Mandatory disclosure rules (DAC6)
A look at private equity investment in Luxembourg

Diogo Duarte de Oliveira and Olivier dal Farra of Baker & McKenzie Luxembourg analyse the DAC6 hallmarks and consider how intermediaries may encounter them in the context of private equity investment structuring in Luxembourg.

On May 25 2018, the Council of the European Union adopted a directive concerning the mandatory automatic exchange of information in the field of taxation, in relation to reportable cross-border arrangements (Council Directive (EU) 2018/822). This EU mandatory disclosure regime, known as the DAC6 Directive, aims to increase transparency by requiring intermediaries and, in certain circumstances, taxpayers, to report cross-border transactions that are deemed to represent aggressive tax planning.

In this article, the authors discuss four examples that intermediaries may encounter in the context of Luxembourg private equity investment structuring.

Luxembourg implementation of the DAC6 Directive

Private equity investment is characterised by intense cross-border activity and, therefore, carries with it a natural exposure to the grip of DAC6.

The Luxembourg law dated March 25 2020 implements the DAC6 Directive in Luxembourg (DAC6 Law) and follows the text of the DAC6 Directive rather closely. In line with the DAC6 Directive, the Luxembourg law envisages two distinct types of intermediaries:

- **Primary intermediaries** are persons involved in designing, marketing, organising, or making available for implementation or managing the implementation of a reportable cross-border arrangement; and
- **Secondary intermediaries** are persons providing aid, assistance or advice with respect to designing, marketing, organising, making available for implementation or managing the implementation of a reportable cross-border arrangement or know, or could reasonably be expected to know, that they have undertaken to provide such aid, assistance or advice.

The concept of intermediary is not limited to tax experts but may include, among other, lawyers, consultants, management companies, investment and portfolio managers, investment advisers, distributors, transfer agents, fund administrators, domiciliation agents or depositories if they qualify as intermediaries within the meaning of the Luxembourg law implementing the DAC6 Directive. In situations where there is no intermediary, either because the taxpayer designs and implements an arrangement in-house, or there are no intermediaries with a sufficient nexus with an EU member state, the taxpayer will have to file the reporting himself.

A penalty of up to EUR 250,000 may be levied in case of failure to report, late reporting or incomplete reporting for intermediaries or taxpayers, or failure to notify or incomplete notification for intermediaries benefiting from the legal privilege.

Transactions are in scope if they involve at least one EU member state and another jurisdiction and the transaction contains a hallmark. The hallmarks listed in the appendix to the Luxembourg law are characteristics or features of cross-border arrangements that present an indication of a potential risk of tax avoidance.

Table 1

Generic (A) & Specific (B) Hallmarks subject to MBT	
Generic	Specific
A1 Confidentiality clause imposed by an intermediary	**B1** Certain tax loss planning arrangements
A2 Intermediaries fee arrangement reflects tax advantage	**B2** Conversion of income into capital, gifts or other categories of revenue which benefit from lower taxation or exemption
A3 Standardised tax arrangements available to more than one taxpayer	**B3** Circular transactions resulting in the round-tripping of funds

Specific Hallmarks relating to cross-border transactions (C)	
C1 (a) Arrangements involving tax-deductible payments to an associated enterprise (AE) with no tax residency	**C1 (d)** Arrangements involving tax-deductible payments to an AE resident in a jurisdiction where the payment benefits from a preferential tax regime
C1 (b)(i) Arrangements involving tax-deductible payments to an AE resident in a jurisdiction with no/almost zero CIT	**C2** Depreciation on same asset in multiple jurisdictions
C1 (b)(ii) Arrangements involving tax-deductible payments to an AE resident in an EU/OECD-blacklisted jurisdiction	**C3** Multiple relief from double taxation
C1 (c) Arrangements involving tax-deductible payments to an AE resident in a jurisdiction where the payment is fully exempt	**C4** Cross-border mismatch in consideration for asset transfer

Hallmarks AEOI and BO (D)
D1 Schemes which may undermine automatic exchange of information under CRS
D2 Schemes involving non-transparent legal or beneficial ownership chain

Hallmarks Transfer Pricing (E)
E1 Use of unilateral safe harbour rules
E2 Transfer between associated enterprises of hard-to-value intangibles
E3 Intra-group transfer of functions and/or risks and/or assets, whereby projected annual EBIT of transferor drops more than 50% during the three-year period after the transfer

Arrangement	✓
Cross Border?	✓
Hallmarks?	

