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INSIGHT: The Implementation of DAC 6 (Mandatory Disclosure Regime) Across Europe – a Call for Reason

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DAC 6 (Council Directive (EU) 2018/822 of 25 May 2018 as regards mandatory exchange of information in the field of taxation for reportable cross-border arrangements) provides for the mandatory disclosure regime (MDR) regarding potentially aggressive tax planning schemes which had to be implemented by EU Member States by December 31, 2019. While a number of EU member states—including Luxembourg —did not manage to adhere to this implementation deadline, it can be expected that DAC 6 will be transposed into the domestic laws of EU member states in the next few months. The MDR should enter into force no later than July 1, 2020.

Under the MDR, intermediaries such as tax advisers, lawyers and accountants that design, promote or provide assistance in regard to certain cross-border arrangements will have to report these to the Luxembourg tax authorities. When the intermediaries are bound by professional secrecy, or in the absence of intermediaries, the reporting obligations are generally shifted to the taxpayer.

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, carrying out tax audits, etc.) (see DAC 6, recital No. 2).

This article analyzes interpretation issues in relation to the MDR and advocates a reasonable approach that is consistent with the purpose and objectives of DAC 6.

1. Variations in DAC 6 implementation across Europe

DAC 6 provides for a framework of mandatory disclosure rules that can be understood as a minimum standard. However, EU member states are free to broaden the scope of the MDR; for example, through the inclusion of additional hallmarks or the expansion of the reporting obligations to mere domestic arrangements (rather than only to cross-border arrangements).

DAC 6 further requires EU member states to introduce penalties that must be effective, proportionate and dissuasive. This requirement seems to pose some interpretation issues among legislators, as the maximum penalties adopted for non-compliance with the MDR vary significantly, from amounts below 10,000 euros ($8,360) in Ireland to excessive penalties of up to 5 million euros per non-reported arrangement in Poland (which has already implemented the MDR as from January 1, 2019).

Apart from variations in respect of MDR laws, the vague definitions and concepts used in DAC 6 are open to interpretation, which will likely result in different reporting preferences on the part of intermediaries and taxpayers within the same EU member state and across the EU. Moreover, the attitude of the tax authorities involved will likely vary from one member state to another.

In light of the above, it might happen that a cross-border arrangement is not reportable under the MDR of one of the EU member states concerned, whereas the same arrangement is reportable under the MDR of another EU member state.

2. What is an arrangement?

The MDR requires EU intermediaries to report cross-border arrangements that are potentially aggressive tax planning arrangements. The term "arrangement" may also include a series of arrangements and an arrangement may comprise more than one step (see Article 1 No. 1 of the Luxembourg Draft Law implementing DAC 6). Hence, the understanding of the term "arrangement" within the meaning of the MDR is rather broad.

An arrangement is considered as cross-border if it concerns either (i) more than one EU member state, or (ii) an EU member state and a third country (in particular, when not all of the participants to the arrangement are resident for tax purposes in the same jurisdiction).

When a taxpayer merely considers a hypothetical transaction with an intermediary that is not implemented in the end, there should be no arrangement that might be reportable under the MDR. Intermediaries should be careful when it is initially not clear whether an arrangement will be implemented or not, so as to avoid "phantom reporting." An investment may not be implemented, for example, because the due diligence brought to light unexpected issues and risks or the parties cannot agree on the sale price.

Reporting obligations under the MDR should be analyzed upon implementation of an arrangement, including subsequent changes to such arrangement. For example, when a loan facility is granted, additional drawdowns or (partial) repayments of the loan should not be arrangements on their own.

Likewise, standard transactions such as dividend payments or the repatriation of cash through the redemption of an existing financing instrument should not be arrangements within the meaning of the MDR: after all, the investment structure and the financing instruments had to be analyzed upon the implementation of the investment, the restructuring, etc.

3. What is an intermediary?

The reporting responsibilities regarding cross-border arrangements generally rest with the intermediary. An "intermediary" is defined as any person that designs, markets, organizes or makes available for implementation or manages the implementation of a reportable cross-border arrangement.

The circle of intermediaries further includes any person that knows, or could be reasonably expected to know, that they have undertaken to provide (directly or by means of other persons), aid, assistance or advice with respect to designing, marketing, organizing, making available for implementation or managing the implementation of a reportable cross-border arrangement.

Accordingly, the definition of intermediaries envisages two distinct types of intermediaries:
primary intermediaries that are involved in designing, marketing, organizing or managing the implementation of an arrangement; and
secondary intermediaries who provide aid, assistance or advice in relation to the designing, marketing, organizing or implementation of reportable cross-border arrangements.

