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Hallmark E3 (Business Restructuring) of the Mandatory Disclosure Regime (DAC 6): What about Liquidations and Cross-border Mergers?

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Editor's Note: The author analyses the extent to which a liquidation or a cross-border merger are reportable transactions under hallmark E3 (Business Restructuring) of the mandatory disclosure regime, considering the guidance released by the Luxembourg tax authorities in an FAQ.

INTRODUCTION

Under the mandatory disclosure regime ("MDR"), tax intermediaries such as tax advisers, accountants, and lawyers that design, promote or provide assistance in regard to certain cross-border arrangements may have to report these arrangements to the tax authorities.

The MDR operates through: (1) a system of hallmarks (that are characteristics or features of cross-border arrangements) that may trigger reporting obligations, and (2) the main benefit test ("MBT")[1] that functions as a threshold requirement for many of these hallmarks. However, hallmark E3 (Business Restructurings) is not subject to the MBT and thus triggers automatic reporting obligations.

This article analyses the extent to which the liquidation or cross-border merger of a Luxembourg company may fall within the scope of hallmark E3, given that the guidance provided by the Luxembourg tax authorities in an FAQ raised some concerns in this respect.

SCOPE OF HALLMARK E3 (BUSINESS RESTRUCTURING)

Hallmark E3 is a transfer pricing hallmark and defined as follows:

> *"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 fall within the scope of Chapter IX (Business Restructurings) of the OECD Transfer Pricing Guidelines. Business restructurings undertaken by multinational enterprises ("MNEs") generally involve the cross-border redeployment (or termination) of functions, assets and risks.

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[1] The main benefit test is satisfied if one of the main benefits, taking into account all relevant facts and circumstances, a person may reasonably expect to derive from an arrangement is the obtaining of a tax advantage.

Such changes to the supply chain are typically accompanied by a reallocation of profits among the members of the restructured multinational group. In this context, the application of the arm's length principle to the restructurings and to the post-restructuring intra-group transactions are important issues.

In managing all aspects of their business from suppliers through to ultimate customers, multinational groups adopt many different business models (also referred to as "supply chain models") that result in either a decentralized (control is given to many companies) or a centralized (control is combined in one entity) supply chain.

With regard to business restructurings, several business models can be distinguished, including:

- Manufacturing models: full-fledged manufacturer, contract manufacturer and toll manufacturer;
- Distributions models: full-fledged distributor, limited risk distributor, commissionaire (and representative office);
- Intellectual property models: dispersed ownership models (licensing and cost sharing), centralized ownership models (intellectual property company) and principal company.

A restructuring of the business model brings along a shift of functions, assets and risks, and its own tax consequences. Thus, labeling an entity that belongs to an MNE as a manufacturer, distributor or service provider (or hybrid entity that combines some of the features of each of these traditional definitions) has the immediate effect that such entity is expected to report profitability levels equivalent to comparable unrelated entities.

Hallmark E3 applies when projected earnings before interest and taxes ("EBIT") over a three-year period after the business restructuring is less than 50% of the projected EBIT over the same period if the transfer had not gone ahead.[2] This test must be considered at the level of the individual company. However, there is evidently a degree of uncertainty in predicting both what the earnings will be and what they would have been had the transaction(s) not gone ahead.

An example of a business restructuring that meets hallmark E3 may be 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 circumstances, a significant drop in profitability might be expected at arm's length. It is worth mentioning that business restructurings should also be disclosed in a multinational's master file.

GUIDANCE PROVIDED BY THE LUXEMBOURG TAX AUTHORITIES

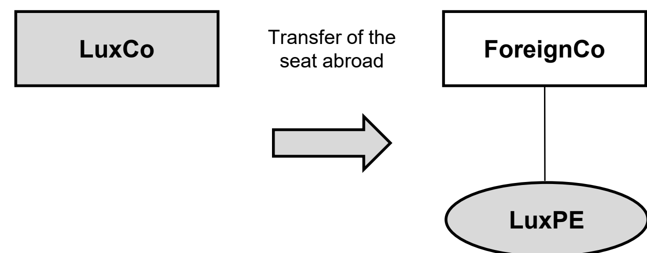
On May 4, 2022, the Luxembourg tax authorities released its updated and extended FAQ regarding the MDR.

