# CONTINUED D.A.C.6 REPORTING OBLIGATIONS AFTER BREXIT

**Author**
Gary Ashford

**Tags**
Category D
DAC6
Hallmark
Mandatory Disclosure Reporting

## INTRODUCTION

At midnight on the December 31, 2020, the U.K. left the E.U., having secured a Free Trade Agreement ("F.T.A."). This occurred in the context of four years of political discussion, several Parliaments, two Prime Ministers and what amounted to two Withdrawal Agreements (but eventually only one F.T.A.). There is no doubt that Brexit has significant implications on the U.K. International V.A.T. rules. Prior to the U.K. exit, V.A.T. was essentially an E.U. administered tax by virtue of the V.A.T. Directive, and continues for the 27 Member States remaining in the E.U. However, the headline grabber relates to the E.U. Directive of Administrative Cooperation ("D.A.C.") known as D.A.C. 6.

## E.U. DIRECTIVE OF ADMINISTRATIVE COOPERATION ("D.A.C.")

**Rules Through December 31, 2020**

The E.U. D.A.C. is one of the key tools E.U. membership countries use to exchange information automatically. Over the years, six different directives have been issued by the European Commission. All of them relate to mandatory exchanges of information designed to shine a light on aggressive tax planning.

- The first D.A.C. (2011/16/E.U.) was introduced in 2013 and provided for automatic exchange of investment interest information by financial institutions where a resident of one Member State held an investment account in another. This D.A.C., now referred to as D.A.C.1, was updated in 2015 to allow for the automatic exchange of information of employment income, directors fees, pensions, life insurance products and immovable property.
- D.A.C.2 (2014/107/E.U.) was introduced in 2016 to effectively implement the O.E.C.D. Standard for Automatic Exchange of financial account Information in Tax Matters, commonly known as the Common Reporting Standard ("C.R.S.").
- D.A.C.3 (2015/2376/E.U.) introduced the automatic exchange of advance cross border tax rulings and advance transfer pricing arrangements in 2017.
- D.A.C.4 (2016/881/E.U.) was also introduced in 2017. It introduced automatic exchanges of country-by-country reporting, the method by which headcount, assets, and income must be reported by large corporate groups.

Gary Ashford, C.T.A. Fellow, A.T.T., is a partner (non-lawyer) at Harbottle and Lewis LLP, London. His practice focuses on high net worth individuals, non-domiciled taxation, and cross border transactions.

- D.A.C.5 (2016/2258/E.U.) brought in the mechanism to hold and exchange information regarding beneficial ownership of vehicles used in cross border tax plans. In the U.K. there are registers on both corporate and trust beneficial ownership.
- D.A.C.6 (2018/822/E.U.) implements B.E.P.S. Action12, relating to Mandatory Disclosure Reporting ("M.D.R.") by Intermediaries.[1] The implementation of D.A.C.6 has been postponed a number of times because of COVID19. The current U.K. reporting deadlines are as follows.
    - For reportable arrangements where the first step was implemented between June 25, 2018, and June 30 ,2020, the deadline February 28, 2021.
    - For arrangements made available or implemented between July 1, 2020, and December 31, 2020, the deadline is January 30, 2021.
    - For arrangements which become reportable after January 1, 2021, the deadline is 30 days from the triggering event. E.U. intermediaries are required to identify and report upon cross-border arrangements which fall within Hallmarks A to E., some of which are reportable only where obtaining a tax advantage is the main purpose for entering an arrangement.

## INFORMATION REPORTING UNDER D.A.C.

Under D.A.C.6, an arrangement will be reportable if it meets at least one of several hallmarks. The hallmarks are delineated by category. Some hallmarks within the various categories must meet a main benefit test; others not. Briefly, the categories of hallmarks that trigger D.A.C.6 reporting are as follows:

### Category A

- *Confidentiality* – Arrangements where the participant or taxpayer enters into a confidentiality agreement that prevents disclosure to other intermediaries or tax authorities of information describing how the arrangement could result in a tax advantage. This hallmark is subject to the main benefit test.
- *Premium Fee Arrangements* – Arrangements where the intermediary fee is based on the tax saved or a similar advantage gained. This hallmark is subject to the main benefit test.
- *Standardized Documentation* – Arrangements involving standardized documentation without substantial customization. This hallmark is subject to the main benefit test.

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[1] See Ashford, Gary, "U.K. Mandatory Disclosure Regime (DAC6)," *Insights* 7, no. 3 (2020): p.11.

**Category B**

- *Loss Buying – Arrangements* involving buying a loss-making company to reduce the tax liability. This hallmark is subject to main the benefit test.
- *Conversion of Income to Capital* – Arrangements which have the effect of converting income into capital gains or another type of income that is taxable at lower rates. This hallmark is subject to the main benefit test.
- *Circular Transactions* – Arrangements involving circular transactions with little or no commercial function. This hallmark is subject to the main benefit test.

