INSIGHT: Luxembourg Implements DAC 6 – Interpreting the Main Benefit Test

BY OLIVER R. HOOR

In the first of a series of three articles, Oliver R. Hoor of ATOZ Tax Advisers (Taxand Luxembourg) analyses the interpretation and application of the main benefit test and how tax intermediaries and taxpayers should prepare for their new reporting obligations.

A draft law (the Draft Law) implementing Council Directive (EU) 2018/822 of May 25, 2018 as regards mandatory exchange of information in the field of taxation in relation to reportable cross-border arrangements ("DAC 6") was submitted by the government to the Luxembourg parliament on August 8, 2019. This article analyzes the main benefit test (MBT) which is a threshold requirement that operates in conjunction with many of the hallmarks that, when present, may create reporting obligations under the new mandatory disclosure regime (MDR).

Under the MDR, tax intermediaries such as tax advisers, accountants and lawyers that design, promote or provide assistance in regard to certain cross-border arrangements will have to report these to the tax authorities.

The purpose of the MDR is to provide tax authorities with comprehensive and relevant information about potentially aggressive tax planning strategies. Such information should enable tax authorities to react promptly against harmful tax practices (closing loopholes by enacting legislation, undertaking adequate risk assessments and carrying out tax audits, etc: see DAC 6, recital No. 2).

It is common knowledge that the investments and business activities of Luxembourg companies often have a cross-border dimension. In all these cases, the question needs to be answered whether a particular piece of advice, or involvement in implementation, is reportable under the MDR.

How to Determine Reportable Cross-border Arrangements?

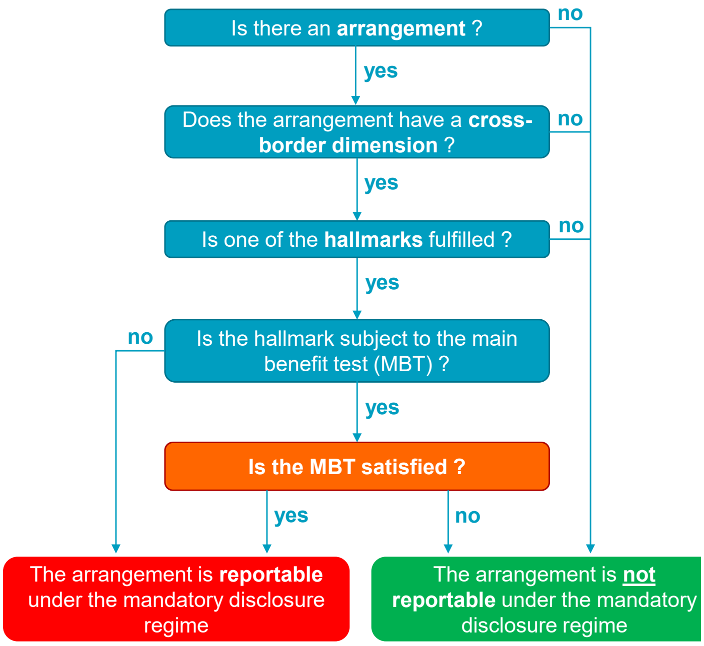
The MDR operates through a system of hallmarks that may trigger reporting obligations and the MBT functions as a threshold requirement for many of these hallmarks. As such, the MBT should filter out irrelevant reporting and enhance the usefulness of the information collected, because the focus will be on arrangements that have a higher probability of truly presenting a risk of tax avoidance.

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 within the meaning of the Draft Law is very broad. When determining whether advice on a particular arrangement is reportable under the MDR, it first has to be analysed whether the arrangement has a cross-border dimension. This would be the case when an arrangement concerns either more than one EU member state or an EU member state and a third country.