Require the main benefit test to be fulfilled

Do **not** require main benefit test to be fulfilled

Main Benefit Test:
"The main benefit or one of the main benefits of the arrangement is to obtain a tax advantage"

The Luxembourg tax authorities have issued guidelines focusing on the form and modalities under which the DAC6 reporting will have to be made (*Précisions concernant l'implémentation de la loi du 25 mars 2020 relative aux dispositifs transfrontières devant faire l'objet d'une déclaration*). However, the guidelines do not comment on the scope of the hallmarks.

DAC6 Law and Luxembourg private equity structures

Luxembourg is a hub for European private equity, and, in the broader sense for the alternative investments funds industry.

Typically, Luxembourg private equity investment structures will involve at the top, one, or several, investment funds pooling the capital from investors. Those investment funds are formed in offshore, low-tax jurisdictions, such as the Cayman Islands, or onshore, in Luxembourg. From a tax perspective, most of the time, the investment funds are tax-exempt platforms to ensure tax neutrality, and effective taxation, ultimately, at investor level. These investment funds usually hold one or several Luxembourg resident limited liability companies in order to manage the shareholdings in the target companies, procure risk segregation, etc. These entities are often financed with shareholder debt and equity, divided in classes of shares with specific economic rights — the so-called classes of shares.

Under the DAC6 Directive, the principle is that cross-border arrangements that come within the scope of at least one of the hallmarks need to be reported to tax authorities. The Luxembourg report should contain *inter alia* the name of the intermediaries and relevant taxpayers, their residence for tax purposes, a summary of the content of the arrangement, the value of the arrangement and the identification of any associated enterprise that participated in the arrangement.

The Luxembourg tax authorities will exchange the information reported automatically with other EU member states via a central directory on administrative cooperation. The exchange of information will occur through the upload to the central directory where the data will be accessible to competent authorities of all other EU member states.

A reportable cross-border arrangement is a cross-border arrangement involving one or more taxes of any kind levied by an EU member state or the EU member state's territorial or administrative subdivisions and that contains at least one of the hallmarks set out in the annex. The definition includes three cumulative elements that should all be fulfilled: (i) a cross-border arrangement (ii) that concerns one or more types of covered taxes and (iii) that contains at least one of the hallmarks.

The hallmarks are described in a simplified version in the reference table above.

Some of the hallmarks have been designed to operate in conjunction with the additional requirement of the main benefit test (Main Benefit Test). The Main Benefit Test is satisfied if it can be established that the main benefit or one of the main benefits that, 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.

The purpose of the Main Benefit Test 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. In Luxembourg, the parliamentary comments to the law implementing the DAC6 Directive indicate that the test compares the amount of the expected tax benefit with all other benefits that may result from the arrangement, and is based on an objective assessment of the tax benefits.

In accordance with parliamentary comments to the law, the Main Benefit Test criterion will not be met if the tax advantage obtained is in line with the object and purpose of the applicable legislation and the intention of the legislator. To determine if a given arrangement is consistent with such intention, the entirety of the elements constituting the arrangement must be considered, the so-called 'holistic approach'. In this respect, Luxembourg professional associations have proposed a set of practical questions to assess the Main Benefit Test:

- Are there other benefits that are more significant than the tax benefits?
- Is the arrangement a mere application of explicit rules as opposed to taking advantage of differences between tax systems?
- Is it reasonable to consider that the investment would have been made in the absence of the tax benefit?
- Are genuine commercial reasons for the transaction considered?

The authors have selected four examples that are common in private equity structures to discuss the hallmarks that Luxembourg intermediaries must know.

Example A: Debt financing

The debt financing of Luxembourg resident limited liability companies by the investment fund is used as a smooth and easy-to-use cash repatriation technique. The use of debt also presents embedded tax advantages, such as the possibility to claim interest tax deductions and mitigate Luxembourg withholding tax.

The sub-hallmarks of Hallmark C1 are likely to require a lot of attention from Luxembourg intermediaries and Luxembourg private equity firms' in-house counsels. The sub-hallmarks of Hallmark C1 focus on the tax treatment at the level of the recipient of a deductible cross-border payment made to an associated enterprise of the payor.

Hallmark C1 would be triggered, with a Main Benefit Test assessment required, in case of a cross-border deductible payment made between two or more associated enterprises where the recipient is resident for tax purposes in a jurisdiction that does not impose corporate tax (Hallmark C1(b)(i)), in situations where the payment benefits from a full exemption from tax in the jurisdiction of the recipient (Hallmark C1(c)), or the payment benefits from a preferential tax regime (Hallmark C1(d)).

