-party service providers are arm's length by nature.

Lux GP is in charge of the management and corporate governance of the RAIF and should be remunerated at arm's length for both the functions performed and the amount of equity at risk. When it is not possible to apply the CUP method (e.g. in the absence of comparable data), the cost-plus method will likely be the most appropriate transfer pricing method for determining an arm's length remuneration for the functions performed. Given that Lux GP has an unlimited liability for the obligations of the RAIF, Lux GP should further earn an arm's length remuneration for the equity at risk.

The remuneration of AdvisoryCo (UK) must adhere to the arm's length standard. When it is possible to apply the CUP method, this should be the most appropriate method. However, when the CUP method cannot be applied (for example because of a lack of comparables), the cost plus method should result in the best approximation of arm's length pricing.

VII. CONCLUSION

Fund management services play an important role in Luxembourg for both UCITS and Alternative investment funds. The way fund management services are organised may significantly vary from one case to another and involve several related and third parties. The remuneration earned by related parties must adhere to the arm's length standard.

Given the amounts at stake, fund management fees frequently attract the attention of the Luxembourg tax authorities. The transfer pricing of fund management services may be challenged by the Luxembourg tax authorities when reviewing the tax returns or during tax audits that span several years. Hence, transfer pricing challenges may entail significant tax risks for Luxembourg (management) companies.

Ultimately, tax risks in relation to transfer pricing may be effectively mitigated through robust transfer pricing documentation that analyses the value chain of fund management services and establishes an arm's length remuneration for the Luxembourg and, potentially, foreign companies involved.