Luxembourg implements the Mandatory Disclosure Regime (DAC 6): What will be the Impact on Private Equity Investments in Luxembourg?

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In this article, Oliver R. Hoor provides an overview of the key features of the new mandatory disclosure regime ("MDR"), analyses the mechanism for determining reportable cross-border arrangements and considers the impact of the MDR on private equity investments made from Luxembourg.

1. Introduction

On 8 August 2019, a draft law (the "Draft Law") implementing the Council Directive (EU) 2018/822 of 25 May 2018 as regards mandatory exchange of information in the field of taxation in relation to reportable cross-border arrangements[1] ("DAC 6") was submitted by the government to the Luxembourg parliament. As expected, the wording of the Draft Law largely resembles the wording of DAC 6 and the commentaries to the draft law provide only few explanations.

Luxembourg is a prominent financial centre and a major hub for the structuring of Private Equity Investments which are often made via a Luxembourg or foreign fund vehicle and Luxembourg companies that directly or indirectly invest into businesses. It is common knowledge that the investments and business activities of Luxembourg companies often have a cross-border dimension. In all these cases, the question needs to be answered as to whether a particular piece of advice, or involvement in implementation, is reportable under the MDR.

DAC6 has been inspired by the Final Report on Action 12 of the OECD Base Erosion and Profit Shifting ("BEPS") Project that provides recommendations regarding the design of mandatory disclosure rules for aggressive and abusive transactions, arrangements or structures. However, mandatory disclosure rules are not a new phenomenon. A number of countries including the UK, Ireland, Portugal, the US, Canada, South Korea, Israel and South Africa implemented disclosure regimes with different scopes in the past.

2. Design principles and main objectives of mandatory disclosure rules

According to the Final Report on BEPS Action 12, mandatory disclosure rules should satisfy the following design principles:

- such regimes should be clear and easy to understand (a lack of clarity may result in a tax administration receiving poor quality or irrelevant information);[2]
- they should balance additional compliance costs to taxpayers with the benefits obtained by the tax administration (unnecessary or additional requirements will increase taxpayer costs and may undermine a tax administration's ability to effectively use the data provided);[3]
- they should be effective in achieving their objectives and accurately identify the schemes to be disclosed (it would be impractical for a mandatory reporting regime to

[1] Council Directive (EU) 2018/822 of 25 May 2018 amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements.
[2] See Final Report on BEPS Action 2, p. 19, No. 19.
[3] See Final Report on BEPS Action 2, p. 19, No. 20.

target all transactions that raise tax avoidance concerns and the identification of "hallmarks" is a key factor to setting the scope of the rules);[4]

- they should be flexible and dynamic enough to allow the tax administration to adjust the system to respond to new risks or carve-out obsolete risks;[5] and
- they should ensure that information collected is used effectively (requiring the implementation of effective procedures at the level of the tax administration).[6]

It is further stated that mandatory disclosure rules both complement and differ from other types of reporting and disclosure obligations in that they are specifically designed to detect tax planning schemes that exploit vulnerabilities in the tax system, while also providing tax authorities with the flexibility to select thresholds, hallmarks and filters to target transactions of particular interest or perceived areas of risk.

The main purpose of mandatory disclosure rules is to increase transparency by providing tax authorities with early information regarding potentially aggressive or abusive tax planning schemes and to identify the promoters and users of those schemes.

Another objective of mandatory disclosure rules is deterrence as taxpayers may be inclined to keep distance from arrangements that trigger reporting obligations. Likewise, there is pressure on tax intermediaries that in each and every case have to consider whether their advice has to be disclosed or not. Given that mandatory disclosure rules target new and innovative schemes, it is also believed that with timely reported information there will only be limited opportunity to implement schemes before they are closed down.[7]

3. Key features of the new reporting regime

3.1. Opening comments

Arrangements that come within the scope of at least one of the hallmarks defined in the Appendix to the Draft Law may need to be reported under the MDR. However, the reporting obligations are limited to "cross-border" situations, namely those involving either more than one Member State or a Member State and a third country.

The reporting regime further limits the number of reportable cross-border arrangements through the adoption of a threshold condition. This means that many of the hallmarks only trigger a reporting obligation to the extent an arrangement meets the main benefit test ("MBT"), reducing the risk of excessive or defensive filings. This should enhance the usefulness of the information collected because the focus will be on arrangements that have a higher probability to serve the purpose of the disclosure regime.

In terms of relevant taxes, the MDR applies to all taxes of any kind levied by, or on behalf of, an EU Member State or the Member State's territorial or administrative subdivisions, including the

[4] See Final Report on BEPS Action 2, p. 20, No. 22.
[5] See Final Report on BEPS Action 2, p. 32, No. 56.
[6] See Final Report on BEPS Action 2, p. 20, No. 23.
[7] See Final Report on BEPS Action 2, p. 27, No. 48.

local authorities. The MDR does not, however, apply to value added tax and customs duties, or to excise duties covered by other Union legislation on administrative cooperation between Member States.

3.1. Reportable arrangements

The Draft Law requires EU tax intermediaries to report cross-border arrangements that are potentially aggressive tax planning arrangements. The term arrangement may also include a series of arrangements and an arrangement may comprise more than one step.[8] Hence, the understanding of the term "arrangement" within the meaning of the Draft Law is rather broad.

An arrangement is considered as cross-border if it concerns either (i) more than one EU Member State or (ii) an EU Member State and a third country. In addition, one of the following conditions must be met:

- Not all of the participants in the arrangement are resident for tax purposes in the same jurisdiction; or
- One or more of the participants in the arrangement is simultaneously resident for tax purposes in more than one jurisdiction; or
- One or more of the participants in the arrangement carries on a business in another jurisdiction through a permanent establishment situated in that jurisdiction and the arrangement forms part or the whole of the business of that permanent establishment; or
- One or more of the participants in the arrangement carries on an activity in another jurisdiction without being resident for tax purposes or creating a permanent establishment situated in that jurisdiction; or
- Such arrangement has a possible impact on the automatic exchange of information or the identification of beneficial ownership.[9]

Cross-border arrangements may be reportable if they contain at least one of the hallmarks set out in the Appendix to the Draft Law. These hallmarks describe characteristics or features of cross-border arrangements that might present an indication of a potential risk of tax avoidance.

3.2. Information to be reported

When a cross-border arrangement is reportable, the following information should be provided:

a) The identification of intermediaries and relevant taxpayers;
b) Details of the hallmarks that make the cross-border arrangement reportable;
c) A summary of the content of the reportable cross-border arrangement;
d) The date on which the first step in implementing the reportable cross-border arrangement has been made or will be made;
e) Details of the national provisions that form the basis of the reportable cross-border arrangement;

[8] See Article 1 No. 1 of the Draft Law.
[9] See Article 1 No. 1 of the Draft Law.

f) The value of the reportable cross-border arrangement;

g) The identification of the Member State of the relevant taxpayer(s) and any other Member States which are likely to be concerned by the reportable cross-border arrangement; and

h) The identification of any other person in a Member State, if any, likely to be affected by the reportable cross-border arrangement.[10]

The EU Commission will develop standard forms for the disclosure of reportable arrangements.