According to this guidance, a cross-border merger or liquidation which involves a cross-border transfer of functions and/or risks and/or assets within the same group and which results, within three years of the transaction, in a decrease of at least 50% in the annual earnings before interest and tax ("EBIT") of the transferor(s) compared to the profit that would have been recorded had the transaction not taken place, falls within the scope of hallmark E3.

The FAQ states that the assessment as to whether a business restructuring results in a change of the company's EBIT should be made based on the information available at the time of the transfer. Furthermore, the decline in EBIT must be inherent in the functions and/or risks and/or assets transferred.

According to the FAQ, the following two scenarios do not fall within the scope of hallmark E3:

- Transfer of the registered seat of a Luxembourg company to another member state when the functions and/or risks and/or assets are maintained in a Luxembourg permanent establishment;



However, when the central administration (that is the place of effective management) of the Luxembourg company remains in Luxembourg, the company should in accordance with an applicable tax treaty remain tax resident in Luxembourg (under the so-called corporate tie-breaker rule). The transfer of the seat alone should not result in a migration abroad. Hence, there should not even be a cross-border arrangement that may fall within the scope of the MDR.

- Tax-exempt cross-border merger between a Luxembourg and another EU company where

[2] The EBIT should be a tax EBIT that includes taxable income and should not include tax exempt income such as dividend income that benefits from the Luxembourg participation exemption regime or income that is tax exempt in accordance with an applicable tax treaty.

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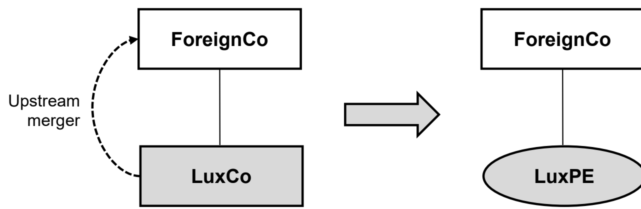
all assets and liabilities remain in a Luxembourg permanent establishment of the absorbing company.



However, cross-border mergers and liquidations as such should not be a business restructuring within the meaning of Chapter IX (Business Restructuring) of the OECD Transfer Pricing Guidelines and, therefore, not trigger reporting obligations under the MDR, unless other facts and circumstances suggest otherwise.

It is interesting to note that the examples mentioned in the FAQ assume that the Luxembourg company involved performs a comprehensive activity before it: (i) migrates to another EU member state, or (ii) is absorbed by a foreign company. However, these situations occur rather seldom in practice.

When a Luxembourg company is liquidated, it will generally not have any significant assets or activities anymore. Hence, it can be assumed that the EBIT of the company during the following three years would be immaterial. Consequently, the ''50% EBIT decrease'' test should not be met in these cases.

Moreover, when a Luxembourg company that is owned by another Luxembourg company (or a Luxembourg fund) is liquidated, the liquidation would not be a cross-border arrangement and, therefore, would not fall within the scope of the MDR.