**Category C**

- *Cross Border Arrangements with Abusive Facts* - Transactions between associated enterprises where any of the following facts exist:
    - The recipient has no tax residence. Here, the hallmark is not subject to main benefit test.
    - The country of tax residence has a zero or close to zero corporation tax rate. The hallmark is subject to main benefit test.
    - The country is included in the O.E.C.D. list as being a non-cooperative jurisdiction. The hallmark is not subject to main benefit test.
    - The payment is exempt from tax in the hands of the recipient in the jurisdiction of receipt. The hallmark is subject to main benefit test.
    - The payment benefits from a preferential tax regime in the jurisdiction of receipt. The hallmark is subject to main benefit test.
- *Double Deduction Arrangements* – Arrangements involving deductions in more than one jurisdiction. The hallmark is not subject to the main benefit test.
- *Double Reliefs from Double Taxation* – Arrangements involving the claiming of relief from double taxation on the same item in more than one jurisdiction. The hallmark is not subject to the main benefit test.
- *Inconsistent Values for Same Transaction* – Arrangements involving the transfer of assets where there is a material difference in the amount treated as payable in consideration for the assets in the jurisdictions involved. The hallmark is not subject to the main benefit test.

**Category D**

- *Transactions to Evade Reporting* – Arrangements which have the effect of undermining the rules on beneficial ownership or any other equivalent agreement on automatic exchange of financial account information or arrangements structured to take advantage of the absence of such automatic exchanges of information. The hallmark is not subject to main benefit test.
- *Hidden Ownership* – Arrangements involving a nontransparent legal or beneficial ownership chain with the use of persons, legal arrangements, or structures that

- do not carry on a substantive economic activity supported by adequate staff, equipment, assets, and premises; and
- are incorporated, managed, resident, controlled or established in any jurisdiction other than the jurisdiction of residence of one or more of the beneficial owners of the assets held by such persons, legal arrangements, or structures.

This hallmark is not subject to the main benefit test.

**Category E**

- *Abusive Transfer Pricing* – Arrangements concerning transfer pricing, including the use of unilateral safe harbors in one of the jurisdictions, or the transfer of hard-to-value intangible assets when no reliable comparable transactions exist, and the projection of future cash flows or income are highly uncertain. This hallmark is not subject to the main benefit test.

## CHANGE IN U.K. RULES AS OF JANUARY 1, 2021

**Brave New World**

On December 29, 2020, H.M.R.C. announced that reporting under D.A.C.6 will be limited to Hallmark D. That hallmark involves fact patterns that are patently designed to hide ownership. Under the F.T.A., the U.K. undertook an obligation to avoid weakening or reducing the level of protection below the level provided for by the standards and rules which have been agreed in the O.E.C.D. in relation to the exchange of information concerning potential cross-border tax planning arrangements. The standard referred to is the O.E.C.D.'s model M.D.R.

While the U.K. has not implemented the O.E.C.D. M.D.R. in domestic legislation, existing rules that were designed to transpose D.A.C.6 into U.K. domestic law were in existence on December 31, 2020. Those rules will be revised so that they are limited to reporting Category D transactions. In principle, by retaining Category D reporting, the U.K. will meet the requirements of the F.T.A.

H.M.R.C. has announced that it will announce a period for consultation on draft legislation designed to implement the O.E.C.D. M.D.R.

**Continued Reporting Under Category D Hallmark**

Hallmark D is not linked to the main benefit test. If arrangements come within the Hallmark D, they are reportable regardless, regardless of the importance to the arrangement.

As mentioned above, the O.E.C.D. standard for M.D.R. must be part of the anticipated U.K. legislation. The O.E.C.D. introduced guidance on March 9, 2018, in relation to mandatory reporting. The M.D.R. effectively requires the reporting of two arrangements. One relates to the avoidance of C.R.S. reporting. The other relates to opaque structures.

## C.R.S. Avoidance Arrangements

Here, reporting involves the automatic exchange of financial account information to countries having a contact with participants. This includes C.R.S. reporting, but potentially could go further into other automatic exchange of information ("A.E.O.I.") agreements regarding financial accounts.