3.3. Reporting responsibilities

The reporting responsibilities regarding cross-border arrangements that fall within the scope of the Draft Law generally rest with the tax intermediary, unless such reporting would be a breach of the intermediary's legal professional privilege. In the latter case, the intermediary should notify any other intermediary or, if there is no such intermediary, the relevant taxpayer that the reporting obligation would then fall to them.[11]

According to the Draft Law, only lawyers subject to the law of 10 August 1991 may rely on their professional secrecy and have the right to a waiver from filing information on a reportable cross-border arrangement. In such circumstances, lawyers acting as intermediary in the sense of the Draft Law must notify, within 10 days, their waiver to any other intermediary or, if there is no such intermediary, to the relevant taxpayer. In this case, the obligation to file information on a reportable cross-border arrangement will lie with the other notified intermediary, or, if there is no such intermediary, with the relevant taxpayer. However, according to the Draft Law, lawyers would still need to report some information on the cross-border arrangement (on a no name basis) and the other tax intermediaries involved.[12]

An intermediary is defined as any person that designs, markets, organises or makes available for implementation or manages the implementation of a reportable cross-border arrangement. This may include, in particular, tax advisers, lawyers and accountants. The Draft Law further extends the circle of intermediaries to "*any persons that know, or could be reasonably expected to know that they have undertaken to provide, directly or by means of other persons', aid, assistance or advice with respect to designing, marketing, organising, making available for implementation or managing the implementation of a reportable cross border arrangement*". Accordingly, the understanding of the term tax intermediary is intentionally very broad, and includes any professional that provides, or has knowledge of, tax advice.[13]

The reporting obligations under the MDR are limited to intermediaries that have an EU nexus based on tax residency, incorporation, etc. Hence, non-EU intermediaries do not have any reporting obligations under the MDR.[14] In these circumstances, a potential reporting obligation would be shifted to the taxpayer benefiting from the cross-border arrangement.[15]

[10] Article 10 (1) of the Draft Law.
[11] Article 3 (2) of the Draft Law.
[12] Article 3 (1) of the Draft Law.
[13] Article 1 No. 4 of the Draft Law.
[14] Article 1 No. 4 of the Draft Law.
[15] Article 4 (1) of the Draft Law.

Likewise, when there is no tax intermediary because, for instance, the taxpayer designs and implements a scheme in-house, the reporting obligation rests with the taxpayer who benefits from the arrangement.[16]

3.4. Overlapping reporting obligations

The broad definition of the term intermediary may likely result in overlapping reporting obligations. According to the Draft Law, when there is more than one intermediary, the obligation to file information on the reportable cross-border arrangement lies with all intermediaries involved. Tax intermediaries should only be exempt from their reporting obligations to the extent they can prove that the same arrangement has already been filed by another intermediary.[17] In addition, Luxembourg tax intermediaries are exempt from reporting if they can prove that the same cross-border arrangement has already been reported in another EU Member State.[18]

Thus, it does not suffice to prove that another intermediary has committed to do the reporting but it is necessary to prove the effective reporting by another intermediary.[19] This obviously requires a certain extent of coordination between the advisers in order to determine whether or not a cross-border arrangement is reportable and, if so, only one intermediary files a report so as to avoid multiple filings in relation to the same arrangement. Given that only the taxpayer should know all the potential tax intermediaries involved, it will likely be the taxpayer that takes over this coordination role; in particular, when arrangements concern two or more EU Member States.

When a cross-border arrangement is not reportable under the MDR, taxpayers should consider, as a best practice, to have this point being analysed and documented by one of the intermediaries involved. This would prove that the taxpayer has carefully considered the potential obligations under the MDR. Moreover, other tax intermediaries may reasonably rely on such analysis.

When an intermediary is liable to file information on reportable cross-border arrangements with the competent authorities of more than one EU Member State, the Draft Law provides for rules to identify one single EU Member State in which the filing should be made.[20]

In case the reporting obligations rest with the taxpayer because the intermediaries would otherwise breach their legal professional privilege, taxpayers may also be subject to multiple reporting obligations in different EU Member States. Here, the Draft Law provides for rules to determine one single EU Member State in which the filing should be made.[21] When there are several relevant taxpayers, the Draft Law provides for rules to determine the one single taxpayer that should report the arrangement.[22]

[16] Article 4 (1) of the Draft Law.
[17] Article 5 of the Draft Law.
[18] Article 2 (4) of the Draft Law.
[19] Article 5 of the Draft Law.
[20] Article 2 (3) of the Draft Law.
[21] Article 4 (3) of the Draft Law.
[22] Article 6 of the Draft Law.

3.5. Timing aspects

The earliest event that can realistically trigger a disclosure requirement is the point at which a tax intermediary makes a scheme available to a taxpayer. With regard to the timing of the reporting, the Draft Law states that tax intermediaries have to file information that is within their knowledge, possession or control on reportable cross-border arrangements within 30 days beginning:

a) On the day after the reportable cross-border arrangement is made available for implementation; or

b) On the day after the reportable cross-border arrangement is ready for implementation; or

c) When the first step in the implementation of the reportable cross-border arrangement has been made,

whichever occurs first.[23]

Alternatively, intermediaries should be required to file information within 30 days beginning on the day after they provided, directly or indirectly, aid, assistance or advice.[24]

In addition, there exists a periodic reporting obligation, every three months, for cross-border arrangements that are to be classified as marketable arrangements. These are defined as arrangements that are designed, marketed, ready for implementation or made available for implementation without a need to be substantially customized.[25]

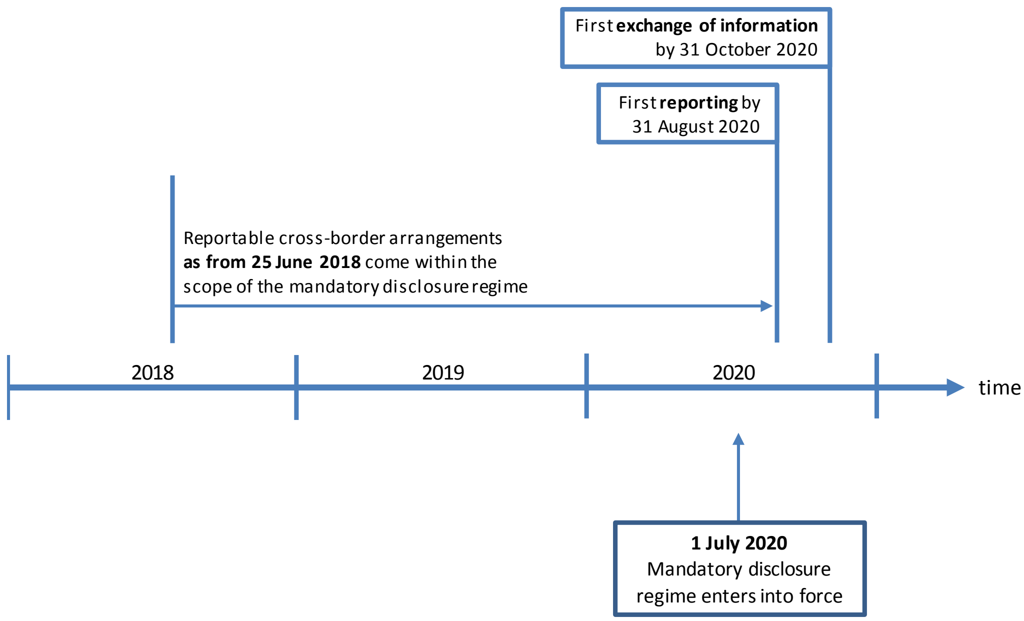
While the MDR applies as from 1 July 2020, reportable arrangements as from 25 June 2018 (that is the date of entry into force of DAC 6) have to be reported by 31 August 2020. It follows that tax intermediaries have to track potentially reportable advice since 25 June 2018.[26]