Investments made through a Luxembourg resident limited liability company used for the acquisition and financing of the target companies, would usually involve cross-border deductible interest payments made to associated enterprises. Where those structures involve the deduction of interest paid to the investment fund(s) located in an offshore, low or zero-tax jurisdiction, the arrangement could be reportable by a Luxembourg intermediary because of the tax-exempt status of the recipient. The recipient associated enterprise could be the investment fund(s), or the investors in case of a tax transparent investment fund(s). Hallmark C1 describes factual situations that could often be met from the point of view of a Luxembourg intermediary, where the investment funds are based, for instance, in the Cayman Islands, Jersey, or Guernsey.

The reference to the term 'deductible' means that Hallmark C1 would not cover payments made by Luxembourg exempt entities, such as Luxembourg investment funds, which are not subject to income tax.

The DAC6 Directive states that the conditions set out in sub-hallmarks (b)(i), (c) or (d) of Hallmark C1 cannot alone be a reason for concluding that an arrangement satisfies the Main Benefit Test. It does not matter (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) if the payee benefits from a preferential tax regime. The assessment of the non-tax benefit(s) expected from the transaction will be critical in those cases. In this respect the business purpose, regulatory and/or operating model of the private equity structure should provide grounds to argue those non-tax benefits in most cases by themselves.

Also relevant is Hallmark C1 (b)(ii), which refers to payments made to entities resident in a blacklisted jurisdiction, and the hallmark does not require the Main Benefit Test to be met. In Luxembourg, the EU list of non-cooperative tax jurisdictions — as agreed by the EU member states as part of the EU's work to fight tax evasion and avoidance — should serve as a main reference. As of October 26 2020, twelve jurisdictions are on the EU list of non-cooperative tax jurisdictions: American Samoa, Anguilla, Barbados, Fiji, Guam, Palau, Panama, Samoa, Trinidad and Tobago, US Virgin Islands, Vanuatu and Seychelles. However, other countries, including the Cayman Islands, were blacklisted earlier in 2020. Given that there is no Main Benefit Test to be applied, Hallmark C1 (b)(ii) might apply to business as usual transactions regardless of non-tax reasons. The case of the Cayman Islands raises an interesting question that is which version of the EU list to refer to during the DAC6 look-back period.

Another key question is the situation of cross-border payments deriving from Luxembourg structures implemented in the past that are executed after the entry into force of the law implementing DAC6.

From a Luxembourg standpoint, payments relating to arrangements that were implemented before June 25 2018, and where no substantial changes have occurred since that date, are not reportable under the DAC6 Law. This would be the case for certain legacy credit-facility agreements providing for additional drawdown notices on or after June 25 2018.

The DAC6 Directive foresees the reporting of arrangements the first step of which was implemented between June 25 2018 and June 30 2020. In the absence of additional guidance, it can be inferred that all arrangements whose first step was *not* implemented on or after June 25 2018 should not fall under the reporting obligations laid down by the law implementing DAC6.

In the particular case of debt agreements, the deductible payments that are mere effects of an arrangement implemented before the June 25 2018 cut-off date should not be assessed against Hallmark C1. For the purpose of determining whether the first step of an arrangement was implemented on or after June 25 2018, the date on which the contractual arrangements were signed should be decisive. Transactions under agreements signed before June 25 2018 should therefore remain out of scope of DAC6, even if payments were performed on or after that date. The payment itself should not usually meet the definition of an 'arrangement' — but only the underlying agreement, and any revisions to it, would do so. Less straightforward is the case of payments under debt instruments that would require the entering into of a separate redemption agreement, e.g., in the case of convertible debt instruments redeemable at fair market value.

Example B: Equity funding (Luxembourg classes of shares)

The equity portion of the funding of Luxembourg resident limited liability companies is often allocated to different classes of shares, such as the so-called alphabet shares, tracking shares, preferred shares, etc. The Luxembourg resident limited liability company(ies) held by the investment fund(s) issue such classes of shares with different economic rights, sometimes tracking certain investment portfolio allowing for instance to segregate the returns on certain assets, or, other times, to compensate management performance. Also, in the context of divestments, the repurchase of a whole class of shares, at fair market value, should lead to an advantageous withholding tax-free treatment as opposed to a Luxembourg dividend distribution.

