DAC6 – A PRACTICAL APPROACH TO COMPLIANCE

EU rules - commonly known as **"DAC 6"** - will soon require businesses with a presence in the EU to report a wide range of transactions to tax authorities in EU Member States – potentially including transactions going back to 25 June 2018.

DAC6 was originally aimed at tax avoidance structures, but the scope is much wider and can include transactions with no particular tax features. Penalties for failing to comply with DAC6 are potentially severe (up to £1m in the UK).

For large and complex businesses such as banks and financial investors it is clearly not feasible to individually analyse each transaction entered into since 25 June 2018. In this briefing, we set out a more practical approach. In our view, the key is to categorise transactions into "good", "bad" and "ugly", with a view to adopting a simple workflow for the "ugly" transactions to identify those that are reportable.

What makes an arrangement reportable?

DAC6 requires intermediaries, or where there are no intermediaries, relevant taxpayers, to report cross-border arrangements that exhibit certain hallmarks. The "hallmarks" are features intended to catch tax avoidance structures, but are drafted broadly and will catch a multitude of normal commercial transactions as well.

An arrangement will be "cross-border" if it concerns an EU Member State and either another EU Member State or a third country. Therefore, any transaction that is conducted entirely outside the EU will not be reportable, but any transaction with an EU party may be.

What is an intermediary?

Taxpayers will usually not have a reporting obligation unless informed by an intermediary. This makes compliance a relatively passive process for taxpayers. In contrast, intermediaries need to actively consider whether the transactions in which they participate are reportable in order to comply.

An "intermediary" is defined broadly and in most member states includes anyone that designs, markets, makes available or implements a reportable cross-border arrangement and anyone who knows, or could reasonably be expected to know, that they have provided aid, assistance or advice in respect of the same. This definition could catch almost any role in a cross-border arrangement – such as arrangers, lenders, investors, service providers and agents, as well as their advisers.

However, in order for a reporting obligation to arise, the intermediary must generally either be incorporated or resident in an EU Member State or be acting from a permanent establishment in an EU Member State. Broadly, any business carried out from outside the EU will not create a reporting obligation.

What steps should intermediaries take?

Many tax authorities are looking for intermediaries to take a reasonable approach to compliance based on what they know and could reasonably be expected to know. So what does a "reasonable approach" look like?

Categorisation

The first step is to carry out a risk assessment and place the intermediaries' lines of business and transactions into three categories, which it's helpful to call "good", "bad" and "ugly".

A "good" type of transaction is one that will never be reportable. This would include business that has no connection with the EU or has no cross-border element. This would also include business that wouldn't meet any of the hallmarks, such vanilla lending.

A "bad" type of transaction is one that will always be reportable, regardless of the precise tax treatment. This would include cross-border intra-group transfers of hard to value IP or other assets where the transferor becomes dormant or is liquidated, as well as deductible cross-border payments between associated enterprises where the recipient is in a jurisdiction that is on the EU blacklist. These transactions are relatively easy to identify, with non-specialists able to screen transactions based on a limited number of commercially-focussed questions.

An "ugly" type of transaction is one that might be reportable depending on the precise tax treatment. This would include some M&A, real estate finance or structured finance transactions. The ugliness is that some analysis will be required to determine if the transaction in fact is reportable, and an initial screening can be undertaken by non-specialists.

The advantage of categorisation is that streamlined processes can then be adopted for particular categories of transaction – and potentially for entire lines of business (where a line of business falls entirely within one category).

Workflows

- Transactions where the intermediary receives no tax information on the underlying transaction should be only "good" or "bad" – they cannot be ugly. This is because an entity cannot be an intermediary if it does not know and cannot reasonably be expected to know that a hallmark is met.
- "Good" transactions (and, in some cases, lines of business) can simply be removed from the DAC 6 workflow (but the rationale should be documented).
- A simple flowchart/checkbox process can be adopted for commercial personnel to determine if a transaction is "bad".

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- For "ugly" transactions a more detailed workflow must be adopted:
    - Is/was an EU adviser acting for the intermediary, with the adviser in possession of as much information on the tax treatment of the transaction as the intermediary? If so, the primary duty to report is with the adviser (although it is prudent to proactively remind advisers of this). In many cases no further steps will be required. Where an adviser is protected by legal professional privilege, careful consideration should be given as to whether it is appropriate to waive privilege so the intermediary can report.
    - If there was no adviser, the next step is to consider whether any of the hallmarks could potentially be met. In other words, a "triage" rather than a full analysis, conducted again by commercial personnel rather than specialist.
    - Where that triage identifies that a transaction is potentially reportable, the matter would be referred to a specialist. Depending on volumes, this could either be an in-house tax adviser (who would carry out a full review), or junior compliance personnel, applying a second-level triage using a more detailed flowchart methodology. Only after this process has determined a transaction is reportable should it be reported.
    - Where the workflow determines that the transaction is not reportable, maintain a record of the process leading to the conclusion. This could be important for establishing any relevant "reasonable processes" defence.

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 overleaf.

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