Proposal for new transparency rules for intermediaries:

Could the Commission be on the brink of requiring Coca-Cola to disclose its famous recipe?

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On 21 June 2017, the European Commission published a proposal (the "Proposal") for a Council directive that aims at amending Directive 2011/16/EU by imposing an obligation on intermediaries to report any cross-border arrangement which contains one or more of the "hallmarks" set forth in the Proposal to the competent tax authority so that the latter be in a position to automatically exchange that information with other EU member States (the "Member States").

Background

It is now well established that one of the key political priorities of the European Union (the "**EU**") is to tackle tax avoidance and evasion so as to create a fairer single market amongst the various Member States.

The Proposal aims at once again amending Council Directive 2011/16/EU of 15 February 2011 on administrative cooperation in the field of taxation that repealed Directive 77/799/EEC and which has already been amended a fairly significant number of times:
- with Directive 2014/107/EU of 9 December 2014 regarding financial account information and common reporting standard;
- with Directive 2015/2376/EU of 8 December 2015 regarding the mandatory exchange of cross-border rulings and advance pricing arrangements; and
- with Directive 2016/881/EU of 25 May 2016 on country-by-country reporting.

In parallel, another proposal for amending the Directive 2013/34/EU as regards disclosure of income tax information by certain undertakings and branches was published on 12 April 2016. It proposes setting up a public country-by-country reporting so that information relating to tax paid and where the profits are made by large multinational enterprises would be publicly made available.

The Proposal to amend Directive 2011/16/EU which was published by the Commission on 21 June 2017 is therefore the latest instrument that is part of the broader tax transparency package. This is a reaction to scandals such as the Panama papers and LuxLeaks, as well as the more recent Malta papers.

This article will address (i) the origins of the Commission's Proposal, and (ii) the scope of the proposed new rules.

Origins of the Proposal

The European Parliament has called for a tougher stance on intermediaries that assist in tax evasion schemes whilst Member States have suggested that the Commission consider initiatives to legislate on the mandatory disclosure rules which stem from Action 12 of the base erosion and profit shifting ("**BEPS**") project in order to introduce more effective disincentives for intermediaries that assist in tax evasion or avoidance schemes.

Whilst neither the Proposal nor the Commission Staff Working Document – Impact Assessment accompanying the Proposal (the "**Working Document**") provide for a clear definition of what constitutes tax avoidance and tax evasion, the Commission Staff Working Document considers that aggressive tax planning includes taking advantage of mismatches in the interaction between two or more tax systems for the purposes of reducing the overall tax liability of a taxpayer or group of companies. Such a working premise is, in the author's view, flawed in that it puts the sole burden of responsibility onto the taxpayer while disregarding an important part of the equation: Member States remain sovereign when it comes to legislating in direct tax matters.

This therefore inevitably results in multiple pieces of domestic legislation which may all aim at addressing the same legal issue and/or which have the same legislative intent. Any attempt to achieve uniformity amongst these various legislations can therefore only be utopian and, as such, this may involuntarily and unknowingly result in mismatches in the interaction between two or more tax systems. The Working Document further considers that aggressive tax planning includes taking advantage of the technical features of a tax system and concedes that a key characteristic of these aggressive tax planning practices usually involves strictly legal arrangements which contradict the intent of the law.

One should question why the law and its technical features were not originally drafted in a way that is clear enough so as to ensure that no misunderstanding can occur in so far as the intent of law is concerned, and that it does not contain any of those technical features which taxpayers could take advantage of.

The Proposal would therefore aim at addressing each Member State's apparent inability to precisely legislate, and more fundamentally would imply that EU law would indirectly take over in the field of direct taxation using article 115 of the Functioning of the European Union as an intrusion tool.

The Working Document further analysed the current mandatory disclosure regimes in jurisdictions located both within and outside the EU. Whilst all have their own specificities (and hence inherent mismatches), one common denominator amongst them is that none of these national regimes cover cross-border schemes.

It is with these guiding principles that the Commission prepared the Proposal.

Scope of the proposed new rule

The rules set out in the Proposal will oblige Member States to take the necessary measures to require intermediaries to file information with the competent tax authorities on a reportable cross-border arrangement or series of arrangements within five working days beginning on the day after the reportable cross-border arrangement or series of arrangements is made available for implementation. Where the intermediary is entitled to a legal professional privilege under its national law, the responsibility will then be shifted onto the taxpayer. Equally, the taxpayer will have the responsibility to file the same information where there is no such intermediary.