Hallmark B2 addresses arrangements that have the effect of converting income into capital, gifts or other categories of revenue that are taxed at a lower level or are exempt from tax. It appears

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clear that a conversion requires one or several specific steps that have the result of modifying the nature of the income into some non-taxable or low-tax form.

One of the interpretation points of this hallmark is to understand at which level a conversion of income should be observed:

- Does a 'conversion of income' require a reclassification of the same flow of income, i.e. as a consequence of the arrangement, an existing income item is treated for tax purposes at the level of the beneficiary in such a way that it converts from a taxable income into a non-taxable type of income?
- Or is it analysed at different levels, for example by taking into account the qualification of an item of income derived by the Luxembourg resident limited liability company(ies) (e.g. dividend) and subsequently a distribution to the investment fund in a different form (e.g. capital gain or the remittance partial liquidation proceeds)?

In the latter, the interposition of Luxembourg resident limited liability(ies) company would have the effect of changing the type of income that the investment fund(s) at the top of the investment structure would derive on a direct investment in the target company(ies).

In respect of Luxembourg classes of shares, the conversion of income should be assessed only at the level of the recipient, the investment fund(s). For investment funds set-up as tax transparent entities (e.g. limited partnerships), the position of the EU Commission seems to be that in such cases the situation of the investors needs to be appraised. For investment funds in the form of tax-exempt opaque companies, the repurchase of an entire class of shares by the Luxembourg limited liability company should not be considered as having the effect of 'converting' an item of income into a category of revenue that is taxed at a lower level. Such investment funds are tax exempt irrespective of the type of income received. Such interpretation has the result that most of classes of shares structures used under tax-exempt opaque companies would fall out of the conditions of the Hallmark B2 and therefore not have to be reported to the tax authorities.

Still, the most robust approach to confirm the absence of DAC6 reporting in this case would be to assess the shares buy-back situation in light of the Main Benefit Test.

The Luxembourg tax authorities, in line with parliamentary comments to the DAC6 Law expressed the view that the Main Benefit Test should not be met if the tax advantage obtained is in line with the object and purpose of the applicable legislation and the intention of the legislator. This means, for example, that classes of asset-tracking shares, which allocate to their holders a return based on the performance of underlying investments, should be in line with the object and purpose of the applicable legislation and the intention of the legislator. Such type of classes of shares are foreseen in Luxembourg law on commercial companies. This being said, other types of classes of shares, widely used in practice, may also be deemed not satisfying the Main Benefit Test.

Example C: Carried interest and management incentive plans

The taxation of fund managers is another important element of Luxembourg private equity structures. Carried interest and management incentive plans (MIPs) usually require detailed analysis around whether such income should be subject to tax as ordinary income or as income from capital. In most jurisdictions, capital gains enjoy a better tax treatment than ordinary income (e.g. professional fees or a mere salary). In Luxembourg private equity structures, it is usual to implement carried interest and MIP structures as equity investments, in the form of specific classes of shares, with a view to align management and investors in the business value strategy.

The EU Commission and foreign tax authorities (e.g. UK, France) focused precisely on MIP situations to illustrate the application of Hallmark B2, which, as stated above, addresses arrangements that have the effect of converting income into capital, gifts or other categories of revenue that are taxed at a lower level or exempt from tax.

In their online International Exchange of Information Manual, page IEIM643020, HMRC describe a remuneration of employees via a share options package. Where a person is employed by a company that is resident in a different jurisdiction, and, as part of their remuneration package they are given share options, exercisable at a later date, any increase in value could be taxed as a capital gain, depending on the jurisdiction of residence. In this example, although the remuneration package could have consisted entirely of salary income, share options are a legitimate commercial choice to remunerate employees. There is no conversion of income into capital; there has simply been a choice made between different options, which are widely used and have an underlying commercial rationale. In contrast, HMRC adds that the addition of steps that are contrived, artificial or outside of normal commercial practice would be more likely to bring the arrangement within the hallmark.

The French tax authorities also describe a share ownership plan (*Plan d'Epargne en Actions* – PEA) example in their guidelines (*Bulletin Officiel des Finances Publiques, Impôts,* BOI-CF-CPF-30-40-30-10-20200429) in which they seem to expect a reporting to be filed.

In Luxembourg, assuming that a conversion of income could be characterised, it could be expected that the holistic approach to the Main Benefit Test would lead to a position that would be equivalent to the one expressed by HMRC. The Luxembourg tax authorities consider that the Main Benefit Test should not be met if the tax advantage obtained is in line with the object and purpose of the applicable legislation and the intention of the legislator.