In addition, relevant taxpayers may be required to file information about their use of an arrangement in each year in which they use it. This reporting should be made in the corporate tax returns.[27]

The information collected by the tax authorities is subject to automatic exchange of information with the tax authorities of all other EU Member States through a centralized database.[28] The exchange of information should take place within one month following the end of the quarter in which the information was filed. Accordingly, the first information is to be communicated by 31 October 2020.[29]

[23] Article 2 (1) of the Draft Law.
[24] Article 2 (1) of the Draft Law.
[25] Article 2 (2) of the Draft Law.
[26] Article 8 of the Draft Law.
[27] Article 7 of the Draft Law.
[28] Article 9 of the Draft Law.
[29] Article 12 of the Draft Law.

Beginning of the reporting obligations



3.6. Penalties for non-compliance

According to the Draft Law, the penalties for non-compliance with the MDR amount to a maximum of EUR 250,000 and may be levied to tax intermediaries and, as the case may be, to taxpayers.[30]

The Luxembourg tax administration will verify whether tax intermediaries and taxpayers adopt a process for insuring compliance with the MDR.[31] Such MDR process should ideally be formalised in a policy that may provide guidance for employees, set out responsibilities and consider practical aspects such as how the reporting is managed from an operational perspective.

Based on experience, it can be assumed that the Luxembourg tax authorities will levy measured penalties in case of wrongdoings, taking into consideration the level of care taken by the tax intermediaries and taxpayers. Thus, when tax intermediaries and taxpayers use their best efforts and dedicate appropriate resources to the implementation of the MDR process (including training of staff) and its systematic application, there should be a limited risk of penalties. On the contrary, in the absence of any efforts to comply with the MDR, it may be expected that Luxembourg tax authorities will levy penalties.

The Draft Law specifically mentions the far-reaching investigation powers of the Luxembourg tax authorities in regard to the verification of compliance with the MDR.[32]

[30] Article 15 (1) of the Draft Law.
[31] Article 16 (1) of the Draft Law.
[32] Article 16 (2) of the Draft Law.

4. The hallmarks of reportable arrangements

4.1. Opening comments

The Appendix to the Draft Law defines a number of hallmarks that, when present in a cross-border arrangement, may trigger reporting obligations under the MDR.

Hallmarks are generally divided into two categories: generic and specific hallmarks. Generic hallmarks target features that are common to promoted schemes, such as the requirement for confidentiality or the payment of a premium fee. Generic hallmarks can be used to capture new and innovative tax planning arrangements as well as mass-marketed transactions that promoters may easily replicate and sell to a variety of taxpayers.

Specific hallmarks are used to target known vulnerabilities in the tax system and techniques that are commonly used in tax avoidance arrangements such as the use of loss creation, leasing and income conversion schemes.

The Directive sets out the following five categories of hallmarks:

- General hallmarks linked to the main benefit test;
- Specific hallmarks linked to the main benefit test;
- Specific hallmarks related to cross-border transactions;
- Specific hallmarks concerning automatic exchange of information and beneficial ownership; and
- Specific hallmarks concerning transfer pricing.

Many of the hallmarks have been designed to operate in conjunction with a threshold requirement (that is the main benefit test, "MBT"). These hallmarks only trigger disclosure obligations if a main benefit of the scheme was obtaining a tax advantage, reducing the risk of over-disclosure and avoiding undue compliance burdens on the part of the taxpayers.

4.3. Hallmarks that are subject to the main benefit test

4.3.1. Generic hallmarks linked to the MBT

The Draft Law provides for the following generic hallmarks which trigger a disclosure obligation to the extent the MBT is met:

- The "Confidentiality" hallmark: An arrangement where the relevant taxpayer or a participant in the arrangement undertakes to comply with a condition of confidentiality which may require them not to disclose how the arrangement could secure a tax advantage vis-à-vis other intermediaries or the tax authorities.

A confidential scheme is one that is offered to the adviser's clients under the conditions of confidentiality. Here, the confidentiality is owed by the client to the promoter (not by the promoter to the client). This limitation on disclosure is to protect the value of the scheme designed by the promoter.

A confidentiality condition indicates that a promoter wishes to keep schemes or arrangements confidential either from other promoters or from the tax authorities, enabling a promoter to sell the same scheme to a number of different taxpayers.

The use of a confidentiality clause in an agreement may mean that the hallmark is met. However, the inclusion of a confidentiality clause is common practice among service providers to protect knowledge and intangible assets (technical knowledge, agreements, etc.) regardless of any motive to protect a tax scheme.

According to the Final Report on BEPS Action 12, even if certain promoters use a confidentiality clause or condition, schemes known to the tax administration are not caught by the confidentiality hallmark. The fact that a scheme is known can be evidenced by, for example, technical guidance notes, case law or past correspondence with the tax administration.

- The “Premium fee” or “contingent fee” hallmark: An arrangement where the intermediary is entitled to receive a fee (or interest, remuneration for finance costs and other charges) for the arrangement and that fee is fixed by reference to:

    - The amount of the tax advantage derived from the arrangement; or
    - Whether or not a tax advantage is actually derived from the arrangement. This would include an obligation on the intermediary to partially or fully refund the fees where the intended tax advantage derived from the arrangement was not partially or fully achieved.

This hallmark is designed to capture those schemes that have been sold on the basis of the tax benefits that accrue under them. Notably, this hallmark targets both “premium fees” (a fee that is to a significant extent attributable to the tax advantage or to any extent contingent upon obtaining that tax advantage) and fees that are contingent on the tax benefits that arise under the scheme (i.e. contingent fees).

The idea of a premium fee is that there is an amount payable that is attributable to both the value of the tax advice and the fact that it is not available anywhere else. However, if the consequences of the scheme are widely-known and understood then the client would be unwilling to pay more than a normal fee for it.

This hallmark would not be met if a tax adviser or another service provider assists a taxpayer in the reclaim of withholding taxes that have been unduly levied on a success fee basis. Here, the payment of the fee would be merely conditional to the refund of withholding taxes which is as such not a cross-border arrangement.

- The “Standardized tax product” hallmark: An arrangement that has substantially standardised documentation and/or structure and is available to more than one relevant taxpayer without a need to be substantially customised for implementation.

This hallmark is intended to capture what is often referred to as “mass-marketed schemes” which means an arrangement that is made available to more than one person and that uses standardised documentation that is not tailored to any material extent to the client’s circumstances.

The fundamental characteristic of such schemes is their ease of replication. Essentially, all the client purchases is a prepared tax product that requires little, if any, modification to suit their circumstances. The adoption of the scheme further does not require the taxpayer to receive significant additional professional advice or services.

The standardized tax product hallmark should not, however, be met in case of documentation such as loan agreements, service agreements and fund documentation as this type of documents has to be adapted to each individual case.[33] Whether or not a service provider has templates that may serve as basis should not impact the analysis of this hallmark.