It follows that the understanding of the concept of intermediary is very broad and may include, in particular, tax advisers, lawyers, financial advisers and accountants. However, as the case may be, other service providers such as consultants, banks, insurance companies or investment managers may qualify as intermediaries within the meaning of the MDR.

Therefore, it may often not be self-evident whether a service provider is an intermediary. This is all the more true in case of secondary intermediaries that are only remotely involved in a transaction. Intermediaries are not, however, expected to do significant extra due diligence to establish whether there is a reportable arrangement. Intermediaries are further not expected to start investigations into arrangements that they are merely aware of.

In these circumstances, the defense for service providers that they did not know and could not reasonably be expected to know that they were part of a reportable arrangement may often be validly put forward, since a service provider might only be involved in a particular part of a wider arrangement, such as a bank providing finance or facilitating payments.

4. Some ambiguous hallmarks

Cross-border arrangements may be reportable if they contain at least one of the "hallmarks" set out in the Appendix to DAC 6. These hallmarks describe characteristics or features of cross-border arrangements that might present an indication of a potential risk of tax avoidance.

However, several hallmarks leave room for interpretation including, in particular:

- the "standardized tax product" hallmark: an arrangement that has substantially standardized documentation and/or structure and is available to more than one relevant taxpayer without a need to be substantially customized for implementation.

This hallmark is intended to capture what is often referred to as "mass-marketed schemes," which means an arrangement made available to more than one person and that uses standardized documentation not tailored to any material extent to the client's situation.

The fundamental characteristic of such schemes is their ease of replication. Essentially, all the client purchases is a prepared tax product that requires little, if any, modification to suit the client's particular situation and circumstances. The adoption of the scheme further does not require the taxpayer to receive significant additional professional advice or services.

The "standardized tax product" hallmark should not, however, be met in case of documentation such as loan agreements, service agreements and fund documentation, as this type of documentation has to be adapted to each individual case. (Investment funds, loan agreements, etc., which are typically used in Luxembourg fund structures are legitimate investment vehicles and commercial transactions that are not open to be interpreted as "standardized tax products".) Whether or not a service provider has templates that may serve as a basis for the preparation of such contracts and documentation does not change this conclusion.

While some advisers seem to consider that transactions such as dividend distributions or the increase and decrease of loan agreements may satisfy the "standardized tax product" hallmark, it is even questionable why a transaction that is closely linked to a cross-border arrangement (that has been analyzed upon implementation) should be treated as an arrangement on its own.

- The "converting income scheme" hallmark: an arrangement that has the effect of converting income into capital, gifts or other categories of revenue which are taxed at a lower level or exempt from tax.

This hallmark addresses schemes for converting income into capital, gifts or other categories of revenue with the intention to benefit from a lower level of taxation.

Here, the question arises whether a transaction as trivial as the financing of participations with debt and the related payment of interest paid out of dividends and capital gains realized in relation to the participation meets the converting income scheme.

Nevertheless, the "converting income scheme" hallmark is only met if the converted income is subject to a lower level of taxation or benefits from a tax exemption at the level of the investor(s). The conversion of income should generally require the involvement of a company. Thus, there should be a comparison of the (hypothetical) tax treatment of the income realized by the company (had it been realized by the investor) with the tax treatment of the actual income (capital or gift) realized by the investor. This obviously requires information on the foreign tax treatment of investors that may often not be available.

- The "circular transactions" hallmark: an arrangement which includes circular transactions resulting in the round-tripping of funds, namely through involving interposed entities without other primary commercial function or transactions that offset or cancel each other or that have other similar features.

This hallmark targets arrangements that include circular transactions involving interposed entities (without any economic activity other than participating in these transactions) or transactions that overall offset each other.

Thus, this hallmark targets non-genuine arrangements and arrangements that are characterized by some artificiality (i.e. offsetting each other) and the absence of genuine economic reasons. On the contrary, an arrangement should not satisfy this hallmark when genuine economic reasons can be established for its existence.

The "circular transaction" hallmark should not be met in case of standard transactions within a group of companies such as the payment in kind of a liability with a receivable or the offsetting of a liability with a receivable (as a payment in kind) between two entities that are performed for legitimate commercial reasons.

It is interesting to note that the aforementioned hallmarks are subject to the main benefit test

(MBT) as a threshold requirement, not triggering automatic reporting obligations.

Another hallmark that may give rise to interpretation issues is the unilateral safe harbor hallmark.

- The "unilateral safe harbor" hallmark: an arrangement which involves the use of unilateral safe harbor rules.

This hallmark captures transactions that rely on unilateral safe harbour rules adopted for transfer pricing purposes. As this hallmark is not subject to the MBT, it triggers automatic reporting obligations. Therefore, it is even more important to clearly delineate the scope of this hallmark.