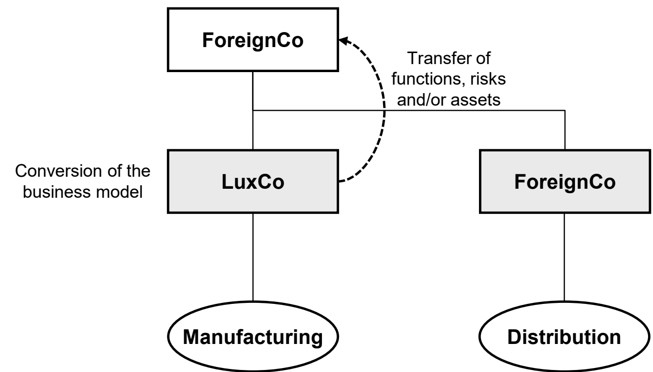
PRACTICAL CASE STUDIES

In this section, the scope of hallmark E3 will be analysed in several practical case studies:

- **Case study 1: Conversion of the business model**

A Luxembourg company (''LuxCo'') is converted from a full-fledged manufacturer into a toll manufacturer which is basically a service provider. Accordingly, the functional and risk profile of the Luxembourg company is significantly reduced following a transfer of risks, functions and/or assets to the foreign parent company (''ForeignCo'').

As a result, a significant drop in profitability is expected at arm's length. It is assumed that the EBIT in the three years following the business restructuring will be reduced by 60% compared to the pre-restructuring situation.

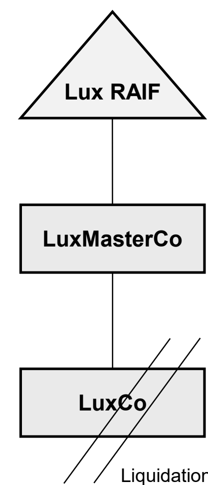


In the present case, the change of the business model of LuxCo is a business restructuring within the meaning of Chapter IX of the OECD Transfer Pricing Guidelines which meets the ''50% EBIT decrease'' test. Thus, the business restructuring must be reported under the MDR.

- **Case study 2: Liquidation of a Luxembourg company in a fund context**

A Luxembourg reserved alternative investment fund (''RAIF'') invests into pan-European real estate assets. The investments of the RAIF are made via a Luxembourg master company (''LuxMasterCo'') that operates as the fund's investment platform and via separate Luxembourg property companies.

Following the sale of a foreign real property by a Luxembourg property company (''LuxCo''), LuxMasterCo liquidates LuxCo.



Given that the liquidation of LuxCo has no cross-border dimension, it cannot be a (potentially reportable) cross-border arrangement within the meaning of the MDR.

- **Case study 3: Liquidation of Luxembourg companies with no material assets or activities**

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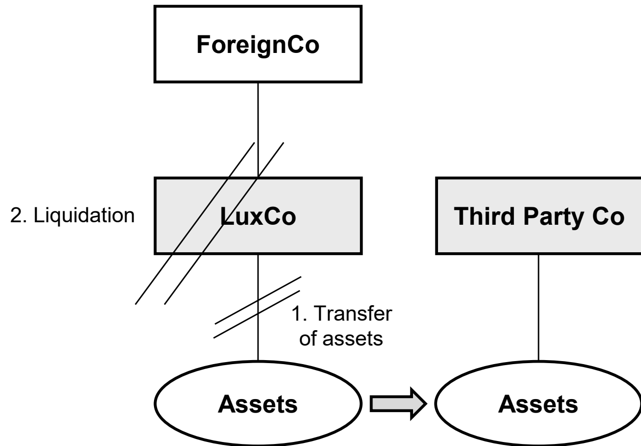
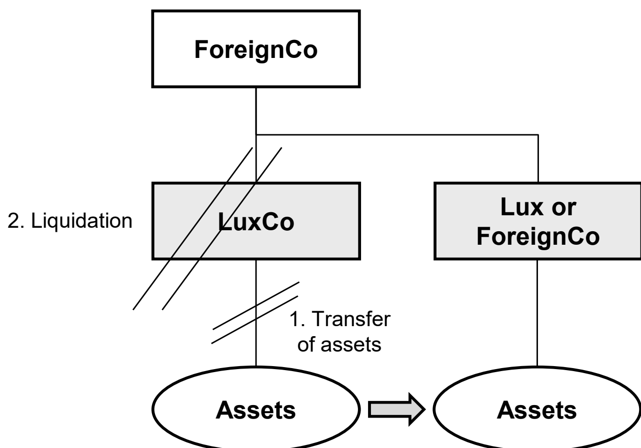
A Luxembourg company ("LuxCo") sold all its assets to a third party and repatriated the cash to its shareholder, a foreign company ("ForeignCo"). As there is no other purpose for LuxCo, ForeignCo liquidates LuxCo.



