Article

HARNEYS

DAC 6 – D Day is imminent – Update of key elements

At a time when lengthy books are beginning to be written on the Sixth Directive on Administrative Co-operation in Tax Matters (***DAC 6***) it is a daunting task to summarise the key elements of DAC 6. However, with an eye on 1 January 2021 when the clock starts ticking for the various deadlines for the initial set of reporting obligations, there are some material elements that deserve particular focus.

The immediate deadlines, using Luxembourg as an example, will be:

- 10 January 2021 for those intermediaries, who are exempt from reporting due to the application of legal professional privilege, to notify other intermediaries or taxpayers of the reporting requirements in relation to reportable cross border arrangements (referred in this article as ***RCBAs***).
- 30 January 2021 for the reporting of any RCBA where the trigger event for reporting occurred between 1 July and 31 December 2020.
- 28 February 2021 for the reporting of any RCBA the first step of implementation of which occurred between 25 June 2018 and 30 June 2020.

This article will consider:

- The policy objectives and whether they are likely to be achieved, particularly bearing in mind the difficulties of interpreting DAC 6.
- The challenges faced by the so-called secondary intermediaries, otherwise known as service provider intermediaries, in meeting their DAC 6 obligations.
- The hallmarks that are likely to be of most relevance to international business structures and some comments on the main benefit test.
- Dealing with the practical challenges faced by international structures that span numerous countries and involve numerous intermediaries.

Policy objectives

In essence, the principal objective is to provide tax authorities with early warning[1] of arrangements that involve aggressive tax planning so that they can take the necessary action to examine those arrangements under existing tax rules and to amend the tax rules as appropriate to prevent further use of such arrangements.

In line with that objective, the EU Commission took a leaf out of the Common Reporting Standard (***CRS***) by targeting certain intermediaries as the people who were considered best placed to identify and therefore report on RCBAs. However, unlike the CRS that targets a relatively limited group of "Financial Institutions", DAC 6 targets anyone that falls within the category of "Intermediary" and this covers potentially anyone who has some involvement with devising or implementing an RCBA. Intermediaries are likely to include tax advisors, accountants, auditors, lawyers, trust and corporate service providers, fund managers, fund administrators, banks, insurers, and the tax and legal departments of multinational groups. A further departure from the CRS model is that DAC 6 places the ultimate reporting obligation on

[1] "Early" seems to mean in advance of any normal reporting cycle. One might reasonably question whether being required to report an arrangement that started to be implemented at the end of June 2018 over 30 months later is in line with that objective.

the so-called "relevant taxpayer" where there is no "Intermediary" that has a reporting obligation.

Being an EU initiative, the intention is to have a uniform set of rules that will be applied uniformly across Europe such that, where several Member States are involved, reporting is only needed in one Member State. Unfortunately, this objective will be difficult to achieve for a number of reasons, not least the different interpretations placed on the DAC 6 rules by different intermediaries, particularly where they operate in different Member States.

Moreover, there is enormous scope for differences in interpretation of DAC 6 due to the imprecise terminology frequently used in DAC 6. It may seem alarmist to make reference to the Rule of Law in this context. However, one of the fundamental requirements of the Rule of Law is that laws should be clear and unambiguous and DAC 6, as crafted by the EU Commission, falls far short of meeting that requirement.

The fact that this is the case should not be particularly surprising. The EU body that crafts Directives is not a legislative body in the normal sense of the term and such as exists in each Member State. Nor is a Directive designed to be legislation but rather to be, in effect, an intergovernmental agreement between Member States as to what measures should be taken in each Member State. The upshot of this is that Directives are not drafted in the precise way and with the rigour that is generally applied by Member States when preparing domestic legislation or regulations.[2] And yet what appears to happen is that Member States, perhaps out of a concern not to be departing from the terms of a Directive, frequently enact local legislation implementing a Directive largely by way of simply replicating the terms of the Directive.

The outcome is a set of unclear rules in a context where infringement of the rules may result in significant financial penalties. There are numerous terms used in DAC 6 that are open to different meanings. To name but a few - "participant", "arrangement", "intermediary", "main benefit", "tax advantage", "relevant taxpayer", "substantially standardised", "the effect of converting income", "not resident for tax purposes", and "may have the effect of".

Thus, there is a desperate need for guidance in the hope that such guidance will serve to provide a sensible interpretation to concepts that can be extremely broad and result in arrangements being treated as RCBAs where they do not in principle fall within the stated objectives of DAC 6 and where reporting is unnecessary and involves significant expense for intermediaries and, ultimately, for tax authorities.

Fortunately, a number of countries are publishing detailed guidance. This would of course be more helpful if there were not inconsistencies between the various publications. And in some countries, Luxembourg being an example, very little guidance on the substantive meaning of DAC 6 has (at the time of writing) been published. And the Luxembourg position is exacerbated by the fact that professional associations have not published guidance or, where they have, it is available only to their members.