4.3.2. Specific hallmarks linked to the MBT

The Draft Law further provides for the following specific hallmarks which trigger reporting obligations to the extent the MBT is met:

- The “Loss company” hallmark: An arrangement whereby a participant in the arrangement takes contrived steps which consist in acquiring a loss-making company, discontinuing the main activity of such company and using its losses in order to reduce its tax liability, including through a transfer of those losses to another jurisdiction or by the acceleration of the use of those losses.

This hallmark targets situations in which a taxpayer acquires a shell company that has significant tax losses with a view to transfer new business activities to the loss company. Here, the idea would be to offset the income from new business activities with existing tax losses.[34]

- The “Converting income scheme” hallmark: An arrangement that has the effect of converting income into capital, gifts or other categories of revenue which are taxed at a lower level or exempt from tax.

This hallmark addresses schemes for converting income into capital, gifts or other categories of revenue with the intention to benefit from a lower level of taxation.

Here, the question arises whether, for example, the financing of participations with debt and the related payment of interest paid out of dividends and capital gains realized in relation to the participation meets the converting income scheme. Nevertheless, this hallmark only triggers reporting obligations if it can be established that the MBT is met.

[33] Investment funds, loan agreements, etc. which are typically used in Luxembourg fund structures are legitimate investment vehicles and commercial transactions that are not open to be interpreted as “standardized tax products”.
[34] This kind of transaction is commonly targeted by anti-abuse legislation implemented by EU Member States and should therefore not be efficient in practice. For example, in Luxembourg the so-called *Mantelkauf* jurisprudence provides for the potential application of the General Anti-Abuse Rule (“GAAR”) to transactions involving loss companies.

- The "Circular transactions" hallmark: An arrangement which includes circular transactions resulting in the round-tripping of funds, namely through involving interposed entities without other primary commercial function or transactions that offset or cancel each other or that have other similar features.

This hallmark targets arrangements that include circular transactions involving interposed entities (without any economic activity other than participating in these transactions) or transactions that overall offset each other. Thus, this hallmark targets non-genuine arrangements and arrangements that are characterized by artificiality (i.e. offsetting each other) and the absence of genuine economic reasons. On the contrary, an arrangement should not satisfy this hallmark when genuine economic reasons can be established for its existence.

4.3.3. Specific hallmarks related to cross-border transactions

The following specific hallmarks related to cross-border transactions trigger reporting obligations to the extent the MBT is met:

- The "No or low taxation" hallmark: An arrangement that involves deductible cross-border payments made between two or more associated enterprises where at least one of the following conditions occurs:

  - although the recipient is resident for tax purposes in a jurisdiction, that jurisdiction does not impose any corporate tax or imposes corporate tax at the rate of zero or almost zero;

  - the payment benefits from a full exemption from tax in the jurisdiction where the recipient is resident for tax purposes;

  - the payment benefits from a preferential tax regime in the jurisdiction where the recipient is resident for tax purposes.

These specific hallmarks focus on the tax treatment of the recipient of a deductible cross-border payment. Non-deductible payments do not come within the scope of this hallmark.

This hallmark should frequently be met in case of foreign funds with a Luxembourg investment platform. In these circumstances, deductible (interest) payments to a foreign fund should generally not be subject to tax.

However, it is interesting to note that the Draft Law explicitly states that the very presence of any of these hallmarks cannot alone be a reason for concluding that an arrangement satisfies the MBT. In other words, the benefit of a deduction at the level of the payer and the absence of taxation at the level of the recipient of the payment does generally not make it "one of the main benefits" of an arrangement for the purposes of the MBT. Otherwise, it would not make sense to subject this hallmark to the MBT.

4.4. Hallmarks that are not subject to the MBT

4.4.1. Specific hallmarks related to cross-border transactions

The following specific hallmarks related to cross-border transactions are not subject to a threshold condition:

- The "State-less company" and "black-listed country" hallmark: An arrangement that involves deductible cross-border payments made between two or more associated enterprises where at least one of the following conditions occurs:
    - the recipient is not resident for tax purposes in any tax jurisdiction;
    - although the recipient is resident for tax purposes in a jurisdiction, that jurisdiction is included in a list of third-country jurisdictions which have been assessed by Member States collectively or within the framework of the OECD as being non-cooperative.

This hallmark targets two situations. First, situations where the recipient of a deductible cross-border payment is not resident for tax purposes in any tax jurisdiction. As a consequence, the income will not be subject to tax anywhere. State-less companies are, however, a very exotic phenomenon and should hardly ever occur in practice.

Second, situations involving recipients of deductible cross-border payments that are resident for tax purposes in a third state that is black listed by the EU or the OECD. Jurisdictions that are currently black listed include American Samoa, Guam, Samoa, Trinidad and Tobago, the US Virgin Islands, Belize, Dominica, Fiji, Marshall Islands, Oman, United Arab Emirates and Vanuatu.

- The "Double dip" hallmark: Deductions for the same depreciation on the asset are claimed in more than one jurisdiction.

This hallmark targets situations where a taxpayer claims deductions for the depreciation of an asset in more than one jurisdiction, resulting in double dip outcomes (i.e. the same expenses are deducted twice).

This hallmark should not be met, however, when for example the income of a subsidiary is included under a controlled foreign company ("CFC") regime in the tax base of the parent company and as such income and expenses are recognised. Rather, this hallmark should merely target the uncommon situation where the depreciation of an asset is claimed in more than one jurisdiction.

- The "Double relief" hallmark: Relief from double taxation in respect of the same item of income or capital is claimed in more than one jurisdiction.

This hallmark captures situations where a taxpayer claims relief from double taxation in respect of the same item of income or capital in more than one jurisdiction. It is difficult to see which kind of situations should be targeted by this hallmark as the application of a tax exemption in more than one jurisdiction would also require that the income is taxable in more than one jurisdiction.

- The "Step-up in value" hallmark: There is an arrangement that includes transfers of assets and where there is a material difference in the amount being treated as payable in consideration for the assets in those jurisdictions involved.

This hallmark applies to transactions where an asset is transferred between associated enterprises and the sales price at the level of the selling entity is significantly lower than the acquisition price that is considered by the acquiring entity resident in another jurisdiction. Such step-up in value may result in higher depreciations at the level of the acquiring entity without the recognition of latent capital gains in the jurisdiction of the entity selling the assets.

4.4.2. Specific hallmarks concerning automatic exchange of information

The Draft Law provides for the following specific hallmarks concerning automatic exchange of information of Financial Account information.

- The "No CRS Reporting" hallmark: An arrangement which may have the effect of undermining the reporting obligation under the laws implementing Union legislation or any equivalent agreements on the automatic exchange of Financial Account information, including agreements with third countries, or which takes advantage of the absence of such legislation or agreements. Such arrangements include at least the following:
    - the use of an account, product or investment that is not, or purports not to be, a Financial Account, but has features that are substantially similar to those of a Financial Account;
    - the transfer of Financial Accounts or assets to, or the use of jurisdictions that are not bound by the automatic exchange of Financial Account information with the State of residence of the relevant taxpayer;
    - the reclassification of income and capital into products or payments that are not subject to the automatic exchange of Financial Account information;
    - the transfer or conversion of a Financial Institution or a Financial Account or the assets therein into a Financial Institution or a Financial Account or assets not subject to reporting under the automatic exchange of Financial Account information;
    - the use of legal entities, arrangements or structures that eliminate or purport to eliminate reporting of one or more Account Holders or Controlling Persons under the automatic exchange of Financial Account information;
    - arrangements that undermine, or exploit weaknesses in, the due diligence procedures used by Financial Institutions to comply with their obligations to report Financial Account information, including the use of jurisdictions with inadequate or weak regimes of enforcement of anti-money-laundering legislation or with weak transparency requirements for legal persons or legal arrangements.