According to the Organization for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines https://www.oecd.org/tax/transfer-pricing/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-20769717.htm "a safe harbour in a transfer pricing regime is a provision that applies to a defined category of taxpayers or transactions and relieves eligible taxpayers from certain obligations otherwise imposed by a country's general transfer pricing rules" (Para. 4.102 of the OECD Transfer Pricing Guidelines). It is further stated that safe harbors involve a trade-off between strict compliance with the arm's length principle and administrability (Para. 4.112).

The Guidelines provide two examples of a safe harbor:

- The safe harbor could allow taxpayers to establish transfer prices in a specific way, for example, by applying a simplified transfer pricing approach provided by the tax administration; or
- The safe harbor could exempt a defined category of taxpayers or transactions from the application of all or part of the general transfer pricing rules.

Transfer pricing safe harbors do not, however, include administrative simplification measures which do not directly involve the determination of arm's length prices such as simplified, or exemption from, documentation requirements (in the absence of a pricing determination), and procedures whereby a tax administration and a taxpayer agree on transfer pricing in advance of the controlled transaction (advance pricing agreements) (Para. 4.103).

The OECD Transfer Pricing Guidelines (Para. 4.105) provide three basic objectives of a safe harbor mechanism:

- simplifying compliance and reducing compliance costs for eligible taxpayers in determining and documenting appropriate conditions for qualifying controlled transactions;
- providing certainty to eligible taxpayers that the price charged or paid on qualifying controlled transactions will be accepted by the tax administrations that have adopted the safe harbor with a limited audit or without an audit beyond ensuring the taxpayer has met the eligibility conditions of, and complied with, the safe harbor provisions;
- permitting tax administrations to redirect their administrative resources from the examination of lower risk transactions to the examination of more complex or higher risk transactions and taxpayers.

In light of the objectives of transfer pricing safe harbors (in particular, the third objective), it is difficult to comprehend the purposes of this hallmark (and related reporting obligations) that would directly counter these objectives (i.e. creating reporting on controlled transactions that are deemed to be minor).

Safe harbor rules that apply in regard to specific anti-abuse provisions such as the interest limitation rules (e.g. the 3 million euro safe harbor applicable under Luxembourg tax law), or the administrative practice of allowing a (maximum) 85:15 debt-to-equity ratio in regard to holding activities performed by Luxembourg companies that is designed to prevent excessive debt funding, cannot be considered as transfer pricing safe harbours.

- The "business restructuring" hallmark: 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 result in a significant reduction of the profitability of an entity as a consequence of the cross-border business restructuring. This could, for example, involve 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 cases, a significant drop in profitability might be expected at arm's length. It is worth mentioning that business restructurings should also be described in a multinational's master file.

The mere transfer of assets by a company (for example, participations or loan receivables) or the liquidation of a company should not be a business restructuring that comes within the scope of this hallmark even if, in the case of a liquidation, the activities of the liquidated company are subsequently performed by another company. Instead, it is evident that this hallmark is targeted at business restructurings within the meaning of Chapter IX of the OECD Transfer Pricing Guidelines.

Applying a different approach to these transfer pricing hallmarks would mean that virtually each and every cross-border investment structure is reportable, resulting in a data cemetery that will not serve the purpose of the MDR.

5. When is the main benefit test met?

The MDR operates through a system of hallmarks that may trigger reporting obligations, and the MBT that 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 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, the MBT sets a relatively high threshold for disclosure.

It is interesting to note that DAC 6 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 (iii) a preferential tax regime. Likewise, the "converting income scheme" hallmark is subject to the MBT despite the fact that investors may benefit from a full tax exemption (suggesting that a tax exemption does not, on its own, suffice for the MBT to be met).

With regard to the application of disclosure rules to international investment structures, 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.

Indeed, each and every arrangement triggers tax consequences and there are generally several options available to taxpayers. However, taxpayers cannot be expected to choose an alternative that is resulting in higher taxes. On the contrary, investment managers and multinationals have a fiduciary duty towards their investors not to pay more taxes than legally due (considering all applicable tax laws).

Taxpayers are free to choose the option that results in the lowest tax liability including, amongst others, the choice of financing instruments (be it equity or debt) and, in an EU context, the choice of the EU member state in which an entity is established and managed (also referred to as freedom of establishment). Thus, the very fact that there exists an alternative that gives rise to a higher effective tax rate cannot inform the analysis of the MBT (unless it can be established that the tax advantage defeats the object or purpose of the applicable tax law).

When there is a series of arrangements, the MBT should be applied in regard to the series of arrangements rather than singling out one specific arrangement. In addition, when a new arrangement is included in a series of arrangements, it should be the series of arrangements that is tested for the purposes of the MBT.

