Executive summary

The United Kingdom (UK) Government has published draft legislation, the International Tax Enforcement (Disclosable Arrangements) Regulations 2019, which is intended to implement the European Union (EU) Directive on the mandatory disclosure and exchange of cross-border tax arrangements (referred to as DAC6 or the Directive).

The draft legislation was issued on 22 July 2019 and is currently subject to public consultation. A consultation document was issued by HM Revenue and Customs (HMRC) alongside the draft legislation and comments on the proposals are requested by 11 October 2019.

The UK draft legislation is subject to the usual legislative process for Statutory Instruments and may well be amended before the final version is laid before Parliament. The consultation document commits the UK Government to producing guidance relating to the application of the final legislation.

The consultation document includes a comment to the effect that leaving the EU will not reduce the UK’s resolve to tackle international tax avoidance and evasion and that the UK will remain an active and influential member of the Organisation for Economic Co-operation and Development (OECD) and the G20.
If implemented as currently proposed in the draft legislation, the UK Mandatory Disclosure Rules (MDR) will be broadly aligned to the requirements of the Directive, and will apply many of the same definitions (including of the terms “cross border arrangement,” “hallmark,” “intermediary,” “relevant taxpayer”) though the draft legislation is more detailed than the underlying Directive in a number of areas and the consultation document provides further clarifications as to how HMRC may interpret and apply the UK legislation. In addition, the consultation provides greater detail on the application of the rules to service providers than the Directive, which may be of special relevance to financial services firms.

The draft legislation is expected to be finalized by 31 December 2019, to comply with the Directive, and to come into force on 1 July 2020.

Scope of taxes covered

The scope of the taxes covered by the UK draft legislation follows the Directive and the draft legislation accordingly applies to all taxes except VAT, customs duties, excise duties and compulsory social security contributions. Regulation 12(2) clarifies that the UK rules will apply to all taxes to which DAC6 applies and any equivalent tax in a jurisdiction other than a Member State. Thus, it is clear that the “tax advantage” under the Main Benefit Test does not have to be realized in a Member State for an arrangement to be reportable.

Reportable arrangements

Under the Directive, an arrangement is reportable if:

- The arrangement meets the definition of a cross-border arrangement; and
- The arrangement features at least one of the hallmarks specified in Annex IV of the Directive.

Cross-border arrangements are defined as arrangements concerning more than one Member State or a Member State and a third country. Certain hallmarks are subject to a Main Benefit Test (MBT).

The draft UK legislation defines reportable arrangements in the same manner as the Directive. In the UK consultation document, HMRC sets out its view that, for arrangements to “concern” multiple jurisdictions, those jurisdictions must be of some material relevance to the arrangement.

By way of example, the consultation document comments on the application of the rules to a company and its permanent establishment (PE), to the effect that an arrangement will not “concern” the company and, therefore, be viewed as “cross-border” solely because it is entered into by its PE and the PE is in the same jurisdiction as all other parties to the arrangement.

Main benefit test

In accordance with DAC6, the MBT will be satisfied 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, the obtaining of a tax advantage.”

The UK consultation document clarifies that this test is an objective one; it is not necessary to consider the specific motives of the person entering the arrangement but whether a tax advantage is one of the main benefits that the person in question would reasonably be expected to obtain from it.
The UK draft legislation provides a very broad definition of the term of “tax advantage” which includes:

i) Relief or increased relief from tax;
ii) Repayment or increased repayment of tax;
iii) Avoidance or reduction of a charge to tax or an assessment to tax;
iv) Avoidance of a possible assessment to tax;
v) Deferral of a payment of tax or advancement of a repayment of tax; and
vi) Avoidance of an obligation to deduct or account for tax.

The draft legislation appears to go further than the Directive by specifying that a tax advantage for this purpose will only arise where the obtaining of a tax advantage cannot reasonably be regarded as being consistent with the principles on which the provisions that are relevant to the reportable cross-border arrangement are based and the policy objectives of those provisions.

**Hallmarks A-E of the Directive**

Most elements of the hallmarks included in DAC6 are not expressly defined. The UK draft legislation applies the same hallmarks as the Directive but with additional clarifications on certain elements of the hallmarks. The consultation document provides further comments on the proposed application of the hallmarks.

Some of the key points of clarification are as follows.

**Category A (subject to MBT)**

The consultation document notes that the A hallmarks have similarities to existing categories of hallmarks in the UK’s domestic law for disclosure of tax avoidance schemes (DOTAS) and that HMRC intends to take a similar approach in interpreting both sets of rules.

