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INSIGHT: The New Mandatory Disclosure Regime: Navigating between Penalties

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In the second of a series of three articles, Oliver R. Hoor and Fanny Bueb of ATOZ Tax Advisers (Taxand Luxembourg) provide an overview of the scope of the mandatory disclosure regime and analyze the fine line between penalties for non-compliance and penalties for the violation of professional secrecy in case of over-reporting.

1. Introduction

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 for reportable cross-border arrangements https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32018L0822&from=EN ("DAC 6") was submitted by the government to the Luxembourg parliament on August 8, 2019. The Draft Law is expected to be adopted soon and will apply as from July 1, 2020.
Under the mandatory disclosure regime (MDR), tax 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.

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).

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

2. Reporting obligations under the MDR

2.1. Tax intermediaries

The reporting responsibilities regarding cross-border arrangements generally rest with the tax 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 that 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 intermediaries is very broad and may include, in particular, tax advisers, lawyers, financial advisers and accountants. However, other service providers such as consultants, banks, insurance companies or investment managers may qualify as intermediaries within the meaning of the MDR.

Given the very broad definition of tax intermediaries, it may often not be self-evident whether a service provider is a tax intermediary: this is still more true in the case of secondary intermediaries that are only remotely involved in a transaction.

2.2. How to determine reportable cross-border arrangements?

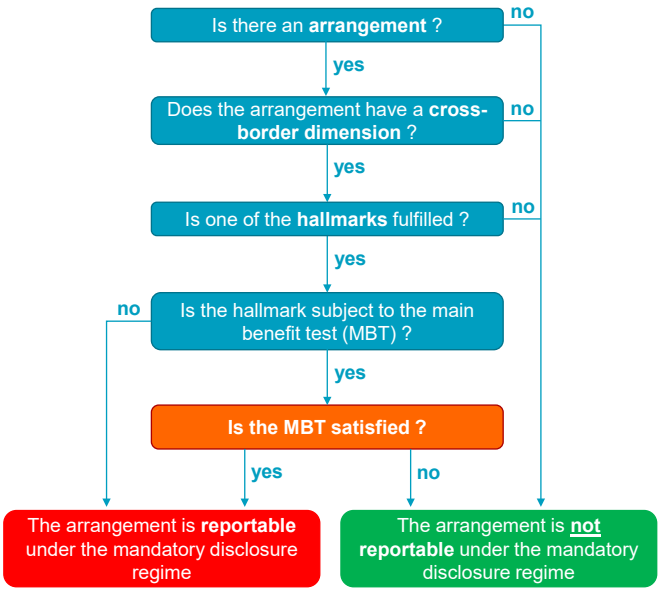
The MDR operates through a system of "hallmarks" that may trigger reporting obligations, and the main benefit test (MBT) that functions as a threshold requirement for many of these hallmarks. As such, the MBT should filter out irrelevant reporting and enhance the usefulness of the information collected,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

The 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 MDR is very broad. When determining whether advice on a particular arrangement is reportable under the MDR, it first has to be analyzed 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 must 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 an objective 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:



2.3. Penalties for non-compliance

DAC 6 requires EU member states to introduce penalties that must be effective, proportionate and dissuasive. According to the Draft Law, the penalties for non-compliance with the MDR amount to a maximum of 250,000 euros ($278,000) and may be levied on tax intermediaries and taxpayers—i.e., when the reporting obligation is, in the absence of an intermediary, shifted to the taxpayer (Article 15 (1) of the Draft Law). Penalties levied for non-compliance with the MDR should be due by the company rather than being a personal liability of any employee or director of the intermediary.

The Luxembourg tax administration will verify whether tax intermediaries and taxpayers adopt a proper process for ensuring compliance with the MDR (Article 16 (1) of the Draft Law). Such MDR process should ideally be formalized in a DAC 6 policy that may provide guidance for employees (interpretation of the hallmarks and the MBT, compilation of a white list of arrangements, etc.), set out roles and responsibilities, and consider practical aspects such as how the reporting is

managed from an operational perspective (work instructions, sign off process, etc.).

Based on experience with penalties in regard to other tax reporting obligations (common reporting standard, FATCA and country-by-country reporting), it can be assumed that the Luxembourg tax authorities will levy measured penalties in case of wrongdoing, taking into consideration the level of care taken by the tax intermediaries and taxpayers.

