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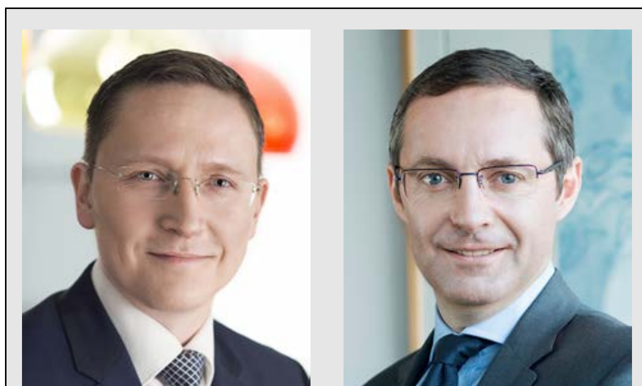
New EU Reporting Obligations for Tax Intermediaries: Impact on Alternative Investments in Luxembourg

by Oliver R. Hoor and Keith O'Donnell



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In this article, the authors analyze the EU's new administrative cooperation directive, provide guidance on when a specific arrangement is reportable, and consider the effects on alternative investments made from Luxembourg.

On May 25 the Economic and Financial Affairs Council adopted the so-called Sixth Directive on Administrative Cooperation (DAC 6),[1] which requires so-called tax intermediaries to report specific cross-border arrangements that contain at least one defined hallmark — that is, characteristics or features of cross-border arrangements. It requires reporting for transactions implemented after June 25, 2018, so it already has effect even though the implementing legislation is not yet available.

It is common knowledge that the investments and business activities of Luxembourg companies often have a cross-border dimension. In all those cases, it must be determined whether a particular piece of advice, or involvement in implementation, is reportable.

This article analyzes the features of the new mandatory disclosure regime, clarifies when a specific arrangement is reportable, and considers in particular the effect on alternative investments made from Luxembourg.

I. Introduction

Luxembourg is a prominent financial center and a major hub for the structuring of alternative investments, such as private equity, real estate, and infrastructure investments. Alternative investments are often structured using a Luxembourg fund vehicle or companies that directly or indirectly invest into the assets.

Luxembourg's attractiveness is the result of several factors, including its flexible and diverse legal, regulatory, and tax framework; many experienced advisers and service providers; a large tax treaty network; an investor-friendly business and legal environment; and political stability, which have made the country an essential part of the global financial architecture. Moreover, it is a founding member of and sits at the heart of the European Union, one of the world's largest sources of capital and investment opportunities.

DAC 6 requires EU members to introduce in their national laws mandatory disclosure rules for

[1] Council Directive (EU) 2018/822 amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements.

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cross-border arrangements. The new directive was inspired by the final report on action 12 of the OECD base erosion and profit-shifting project that provides recommendations for the design of mandatory disclosure rules for aggressive and abusive transactions, arrangements, or structures. However, mandatory disclosure regimes are not new. Many countries, including Canada, Ireland, Israel, Portugal, South Africa, South Korea, the United Kingdom, and the United States, have implemented disclosure regimes of varying scope.

II. Mandatory Disclosure Regimes

According to the final report on BEPS action 12, mandatory disclosure regimes should satisfy the following design principles:

- be clear and easy to understand (a lack of clarity could result in tax administrations receiving poor quality or irrelevant information);
- balance additional compliance costs to taxpayers with the benefits obtained by tax administrations (unnecessary or additional requirements will increase taxpayer costs and might undermine a tax administration's ability to effectively use the data provided);
- be effective in achieving their objectives and accurately identify the schemes to be disclosed (it would be impractical for a mandatory reporting regime to target all transactions that raise tax avoidance concerns, and the identification of hallmarks is a key factor to setting the scope of the rules);
- be flexible and dynamic enough to allow tax administrations to adjust the system to respond to new risks or carve out obsolete risks; and
- ensure that information collected is used effectively (requiring the implementation of effective procedures by tax administrations).

Further, mandatory disclosure regimes should both complement and differ from other types of reporting and disclosure obligations. They are 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 regimes 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 regimes is deterrence because taxpayers may be inclined to avoid arrangements that trigger reporting obligations. Likewise, there is pressure on tax intermediaries to consider whether their advice must always be disclosed. Given that mandatory disclosure regimes target new and innovative schemes, it is also believed that with timely reported information there will be only limited opportunity to implement schemes before they are shut down.

III. Key Features of the New Regime

Arrangements that come within the scope of at least one of the hallmarks in Appendix IV to the directive might need to be reported under the mandatory disclosure regime. 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 via a threshold: Many of the hallmarks trigger a reporting obligation only if an arrangement meets the main benefit test (MBT), reducing the risk of excessive or defensive filings. That should enhance the usefulness of the information collected because the focus will be on arrangements that have a higher probability of being the kind the regime is meant to target.

The directive 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 local authorities. The directive does not apply to VAT and customs duties, or to excise duties covered by other EU legislation on administrative cooperation between member states.

A. Reportable Arrangements

The directive requires EU tax intermediaries to report cross-border arrangements that are potentially aggressive tax planning

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arrangements. The term "arrangement" may also include a series of arrangements, and an arrangement may comprise more than one step. Hence, the understanding of the term "arrangement" under the directive is broad.

In addition to involving either more than one EU member state or an EU member state and a third country, an arrangement must meet at least one of the following conditions:

- not all the participants are resident for tax purposes in the same jurisdiction;
- at least one participant is simultaneously resident for tax purposes in more than one jurisdiction;
- at least one participant carries on a business in another jurisdiction through a permanent establishment in that jurisdiction and the arrangement forms part or all of that PE's business;
- at least one participant carries on an activity in another jurisdiction without being resident for tax purposes or creating a PE in that jurisdiction; or
- it could affect the automatic exchange of information or the identification of beneficial ownership.