According to the O.E.C.D. guidance,[2] arrangements that come within the scope of continued reporting include the following:

- The use of an account, product or investment that is not, or that purports not to be, a financial account, but has features that are substantially similar to those of a financial account.
- The transfer of financial accounts or assets to, or the use of entities based in, jurisdictions that are not bound by the automatic exchange of financial account information with the State of residence of the relevant taxpayer.
- The reclassification of income and capital into products or payments that are not subject to the automatic exchange o financial account information.
- The transfer or conversion of a financial institution or a financial account or the assets therein into a financial institution or a financial account or assets that are not subject to reporting under the automatic exchange of financial account information.
- The use of legal entities, arrangements or structures that eliminate or purport to eliminate reporting of one or more account holders or controlling persons under the A.E.O.I.
- Arrangements that undermine, or exploit weaknesses in, the due diligence procedures used by financial institutions to comply with their obligations to report financial account information, including the use of jurisdictions with inadequate or weak regimes of enforcement of anti-money-laundering legislation or with weak transparency requirements for legal persons or legal arrangements.[3]

***"The M.D.R. Report states that the test of a reportable arrangement is whether it is reasonable to conclude that the arrangement is a C.R.S. avoidance arrangement."***

The M.D.R. Report states that the test of a reportable arrangement is whether it is reasonable to conclude that the arrangement is a C.R.S. avoidance arrangement. Presumably, this will be based on reasonable conclusions in light of all the facts and circumstances. Of course, the standard likely is to be judged by compliance officers and regulators. Hence, it may be more accurate to describe the standard as whether it is reasonable from the viewpoint of a compliance officer or regulator to conclude that the arrangement is designed to have, or is marketed as having, the effect of circumventing C.R.S. legislation? If yes, the transaction is reportable.

Note, however, that the M.D.R. Report states the following regarding conversion of accounts:

> The simple fact that an Arrangement has the effect of non-reporting is not sufficient for it to be considered to have the effect of circumventing

[2] O.E.C.D. Model Mandatory Disclosure Rules for CRS Avoidance Arrangements and Opaque Offshore Structures (2018) ("O.E.C.D. M.D.R. Report").

[3] M.D.R. Report, p.14.

> CRS Legislation. This will only be the case where it is reasonable to conclude that the Arrangement undermines the intended policy of the CRS Legislation. The mandatory disclosure rules are not intended to second guess clear policy choices that were made in the design of the CRS. For instance, real estate is an asset class that is not within the intended scope of the CRS. As a result, an Arrangement to withdraw funds from a reportable Depository Account to purchase an apartment will not constitute a CRS Avoidance Arrangement despite the fact that the Arrangement results in non-reporting of the funds that are used for the purchase. Similarly, the CRS expressly provides for categories of Excluded Accounts and Non-Reporting Financial Institutions that are excluded from reporting to minimize compliance burdens and because, on balance, they do not pose a substantial risk of non-compliance. Accordingly, a transfer of funds from a reportable Depository Account into a pension product that qualifies as an Excluded Account, will, in normal circumstances, not be considered to have the effect of circumventing CRS Legislation.[4]

The same provision of the M.D.R. Report proceeds with illustrations of reportable conversion transactions. They tend to focus on marketing and moving from the C.R.S. reporting system to the F.A.T.C.A. reporting system where full U.B.O. reporting does not occur.

> However, the marketing of a scheme that makes use of such an exclusion in ways that undermine the policy rationale for providing that exclusion would be considered a CRS Avoidance Arrangement. An Arrangement does not have the effect of circumventing CRS Legislation if the Financial Account(s) information is exchanged under a FATCA Model 1A Intergovernmental Agreement with the jurisdiction(s) of tax residence of the Reportable Taxpayer. For example, if a Reportable Taxpayer that is tax resident in jurisdiction X transfers a Financial Account to the United States, that transfer would not have the effect of circumventing CRS Legislation, provided the account information is exchanged by the Competent Authority of the United States with jurisdiction X.[5]

In terms of the test of reasonableness, the M.D.R. Report states:

> The test of "reasonable to conclude" is to be determined from an objective standpoint by reference to all the facts and circumstances and without reference to the subjective intention of the persons involved. Thus, the test will be satisfied where a reasonable person in the position of a professional adviser with a full understanding of the terms and consequences of the Arrangement and the circumstances in which it is designed, marketed and used, would come to this conclusion.[6]

In practice, the standard likely is to be judged by compliance officers and regulators. Hence, it may be more accurate to describe the standard as whether it is reasonable

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4 Paragraph 1.1.5, M.D.R. Report, p. 25.

5 *Id.*

6 Paragraph 1.1.6, M.D.R. Report, p. 25.

from the viewpoint of a compliance officer or regulator to conclude that the arrangement is designed to have, or is marketed as having, the effect of circumventing C.R.S. legislation? If yes, it would be prudent for a professional adviser assess the transaction as reportable.

Finally, the M.D.R. Report states that for reporting to be required, an "intent" standard must be met by the intermediary.