Thus, when tax intermediaries and taxpayers use their best efforts and dedicate appropriate resources to the implementation of a DAC 6 process (including training of staff) and its systematic application (which should be properly documented), there should be a limited risk of penalties. On the contrary, in the absence of appropriate efforts to comply with the MDR, it may be expected that the Luxembourg tax authorities will levy penalties in case of failure to meet the reporting obligations.

3. Professional secrecy under Luxembourg law

Tax intermediaries are generally bound by professional secrecy rules that are governed by Article 458 of the Penal Code. According to this provision, non-compliance with professional secrecy is punishable with imprisonment between eight days and six months, and a fine of 500–5,000 euros. This is a criminal penalty that is imposed on the individual employee that violates the professional secrecy.

Specific professional secrecy rules apply to certain professions and industries including, in particular, Certified Public Accountants (Articles 4, 6 of the Law of June 10, 1999 relating to the organization of the profession of Expert Comptable, lawyers (Article 19 of the Law of August 10, 1991 on the legal profession), credit institutions (Article 41 of the Law of April 5, 1993 on the financial sector) and insurance companies (Article 300 of the Law of December 7, 2015 on the insurance sector). All these rules have in common that a violation would be subject to the penalties laid down in Article 458 of the Penal Code.

However, the obligation to maintain secrecy does not exist when disclosure of information is authorized or required by law. Therefore, tax intermediaries are exempt from their professional secrecy to the extent a cross-border arrangement is reportable under the MDR.

As an exception to this rule, lawyers may, in accordance with the Draft Law, rely on their legal professional secrecy and have the right to a waiver from filing information on a reportable cross-border arrangement. However, lawyers acting as intermediaries must still notify their waiver to any other intermediary (or, when there is no other tax intermediary, the taxpayer) and report certain information to the Luxembourg tax authorities (information about the cross-border arrangement on a no-name basis and declaration of the other intermediaries involved: Article 3 (1) of the Draft Law).

However, in the recent opinion of the Luxembourg State Council on the Draft Law, the State Council opposed the different treatment of lawyers from other professions subject to professional secrecy. According to the State Council, such different treatment would be inconsistent with the Luxembourg Constitution. The State Council requested the legislature to amend the Draft Law to extend the exemption from reporting obligations to other intermediaries subject to professional secrecy. It therefore remains to be seen whether all intermediaries that are subject to professional secrecy may not report under the MDR; in which case the potential reporting obligations would be shifted to the taxpayers.

4. To sum up

The new reporting obligations under the MDR will soon become a reality and require tax 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 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, ultimately, the investors 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 carefully potential reporting obligations at all times.

The Draft Law largely resembles DAC 6 and does not provide for any further guidance. Thus, the legal uncertainty inherent in some of the vague definitions and concepts introduced by DAC 6 remains, and intermediaries have to analyze carefully whether or not a cross-border arrangement is reportable. As an example, many of the hallmarks entail a certain ambiguity. Here, the MBT will be extremely helpful to arrive at a clear-cut result (to the extent a hallmark is subject to the MBT as threshold requirement).

The analysis of reporting obligations will be particularly complex for service providers that are not tax specialists. However, it may be expected that the assessment of potential reporting obligations will often be made by a tax adviser and followed by the secondary intermediates.

Nevertheless, intermediaries would be wise not to conclude that in case of doubt, a cross-border arrangement should be reported. While a company that does not comply with the reporting obligations under the MDR may be punished with penalties of up to 250,000 euros, it will be the employees engaging in over-reporting that violate their professional secrecy and risk personal penalties in the form of imprisonment and fines.

Intermediaries therefore have to take their obligations under the MDR very seriously and dedicate the appropriate resources to comply with the new reporting obligations.

5. Planning points

Compliance with the MDR is essentially about the avoidance of penalties. Intermediaries and taxpayers therefore have to focus on developing an appropriate process that is systematically followed. The analysis of potential reporting obligations should further be performed as soon as a cross-border arrangement is considered, 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, the volume of cross-border arrangements to be assessed, and the EU member states relevant for the organization. Service providers 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, intermediaries and taxpayers are now in a position to prepare themselves for the new reporting obligations that will apply as from July 1, 2020. With less than six months to go, DAC 6 readiness is becoming an urgent matter.

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