Cross-border arrangements may be reportable if they contain at least one of the hallmarks in Annex IV of the directive. Those hallmarks describe characteristics or features of cross-border arrangements that might present an indication of a potential risk of tax avoidance.

B. Information to Be Reported

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

- the identification of intermediaries and relevant taxpayers;
- details of the hallmarks that make the arrangement reportable;
- a summary of the arrangement;
- the date when the first step in implementing the arrangement was made or will be made;
- details of the national provisions that form the basis of the arrangement;
- the value of the arrangement;
- the identification of the member state of the relevant taxpayer(s) and any other member states that are likely to be concerned by the arrangement; and
- the identification of any other person in a member state likely to be affected by the arrangement.

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

C. Reporting Responsibilities

The reporting responsibilities for cross-border arrangements that fall under the directive generally rest with the tax intermediary, unless reporting would breach the intermediary's legal professional privilege. If so, the intermediary should notify any other intermediary or, if there is not one, the relevant taxpayer of their reporting obligation.

Luxembourg lawyers, tax advisers, accountants, and other service providers are all bound by professional secrecy, noncompliance with which may be punished with up to six months imprisonment and a fine of up to €5,000. Accordingly, when a cross-border arrangement is reportable, the reporting obligation should be shifted to the taxpayer unless the taxpayer waives its right of confidentiality. That aspect should be clarified by the Luxembourg legislature when implementing the directive into Luxembourg law.

An intermediary is defined as any person who designs, markets, organizes, makes available for implementation, or manages the implementation of a reportable cross-border arrangement. That can particularly include tax advisers, lawyers, and accountants. The directive 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 concept of a tax intermediary is broad, and includes any professional that provides tax advisory services.

The reporting obligations under the directive are limited to intermediaries that have an EU nexus based on, for example, tax residency or

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incorporation, so non-EU intermediaries do not have any obligation to report. If a non-EU intermediary is involved, a potential reporting obligation would be shifted to the taxpayer benefiting from the cross-border arrangement.

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.

D. Overlapping Reporting Obligations

The broad definition of the term "intermediary" could result in overlapping reporting obligations. According to the directive, when there is more than one intermediary, the obligation to file information on the reportable cross-border arrangement lies with all intermediaries involved. Intermediaries should be exempt from their reporting obligations only if they can prove that the same arrangement has already been reported by another intermediary.

Thus, it is insufficient to prove that another intermediary has committed to do the reporting and necessary to prove the effective reporting by another intermediary. That obviously requires some coordination between the advisers to determine whether a cross-border arrangement is reportable and, if so, which intermediary will file a report to avoid multiple filings for the same arrangement.

When a cross-border arrangement is not reportable under the mandatory disclosure regime, taxpayers should have that verified and documented by one of the intermediaries involved. That would prove that the taxpayer has carefully considered the potential obligations under the directive and would allow other intermediaries to reasonably rely on the analysis.

When an intermediary must file information on reportable cross-border arrangements with the competent authorities of more than one EU member state, the directive provides rules to identify one single EU member state in which the filing should be made.

If 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 states. Here, the directive provides rules to determine one single EU member state in which the filing should be made. When there are several relevant taxpayers, the directive provides for rules to determine the single taxpayer that should report the arrangement.

E. 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. The directive states that tax intermediaries must file information within their knowledge, possession, or control on reportable cross-border arrangements within 30 days, beginning on whichever of the following comes first:

- the day after the arrangement is made available for implementation;
- the day after the arrangement is ready for implementation; or
- when the first step in implementing the arrangement has been made.

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

Although the 30-day deadline seems to be short, given that there might be cases in which advisers in different jurisdictions may have to analyze and agree on whether an arrangement is reportable, it is long compared with other mandatory disclosure regimes. For example, U.K. disclosure rules require reporting within five days.

There is also a periodic reporting obligation, every three months, for cross-border arrangements that are to be classified as marketable arrangements. Those are defined as arrangements that are designed, marketed, ready for implementation, or made available for implementation without a need for substantial customization.

The first reporting must be made by August 31, 2020, covering reportable arrangements as from the date of entry into force of the directive; thus, tax intermediaries must track potentially reportable advice as of June 25, 2018.

Further, relevant taxpayers may be required to file information about their use of an arrangement in every year they use it.

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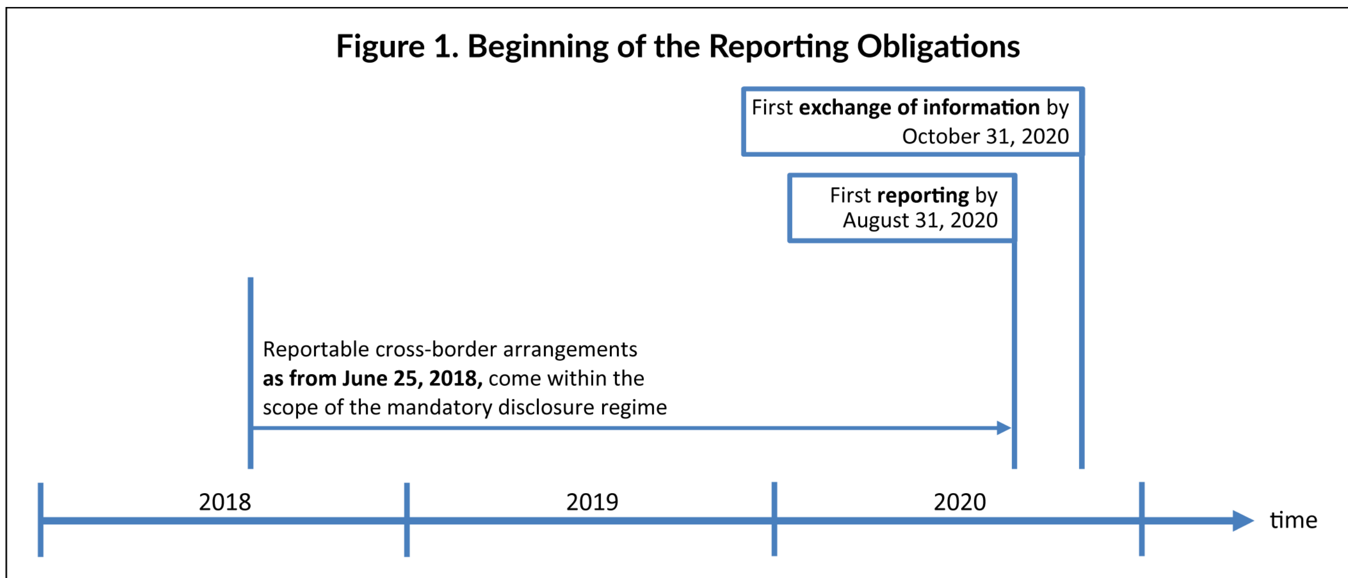
Figure 1. Beginning of the Reporting Obligations