This specific hallmark captures situations where taxpayers enter into transactions that undermine reporting obligations in relation to automatic exchange of Financial Account information (Common Reporting Standard, CRS) regardless of whether this was intentional or not. Nevertheless, when this hallmark is satisfied, it is likely that the obligations under CRS have not been complied with. Thus, in these circumstances it would be wise to consider compliance with CRS obligations rather than reporting non-compliance with CRS obligations under the MDR.

4.4.3. Specific hallmarks concerning beneficial ownership

The Draft Law also sets out a specific hallmark relating to beneficial ownership which is not subject to a threshold requirement:

- The "Disguising beneficial owners" hallmark: An arrangement involving a non-transparent legal or beneficial ownership chain with the use of persons, legal arrangements or structures:
    - that do not carry on a substantive economic activity supported by adequate staff, equipment, assets and premises; and
    - that are incorporated, managed, resident, controlled or established in any jurisdiction other than the jurisdiction of residence of one or more of the beneficial owners of the assets held by such persons, legal arrangements or structures; and
    - where the beneficial owners of such persons, legal arrangements or structures, as defined in Directive (EU) 2015/849, are made unidentifiable.

This hallmark targets situations where a taxpayer intends to disguise its beneficial ownership through a cross-border investment structure that lacks substance. Here, disclosure obligations are triggered when the three conditions are met cumulatively.

The first condition requires an analysis of the substance of the entities involved. When analysing the appropriateness of substance in an EU context, the wholly artificial arrangement doctrine of the Court of Justice of the European Union ("CJEU") should be considered. This should significantly limit the reporting obligations under this hallmark.

The relevance of this hallmark should be largely diminished through the introduction of the new ultimate beneficial owner ("UBO") register in Luxembourg that captures information on the UBOs of Luxembourg companies.

4.4.4. Specific hallmarks concerning transfer pricing

Finally, the Draft Law provides for the following specific hallmarks concerning transfer pricing that are not subject to a threshold condition:

- The "Unilateral safe harbour" hallmark: An arrangement which involves the use of unilateral safe harbour rules.

This hallmark captures transactions that rely on unilateral safe harbour rules adopted for transfer pricing purposes. However, safe harbours are by definition targeted at transactions that are deemed immaterial by the legislator with a view to limit the administrative burden (in regard to small transaction that should not be material concerns to tax administrations). Therefore, it is difficult to comprehend the relevance of this hallmark in practice.

- The “Hard-to-value Intangibles” hallmark: An arrangement involving the transfer of hard-to-value intangibles. The term “hard-to-value intangibles” covers intangibles or rights in intangibles for which, at the time of their transfer between associated enterprises:
    - no reliable comparables exist; and
    - at the time the transaction was entered into, the projections of future cash flows or income expected to be derived from the transferred intangible, or the assumptions used in valuing the intangible are highly uncertain, making it difficult to predict the level of ultimate success of the intangible at the time of the transfer.

Hard-to-value intangibles received a lot of attention throughout the OECD BEPS Project. The Final Report on BEPS Actions 8 – 10 (Aligning transfer pricing outcomes with value creation) and the 2017 Revision of the OECD Transfer Pricing Guidelines include specific guidance on transfer pricing aspects of hard-to-value intangibles.

The reason for this is that intangibles are increasingly important value drivers for multinational businesses and the absence of reliable data when intangibles are transferred at an early stage (when it is not clear whether an intangible will be successful or not) created much concern on the part of tax administrations.

- The “Business restructuring” hallmark: An arrangement involving an intragroup cross-border transfer of functions and/or risks and/or assets, if the projected annual earnings before interest and taxes (EBIT), during the three-year period after the transfer, of the transferor or transferors, are less than 50 % of the projected annual EBIT of such transferor or transferors if the transfer had not been made.

This hallmark targets business restructurings that result in a significant reduction of the profitability of an entity as a consequence of the cross-border business restructuring. This could, for example, involve the conversion of a full-fledged manufacturer into a toll manufacturer that merely renders services to other group companies or the conversion of a full-fledged distributor into a limited-risk distributor. In these cases, a significant drop in profitability might be expected at arm’s length. It is worth mentioning that business restructurings should also be covered in a multinational’s master file.

The liquidation of a company should not be a business restructuring that comes within the scope of this hallmark even if the activities of the liquidated company are subsequently performed by another company. Instead, it is evident that this hallmark is targeted at business restructurings within the meaning of Chapter IX of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

5. The Main Benefit Test

5.1. Overview

As mentioned above, many of the hallmarks set out in the Appendix to the Draft Law are subject to an additional threshold test. The purpose of the MBT is to filter out irrelevant disclosure and to reduce some of the compliance and administration burden of the disclosure regime by targeting only tax-motivated transactions that are likely to pose the greatest tax policy and revenue risks.

The MBT is fulfilled if "*it can be established that the main benefit or one of the main benefits which, having regard to all relevant facts and circumstances, a person may reasonably expect to derive from an arrangement is the obtaining of a tax advantage*". Hence, this test compares the value of the expected tax advantage with any other benefits likely to be obtained from the transaction. This requires an objective analysis of all benefits obtained from an arrangement. According to the Final Report on BEPS Action 12, the MBT sets a relatively high threshold for disclosure.

It is interesting to note that the Draft Law explicitly states that the tax treatment of a cross-border payment at the level of the recipient cannot alone be a reason for concluding that an arrangement satisfies the MBT. Thus, it does not matter per se (i) if the jurisdiction of the recipient of a payment does not impose any corporate tax or imposes corporate tax at a rate of zero or almost zero or (ii) if the payment benefits from a full exemption or (iii) a preferential tax regime.

The analysis of the MBT can further not be seen in isolation from certain anti-abuse legislation such as the GAAR that had to be implemented by EU Member States in accordance with the EU Anti-Tax Avoidance Directive ("ATAD") and the principal purposes test ("PPT") that has been implemented in bilateral tax treaties through the multilateral instrument ("MLI"). In other words, when it is concluded that the main benefit or one of the main benefits of an arrangement was a tax benefit, this may also have an impact on the analysis of the GAAR or the PPT.

5.2. Application to international investments

With regard to the application of disclosure rules to international investment structures, the Final Report on BEPS Action 12 states that several countries with MDR indicated that, in practice, they receive comparatively fewer disclosures of cross-border schemes. The reason for this lower number of disclosures is considered to be partly a consequence of the way international schemes are structured and the approach taken by these regimes in formulating the requirements for disclosure of a reportable scheme.

The Final Report on Action 12 mentions that cross-border schemes typically generate multiple tax benefits for different parties in different jurisdictions and the domestic tax benefits that arise under a cross-border scheme may seem unremarkable when viewed in isolation from the rest of the arrangement as a whole.