The information so received would then be automatically exchanged by the competent tax authority on a regular basis with all other Member States.

What is a cross-border arrangement?

A cross-border arrangement is an arrangement or series of arrangements in either more than one Member State or a Member State and a third country where at least one of the following conditions are met: (i) not all the parties are resident for tax purposes in the same jurisdiction, (ii) one or more of the parties is simultaneously resident for tax purposes in more than one jurisdiction, (iii) one or more of the parties carries on a business in another jurisdiction through a permanent establishment and the arrangements form part or the whole of the business of the permanent establishment or (iv) the arrangements have a tax-related impact on at least two jurisdictions.

This definition is consequently not subject to a separate cumulative requirement that there be a tax impact on at least two jurisdictions, which therefore results in an extremely broad scope of what may constitute a cross-border arrangement. It is therefore not entirely unlikely that even a wholly domestic arrangement could meet the definition. Therefore, one may anticipate that most, if not, all cross-border transactions will likely be captured by this definition thereby substantially increasing the potentiality of reporting volume.

What is a reportable cross-border arrangement?

For information to be filed with the competent tax authorities, the cross-border arrangement has to be a reportable one, that is to say one that satisfies at least one of the hallmarks set out in the annex IV to the Proposal. These hallmarks are split into two categories: (i) general hallmarks and (ii) specific hallmarks. General hallmarks and category B specific hallmarks have to meet a main benefit test. This test will be satisfied where the main benefit of an arrangement or of a series of arrangements is to obtain a tax advantage if it can be established that the advantage is the outcome which one may expect to derive from such an arrangement. This definition is in the author's view circular and suggests that the mere fact that there is an advantage which may have been deliberately made available by the relevant Member State as an outcome to an arrangement suffices to conclude that the main benefit is to obtain that advantage, and that as such would not prevent the arrangement from being reportable.

This is deeply disturbing from an interpretational perspective and invites the risk of bringing a complete lack of legal certainty to taxpayers, although one of the key objectives of the Working Document when designing the disclosure regime was to ensure legal certainty about which types of schemes or arrangements would be disclosed to the tax authorities so that the disclosure regime would be efficient.

Without going into detail for each hallmark, hallmark B1 suggests that any loss utilisation – even by the very taxpayer that generated them – would become a reportable cross-border arrangement. Companies, in the same way as finance generally, encounter cycles where they are loss-making at some point, and eventually profit-marking at another. Yet, this hallmark implies that companies that are utilising their own losses to offset taxable profit – which is probably a common tax concept amongst a majority of jurisdictions worldwide, albeit with local specificities, would be carrying out a potentially aggressive tax arrangement.

The Working Document further suggests that it will not impact small and medium enterprises, grounding its reasoning on the fact that solely multinational enterprises are engaged in potentially tax aggressive tax planning arrangements. One may, for example, assume that a start-up company that operates cross-border that has yet to reach a profitable status will therefore be captured by the rules, thereby totally contradicting the results of the research that was performed as summarised in annex 4 of the Working Document.

Not only would this contradict the intent of the Proposal, but it would further constitute a rather significant hindrance to the European economy by involuntarily putting too high a burden on all market players, including notably small and medium enterprises. Such an approach could, in the longer run, annihilate the very purpose of the Proposal – which is to establish a fairer and deeper single market amongst the various Member States – as it would clearly result in rendering European economy less competitive.

Category E specific hallmark on transfer pricing is once again very wide in that it captures everything that is not compliant with the arm's length principle.

The hallmarks of the Proposal have been presumably widely drawn so as to facilitate achieving the aim of this new tax transparency initiative, an initiative whose goal is to ensure that Member States receive an early warning of potentially aggressive tax planning arrangements so that they may be in a position to assess their potential risks and legislate accordingly, but this imprecise drafting is likely to result in complete legal uncertainty.

When does the report have to be done?