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

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

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



How to apply the Main Benefit Test

The MBT is fulfilled if "it can be established that the main benefit or one of the main benefits which, having regard to all relevant facts and circumstances, a person may reasonably expect to derive from an arrangement is the obtaining of a tax advantage." Hence, this test compares the value of the expected tax advantage(s) with any other benefits likely to be obtained from the transaction. This requires an objective analysis of all benefits obtained from an arrangement. According to the Final Report on BEPS Action 12 https://www.oecd.org/tax/mandatory-disclosure-rules-action-12-2015-final-report-9789264241442-en.htm, the MBT sets a relatively high threshold for disclosure.

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

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

Considerations Regarding International Investments

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

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

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

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

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

Developing a Reasonable Approach Towards the MBT

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

While the analysis of reporting obligations under the MDR requires a good understanding of Luxembourg and international tax law (i.e. is a specific hallmark or the MBT met), tax intermediaries are not per se tax specialists. Therefore, it is important to develop a reasonable approach that can be systematically applied by all tax intermediaries and which produces clear-cut results, taking away the ambiguity from the MBT.

Based on the wording of the MBT and the purpose of the MDR, practitioners might consider analysing five questions. Three of these are primary questions that are directly linked to the MBT (questions 1–3), whereas the remaining two questions are complementing the analysis through a focus on logical aspects (questions 4 and 5).

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

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

2. Are the commercial and other benefits more significant than the tax advantage?

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

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

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

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

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

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

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

The mandatory disclosure regime aims at providing early information on potentially aggressive cross-border tax planning arrangements. In the Preamble (No. 2) of the Commission Recommendation of December 6, 2012 on aggressive tax planning, the latter has been defined as follows:

"Aggressive tax planning consists in taking advantage of the technicalities of a tax system or of mismatches between two or more tax systems for the purpose of reducing tax liability. Aggressive tax planning can take a multitude of forms. Its consequences include double deductions (e.g. the same loss is deducted both in the State of source and residence) and double non-taxation (e.g. income which is not taxed in the source State is exempt in the State of residence)."

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

However, even if one considers a broader meaning of aggressive tax planning, the mere application of tax law that explicitly governs an arrangement should not meet the MBT (for example, the application of a tax exemption under a participation exemption regime or the tax treatment of interest expenses in accordance with the arm's length principle and interest deduction limitation rules). Here, the tax treatment of the arrangement is in line with the policy intent of the legislation upon which the arrangement relies. This question might be found difficult to answer by non-tax experts.

5. **Is the arrangement or a series of arrangements known to the tax authorities involved?**

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

To Sum Up

The new MDR enters into force on July 1, 2020 and applies to cross-border arrangements whose first step was implemented since June 25, 2018 (to be reported by August 30, 2020). It can be anticipated that the analysis of potential reporting obligations under the MDR will become an integral part of each and every tax analysis. This on its own will have the desired deterrence effect, as both tax intermediaries and taxpayers will need to carefully consider potential reporting obligations.

When the MBT applies, it should set a relatively high threshold for disclosure, filtering out irrelevant disclosure which would otherwise dilute the relevance of the information received by the tax authorities. The approach set out in this article may help both tax intermediaries and taxpayers to consider all relevant aspects and to arrive at thorough conclusions.

The analysis of the MBT should further not be seen in isolation since several anti-abuse provisions such as the GAAR and the PPT include concepts that are fairly similar to those deployed by the MBT.

It is interesting to note that any reporting under the MDR does generally not mean that taxpayers engage in illegal conduct or that the tax treatment of a cross-border arrangement can be challenged. It may, however, be assumed that reported cross-border arrangements will be more in the focus of the tax authorities involved.

Planning Points

With the Draft Law being released, tax intermediaries and taxpayers are now in a position to prepare themselves for the new reporting obligations. How exactly tax intermediaries and taxpayers should prepare for the new reporting obligations will be analysed in two further articles to be published by Bloomberg Tax.

Ultimately, the MDR may also be viewed as an opportunity to consider and emphasize the commercial reasons and business rationale driving international investments and business activities.

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