LOOK OUT – WHY NEW EU TAX REPORTING REQUIREMENTS ARE AHEAD!

New EU rules - commonly known as **"DAC 6"** - under the Directive on Administrative Cooperation require taxpayers and intermediaries to report a wide range of transactions to their home tax authorities. In some cases these are transactions that are tax-motivated. In other cases they may be ordinary course financing or corporate transactions with no particular tax objective.

In the next few weeks EU taxpayers and intermediaries will have to put in place systems to enable identification and reporting of affected transactions. This briefing outlines the new rules and suggests how such systems could work.

What are the new reporting rules?

The Directive on Administrative Cooperation has been amended to require taxpayers and intermediaries to report details of "reportable cross-border arrangements" to their home tax authority, which will then automatically exchange the information with tax authorities in other Member States.

These rules are intended to give tax authorities greater visibility on aggressive tax planning. However, the scope of DAC 6 is intentionally much wider than that and includes a range of transactions which in many cases will have no particular tax objective.

When do the reporting rules come into effect?

The amending directive will come into force on 25 June 2018. It requires Member States to bring the rules into their national law by the end of 2019 and to apply those rules from 1 July 2020.

However, in practical terms DAC 6 will apply much sooner. The rules will require taxpayers and intermediaries to report in respect of all relevant arrangements starting after the date the Directive comes into force.

Taxpayers and intermediaries will therefore have to put in place systems to enable transactions to be captured for reporting from as early as July 2018. This is particularly challenging when the scope of the Directive is so wide.

The national implementing rules or administrative guidance may narrow the scope of the requirements – but this will not be known for some time.

What arrangements must be reported?

The new rules will apply to "reportable cross-border arrangements".

An arrangement will be "cross-border" if it concerns a Member State and either another Member State or a third country. Arrangements where all the parties are in one Member State, and there is no tax-related impact in any other jurisdiction, will not be "cross-border".

An arrangement will be "reportable" if it contains at least one of five "hallmarks". The detail of the hallmarks is broad and complex (see box below) but in summary they are:

Category A hallmarks apply where one of the main benefits of the arrangement is the avoidance of tax, and there are commercial features typically seen in tax avoidance schemes such as confidentiality conditions, fees geared to tax savings or standardised documents.

Category B hallmarks apply where one of the main benefits of the arrangement is the avoidance of tax, and there are technical features typically seen in tax avoidance schemes such as the sale of a loss-making company to reduce the tax liability of the purchaser, income is converted into capital or circular transactions which result in the round-tripping of funds are entered into.

The **Category C hallmarks** are features which are shared by many tax avoidance schemes and many entirely commercial transactions. They cover arrangements where payments or transfers are made between associated enterprises and tax is not charged on the receipt or the recipient is in a blacklisted country. Whether or not the main benefits of an arrangement include tax avoidance is not relevant for some of these hallmarks.

Category D hallmarks are intended to relate to attempts to undermine the EU's common reporting standards (CRS) and other tax reporting regimes. They are defined by reference to the **effect** of the arrangements, not their purpose. Hence, they will again catch many entirely commercial arrangements.

The **Category E hallmarks** loosely relate to transfer pricing and apply to arrangements which involve the use of unilateral safe harbour rules from transfer pricing, certain arrangements involving hard-to-value intangibles and arrangements involving an intra-group cross-border transfer of functions, risks or assets, if the transfer results in a 50% reduction in the projected annual earnings of the transferor. Whether or not the main benefits of an arrangement include tax avoidance is not relevant.

What kind of transactions will be reportable in practice?

Many of the hallmarks will only apply to tax avoidance schemes. Few businesses have any desire to enter into such arrangements in the modern world – those that do should not be surprised to have a reporting obligation.

However, the scope of the categories of hallmarks means that a great many entirely commercial transactions will be potentially reportable, even though they would not generally be regarded as involving tax avoidance.