The Proposal provides a very tight deadline within which to file the information. Indeed, information will have to be filed within five working days beginning on the day after the reportable cross-border arrangement or series of arrangements is made available for implementation to a taxpayer where the intermediary files or, where the responsibility shifts onto the taxpayer, within five working days after the first step of the implementation. The reporting will therefore clearly be an *ex post* reporting although one of the key objectives of the Proposal is to obtain timely and early information about the arrangements, preferably *ex ante*, so that Member States may react quickly and accordingly.

Closing remarks

The Proposal further has to be considered from a proportionality perspective.

The Working Document concludes that the Proposal is in line with the proportionality principle on the basis that (i) the proposed rules are limited to addressing potentially aggressive tax planning schemes containing a cross-border element and (ii) that the imposition of penalties for non-compliance with national provisions that implement the proposed Directive into national law will remain under the sovereign control of Member States. However, it has to be questioned whether the wide definition of what constitutes a reportable cross-border arrangement could be seen as being disproportionate, for it could technically encompass a wide array of schemes which (i) may not necessarily have a tax impact in more than one jurisdiction (the Proposal targets potentially aggressive tax planning arrangements whereas the very existence of one should be a, if not the, fundamental principle underlying the Proposal) and (ii) may not necessarily be illegitimate or illegal.

In addition, the fact that imposition of penalties are left to national discretion would presumably imply that the taxpayer remains entitled to an effective judicial remedy as guaranteed by the European Convention for the Protection of Human Rights and Fundamental Freedoms as well as Article 47 of the Charter of the Fundamental Rights of the European Union because the national penalties would result from an obligation imposed by an EU Directive. This was judged by the European Court of the European Union on 16 May 2016 in the case C-682/15, *Berlioz Investment Fund SA v Directeur de l'Administration des Contributions Directes*. The question here is how such a fundamental right could be guaranteed in the specific context of the mandatory exchange of information.

Moreover, due to the recent developments in this field, namely the various amendments to the Council Directive 2011/16/EU together with Directive 2016/1164/EU laying down rules against tax avoidance practices that directly affect the functioning of the internal market as amended by the Anti-Avoidance Directive II which was formally adopted by the EU Council on 29 May 2017, it is questionable whether EU Member States do not already have the necessary tools to combat tax evasion and could proceed, where necessary, to changes in their domestic legislation to secure their fiscal revenues.

Finally, from a strict cost-benefit analysis, the Working Document suggests that the Proposal should not bring any additional burden or cost onto intermediaries or taxpayers, or even tax authorities. Indeed, while it is conceded in the Working Document that the impact on total tax loss is difficult to measure given the nature of tax avoidance and evasion, the Proposal works on the assumption that intermediaries would simply have to share the notes which are being prepared for their clients. This assumption is fundamentally erroneous as files which are being exchanged between taxpayers and their advisors probably contain information which goes well beyond the simple arrangement that is intended to be implemented (and is certainly one of the reasons why this information is legally privileged).

Although potentially everyone would like to know the famous Coca-Cola recipe, one could legitimately argue that the Proposal could lead to potential disclosure of trade secrets and know-how which would clearly be contrary to the fundamental right to privacy as enshrined in, amongst others, the Universal Declaration of Human Rights of 1948. Moreover, in light of the wide definition of reportable cross-border arrangement set forth in the Proposal, it is doubtful that the competent tax authorities will have the necessary staff to review all filed reportable cross-border arrangements.

Conclusion

The Commission has been very active in the past recent years to propose legislative instruments that would enhance transparency within the EU so as to combat tax avoidance and tax evasion. These various initiatives have received very positive feedback from taxpayers and intermediaries alike. The Proposal is the latest publication in this regard and aims at addressing technical points which the previous legislation apparently did not address. However, its effects – under the current proposed drafting – are likely to attract fairly negative feedback from market players.

The rules that are contained therein go well beyond any proportionality principle, invite the risk of creating substantial legal uncertainty for taxpayers and due to their extremely wide scope, are likely to capture all cross-border arrangements which will inevitably result in information overload both on the taxpayers' and intermediaries' end, but also on the part of the competent tax authorities.

The risk of information overload gives way to a much greater danger of seeing this disclosure regime become entirely useless as it would lack a key fundamental element: legal certainty for the taxpayer. It would therefore be advisable for the Commission to reconsider this Proposal and possibly assess beforehand whether the existing tools that Member States possess are not already sufficient to achieve the goals which are being set.

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