The general circumstances of the arrangement should be assessed in order to determine whether it is in accordance with the object or the purpose of the applicable legislation and with the intention of the legislator. The guidance issued by the tax authorities and parliamentary works indicate that an arrangement will meet the Main Benefit Test if it does not comply with this intention, for example by taking advantage of the technicalities of a tax system or inconsistencies between two or more tax systems in order to reduce the tax to be paid. Standard MIPs, which do not encompass aggressive tax features should not fall under this hallmark when considered by Luxembourg intermediaries.

Example D: Corporate reorganisations

Corporate reorganisations are part of the life of private equity portfolio companies and of their Luxembourg resident holding companies. It is common that private equity firms following an acquisition rationalise the corporate structure. In case of business reorganisations such as mergers, demergers, contributions in kind or liquidations involving Luxembourg and foreign entities, the question often arise whether such reorganisation could fall under the scope of Hallmark E3.

This hallmark applies to: "*An arrangement involving an intra-group cross-border transfer of functions and/or risks and/or assets, if the projected annual earnings before interest and taxes 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". Hallmark E3 does not require the Main Benefit Test.

In Luxembourg, Hallmark E3 has been implemented without additional comments from the legislator or the tax authorities. As is the case in other EU member states, it is expected that the Luxembourg tax authorities would rely on the concept of 'business restructurings' according to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD TP Guidelines), in particular on Chapter IX Transfer Pricing Aspects of Business Restructurings. An interpretation to assess cross-border transfers of functions and/or risks and/or assets that would refer to the concept of 'business restructurings' as per the OECD TP Guidelines is supported by the similarity of the language used in Hallmark E3.

Even if there is no legal or universally accepted definition of business restructuring, the scope of Chapter IX of the OECD TP Guidelines focuses on the allocation of risks/assets/functions between entities of the same-group in a multinational entreprise (MNE) context. According to the OECD TP Guidelines, a business restructuring may typically consist of:

- The conversion of full-fledged distributors into limited-risk distributors;
- The conversion of full-fledged manufacturers into contract manufacturers or toll manufacturers;
- Transfers of intangibles or rights in intangibles to a central entity within the group; or
- The concentration of functions in a regional or central entity, with a corresponding reduction in scope or scale of functions carried out locally.

Many reorganisations implemented in a Luxembourg private equity context should not fall under the description of business restructuring as per the OECD TP Guidelines. In most cases, the Luxembourg resident limited liability company(ies) held by the investment fund(s) carry out shareholding and financing activities that do not provide opportunities to reorganise risks/assets/functions in order to rely abusively on transfer pricing rules, in a manner contrary to Chapter IX of the OECD TP Guidelines. Conversely, reorganisations involving the transfer of intellectual property (IP) rights by a Luxembourg resident company should be carefully reviewed.

In addition, Hallmark C4 targets arrangements that include transfers of assets where there is a material difference in the amount being treated as payable in consideration for the assets in those jurisdictions involved. The hallmark does not require the Main Benefit Test to be met.

A share-for-share exchange transaction that results in a material difference between the tax value of the shares contributed at the level of the transferor, claiming capital gains roll-over, and the tax value at the level of the recipient, benefitting from the fair market value step-up, between two EU member states should not trigger this hallmark in a situation where the tax consequences derive directly from the EU Merger Directive. Indeed, the EU Merger Directive's purpose is to implement tax neutrality in restructuring transactions involving several EU member states and should not, reasonably, be considered a mechanism of aggressive tax planning for DAC6 purposes.

Conclusion

As illustrated in this article, the Luxembourg private equity structures described above should normally require the review of certain DAC6 hallmarks. For hallmarks subject to the Main Benefit Test, it is possible to anticipate that investment funds and investment structures should generally respond to multiple business purposes and their transactions should therefore not be object to recurrent DAC6 reporting by Luxembourg intermediaries (subject to a case-by-case assessment).

However, some hallmarks and the Main Benefit Test are subject to different interpretation amongst EU member states and Luxembourg intermediaries and asset managers should be paying particular attention to the various jurisdictions involved when considering arrangements that may give rise to a reporting obligation. The different views of all the jurisdictions involved need to be carefully scrutinised to ensure full compliance with DAC6.

The views reflected in this article are the views of the authors and do not necessarily reflect the views of Baker McKenzie.