The information collected by tax authorities is subject to automatic exchange with the tax authorities of all other EU states through a centralized database. The exchange 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 October 31, 2020.

F. Penalties for Noncompliance

The directive requires EU members to establish penalties for noncompliance that are effective, proportionate, and dissuasive. Considering the penalties introduced by Luxembourg for the common reporting standard, the U.S. Foreign Account Tax Compliance Act, or exchange of information on demand, the maximum penalty in Luxembourg can be expected to be €250,000.

However, in practice, the Luxembourg tax authorities will probably levy measured penalties in case of wrongdoings, taking into consideration the level of care taken by the tax intermediaries and taxpayers.

IV. Hallmarks of Reportable Arrangements

Appendix IV of the directive defines several hallmarks that when present in a cross-border arrangement might trigger reporting obligations under the mandatory disclosure regime. Accordingly, the hallmarks work to identify the features of arrangements that tax administrations are interested in.

The directive states that it was deemed more practical to compile a list of hallmarks than to define the concept of aggressive tax planning; indeed, it would have been difficult to develop a clear and objective definition of the concept. Therefore, it is positive that the disclosure regime relies on objective hallmarks.

A. Generic vs. Specific Hallmarks

The hallmarks are generally divided into two categories: generic and specific. Generic hallmarks target features 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 can easily replicate and sell to many taxpayers. Specific hallmarks are used to target known vulnerabilities in the tax system and techniques 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 regarding cross-border transactions;

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- 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. The hallmarks trigger disclosure obligations only if a main benefit of the scheme was obtaining a tax advantage, reducing the risk of overdisclosure, and avoiding undue compliance burdens for taxpayers.

B. Hallmarks Subject to the MBT

1. Generic Hallmarks Linked to the MBT

The directive provides for several generic hallmarks that trigger a disclosure obligation if the MBT is met.

First is the confidentiality hallmark, which flags arrangements that require a taxpayer or participant to comply with a condition of confidentiality that might include nondisclosure of how the arrangement could secure a tax advantage vis-à-vis other intermediaries or the tax authorities.

The confidentiality is owed by the client to the promoter (not by the promoter to the client). That limit 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 many taxpayers.

The use of a confidentiality clause in an agreement could meet the requirement. However, according to the final report on BEPS action 12, even if some promoters use that kind of clause or condition, schemes known to tax administrations are not caught by the confidentiality hallmark. That a tax administration knows a scheme can be evidenced by, for example, technical guidance notes, case law, or past correspondence.

Second is the premium or contingent fee hallmark. It catches arrangements in which the intermediary is entitled to receive a fee (or interest, remuneration for finance costs, and other charges) for the arrangement, which is fixed by reference to:

- premium fees, or the amount of the tax advantage derived from the arrangement; or
- contingent fees, collected based on whether a tax advantage actually results from the arrangement (including an obligation on the intermediary to partially or fully refund the fees if the intended tax advantage derived from the arrangement was not partially or fully achieved).

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 that it is unavailable elsewhere; if the consequences of the scheme are widely known and understood, the client would be unwilling to pay more than a normal fee.

Last is the standardized tax product hallmark, which involves arrangements that have substantially standardized documentation or structure and are available to more than one taxpayer without needing to be substantially customized for implementation. The fundamental characteristic of "mass-marketed schemes" is their ease of replication. Essentially, all the client purchases is a prepared tax product that requires little, if any, modification to suit its circumstances. Further, adopting the scheme does not require the taxpayer to receive significant additional professional advice or services.

2. Specific Hallmarks

a. Specific hallmarks linked to MBT. The directive also provides for specific hallmarks that trigger reporting obligations if the MBT is met.

First is the loss company hallmark, which captures arrangements in which a participant takes specific steps to reduce its tax liability by acquiring a loss-making company; discontinuing the main activity of that company; and using its losses to reduce taxes, including by transferring those losses to another jurisdiction or accelerating their use.

Next is the converting income scheme hallmark, designed to flag arrangements that convert income into capital, gifts, or other categories of revenue that are taxed at a lower rate or exempt.

Last is the circular transactions hallmark to catch arrangements that include circular transactions resulting in the round-tripping of funds — namely, through involving interposed

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entities without other primary commercial function or transactions that offset or cancel each other or that have other similar features.

b. Specific hallmarks related to cross-border transactions. There are several specific hallmarks for cross-border transactions that trigger reporting obligations if the MBT is met.

First is the no- or low-taxation hallmark. It flags arrangements that involve deductible cross-border payments made between two or more associated enterprises if at least one of the following conditions occurs:

- although the recipient is tax resident in a jurisdiction, that jurisdiction does not impose any corporate tax or imposes corporate tax at a zero or near-zero rate;
- the payment benefits from a full tax exemption in the jurisdiction where the recipient is tax resident; or
- the payment benefits from a preferential tax regime in the jurisdiction where the recipient is tax resident.

Those hallmarks focus on the tax treatment of the recipient of a deductible cross-border payment; nondeductible payments do not fall within their scope.