It remains unclear how tax authorities will interpret the new rules, but the following lists examples of straightforward arrangements that may be reportable:

- As part of a securitisation, an EU bank transfers financial assets to a Jersey subsidiary special purpose vehicle (SPV). The arrangements may contain a category D hallmark and thus be reportable.
- An EU corporation makes a tax-deductible payment to an associated partnership in another jurisdiction. The recipient is "not resident for tax purposes in any tax jurisdiction" and therefore the arrangement seems to contain a category C hallmark. It is irrelevant whether or not there is a tax benefit.
- An individual in France transfers cash to his or her family in a country which does not automatically exchange financial account information with France. The arrangement would contain a category D hallmark.
- An Italian company uses cash in an Italian bank account to acquire real estate in France. The account was subject to reporting under OECD automatic exchange of information rules; the real estate and its income is not. Hence, the arrangement contains a category D hallmark.
- A bank resident in one jurisdiction but acting through a branch in another offers retail investors a government-approved standardised tax-advantaged savings product, such as an Individual Savings Account (ISA) in the UK. This arrangement seems to satisfy the main benefit test, as one of the main benefits includes the obtaining of a tax advantage. It is also standardised and available to multiple taxpayers. Therefore, the arrangement appears to contain a category A hallmark.
- As part of an intra-group reorganisation, a company in one jurisdiction sells most of its income-generating assets to an affiliate in another jurisdiction. This exhibits a category E hallmark. The absence of a tax benefit is irrelevant.
- As part of a securitisation, a special purpose company sells all of its assets to a newly established affiliate, which issues bonds to the market. Again, this exhibits a category E hallmark, and the absence of a tax benefit is irrelevant.
- A French company makes a payment to a UK affiliate, who relies on the UK SME exemption from transfer pricing rules. This transaction may involve the use of a unilateral safe harbour (a category E hallmark) and it is irrelevant whether or not there is a tax benefit.

Who has the obligation to report?

The Amendment places the reporting obligation, in the first instance, on intermediaries.

An "intermediary" is defined broadly, as any person (natural or legal) that designs, markets, organises or makes available for implementation or manages the implementation of a reportable cross-border arrangement.

That definition is then widened further to include any person that knows, or could reasonably be expected to know, that they have provided aid, assistance or advice with respect to designing, marketing, organising, making available for implementation or managing the implementation of a reportable cross-border arrangement.

The potential intermediary must also be resident (or have a permanent establishment) in a Member State, be registered to a professional association related to legal, taxation or consultancy services in a Member State or be incorporated in, or governed by the law of, a Member State.

This is a very broad definition, and one that potentially captures a wide range of people involved in the transaction, including holding companies, corporate treasuries or other group companies if they are incorporated in the EU and if they organise or manage the implementation of a group's cross-border arrangements. Banks which are involved will also be within the term.

The reporting obligation on intermediaries is subject to legal professional privilege – and where privilege applies, the intermediary has no reporting obligation. However, the intermediary must then notify any other intermediary or, if there is so such intermediary, the relevant taxpayer of their disclosure obligation.

If there is no intermediary to the arrangement, or legal professional privilege applies, then the obligation to report will lie with the taxpayer.

Whether the taxpayer or intermediary is subject to the reporting obligation, the required information will have to be filed with the competent authority within 30 days. This time limit will be triggered the day after the earliest of: (i) the day the arrangement is made available for implementation; (ii) the day the arrangement is ready for implementation; or (iii) when the first step in the implementation of the arrangement has been made.

What information must be reported?

Individual Member States will set the precise content required in reports by taxpayers and intermediary, but the reports will have to include:

- the identification of intermediaries and relevant taxpayers and, where appropriate, the persons who are associated enterprises to the relevant taxpayer;
- details of the applicable hallmarks;
- a summary of the content of the reportable cross-border arrangement, including a reference to the name by which they are commonly known, if any, and a description in abstract terms of the relevant business activities or arrangements;
- the value of the reportable cross-border arrangement; and
- the identification of the Member State of the relevant taxpayer(s) and any other Member States which are likely to be concerned by the reportable cross-border arrangement.

What are the consequences of failing to report?

The new Directive will require Member States to implement "effective, proportionate and dissuasive" penalties for any infringement of the national legislation implementing the reporting rules.

Will the new rules apply to the UK after Brexit?

It is expected that the UK will leave the EU in March 2019. However, the text of the draft Withdrawal Agreement agreed so far envisages that there will be an implementation or transition period expiring on 31 December 2020 during which the UK will be required to implement and apply new EU legislation as if it were still a Member State.

If the UK left the EU in March 2019 without a Withdrawal Agreement with the EU, then, unless the UK Government has already adopted a statutory instrument implementing the requirements of the new Directive, it would be a matter for the UK Parliament to decide whether to adopt similar rules, for example, to ensure continued equivalence with the EU regime. In these circumstances, the new Directive would not form part of 'retained EU law' and so would not be preserved as part of UK law under the proposed European Union (Withdrawal) Bill currently passing through the UK legislative process.