For those hallmarks that need to meet the MBT as a threshold condition for disclosure, it is stated that the MDR can be difficult to apply in the context of cross-border arrangements that trigger tax consequences in a number of different jurisdictions. In practice, such arrangements may not meet the MBT if the taxpayer can demonstrate that the value of any (domestic) tax benefits was incidental when viewed in light of the commercial benefits of the transaction as a whole.

The Final Report on Action 12 acknowledges that cross-border investments often involve a broader commercial transaction such as an acquisition, refinancing or restructuring. Such arrangements are customized so that they are taxpayer and transaction specific and may not be widely promoted in the same way as a domestically marketed scheme. It is stated that for these reasons it may be difficult to target these schemes with generic hallmarks that target promoted schemes, which can be easily replicated and sold to a number of different taxpayers.

In view of the high threshold standard presented by the MBT, the Final Report on Action 12 even recommended not to include it as a threshold condition. Instead, it was recommended to include hallmarks that focus on the kinds of BEPS techniques that are known to give rise to tax policy or revenue concerns without including a threshold requirement.

Nevertheless, as stated in DAC 6, the principle of proportionality has been considered when designing the scope of the Directive. Under the principle of proportionality, the content and form of Union action shall not exceed what is necessary to achieve the objectives of the Treaties. In this regard, the MBT is key to limit disclosure obligations to tax-driven arrangements that take advantage of loopholes.

In light of the above, it can generally be considered that international investments in real estate, businesses or debt, even if they are structured in a way that takes account of tax benefits and costs, should seldom be subject to mandatory disclosure unless one of the hallmarks that trigger automatic reporting obligations is fulfilled.

5.3. Developing a reasonable approach

The Final Report on BEPS Action 12 provides useful guidance with regard to the interpretation of the MBT. Nevertheless, the somewhat vague wording of the MBT may make it unpractical to apply this test in practice.

While the MDR requires a good understanding of Luxembourg and international tax law and judgement when it comes to the assessment as to whether a hallmark is applicable or the MBT is met, tax intermediaries are not per se tax specialists. Therefore, it is important to develop a reasonable approach that can be systematically applied by all tax intermediaries and which produces clear-cut results, taking away the ambiguity from the MBT.

Based on the wording of the MBT and the purpose of the MDR, practitioners might consider analysing five questions. Three of these questions are primary questions that are directly linked to the MBT (questions a – c), whereas the remaining two questions are complementing the analysis through a focus on logical aspects (questions d and e).

a) Is it reasonable to consider that the investment would have been made in the absence of the tax benefit?

When it can be reasonably established that an arrangement or investment would have been entered into or made in the absence of a particular tax benefit, such arrangement or investment should generally not be made for the purpose of obtaining a tax advantage. Instead, a tax benefit may result from the optimization of the overall tax position within the limits of all applicable tax laws. In these circumstances, the tax benefits are ancillary to the main purpose of generating income, creating value and benefiting from an increase in value.

b) Are the commercial and other benefits more significant than the tax advantage?

This question is related to the first question and compares the value of all commercial and other benefits to the aggregate amount of tax advantages. However, in practice it may not be clear what amounts are to be compared given that various commercial and tax benefits may arise in several jurisdictions which requires a good understanding of international tax law.

In the absence of any clear guidance in this respect, it seems reasonable to make a broad approximation of the aggregate commercial and tax benefits. When investments are focusing on the generation of income, tax benefits should generally only be a fraction of the amount of income.

In stark contrast, if obtaining a tax benefit is a main benefit, the pre-tax profit may be expected to be insignificant compared to the tax benefit. In these circumstances, the arrangement is tax driven and taxpayers aim at benefiting from a tax advantage (for example, benefiting from a tax feature such as the allocation of losses in case of certain loss creation schemes) rather than realizing a return on their investments. In other words, taxpayers engage into a scheme with a view to obtain tax advantages rather than merely optimizing the tax position of an arrangement that is intended to generate income.

c) Are there genuine commercial reasons for an investment other than benefiting from a tax advantage?

This question considers the commercial rationale and business purpose of an arrangement or a series of arrangements and is linked to the potential application of the GAAR. The GAAR applies in case of an arrangement or a series of arrangements which has been put in place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the applicable tax law. For the purposes of the GAAR an arrangement or a series thereof shall be regarded as non-genuine to the extent they are not put in place for valid commercial reasons which reflect economic reality.

Thus, the existence of commercial reasons and business purpose may exclude the application of the GAAR. Despite the scope of the mandatory disclosure regime is broader than that of the GAAR, the answer to this question will be helpful to rule out a potential application of the GAAR and informs the analysis of the MBT.

d) Does the arrangement merely rely on the application of tax law (i.e. there are explicit rules) as opposed to taking advantage of loopholes or mismatches between two or more tax systems?

The mandatory disclosure regime aims at providing early information on potentially aggressive cross-border tax planning arrangements. In the Preamble (No. 2) of the Commission Recommendation of 6 December 2012 on aggressive tax planning, the latter has been defined as follows: "*Aggressive tax planning consists in taking advantage of the technicalities of a tax system or of mismatches between two or more tax systems for the purpose of reducing tax liability. Aggressive tax planning can take a multitude of forms. Its consequences include double deductions (e.g. the same loss is deducted both in the State of source and residence) and double non-taxation (e.g. income which is not taxed in the source State is exempt in the State of residence)*."

This definition suggests that aggressive tax planning relies on loopholes and mismatches between different tax systems that result in double deductions or double non-taxation. This definition of aggressive tax planning would significantly limit the scope of the reporting obligations under the MDR.

However, even if one considers a broader meaning of aggressive tax planning, the mere application of tax law that explicitly governs an arrangement should not meet the MBT. Here, the tax treatment of the arrangement is in line with the policy intent of the legislation upon which the arrangement relies. This question might be difficult to answer by non-tax experts though.

e) Is the arrangement or a series of arrangements known to the tax authorities involved?

When an arrangement or a series of arrangement is known to the tax authorities directly concerned by the arrangement(s), it can be assumed that the tax authorities and the legislator have all necessary information at their disposal to tackle such arrangement. Thus, when the answer to this question is yes, the reporting of these arrangements might not provide useful information to the tax authorities.

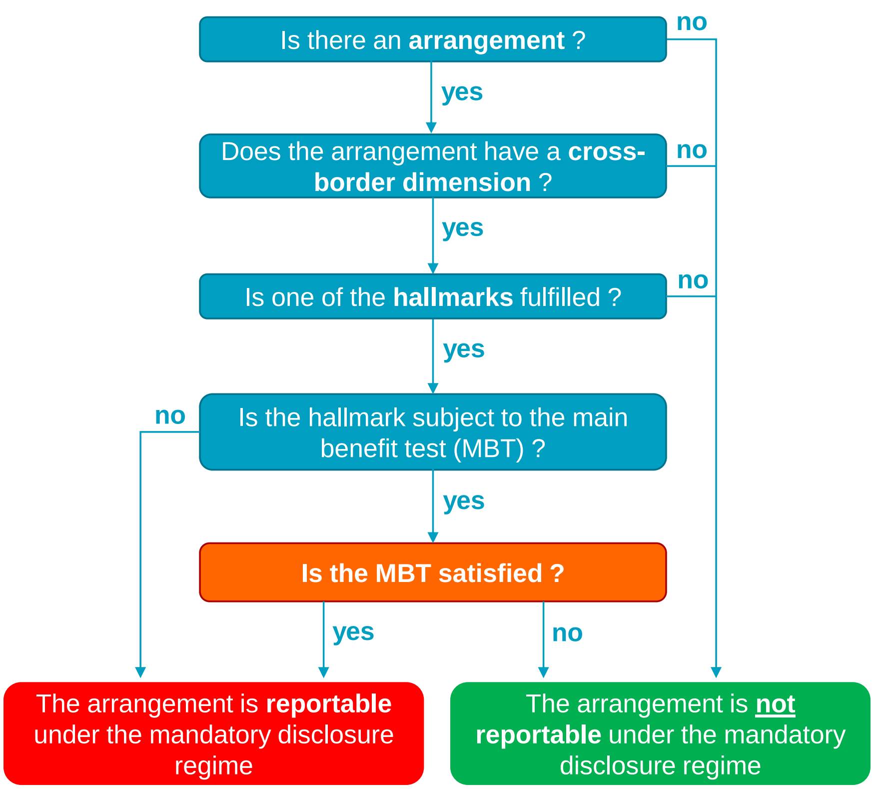
6. Determining reportable cross-border arrangements