Overall, the MBT comes down to the assessment as to whether an arrangement or a series of arrangements is tax driven (i.e. targeting a tax benefit that is not ancillary to the commercial benefit) or the tax advantage is ancillary to the main benefit of generating on-going income and benefiting from value appreciation at the end of the investment (the latter can be referred to as optimizing the tax position in accordance with all applicable tax laws).

Last but not least, the EU Anti-Tax Avoidance Directives ("ATAD 1 & 2") required EU Member

States to implement as from 2019 a number of anti-abuse rules in their domestic tax laws including, hybrid mismatch rules, interest limitation rules, controlled foreign company ("CFC") rules, a general anti-abuse rule ("GAAR") and exit tax rules. Thus, there exist explicit rules in all the areas that have been identified as critical and taxpayers can merely comply with the applicable rules rather than taking advantage of loopholes that may otherwise meet the MBT.

6. When does the 30 day reporting period begin?

Another very practical aspect of the MDR that may give rise to uncertainties is the question of when the reporting period begins to run. The earliest event that can realistically trigger a disclosure requirement is the point at which an intermediary makes a scheme available to a taxpayer.

According to DAC 6, intermediaries have to file information that is within their knowledge, possession or control on reportable cross-border arrangements within 30 days beginning:

a) on the day after the reportable cross-border arrangement is made available for implementation; or
b) on the day after the reportable cross-border arrangement is ready for implementation; or
c) when the first step in the implementation of the reportable cross-border arrangement has been made,

whichever occurs first (Article 2 (1) of the Draft Law). Alternatively, intermediaries should be required to file information within 30 days beginning on the day after they provided, directly or indirectly, aid, assistance or advice (Article 2 (1) of the Draft Law).

Given this fairly tight time window, it would be wise to consider potential reporting obligations at a very early stage (as part of the initial analysis of an arrangement). When it is concluded that the arrangement is not subject to reporting, the 30-day reporting period is irrelevant. In contrast, when a cross-border arrangement is reportable under the MDR of any of the EU member states concerned, the start of the reporting period is very relevant and needs to be carefully monitored (the start of the reporting period may also vary from one intermediary to another based on the timing of its involvement).

As phantom reporting (that is reporting on arrangements that are finally not implemented) would not advance the objective of DAC 6, intermediaries should keep their analysis in draft form until it is clear that the reportable arrangement will be implemented. This would also ensure that the fact pattern presented in the final analysis is consistent with reality and does not describe an outdated situation.

7. To sum up

The reporting obligations under the MDR will soon become a reality in the EU and require intermediaries and taxpayers to deal with a backlog relating to cross-border arrangements whose first step was implemented since June 25, 2018, as DAC 6 applies with retroactive effect.

It can be anticipated that the reporting obligations under the MDR will become an integral part of each and every tax analysis and be omnipresent in discussions between taxpayers and their service providers. As such, the new reporting obligations will not only have an impact on tax advisers but also on lawyers, financial advisers, accountants, banks, etc., and the taxpayers themselves that have, at a minimum, to fulfil a coordination role between the different service providers in Luxembourg (and abroad). This on its own will achieve the desired deterrence effect, as both intermediaries and taxpayers will need to consider potential reporting obligations carefully at all times.

For the time being, DAC 6 creates considerable legal uncertainty because of the introduction of vague definitions and concepts, variations in the scope of the MDR in different EU member states combined, expected varying attitudes on the part of the tax authorities involved, uncertainties around the beginning of the reporting period, and a lack of guidance from the European Commission and local legislators.

Responding to this uncertainty through systematic over-reporting would, however, be bad for a number of reasons. Tax authorities would need to dedicate scarce resources to searching for a needle in a haystack, taxpayers may be put in the spotlight despite the conditions of the MDR not being met, and taxpayers may face reputational risk as it can be assumed that investors and other stakeholders will be interested in DAC 6 reporting.

8. Planning points

Compliance with the MDR is essentially about the avoidance of penalties. Therefore, intermediaries and taxpayers have to focus on developing an appropriate process that is systematically followed. The analysis of potential reporting obligations should be performed as soon as a cross-border arrangement is considered, so as to be able to comply with the short reporting deadlines (if reporting is necessary).

Overall, the efforts used by intermediaries and taxpayers should be commensurate with the activities performed and the volume of cross-border arrangements to be assessed. Service providers that are involved in a large number of cross-border arrangements would be wise to prepare a comprehensive DAC 6 policy that defines internal processes, allocates roles and responsibilities and provides practical guidance. Intermediaries and taxpayers involved in several EU member states should further aim at a consistent interpretation throughout Europe (to the extent this is possible, given variations in the transposition of DAC 6).

Ultimately, with less than four months before the MDR enters into force on July 1, 2020, DAC 6 readiness is becoming an urgent matter for both intermediaries and taxpayers alike.

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