> The fact that an Arrangement is a CRS Avoidance Arrangement will not, on its own, make that Arrangement subject to disclosure by the Intermediary under these model rules. For this to be the case, there must also be an Intermediary operating within the reporting jurisdiction that is either responsible for the design or marketing of that Arrangement or that provides Relevant Services and can reasonably be expected to know that the Arrangement is a CRS Avoidance Arrangement. The test of what an Intermediary "can reasonably be expected to know" is to be determined from an objective standpoint by reference to all the facts and circumstances and without reference to the subjective intention of the persons involved. Thus, the test will be satisfied where a reasonable person in the position of a professional adviser would be aware of this information. * * * [7]

## Opaque Offshore Structures

The second reporting category is for arrangements involving a passive offshore vehicle that is held through an Opaque Structure. The M.D.R. Report describes a passive offshore vehicle as a Legal Person or Legal Arrangement that does not carry on a substantive economic activity supported by adequate staff, equipment, assets, and premises in the jurisdiction where it is established or is tax resident.[8] An opaque structure is a structure that meets three tests:

- It is reasonable to conclude that the structure (i) is designed to allow, (ii) is marketed as allowing, or (iii) has the effect of allowing a natural person to be a beneficial owner of a passive offshore vehicle.
- It is reasonable to conclude that the structure (i) does not allow for the accurate determination of such beneficial ownership or (ii) creates the appearance that such person is not a beneficial owner.
- It is reasonable to conclude the obfuscation of beneficial ownership is achieved through (i) the use of nominee shareholders with undisclosed nominators, (ii) the use of means of indirect control beyond formal ownership, (iii) the use of arrangements that provide a beneficial owner to have access to assets without being identified as a beneficial owner, (iv) the absence of any requirement or mechanism to obtain basic information as to the identity of beneficial owners, as defined in the latest Financial Action Task Force recommendations, or (v) the absence of any requirement or mechanism for a trustee to obtain information on the beneficial ownership of trust income and assets.

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[7] Paragraph 1.1.7 of the M.D.R. Report, p. 25.

[8] Paragraph 1.2.

## REPORTING BY U.K. INTERMEDIARIES WHEN CATEGORY D HALLMARK EXISTS

For outside advisers categorized as intermediaries to a cross border arrangement possibly containing a Category D Hallmark, the reporting obligations of D.A.C.6 remain applicable. Consequently, an outside adviser must go through the normal routine applicable under D.A.C.6.

***"Under D.A.C. 6, an intermediary is any person that designs, markets, organizes or makes available for implementation, or manages the implementation of a reportable cross border arrangement."***

### Adviser as an Intermediary

Under D.A.C. 6, an intermediary is any person that designs, markets, organizes or makes available for implementation, or manages the implementation of a reportable cross border arrangement.

Covered by the above definition is any person that knows or can reasonably be expected to know that it has undertaken the performance of the foregoing services, knows or could be reasonably expected to know that they have undertaken to aid, assist, or provide advice with respect to the design, marketing, organizing, or managing the implementation of a reportable cross border arrangement. This latter group of intermediaries is sometimes referred to as service providers.

### Lack of Knowledge as a Defense

In the event of noncompliance with reporting obligations, a claim of reasonable lack of knowledge is a defense for service providers. Access to the defense is lost when a service provider deliberately structures matters to avoid having knowledge even though standards of performance generally knowledge of the customer. If access to the defense is denied, civil and criminal penalties may be imposed by H.M.R.C.

### Reporting Based on U.K. Nexus

Reporting is required if the taxpayer involved in the cross border transaction has a U.K. nexus and for that reason is relevant U.K. taxpayer. This occurs in any of the following circumstances:

- The U.K. is the jurisdiction where the relevant taxpayer is resident for tax purposes.
- The U.K. is the jurisdiction where the relevant taxpayer maintains a permanent establishment benefiting from the arrangement.
- The U.K. is the jurisdiction where the relevant taxpayer receives income or generates profits, even though the relevant taxpayer is neither a resident for tax purposes in an E.U. member State nor maintains a permanent establishment in an E.U. Member State.
- The U.K. is the jurisdiction where the relevant taxpayer carries on an activity, although the relevant taxpayer is neither a resident of the U.K. for U.K. tax purposes nor maintains a permanent establishment in the U.K.

The U.K. leaving the E.U. on December 31, 2020 will open up a number of potential challenges for clients and advisers.

## CONCLUSION

Many advisers in the U.K. and other jurisdictions are delighted that the U.K. has significantly limited the scope of the reporting under D.A.C.6. Beginning this year, such reporting is limited to transactions covered the Category D hallmark – C.R.S. avoidance transactions and opaque overseas structures. U.K. advisers and advisers in third country advisers where the U.K. is the only connection to Europe should be able to benefit from limited D.A.C.6 coverage. The reduction is not a total reduction. In line with broader international obligations the U.K. will likely continue to hold beneficial ownership registers for corporations and trusts, and will be a leading participant on O.E.C.D. initiatives and those of the Financial Action Task Force.