When determining whether advice on a particular arrangement is reportable under the MDR, it first has to be analysed whether the arrangement has a cross-border dimension. In case of Private Equity investments made via Luxembourg, arrangement will often meet this condition.

Thereafter, it has to be analysed whether one of the hallmarks is present. In case of Luxembourg fund structures, none of the hallmarks might be fulfilled. In case of foreign fund structures, the cross-border relationships between a Luxembourg company and the foreign fund may likely fall within the "no or low taxation" hallmark when interest or other payments are made to the fund that are deductible for Luxembourg tax purposes (despite a Luxembourg fund vehicle would also benefit from a corporate income tax exemption).

When at least one of the hallmarks is fulfilled, it has to be verified whether the hallmark is subject to the MBT. If this is not the case, there is an automatic reporting obligation under the MDR. When the hallmark is subject to the MBT, it is necessary to perform a comprehensive analysis of all relevant facts and circumstances in order to determine whether the main benefit or one of the main benefits was the obtaining of a tax advantage.

The analysis to be performed is depicted in the checklist below:

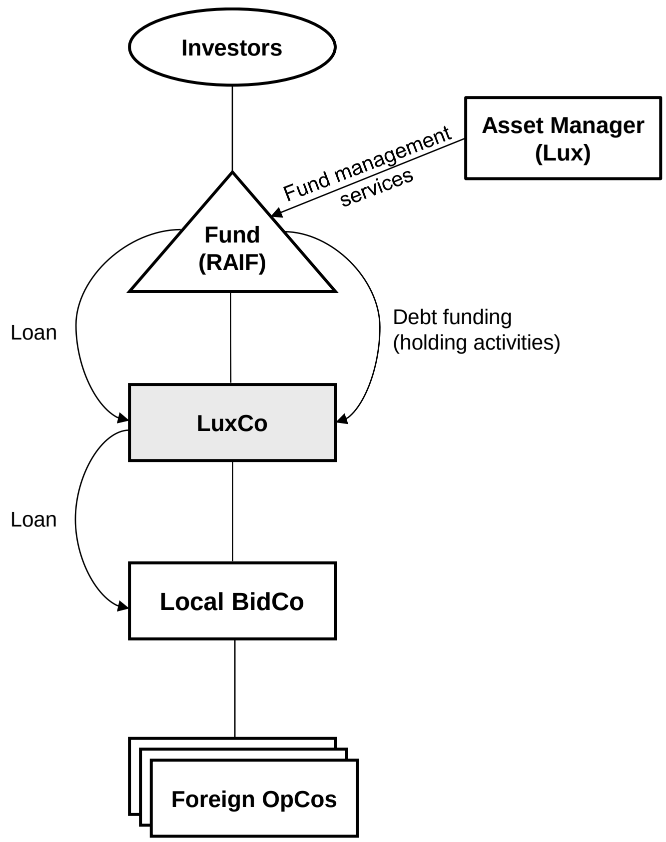


Case study: The Luxembourg private equity fund

On 1 March 2019, a Luxembourg asset manager established a Luxembourg fund (a Reserved Alternative Investment Fund or “RAIF”, in the legal form of a special limited partnership) for investing into businesses across Europe. The investors in the Fund are institutional investors such as pension funds and insurance companies resident in the EU and North America that invest the contributions of assured persons to generate regular income to be able to fulfil their obligations towards them. The asset manager employs a number of qualified employees in Luxembourg that render fund management services to the Fund.

The investments of the fund are made via a Luxembourg company (“LuxCo”) and local holding companies (“Local BidCo”). The investments in the foreign operational companies (“Foreign OpCos”) are financed by a mixture of equity and debt. To the extent possible, debt funding is generally preferred as it is less formalistic to grant and repay a loan and the interest accrued under a loan facilitates cash repatriation. The Local BidCos and Foreign OpCos are generally subject to tax in their state of residence.

The fund structure is depicted in the following chart:



The Local BidCos may deduct arm's length interest charged under the loan granted by LuxCo (within the limits of local thin capitalization or earning stripping rules).

Dividend and interest payments made by the Local BidCos and Foreign OpCos should generally not subject to withholding tax or benefit from a reduced or zero withholding tax rate under EU Directives or an applicable tax treaty.

At the level of LuxCo, the interest income is subject to corporate income tax and municipal business tax at an aggregate rate of 24.94% (in 2019). LuxCo finances the loan receivables owed by the Local BidCos largely with loans granted by the Fund. In this regard, LuxCo determined an arm's length financing margin for remunerating the functions performed, risks assumed and the assets used. In accordance with the new Luxembourg transfer pricing regime, LuxCo bears all the risks in relation to the financing activities (credit risk, etc.) and has the financial capacity to bear the risk in case it materializes (i.e. LuxCo is financed with sufficient equity to cover the risk in case it materializes). Dividends received by LuxCo from the Local BidCos benefit from a tax exemption under the Luxembourg participation exemption regime (that is the implementation of the EU Parent/Subsidiary Directive into Luxembourg tax law).

Interest payments made by LuxCo to the Fund are not subject to Luxembourg withholding tax. In contrast, dividends paid by LuxCo to the Fund should likely be subject to Luxembourg withholding tax at a rate of 15%, subject to any reliefs available due to the nature of the investors in the Fund. The Fund is not subject to corporate income tax, municipal business tax and net wealth tax but has to pay an annual subscription tax of 0.01% (applicable on the net asset value of the Fund).

There exist a number of commercial reasons for investing via separate Local BidCos into different businesses (segregation of investments, managing bank guarantees, adding flexibility in regard to future disposals, etc.). Likewise, LuxCo is established for a number of commercial and legal reasons, such as:

- Protection of the Fund from the liabilities of and potential claims against the Fund's investments;
- Facilitation of debt funding (including debt obtained from third parties);
- Management of investments (including the acquisition and disposal thereof);
- Administration of claims for relief of withholding tax under any applicable tax treaty.

LuxCo performs a number of functions in regard to its investment activities, including:

- Approving and monitoring of investments;
- Carrying on treasury functions;
- Maintaining the books and records of the company;
- Ensuring compliance with regulatory requirements in the investment jurisdictions;
- Rendering of administrative and other services to subsidiaries;
- Monitoring of dividend, interest and other payments;
- Monitoring and management of risks in relation to the investment activities;
- Dealing with accounting and bookkeeping requirements.