The directive states that the presence of any of those hallmarks alone cannot be a reason for concluding that an arrangement satisfies the MBT.

C. Hallmarks Not Subject to the MBT

1. Specific Hallmarks

a. Specific hallmarks related to cross-border transactions. Four specific hallmarks for cross-border transactions are not subject to a threshold.

First, the stateless company and blacklisted country hallmark captures arrangements that involve deductible cross-border payments made between two or more associated enterprises when at least one of the following conditions is met:

- the recipient is not tax resident in any tax jurisdiction (so the income will not be subject to tax anywhere); or
- although the recipient is tax resident in a jurisdiction, that jurisdiction has been blacklisted by the member states collectively or in the OECD framework as being noncooperative.

Second is the double-dip hallmark to cover deductions claimed for the same depreciation on an asset in more than one jurisdiction, resulting in double-dip outcomes.

Third, the double relief hallmark is relevant when relief from double taxation for the same item of income or capital is claimed in more than one jurisdiction.

Finally, the step-up in value hallmark applies to arrangements that involve transfers of assets and there is a material difference in the amount being treated as payable in consideration for the assets in the jurisdictions involved. It affects transactions in which 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 considered by the acquiring entity resident in another jurisdiction. That step-up in value could result in higher depreciations at the acquiring entity's level without the recognition of latent capital gains in the jurisdiction of the entity selling the assets.

b. Specific hallmarks concerning automatic exchange of information. The directive provides for several specific hallmarks concerning the automatic exchange of financial account information.

First, the no CRS reporting hallmark flags arrangements that could undermine the reporting obligation under EU law or any equivalent agreement on the automatic exchange of financial account information, including agreements with third countries, or that take advantage of the absence of that kind of legislation or agreement. Those arrangements include at least one of 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

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- 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; or
- 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 in which taxpayers enter into transactions that undermine reporting obligations in relation to automatic exchange of financial account information, regardless of intention.

c. Specific hallmarks concerning beneficial ownership. The disguising beneficial owners hallmark is not subject to a threshold. It catches arrangements involving nontransparent legal or beneficial ownership chains 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;
- 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 those persons, legal arrangements, or structures; and
- if the beneficial owners of those persons, legal arrangements, or structures, as defined in Directive (EU) 2015/849, are made unidentifiable.

This hallmark targets situations in which 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 analyzing the appropriateness in an EU context, the wholly artificial arrangement doctrine of the Court of Justice of the European Union should be considered, which should significantly limit the reporting obligations under this hallmark.

d. Specific hallmarks concerning transfer pricing. Finally, the directive provides for numerous specific hallmarks concerning transfer pricing that are not subject to a threshold.

First, the unilateral safe harbor hallmark captures transactions that rely on unilateral safe harbor rules adopted for transfer pricing purposes. Given that safe harbors are by definition rather low to limit the administrative burden for small transactions that should not be a material concern for tax administrations, it is difficult to see the relevance of this hallmark.

Next, the hard-to-value intangibles hallmark flags arrangements involving the transfer of intangibles or rights in intangibles for which, at the time of their transfer between associated enterprises:

- no reliable comparables exist; and
- when 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 were highly uncertain, making it difficult to predict the level of ultimate success of the intangible at the time of transfer.

Hard-to-value intangibles received much attention during 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 guidance on hard-to-value intangibles. That is because 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 unclear whether an intangible will be successful) caused much concern for tax administrations.

Last, the business restructuring hallmark catches arrangements involving an intragroup cross-border transfer of functions, risks, or assets if the transferor's projected annual earnings

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before interest and taxes (EBIT) during the three years after the transfer are less than 50 percent of the transferor's projected annual EBIT had the transfer not been made. It targets cross-border business restructurings that result in a significant reduction of an entity's profitability. That 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 those cases, a large drop in profitability might be expected at arm's length.

V. The MBT

As mentioned, many of the hallmarks in Appendix IV to the directive are subject to an additional threshold — the MBT, which is meant to filter out irrelevant disclosure and reduce some of the regime's compliance and administration burdens by targeting the tax-motivated transactions likely to pose the greatest tax policy and revenue risks. The MBT compares the value of the expected tax advantage with other benefits likely to be obtained from the transaction. According to the action 12 final report, the test sets a relatively high threshold for disclosure.

The directive also states that the tax treatment of a cross-border payment at the recipient level cannot alone be reason for concluding that an arrangement satisfies the MBT. Thus, it does not matter per se if the payee's jurisdiction does not impose any corporate tax or imposes corporate tax at a zero or near-zero rate, or if the payment benefits from full exemption or a preferential tax regime.

A. Developing a Reasonable Approach

According to the final report on BEPS action 12, the MBT compares the value of the expected tax advantage with any other benefit likely to be obtained from the transaction. This requires an objective analysis of all benefits obtained from an arrangement and is assumed to set a relatively high threshold for disclosure. Thus, the management of the tax position of a cross-border arrangement or investment that aims at generating income should not meet this threshold condition, because any tax benefit, quite naturally, can only be a fraction of the overall income.

When analyzing the MBT, it can also be helpful to look to the United Kingdom, which introduced disclosure rules in 2004 that are built — like the directive's mandatory disclosure regime — around a set of hallmarks that determine whether a scheme should be reported. The country also adopted the MBT as a threshold.

According to HM Revenue & Customs guidance regarding the MBT, "The advantage is one of the main benefits of the arrangements if it is a significant or important element of the benefits and not incidental or insubstantial." Accordingly, the test is objective and considers the value of the expected tax advantage compared with the value of any other likely benefits. The guidance further states that it should be obvious to any potential client what the relationship is between the tax advantage and any other financial benefits of the product they are buying.

HMRC publishes annual statistics on reported schemes. The latest available statistics cover 2006 to 2014; from 2012 to 2014, the number of reported arrangements dropped significantly. From April 1, 2014, to September 30, 2014, there were fewer than five corporate disclosures under the U.K. mandatory disclosure regime.

