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International Tax News®

European Union

INSIGHT: The New Reporting Obligations of Tax Intermediaries in the EU (Part 1)

BY OLIVER R. HOOR AND KEITH O'DONNELL

The so-called sixth Directive on Administrative Cooperation (''DAC6'', the ''Directive''), adopted by the Economic and Financial Affairs Council on May 25, 2018, requires EU member states to introduce in their national law mandatory disclosure rules for cross-border arrangements.

Part 1 of this two-part series looks at the key features of the new regime and the requirements it introduces.

The new Directive has been inspired by the Final Report on Action 12 of the Organization for Economic Cooperation and Development (''OECD'') Base Erosion and Profit Shifting (''BEPS'') Project that provides recommendations regarding the design of mandatory disclosure rules for aggressive and abusive transactions, arrangements or structures.

The Directive requires tax intermediaries to report certain ''cross-border arrangements'' that contain at least one of the hallmarks (that are characteristics or features of cross-border arrangements) defined in the Directive.

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

This article analyzes the features of the new mandatory disclosure regime and provides clear guidance as to when a specific arrangement is reportable or not. DAC 6 requires reporting in respect of transactions implemented after June 25, 2018, so it already has effect even though the implementing legislation is not yet available.

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Key Features of the New Reporting Regime

Reportable Arrangements Arrangements that come within the scope of at least one of the hallmarks defined in Appendix IV to the Directive may need to be reported under the mandatory disclosure regime. The hallmarks describe characteristics or features of cross-border arrangements that might present an indication of a potential risk of tax avoidance.

Hallmarks are generally divided into two categories: generic and specific hallmarks.

Generic hallmarks target features that are common to promoted schemes, such as the requirement for confidentiality or the payment of a premium fee. Generic hallmarks can be used to capture new and innovative tax planning arrangements as well as mass-marketed transactions that promoters may easily replicate and sell to a variety of taxpayers.

Specific hallmarks are used to target known vulnerabilities in the tax system and techniques that are commonly used in tax avoidance arrangements such as the

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use of loss creation, leasing and income conversion schemes.

The Directive sets out the following five categories of hallmarks:

- general hallmarks linked to the main benefit test ("MBT");
- specific hallmarks linked to the MBT;
- specific hallmarks related to cross-border transactions;
- specific hallmarks concerning automatic exchange of information and beneficial ownership; and
- specific hallmarks concerning transfer pricing.

The term ''arrangement'' is meant to have a broad meaning and may also include a series of arrangements. However, the reporting obligations are limited to ''cross-border'' situations, namely those involving either more than one member state or a member state and a third country.

The reporting regime limits the number of reportable cross-border arrangements through the adoption of a threshold condition. This means that many of the hallmarks only trigger a reporting obligation to the extent an arrangement meets the MBT, reducing the risk of excessive or defensive filings.

This should enhance the usefulness of the information collected because the focus will be on arrangements that have a higher probability of serving the purpose of the disclosure regime.

Reporting Responsibilities The reporting responsibilities regarding cross-border arrangements that fall within the scope of the Directive generally rest with the tax intermediary, unless such reporting would be a breach of the intermediary's legal professional privilege. In the latter case, the intermediary should notify any other intermediary or, if there is no such intermediary, the relevant taxpayer of their reporting obligation.

Luxembourg lawyers, tax advisers, accountants and other service providers are all bound by professional secrecy. Non-compliance with the professional secrecy may, in accordance with Article 458 of the Luxembourg Penal Code, be punished with imprisonment (up to six months) and a fine (up to 5,000 euros ($5,860)).

Accordingly, when a cross-border arrangement is reportable, the reporting obligation should be shifted to the taxpayer except where the taxpayer explicitly waives its right of confidentiality. This aspect should be clarified by the Luxembourg legislator when implementing the Directive into Luxembourg law.

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. This may include, in particular, tax advisers, lawyers and accountants.

The Directive further extends the circle of intermediaries to ''any persons that know, 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 understanding of the term ''tax intermediary'' is very broad, including any professional that provides, or is aware of, tax advisory services, thus including banks or other parties that might not be actively involved in the design or marketing of the arrangement.