Particular challenges for secondary intermediaries

The world of intermediaries is divided up between those that are considered to be in the frontline when it comes to devising aggressive tax planning techniques and those that provide a supporting role. The former are frequently referred to as "Primary Intermediaries" or "Promoters", although the latter term would also include tax advisers (whether they be accountants, lawyers or tax specialists) who provide a bespoke tax related solution to a particular client. Nevertheless, if one for the moment accepts that intermediaries are the right people to be targeted, then these frontline advisers should logically be included.

Less logically included are the other category, referred to as "Secondary Intermediaries" or simply as "Service Providers". These are the intermediaries that provide "aid, assistance or advice" to the Primary Intermediaries. In the context of Primary Intermediaries frequently being excused from reporting due to the application of the professional legal privilege exemption[3], it is beginning to emerge that it is the Secondary Intermediaries who find themselves as bearing the bulk of the burden of DAC 6 compliance.

While DAC 6 recognises that Secondary Intermediaries should only be treated as such where they have knowledge, or should be treated as having knowledge, of the RCBA in question, it is questionable whether merely having knowledge of an RCBA should be the basis for placing such a significant compliance obligation on businesses such as trust and company service providers, banks and insurers where they have minimal involvement in the planning of the affairs of taxpayers. And even if they can rely on an absence of knowledge, they need to do the work necessary to ensure that they do not have on file information that would give them the required degree of knowledge.

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[2] As evidence of this in relation to DAC 6, is the appearance of a term, namely "bespoke arrangement", in the definition section of DAC 6 where that term is not actually used in the DAC 6 text.

[3] This is particularly the case in Luxembourg, for example, where not only lawyers but also chartered accountants and auditors are exempt from reporting.

Frequently relevant hallmarks

In the world of international business structuring, certain of the so-called hallmarks (ie the features of a cross border arrangement that make it reportable) are emerging as the ones that are most likely to come up for consideration. They are as follows:

- Hallmark A3 involving the use of standardised documentation.
- Hallmark B2 involving the conversion of income into forms of capital or into forms of income that are subject to a lower level of taxation.
- Hallmark C1 involving deductible payments between associated enterprises.
- Hallmark D1 involving CRS avoidance arrangements.
- Hallmark E3 involving business re-organisations.

Main Benefit Test

Before going on to examine some of the material features of these particular hallmarks, it is helpful to examine certain aspects of the so-called "Main Benefit Test" (***MBT***) that is an additional requirement to be satisfied in relation to certain hallmarks (in particular A3, B2 and C1 out of those named above).

An arrangement will satisfy the MBT if "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."

A question that frequently arises in the context of structures that involve Member States that have particular tax regimes that generate tax efficiencies for particular structures is whether the fact that tax is a material feature in the choice of jurisdiction creates an assumption that the MBT is going to be satisfied. The question leads on to a discussion as to how extensive the tax benefit needs to be in order for it to be treated as "one of the main benefits", especially in comparison with other non-tax related benefits, and whether, but for the tax benefit, the particular jurisdiction would not have been chosen.

Fortunately, a number of countries are producing guidance to the effect that, if the tax treatment is in line with the terms and policy objectives of existing legislation, that tax treatment will not be treated as being "one of the main benefits" of the arrangement. An important ingredient of the arrangement, in order for it to be within line of policy objections, will be that it could not be treated as abusive, in particular that there is a commercial or economic justification for a particular structure.

A3 – Standardised documentation

This hallmark describes the arrangement as one that "has substantially standardised documentation and/or structure and is available to more than one relevant taxpayer without a need to be substantially customised for implementation".

This hallmark has been causing considerable concern in a world where increasing use is made of standardised documentation whether in the context of bank products, insurance related products or the templates that form part of lawyers' stock in trade in a wide range of transactions.

The first thing to note is that if this hallmark is satisfied then the arrangement in question is likely to be a so-called "marketable arrangement" and one that is going to involve quarterly updated reporting. It is clear that such arrangements should be limited to those that are in the form of a product that is frequently used by different taxpayers with little modification.

The second point to note is that, notwithstanding that documentation takes on a seemingly standardised form, frequently it is going to require a material amount of adaptation to the transaction in question. This will generally be the case in relation to documents that are generated by a lawyer from a standard template.

If the above points do not serve to take a particular arrangement out of range of this hallmark, the need also to satisfy the MBT will in many cases achieve that result. As examples, the use of standardised banking documentation used for home loans and related security arrangements or standard insurance wrapper documentation will frequently not satisfy the MBT. Any tax advantage associated with such arrangement would generally be clearly envisaged by the relevant tax rules applicable to the taxpayer in question.

B2 – Conversion of income

There was some initial concern that this could be wide enough to cover the receipt by a company of one form of income, for example dividends that are exempt under a particular participation exemption regime, and then the payment of that income out to a third party in the form of interest on a loan. To the extent that this was ever a credible concern, it now appears that it is no longer so.