HMRC Statistics on Reported Arrangements

Period		Disclosures Under the Main Regime
April 1, 2006	March 31, 2007	125
April 1, 2007	March 31, 2008	205
April 1, 2008	March 31, 2009	102
April 1, 2009	March 31, 2010	116
April 1, 2010	March 31, 2011	97
April 1, 2011	March 31, 2012	116
April 1, 2012	March 31, 2013	59
April 1, 2013	March 31, 2014	28
April 1, 2014	September 30, 2014	Fewer than 5

The number of reported arrangements generally seems low compared with the number of transactions entered into by U.K. companies and international investments made in the United

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Kingdom. That suggests that the MBT effectively filters out all legitimate investment activities and keeps the focus on abusive types of arrangements in which a tax benefit is a main benefit.

Thus, for example, any inbound investment into the United Kingdom might receive a tax benefit if appropriately structured — generally the case for investments in commercial real estate by a nonresident over the reference period, when use of a suitable foreign investment vehicle resulted in nontaxation of capital gains. However, the existence of a tax benefit per se would not satisfy the MBT, because the tax benefit was an incidental, not main, benefit of the transaction.

Moreover, it may be speculated that the marked drop of reported arrangements since 2012 may be a direct consequence of the OECD BEPS project, related media coverage, and the anticipation of changes in the international tax landscape, leading taxpayers and their advisers to avoid aggressive schemes.

B. Application to International Investments

The action 12 final report states that several countries with mandatory disclosure regimes indicated that in practice, they receive comparatively fewer disclosures of cross-border schemes. That lower number is considered partly a consequence of the way international schemes are structured and the approach those regimes take in formulating the requirements for disclosing a reportable scheme. The action 12 report mentions that cross-border schemes typically generate multiple tax benefits for different parties in different jurisdictions and that the domestic tax benefits that arise under a cross-border scheme may seem unremarkable when viewed in isolation.

The report says that for those hallmarks that must meet the MBT as a condition for disclosure, the mandatory disclosure regime can be difficult to apply to cross-border arrangements that trigger tax consequences in numerous jurisdictions. In practice, those arrangements might not meet the MBT if the taxpayer can demonstrate that the value of any (domestic) tax benefits was incidental when weighed against the commercial benefits as a whole.

The action 12 final report acknowledges that cross-border investments often involve broader commercial transactions customized to be taxpayer- and transaction-specific that might not be widely promoted the same way as a domestically marketed scheme. For those reasons, it could be difficult to target those schemes with generic hallmarks that target promoted schemes, which can be easily replicated and sold to many different taxpayers, according to the report.

Given the high threshold standard presented by the MBT, the final report recommends not including it as a threshold. Instead, it recommended including hallmarks that focus on the kinds of BEPS techniques known to give rise to tax policy or revenue concerns without including a threshold requirement.

However, as stated in the directive, the principle of proportionality was considered when designing the directive. Under that principle, the content and form of EU action cannot exceed what is necessary to achieve treaty objectives. Here, the MBT is key to limit disclosure obligations to tax-driven arrangements that take advantage of loopholes.

In that regard, international investments in real estate, businesses, or debt, even if structured in a way that takes account of tax benefits and costs, should hardly ever be subject to mandatory disclosure unless one of the hallmarks that trigger automatic reporting obligations is fulfilled.

C. GAAR Considerations

The action 12 final report also identifies some inevitable overlap between the operation and effects of mandatory disclosure and a general antiabuse rule that gives tax administrations the ability to respond directly to tax avoidance that has been disclosed under a mandatory regime. It does, however, mention that a mandatory disclosure regime is meant to provide tax administrations with information on a wider range of tax policy and revenue risks other than those raised by transactions that would be classified as avoidant under a GAAR. Accordingly, the definition of a reportable scheme for disclosure purposes will generally be broader than the definition of tax avoidance schemes covered by a GAAR.

Thus, the scope of reportable schemes under the directive is broader than the GAAR in the so-

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called anti-tax-avoidance directive (ATAD),[2] which becomes evident when looking at the hallmarks that trigger reporting obligations without an MBT threshold. The preamble to the directive also refers to the GAAR, stating that aggressive cross-border tax planning arrangements fall under it. Although the GAAR is not the threshold for reportable schemes, it may still be relevant when analyzing whether an arrangement must be disclosed. When, for example, one analyzes whether the MBT is met for an alternative investment fund that invests from a Luxembourg subsidiary into pan-European assets, the question whether the mere involvement of the Luxembourg company is determinant can be tested using the GAAR standard.

In an EU context, national antiabuse legislation such as the GAAR must be targeted to prevent conduct involving the creation of wholly artificial arrangements that do not reflect economic reality and are used to unduly obtain a tax advantage. That framework for antiabuse legislation flows from the wording of the GAAR in the ATAD and from CJEU case law on freedom of establishment.[3] An abusive situation does not depend only on the taxpayer's intention to obtain tax benefits (a motive test), but also requires the existence (or absence) of specific objective factors, including an actual establishment in the host state (for example, staff, facilities, and equipment) and the performance of genuine economic activity. Notably, to show the existence of an actual establishment, the CJEU does not seem to require an extensive level of substance.

On that basis, local tax advisers should not easily conclude that the MBT is satisfied. Disregarding the GAAR standard for EU companies would risk overdisclosure, which would not help tax administrations identify aggressive tax planning schemes that might be tackled by changing tax laws or applying antiabuse legislation. That is because EU companies can rely on freedom of establishment, and EU members cannot implement rules that would impede the use of that freedom.