The reporting obligations under the Directive are limited to intermediaries that have a European Union (''EU'') nexus based on tax residency, incorporation, etc. Hence, non-EU intermediaries do not have any reporting obligations under the Directive. In these circumstances, a potential reporting obligation would be shifted to the taxpayer benefiting from the cross-border arrangement.

Likewise, when there is no tax intermediary because, for instance, the taxpayer designs and implements a scheme in-house, the reporting obligation rests with the taxpayer who benefits from the arrangement.

Overlapping Reporting Obligations The broad definition of the term intermediary may result in overlapping reporting obligations. According to the Directive, when there is more than one intermediary, the obligation to file information on the reportable cross-border arrangement lies with all intermediaries involved. Intermediaries should only be exempt from their reporting obligations to the extent they can prove that the same arrangement has already been filed by another intermediary.

Thus, it does not suffice to prove that another intermediary has committed to do the reporting, but it is necessary to prove the effective reporting by another intermediary. This obviously requires a certain extent of coordination between the advisers in order to determine whether or not a cross-border arrangement is reportable and, if so, only one intermediary files a report so as to avoid multiple filings in relation to the same arrangement.

When a cross-border arrangement is not reportable under the mandatory disclosure regime, taxpayers should consider, as a best practice, to have this point analyzed and documented by one of the intermediaries involved. This would prove that the taxpayer has carefully considered the potential obligations under the Directive. Moreover, other tax intermediaries may reasonably rely on such analysis.

When an intermediary is liable to file information on reportable cross-border arrangements with the competent authorities of more than one EU member state, the Directive provides for rules to identify one single EU member state in which the filing should be made.

In case the reporting obligations rest with the taxpayer because the intermediaries would other-wise breach their legal professional privilege, taxpayers may also be subject to multiple reporting obligations in different EU member states. Here, the Directive provides for rules to determine one single EU member state in which the filing should be made.

When there are several relevant taxpayers, the Directive provides for rules to determine the one single taxpayer that should report the arrangement.

Timing Aspects The earliest event that can realistically trigger a disclosure requirement is the point at which a tax intermediary makes a scheme available to a taxpayer. With regard to the timing of the reporting, the Directive states that tax intermediaries have to file information that is within their knowledge, possession or control on reportable cross-border arrangements within 30 days beginning:

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

whichever occurs first.

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.

In addition, there exists a periodic reporting obligation, every three months, for cross-border arrangements that are to be classified as marketable arrangements. These are defined as arrangements that are designed, marketed, ready for implementation or made available for implementation without a need to be substantially customized.

The first reporting has to be made by August 31, 2020, covering reportable arrangements as from June 25, 2018 (the date of entry into force of the Directive). It follows that tax intermediaries have to track potentially reportable advice since June 25, 2018.

In addition, relevant taxpayers may be required to file information about their use of an arrangement in each of the years in which they use it.

The information collected by the tax authorities is subject to automatic exchange of information with the tax authorities of all other EU member states through a centralized database.

The exchange of information should take place within one month following the end of the quarter in which the information was filed. Accordingly, the first information is to be communicated by October 31, 2020.

Penalties for Non-compliance The Directive requires EU member states to implement penalties for non-compliance which should be effective, proportionate and dissuasive. Considering the penalties introduced by Luxembourg in regard to the Common Reporting Standard, the Foreign Account Tax Compliance Act or exchange of information on demand, it can be expected that the maximum penalty in Luxembourg should amount to 250,000 euros.

However, in practice, the Luxembourg tax authorities will probably levy measured penalties in case of wrongdoing, taking into consideration the level of care taken by the tax intermediaries and taxpayers.

Part 2 of this series will consider the MBT.

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INSIGHT: The New Reporting Obligations of Tax Intermediaries in the EU (Part 2)

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In order for a cross-border arrangement to require reporting, it must come within the scope of at least one of the generic and specific hallmarks, as outlined in Part 1 of this series.

Many of the hallmarks set out in Appendix IV to the sixth Directive on Administrative Cooperation (''DAC6'', the ''Directive'') are subject to an additional threshold test.

The Main Benefit Test The European Union (''EU'') opted for the main benefit test (''MBT'') which is the most common threshold requirement. The purpose of the MBT is to filter out irrelevant disclosure and to reduce some of the compliance and administration burden of the disclosure regime by targeting only tax-motivated transactions that are likely to pose the greatest tax policy and revenue risks.