All these activities are performed by the Directors of LuxCo. LuxCo rents office premises that are at the disposal of its Directors. With regard to some functions, the Luxembourg Directors rely on information provided by the asset manager (e.g. approving and monitoring of investments).

In addition, the Directors of LuxCo supervise the following functions that are outsourced to qualified Luxembourg service providers:

- Drafting of legal documentation;
- Preparation of financial reporting;
- Direct and indirect tax compliance.

With regard to the choice of Luxembourg as a fund and holding location, the asset manager had a number of reasons including, in particular:

- Extensive experience with the Luxembourg regulatory environment and available fund regimes;
- The flexible and diverse regulatory and legal environment;
- Lender and investor familiarity with the location;
- Access to qualified personnel;
- Existing business relationships with various services providers, depositary banks, etc;
- The extensive tax treaty network of Luxembourg; and
- Political stability.

The question arises whether the tax intermediaries involved are under an obligation to report the Luxembourg investment platform by 31 August 2020 under the MDR.

- **Is there a cross-border arrangement?**

The Fund invests into European businesses via a Luxembourg investment platform that should (together with all the other relationships such as loan agreements) be cross-border arrangements within the meaning of the MDR.

- **Is one of the hallmarks fulfilled?**

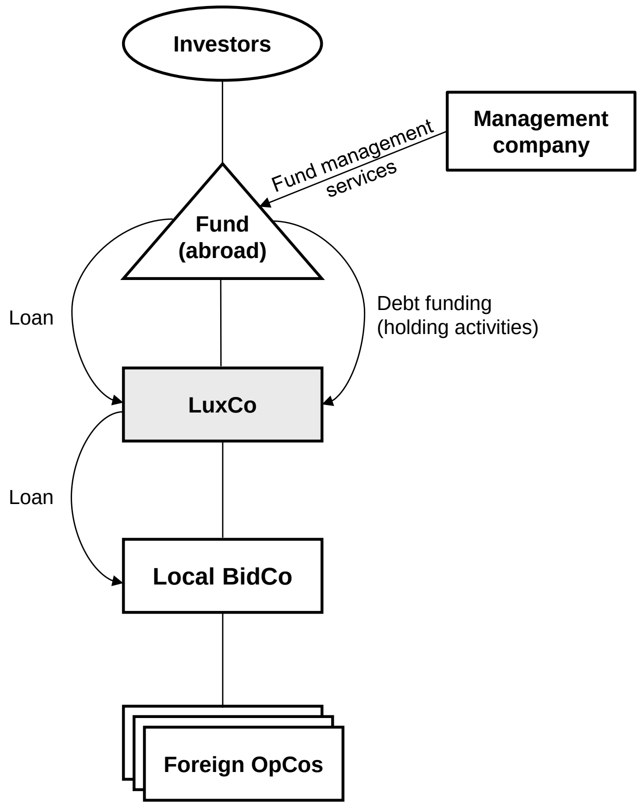
In the present case, none of the hallmarks should be fulfilled. With regard to the “no or low tax” hallmark that might be considered with regard to payments made by LuxCo to the Fund, the cross-border element is missing as both the Fund and LuxCo are established in Luxembourg. Payments made by the Local BidCos to LuxCo are taxable in Luxemburg so that the “no or low tax” hallmark is equally not satisfied in this respect.

It follows that this Luxembourg private equity fund is not a reportable scheme under the MDR.

Case study: The foreign private equity fund

On the basis of the fact pattern of the previous case study, it is assumed that the fund is established abroad in the form of a Limited Partnership (L.P.). In this case, the Fund invests in LuxCo that functions as a Luxembourg investment platform for investments into businesses across Europe.

The fund structure is depicted in the following chart:



The question arises whether the tax intermediaries involved are under an obligation to report the foreign fund with the Luxembourg investment platform by 31 August 2020 under the MDR.

- **Is there a cross-border arrangement?**

The Fund invests into European businesses via a Luxembourg investment platform that should (together with all the other relationships such as loan agreements) be cross-border arrangements within the meaning of the MDR.

- **Is one of the hallmarks fulfilled?**

In the present case, the "no or low tax" hallmark should be fulfilled assuming that deductible interest payments made by LuxCo to the Fund are tax exempt. This is because of the cross-border context of payments made from Luxembourg to the fund jurisdiction (despite a Luxembourg fund would also be exempt from corporate income taxation). However, the “no or low tax” hallmark only triggers reporting obligations if the MBT is met.

- **MBT**

When analysing the MBT, the following questions should be considered:

a) Is it reasonable to consider that the investment would have been made in the absence of the tax benefit?

Private equity investments are made for generating ongoing income, to create value and to realize capital gains at the end of the investment period. Any tax benefit generated as part of these investments should only be a fraction of the overall income. Therefore, it can be reasonably assumed that a typical investor would make the investment in the fund even in the absence of any particular tax benefit.

b) Are the commercial and other benefits more significant than the tax advantage?

Given that the amount of any tax benefit obtained in the context of private equity investments should be a fraction of the amount of income and capital gains generated, it is reasonable to assume that the commercial benefits are much more significant than the aggregate amount of tax benefits.

c) Are there genuine commercial reasons for an investment other than benefiting from a tax advantage?

As mentioned in the fact pattern, there exist a number of genuine commercial reasons for the existence of the fund and its Luxembourg investment platform.

d) Does the arrangement merely rely on the application of tax law (i.e. there are explicit rules) as opposed to taking advantage of loopholes or mismatches between two or more tax systems?

The tax treatment of all aspects of the investment structure is governed by law that, among others, limits the amount of debt funding and the amount of deductible interest expenses. Likewise, the tax treatment of the equity investment is specified under the domestic tax laws of the jurisdictions concerned. Thus, the tax treatment is consistent with the policy intent of the legislator.

e) Is the arrangement or a series of arrangements known to the tax authorities involved?

The investments rely on common commercial arrangements that are known to the tax authorities concerned by their tax treatment. Therefore, the reporting of these investments should be irrelevant.
In light of the above, it may be concluded that the MBT is not met in the present case.

7. Conclusion

The new MDR enters into force on 1 July 2020 and applies to cross-border arrangements whose first step was implemented after 25 June 2018 (that is the day DAC 6 entered into force). It can be anticipated that the analysis of potential reporting obligations under the MDR will become an integral part of each and every tax analysis. This on its own will have the desired deterrence effect as both tax intermediaries and taxpayers will need to carefully consider potential reporting obligations.

Private equity investments are not in the focus of the MDR. While in many cases none of the hallmarks should be fulfilled, it can be anticipated that if a hallmark is fulfilled, it will likely be a hallmark that is subject to the MBT. This sets the bar for reporting quite high. Given that international investments are made for legitimate commercial reasons (generating regular income, maximization of value, etc.) and not for generating tax benefits, the MBT should generally not be met in these cases.

With the Draft Law being released, tax intermediaries and taxpayers are now in a position to prepare themselves for the new reporting obligations. Ultimately, the mandatory disclosure regime may also be viewed as an opportunity to consider and emphasize the commercial reasons and business rationale driving international investments and business activities.

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