VI. Determining Reportable Arrangements

When determining whether advice on a particular arrangement is reportable under the mandatory disclosure regime, it must first be analyzed whether the arrangement has a cross-border dimension. Given that Luxembourg companies involved in alternative investment fund structures are frequently involved in cross-border investments, this will often exist (although not all transactions have a cross-border element). Then, one must ask whether a hallmark is present. For Luxembourg fund structures, it is likely that none is fulfilled. For foreign fund structures, the cross-border relationship between a Luxembourg company and the foreign fund will likely fall in the no- or low-taxation hallmark (despite a Luxembourg fund vehicle also benefiting from a corporate income tax exemption).

When at least one hallmark is fulfilled, it has to be verified whether the hallmark is subject to the MBT. If not, there is an automatic reporting obligation under the mandatory disclosure regime. When the hallmark is subject to the MBT, all relevant facts and circumstances must be analyzed to determine whether the main benefit or one of the main benefits was the obtaining of a tax advantage. (See Figure 2.)

A. Case Study: Luxembourg Real Estate Fund

1. Scenario

On September 1, a Luxembourg asset manager established a Luxembourg fund (a reserved alternative investment fund (RAIF), in the legal form of a special limited partnership) for investing in real property across Europe. The investors 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 fulfill their obligations to those persons. The asset manager employs several qualified employees in Luxembourg who provide fund management services to the fund.

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[2] Council Directive (EU) 2016/1164 of July 12, 2016, laying down rules against tax avoidance practices that directly affect the functioning of the internal market, as amended by Council Directive (EU) 2017/952 of May 29, 2017, amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries.

[3] *See, e.g., Cadbury Schweppes PLC and Cadbury Schweppes Overseas Ltd. v. Inland Revenue*, C-196/04 (CJEU 2006); *Eqiom SAS, Enka SA v. Ministre des Finances et des Comptes Publics*, C-6/16 (CJEU 2007); *Deister Holding AG and Juhler Holding A/S v. Bundeszentralamt für Steuern*, joined cases C-504/16 and C-613/16 (CJEU 2017); and *GS v. Bundeszentralamt für Steuern*, C-440/17 (CJEU 2018).

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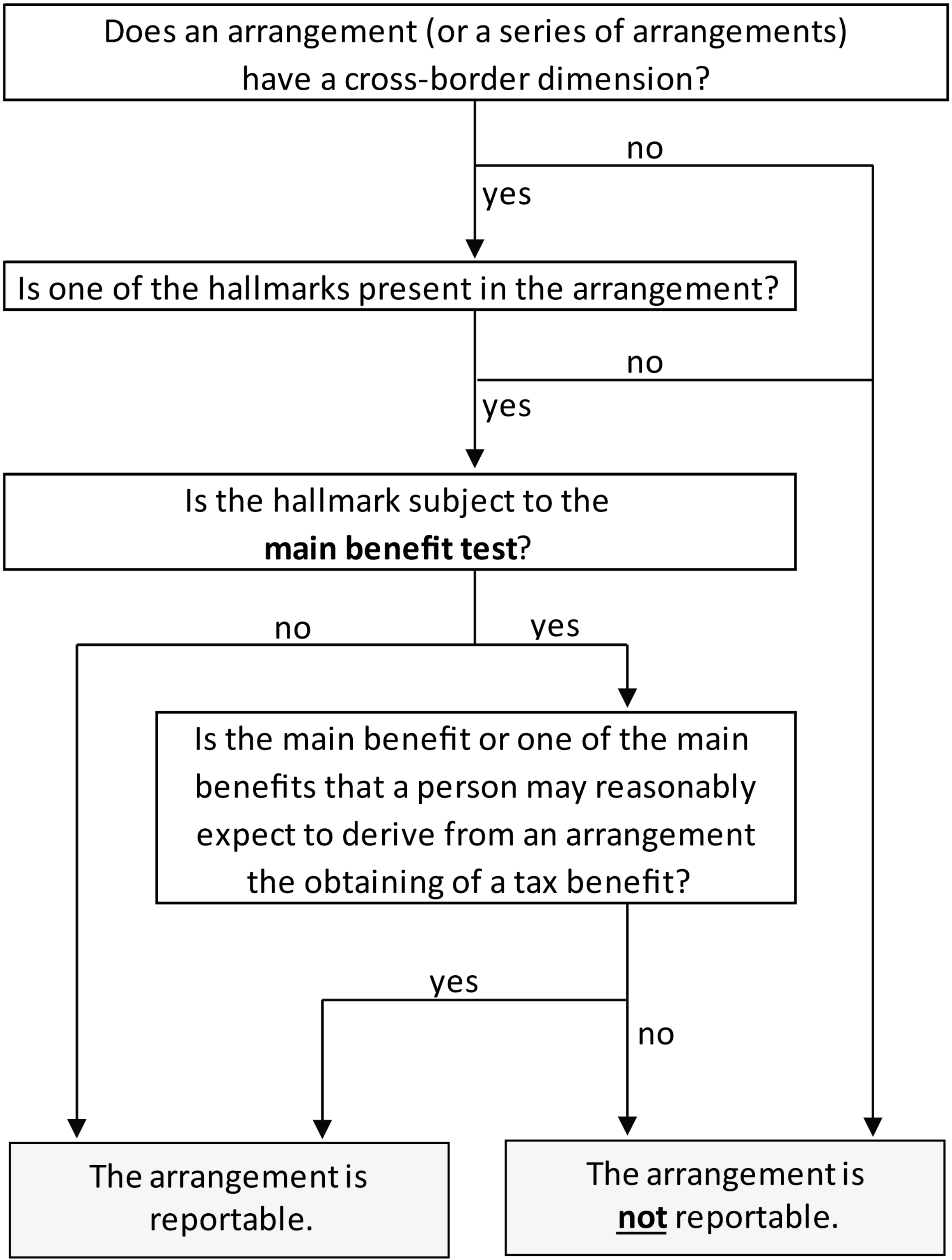
Figure 2. Checklist: Reporting Obligations Under DAC 6