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.''

According to the Final Report on BEPS Action 12, the MBT compares the value of the expected tax advantage with any other benefit likely to be obtained from the transaction. This requires an objective analysis of all benefits obtained from an arrangement and is assumed to set a relatively high threshold for disclosure.

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Thus, the management of the tax position of a cross-border arrangement or investment that aims at generating income should not meet this threshold condition, since any tax benefit, quite naturally, can only be a fraction of the overall income.

In other words, for the MBT to be met taxpayers need to engage in transactions or schemes with a view to obtaining tax advantages rather than optimizing the tax position of an arrangement that is intended to generate income.

It is interesting to note that the Directive 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.

When analyzing the MBT, it can also be helpful to have a look at the U.K. The U.K. introduced rules on Disclosure of Tax Avoidance Schemes (''DOTAS'') back in 2004 that are built, like the mandatory disclosure regime provided in the Directive, around a set of hallmarks which determine whether a scheme should be reported. The U.K. also adopted the MBT as a threshold condition.

Guidance provided by HM Revenue & Customs (''HMRC'') in regard to the MBT explicitly states that ''the advantage is one of the main benefits of the arrangements if it is a significant or important element of the benefits and not incidental or insubstantial.'' Accordingly, the test is objective and considers the value of the expected tax advantage compared to the value of any other benefits likely to be enjoyed.

The guidance further states that it should be obvious to any potential client what the relationship is between the tax advantage and any other financial benefits of the product they are buying.

HRMC publishes annual statistics about the number of reported schemes. The latest available statistics cover the period from 2006 until 2014. It is interesting to note that in the years 2012 until 2014, the number of reported arrangements dropped significantly. In the period from April 1, 2014 until September 30, 2014, there have been fewer than five disclosures under the U.K. mandatory disclosure regime applicable to corporate taxpayers (that is the main regime).

The number of reported arrangements generally seems to be very low compared to the number of transactions entered into by U.K. companies and international investments made in the U.K., suggesting that the MBT is effective in filtering out all legitimate investment activities and keeping the focus on abusive types of arrangements where the tax benefit is a main benefit of the arrangement.

Thus, for example, any inbound investment into the U.K. might benefit from a tax benefit if appropriately structured—this was generally the case for investments in commercial real estate by a nonresident over this reference period, where use of a suitable foreign investment vehicle allowed a non-taxation of capital gains. However, the existence of a tax benefit per se would not satisfy the MBT, as the tax benefit was incidental and not a main benefit of the investment transaction.

Moreover, it may be speculated that the marked drop of reported arrangements since 2012 may be a direct consequence of the OECD BEPS project, the related media coverage and the anticipation of changes in the international tax landscape leading taxpayers and their advisers to steer clear of aggressive schemes.

Planning Points The objective of DAC6 is to discourage the use of aggressive cross-border planning arrangements. DAC6 requires EU member states to introduce mandatory disclosure rules for cross-border arrangements that fulfill certain hallmarks. DAC6 has been inspired by the recommendations provided in the Final Report on Action 12 of the OECD BEPS project regarding the design of mandatory disclosure rules for aggressive and abusive transactions, arrangements or structures.

When determining whether advice on a particular arrangement is reportable under the mandatory disclosure regime, it first has to be analyzed whether the arrangement has a cross-border dimension. Thereafter, it has to be analyzed whether one of the hallmarks is present. While some of the hallmarks, when present in a cross-border arrangement, trigger automatic disclosure obligations, other hallmarks are subject to a threshold condition (i.e., the MBT).

Where the MBT applies, it should set a relatively high threshold for disclosure, filtering out irrelevant disclosures which would otherwise dilute the relevance of the information received by tax administrations and increase the costs and administrative burden for taxpayers, tax administrations and tax intermediaries.

In practice, cross-border 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.

The mandatory disclosure regime applies to reportable cross-border arrangements as from June 25, 2018 and requires first filings by the end of August 2020. Thus, tax intermediaries and taxpayers have to get ready and track potentially reportable arrangements.

Ultimately, this timeline forces all parties involved to constantly consider reporting obligations under the new disclosure regime, which will likely have the desired deterrence effect.

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