The liquidation of LuxCo by ForeignCo should be a cross-border arrangement within the meaning of the MDR. However, prior to the liquidation, LuxCo has no material assets and does not perform any significant functions anymore. Hence, it can be concluded that the EBIT of LuxCo during the three years following the liquidation would be insignificant. As such, the "50% EBIT decrease" test should not be met.

As a variation to the previous example, it is assumed that LuxCo sells its assets prior to its liquidation to a related party, be it Luxembourg company or a foreign company.

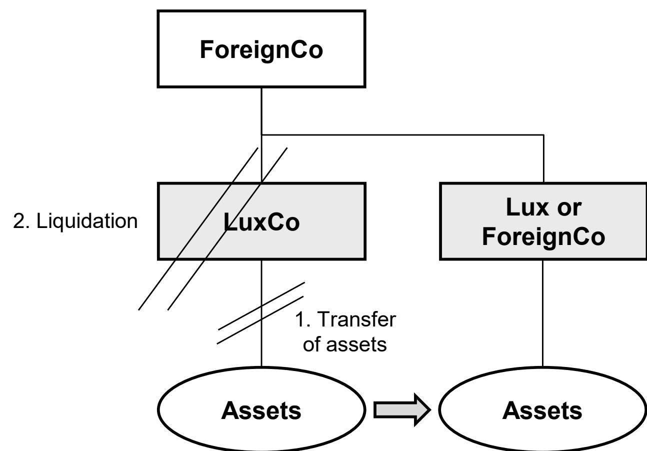


While the liquidation might be classified as a cross-border arrangement, LuxCo should not be expected to realize any material EBIT in the three years to come absent any material assets or business activities. On this basis, hallmark E3 should not be met.

The very fact that the assets are sold to a related party should not jeopardize this conclusion, unless the transfer of the assets and the liquidation are part of a business restructuring within the meaning of Chapter IX of the Transfer Pricing Guidelines.

- **Case study 4: Liquidation of a Luxembourg holding company**

A Luxembourg company ("LuxCo") that owns a 100% participation in a foreign subsidiary ("Subsidiary") and a shareholder loan that has been granted to Subsidiary will be liquidated for cost saving purposes. The EBIT prior to the liquidation is approximately EUR 1m per year.



The liquidation of LuxCo by ForeignCo should be a cross-border arrangement within the meaning of the MDR.

Nevertheless, the mere transfer of assets by an asset management company (for example, participations or loan receivables) or the liquidation of a company that owns assets should, on its own, not be viewed as a business restructuring within the meaning of Chapter IX of the OECD Transfer Pricing Guidelines. Therefore, the liquidation of LuxCo should not fall within the scope of hallmark E3.

CONCLUSION

Hallmark E3 is a transfer pricing hallmark that applies in case of business restructurings that result in a decrease of more than 50% of the company's EBIT in the three years following the reorganisation.

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The updated and extended FAQ provides that liquidations and cross-border mergers may in principle fall within the scope of hallmark E3. However, considering that hallmark E3 is a transfer pricing hallmark, the guidance provided in Chapter IX (Business Restructurings) of the OECD Transfer Pricing Guidelines must be considered when interpreting the term ''business restructuring''.

Ultimately, the potential application of hallmark E3 in case of liquidations can often be excluded on the basis that the liquidation has no cross-border dimension (when the shareholder is resident for tax purposes in Luxembourg) or the ''50% EBIT decrease'' test is not met (when the company has no material assets or business activities prior to the liquidation).

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