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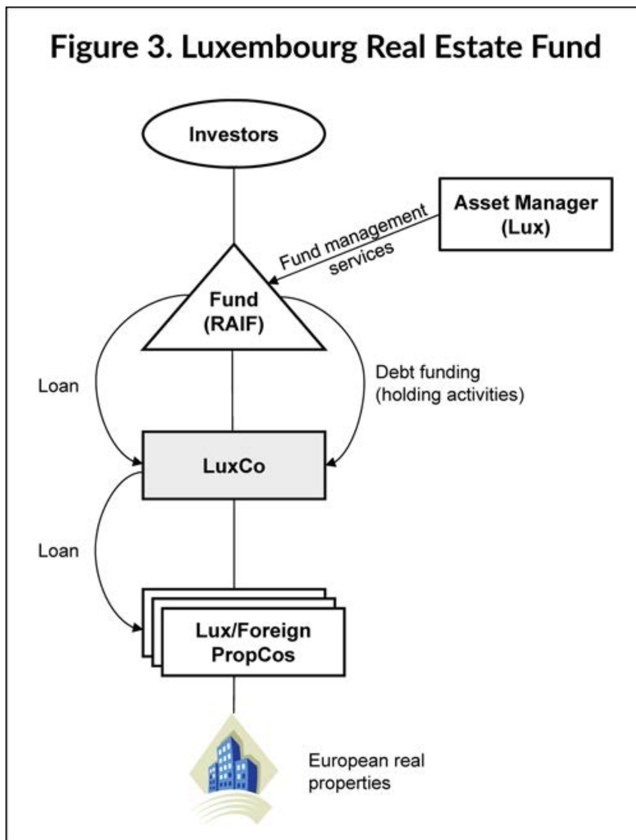
The fund's investments are made via a Luxembourg company (LuxCo) and Luxembourg or local property companies. The investments in the foreign real properties are financed by a mixture of equity and debt in accordance with the tax rules applicable in the state where the properties are located. If possible, debt funding is generally preferred because it is less formalistic to grant and repay a loan and the interest accrued under a loan facilitates cash repatriation. Otherwise, there could be times when cash cannot be repatriated in the form of dividends because a property company does not have distributable reserves (a cash trap). The property companies are subject to tax on their rental income and potential capital gains realized on a disposal of the real properties in their respective jurisdictions. (See Figure 3.)

Figure 3. Luxembourg Real Estate Fund



The property companies can deduct the depreciation of the property, arm's-length interest charged under the loan granted by LuxCo (within the limits of thin capitalization or earnings stripping rules applicable in the investment jurisdiction), and other business expenses when determining their taxable income in the state where the properties are located. For Luxembourg property companies, the income (including capital gains) realized on real properties in other EU member states is exempt in Luxembourg under applicable tax treaties.

Dividend and interest payments made by the property companies are not subject to withholding tax. For Luxembourg property companies, interest payments are not subject to Luxembourg withholding tax, and dividend payments to LuxCo benefit from an exemption under Luxembourg legislation implementing the EU parent-subsidiary directive.[4] Likewise, for foreign property companies, interest and dividend payments should benefit from withholding tax exemptions under EU directives (many EU countries do not even levy withholding tax on interest payments).

At LuxCo's level, the interest income is subject to corporate income tax and municipal business tax at an aggregate rate of 26.01 percent (in 2018). LuxCo largely finances the loan receivables owed by the property companies with a loan granted by the fund. LuxCo determined an arm's-length financing margin for remunerating the functions performed, risks assumed, and assets used. In accordance with the new Luxembourg transfer pricing regime, LuxCo bears all the risks in relation to the financing activities (credit risks and so forth) and has the financial capacity to bear it (that is, LuxCo is financed with sufficient equity to cover the risk in case it materializes). Dividends received by LuxCo from the property companies benefit from a tax exemption under the Luxembourg participation exemption regime — that is, the implementation of the EU parent-subsidiary directive into Luxembourg law.

Interest payments LuxCo makes to the fund are not subject to Luxembourg withholding tax, but dividends it pays to the fund should be subject to Luxembourg withholding tax at 15 percent, subject to any relief available as a result of the nature of the investors. The fund is exempt from corporate income tax, municipal business tax, and net wealth tax, but subject to an annual

[4] *See* article 147 of the Luxembourg Income Tax Law; and Directive 2011/96/EU.

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subscription tax of 0.01 percent (applicable on its net asset value).

There are several commercial reasons for investing via separate property companies into real estate assets, including segregation of investments, managing bank guarantees, adding flexibility in regards to future disposals, and so forth. Likewise, LuxCo is established for numerous commercial and legal reasons, such as:

- protecting the fund from the liabilities of, and potential claims against the fund's immovable property assets;
- facilitating debt funding (including debt obtained from third parties);
- managing investments (including acquisition and disposal); and
- administering claims for relief of withholding tax under any applicable tax treaty.

LuxCo performs several functions regarding its investment activities — including approving and monitoring investments; carrying on treasury functions; ensuring compliance with regulatory requirements in the investment jurisdictions; handling accounting and bookkeeping requirements; rendering of administrative and other services to subsidiaries; monitoring dividend, interest, and other payments; and monitoring and management of risks in relation to investment activities — all of which are performed by its directors. LuxCo rents office premises that are at the disposal of its directors, and for some functions, the directors rely on information provided by the asset manager (for example, approving and monitoring investments). The directors also supervise some functions outsourced to qualified Luxembourg service providers: drafting legal documentation, preparing financial reporting, and complying with direct and indirect tax rules.

The asset manager had many reasons to choose Luxembourg as a fund and holding location, 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, and so forth;
- its extensive tax treaty network; and
- political stability.

The question is whether the tax intermediaries involved in advising the asset manager on the fund structuring are under an obligation to report the Luxembourg investment platform by August 31, 2020.