In our view it is prudent to assume that the UK will be required to adopt and apply the new rules in July 2020.

What should intermediaries and taxpayers be doing now?

Financial institutions and others involved in transactions where tax is one of the main benefits will clearly need to put in place procedures to identify transactions which contain one of the hallmarks. We anticipate this will be relatively straightforward given that tax personnel are likely already involved.

The more difficult question is what procedures financial institutions and corporates can put in place to capture other transactions where tax is not one of the main benefits, but which may contain one of the hallmarks.

One approach would be to draw up a list of broad transaction types that are potentially within scope (e.g. transactions with fiscally transparent group entities) and require that all such transactions are escalated to the company's tax team, for determination as to whether reporting is required.

This kind of approach would need to be adopted by financial institutions and intermediaries arranging transactions, as well as corporates entering into them.

Further information

If you would like further information on any aspect of this briefing, or to discuss how your business can plan for the implementation of DAC 6, please speak to your usual Clifford Chance contact, or any of those listed on page 8.

What are the hallmarks that make an arrangement reportable?

The **Category A hallmarks** are intended to capture typical commercial features of tax avoidance schemes, and cover arrangements where:

- the participant in the arrangement undertakes to comply with a condition of confidentiality;
- the intermediary is entitled to receive a fee that is fixed by reference to either the existence of a tax advantage or the amount of the tax advantage resulting from the arrangement; or
- the documentation and/or structure is substantially standardised and is available to more than one relevant taxpayer without a need to be substantially customised for each taxpayer.

The hallmarks only apply if the "**main benefit test**" is satisfied. This will be the case if the main benefit, or one of the main benefits which a person may reasonably expect to derive from an arrangement is the obtaining of a tax advantage.

The **Category B hallmarks** are intended to capture typical technical objectives of tax avoidance schemes, and cover arrangements where

- a loss-making company is acquired in order to reduce the tax liability of the purchaser;
- income is converted into capital or other categories of revenue which are subject to either lower tax or are tax-exempt; or
- circular transactions are entered into resulting in the round-tripping of funds.

The **Category C hallmarks** are features which are shared by many tax avoidance schemes and many entirely commercial transactions. They cover arrangements where:

- deductible cross-border payments are made between two or more associated enterprises, the main benefit test is satisfied, and either:
  - the recipient is resident in a jurisdiction that does not impose any corporate tax, or imposes corporate tax at the rate of zero (or almost zero);
  - the payment benefits from a full exemption from tax in the jurisdiction where the recipient is tax resident; or
  - the payment benefits from a preferential tax regime in the jurisdiction where the recipient is tax resident;
- deductible cross-border payments are made between two or more associated enterprises, and (whether or not the main benefit test is satisfied) either:
  - the recipient is not tax resident in any tax jurisdiction; or
  - the recipient is resident in a non-EU jurisdiction which has been assessed as non-cooperative (i.e. put on a "blacklist") by the EU or the OECD;
- the same depreciation is claimed in relation to the same asset in more than one jurisdiction;
- relief from double taxation in respect of the same item of income is claimed in different jurisdictions; or
- assets are transferred and there is a material difference in the amounts treated as payable as consideration for those assets in the jurisdictions involved.

The **Category D hallmarks** are intended to relate to attempts to undermine the EU's common reporting standards (CRS) and other tax reporting regimes. However, they are defined by reference to the **effect** of the arrangements, not their purpose. The arrangements covered are those that involve:

(a) that do not carry on a substantive economic activity supported by adequate staff, equipment, assets and premises;

(b) that are incorporated, managed, resident, controlled or established in any jurisdiction other than the jurisdiction of residence of one or more of the beneficial owners of the assets held by such persons, legal arrangements or structures; and

(c) where the ultimate beneficial owners of such persons, legal arrangements or structures are made unidentifiable.

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The **Category E hallmarks** loosely relate to transfer pricing, and apply (regardless of whether the main benefit test is satisfied) to:

- arrangements which involve the use of unilateral safe harbour rules from transfer pricing (for example exemptions from transfer pricing for SMEs);
- certain arrangements involving hard-to-value intangibles; or
- arrangements involving an intra-group cross-border transfer of functions and/or risks and/or assets, if (broadly speaking) the transfer results in a 50% or greater reduction in the projected annual earnings of the transferor during the 3 year period after the transfer.

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