What this hallmark is targeting is an arrangement that involves changing the nature of the payment received by somebody so that it causes that person to pay less tax on that payment than they did before, for example a dividend under an employee share scheme instead of normal employment income or a capital gain instead of dividend income.

This can be illustrated by an arrangement that might involve a shareholder receiving its return on a share by redeeming that share through a repurchase and cancellation of that share by the company rather than through a dividend being paid on that share.

There are a number of points that indicate that such an arrangement may often not be reportable:

- If the shares are, at the time of issue, capable of being redeemed by either the shareholder or the company and if either of them subsequently chooses redemption over a dividend, there would appear to be no conversion of a pre-existing income stream.
- From the perspective of the company, there may be no “conversion” as the payment made on the repurchase of the shares from a legal and accounting perspective may be no different from a dividend as in each case there is a distribution by the company of the relevant distributable reserves (with only a relatively small capital payment made on the cancellation of the shares).
- Even if there is a conversion of income such that less tax is payable, provided that this is a mechanism that can be and is legitimately used by reference to the applicable pre-existing tax rules, the MBT may not be satisfied.

Similar considerations might apply if a shareholder chooses to fund its company with debt rather than equity or prefers that the company is put into solvent liquidation rather than first distributing the available accumulated profits to the shareholder.

C1 – Deductible payments between associated enterprises

The first thing to note is that “associated enterprises” are not limited to legal persons or arrangements, but also include individuals if the relevant control criteria are met.

Deductible payments (for example, interest, royalties, fees) made in favour of entities resident in blacklisted countries or to entities that have no residence for tax purposes are reportable without the need to apply the MBT. It appears that tax transparent entities would not be covered by this nor would corporate recipients that are resident in countries that have no corporate tax.

Deductible payments made to associated enterprises that are subject to zero or near zero tax or payments that are tax exempt or that benefit from a preferential tax regime will be caught only if the MBT is also satisfied. Where such payments are limited to what is allowed by the relevant tax rules of the payer, they may well not satisfy that test. In particular, it should be noted that just because a payment falls within this hallmark, it cannot be taken to mean that the MBT is satisfied.

D1 – CRS avoidance arrangements

Hallmark D1 is extremely broadly drafted and could potentially catch a very large number of transactions that “may have the effect of undermining the reporting obligations” under the CRS. Fortunately, there is a very clear statement to the effect that EU Member States can choose to interpret D1 in line with guidance published by the OECD in relation to their Mandatory Disclosure Rules. This is potentially extremely helpful and would therefore result in excluding from reporting arrangements that are consistent with the policy objectives of the CRS.

Thus, converting assets held through financial accounts into assets (for example, real estate, works of art) that are not covered by the CRS should generally not be caught unless abusive or part of a concerted promotion of such arrangements. However, care should continue to be exercised in relation to arrangements that involve the transfer of assets or financial institutions to the United States.

E3 – Transfer pricing and group re-organisations

This hallmark presents some difficulties as, although it is clearly intended to address transfer pricing concerns, the way it is drafted has the result of it potentially covering a large number of transactions that are typically used in the context of corporate re-organisations. These would include, for example, migrations, mergers, de-mergers, transfers of subsidiaries, and liquidations. A particular difficulty arises as the MBT does not apply to this hallmark.

There is some guidance emerging to the effect that these kinds of transactions should not be caught, supported by the fact that the OECD Transfer Pricing Guidelines simply do not address these as being of concern in the context of business re-organisations (where the focus is on the transfer of functions and risks).

Reporting – practical challenges

As we have seen, the principal reporting obligation is on "intermediaries" and it is clear that a large number of intermediaries could be involved in any particular arrangement and, as DAC 6 targets cross-border arrangements, the intermediaries are likely to be located in a number of different jurisdictions.

We have also seen that there is a likelihood that different intermediaries will have differing views on whether a particular arrangement is reportable or not. This will be partly due to the inherent uncertainties in the interpretation of the relevant rules. However, it will also be due to the fact that the rules and their interpretation are likely to vary across the different EU Member States.

It will clearly be in the interests of the client that there be as uniform an approach to reporting as possible and that the number of reports is kept to a minimum. There is a clear mechanism for allowing intermediaries not to report where an arrangement has been reported by another intermediary in any EU Member State and where the other intermediaries have adequate proof of the reporting.

This is all well and good but, once the reporting period up to 31 December 2020 has been dealt with (and there is some time for preparing that reporting process), reports will need to be filed within 30 days of the relevant trigger date. This does not leave much time for intermediaries to ensure that someone else has done the reporting and to get the required proof of that. The risk is that intermediaries, out of a concern to ensure that they are being DAC 6 compliant, will simply file their reports, thus leading to a multiplicity of reporting where the reports may themselves be different.

Relevant taxpayers (ie clients) would be advised to take a pro-active role (together with their principal advisers) to ensure that the reporting process is tightly co-ordinated and that there is an agreed process for any reporting before the 30-day period starts to run.

Andrew Knight
+352 27 86 71 06
andrew.knight@harneys.com
Luxembourg

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