2. Analysis

The fund invests into pan-European real estate assets and should thus qualify as a cross-border arrangement. Further, none of the hallmarks should be fulfilled. For the no- or low-taxation hallmark that might be considered regarding payments LuxCo made to the fund, the cross-border element is missing because the fund and LuxCo are in the same jurisdiction. Payments made by (local) property companies to LuxCo are taxable in Luxembourg, so the no- or low-tax hallmark is also not satisfied in that respect.

Thus, this fund structure is not a reportable scheme under the mandatory disclosure regime.

Further, it cannot be construed that payments made by local property companies to LuxCo are deemed directly made to the fund because LuxCo is the beneficial owner of the income received from the property companies.

B. Case Study: The Foreign Real Estate Fund

1. Scenario

Using the fact pattern from the previous study, assume the fund is established in the Cayman Islands as a limited partnership and invests in a LuxCo that makes investments in Luxembourg or local property companies investing in real properties across Europe. (See Figure 4.)

2. Analysis

The question arises whether establishing a foreign fund vehicle will require the tax intermediaries involved in advising the asset manager to report the investment platform by August 31, 2020.

The fund invests via LuxCo into pan-European real estate assets and should therefore

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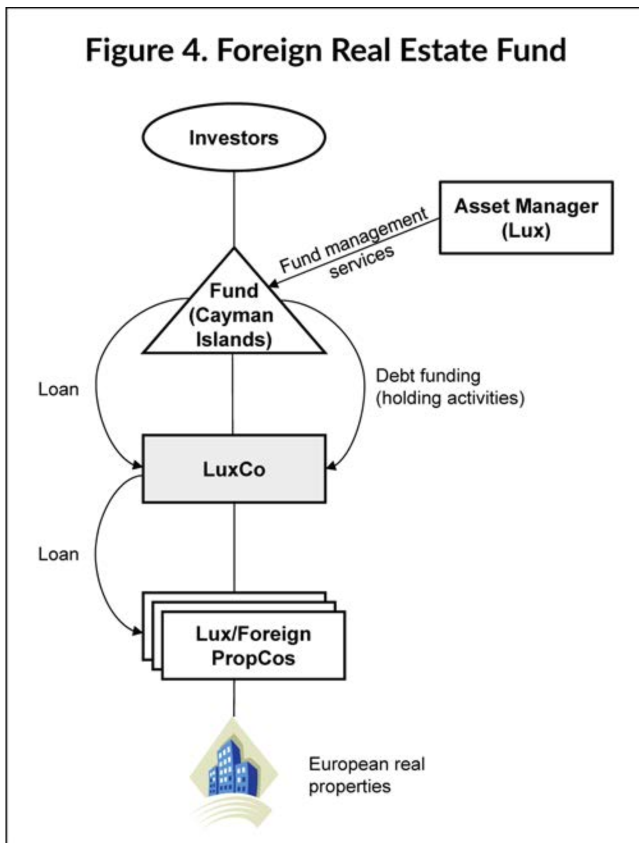
Figure 4. Foreign Real Estate Fund



qualify as a cross-border arrangement. However, unlike in the earlier case study, here, the no- or low-tax hallmark should be fulfilled because deductible interest payments LuxCo makes to the fund should be tax exempt in the Cayman Islands. The cross-border context of payments made from Luxembourg to the Cayman fund should result in the hallmark being fulfilled, even though a Luxembourg fund would also be tax exempt. However, meeting the hallmark does not trigger an automatic reporting obligation because the MBT threshold applies. Under the MBT, one must analyze whether the expected pretax profit was insignificant compared with the amount of the expected tax benefit.

Investments are made into pan-European real estate for generating regular income to improve the value of the properties and to realize capital gains at the end of the investment period. Pooling investor money to make common investments is legitimate. Investments in real estate are generally not made to generate tax benefits, although tax aspects cannot be neglected, given the asset manager's fiduciary duty to prudently manage the investments, including by paying only legally due taxes.

If local tax intermediaries analyzed the MBT in this situation, LuxCo's involvement could be viewed critically. While it might be argued that under the freedom of establishment, the establishment of a company in Luxembourg should as such not be considered when analyzing the MBT (apart from the fact that the involvement of EU parent companies is not a hallmark under the disclosure regime), if it were to be considered problematic, the CJEU's wholly artificial arrangement doctrine would have to be considered. Hence, the question will become whether the substance of LuxCo is appropriate for the functions performed.

Based on the fact pattern, LuxCo has a comprehensive functional and risk profile and appropriate substance for the activities performed, and thus cannot be classified as a wholly artificial arrangement. Further, the MBT should not be considered met.

VII. Conclusion

DAC 6, inspired by the recommendations in the action 12 final report, requires EU members to introduce mandatory disclosure rules for cross-border arrangements that fulfill certain hallmarks.

While some of the hallmarks, when present in a cross-border arrangement, trigger automatic disclosure obligations, other hallmarks are subject to a threshold condition — that is, the MBT. When the MBT applies, it should set a relatively high threshold for disclosure, filtering out irrelevant disclosures that would otherwise dilute the relevance of the information received by tax administrations and increase the costs and administrative burden for taxpayers, tax administrations, and tax intermediaries.

Alternative investments should not generally be a focus of the new disclosure regime because by definition, they seek benefits other than tax benefits. Thus, they should rarely be subject to mandatory disclosure. While in many cases none of the hallmarks will be fulfilled, if a hallmark is fulfilled, it is likely to be a hallmark that triggers reporting obligations only if the MBT is satisfied. Given that international investments are made for legitimate commercial reasons (generating regular income, maximization of value, and so

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forth) and not for generating tax benefits, the MBT should generally not be met.

The mandatory disclosure regime applies to reportable cross-border arrangements as of June 25, 2018, and requires first filings by the end of August 2020. Thus, tax intermediaries and taxpayers must prepare to track potentially reportable arrangements. Ultimately, that forces all parties to constantly consider reporting obligations under the new disclosure regime, which will likely have the desired deterrence effect. ■

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