On the specific hallmarks, the consultation document includes the following comments:

- **Hallmark A(1) (Confidentiality):** the definition of a confidential arrangement is widely drafted to include inter alia prohibitions on responding to HMRC information requests unless the request is made under statutory notice. However, the consultation document clarifies that the confidentiality arrangements should be specific, and that commercial confidentiality obligations that do not relate to how a tax advantage could be secured are not expected to trigger a reporting requirement.

- **Hallmark A(2) (Remuneration related to tax advantage):** the consultation document follows DAC6 and comments that the hallmark is deliberately broadly defined to ensure that it captures all types of fees and other financial arrangements which, broadly, relate to the amount of the tax advantage “derived” from the arrangement.

- **Hallmark A(3) (Standardized documentation):** the consultation document clarifies that the use of standardized documentation for many products, such as Individual Savings Accounts and enterprise investment schemes, are not inherently caught as they are unlikely to trigger the MBT. HMRC note that this is likely to be relevant for many common financial products and instruments.

As part of the discussion on Hallmark A, HMRC notes that the Directive is wider in scope than the Code of Practice for Banks, and so being Code-compliant will not mean that a bank is compliant with the Directive.

**Category B (subject to MBT)**

HMRC introduces the concept of a “hypothetical, informed observer” in relation to Hallmarks B1 and B2 (as well as D2, E2 and E3). This concept is used elsewhere in UK anti-avoidance legislation and guidance including DOTAS. In essence, this is a test of what such a person would reasonably conclude in relation to the arrangements in question, considering all relevant facts and circumstances.

The consultation document includes the following comments:

- **Hallmark B(1) (Loss buying):** would the informed observer reasonably conclude that the steps taken are straightforward and serve a commercial purpose or are complex for no evident commercial reason?

- **Hallmark B(2) (Income into capital):** the consultation focuses on the need for “conversion” and sees the appropriate test as whether the informed observer would reasonably conclude that there had been a conversion of income into some other non-taxable or low-tax form. The example is given of the provision to employees as part of their remuneration package of share options exercisable at a later date with an increase in value taxable as a chargeable gain. The document comments that this is unlikely by itself to trigger this hallmark, since here there is no “conversion” of income into capital but simply a choice made between different options which are widely used and have commercial rationale. However, the document goes on to say that where additional, artificial steps are taken which have the result of making the payments non-taxable, then it is likely that hallmark B(2) will be triggered as income will have been converted into non-taxable form.
Hallmark B(3)(Circular transactions): there must be a circular transaction resulting in the round tripping of funds which involves either interposed entities without primary commercial function, transactions that offset or cancel each other, or other similar features. The consultation document observes that this hallmark will commonly apply where funds are routed via an offshore jurisdiction, despite having a domestic origin, in order to benefit from preferential tax treaty terms or other similar benefits, a fact pattern which it states is commonly seen with respect to foreign direct investment.

Category C (MBT only applies to 1(b)(i), 1(c) and 1(d))

Hallmark C(1)(Deductible cross border payments): in relation to the definition of a recipient in the context of transparent vehicles such as general partnerships, the document states that it will be the partners who are recipients for the purpose of judging whether the hallmark is met. Also, it states that a tax rate is “almost zero” if it is less than 1%.

Hallmark C(1)(b)(ii) (Non-cooperative jurisdictions): the relevant list of non-cooperative states should be examined on the date the reporting obligation arises and does not need to be revisited subsequently. No exception is provided for countries which are added to the EU’s “blacklist” temporarily, such as Bermuda which was added in March 2019 and removed in May.

Hallmark C(1)(c) (Payment benefits from full exemption): the focus is on the nature of the payments rather than the status of the recipient which means that an exempt body such as a pension fund will not automatically be included.

Hallmark C(2) (Depreciation): the consultation document notes that claims for tax relief under either the capital allowances regime or the intangible fixed assets regime should be treated as being equivalent to depreciation for the purposes of applying this hallmark.

Hallmark C(4) (Transfer of assets): the consultation document states that the amount being treated as payable for the transfer of assets should be the amount payable for tax purposes, rather than for accounting purposes, in the relevant jurisdictions.

Category D (not subject to MBT)

The draft legislation specifies that these hallmarks must be interpreted in accordance with the Model Mandatory Disclosure Rules for Common Reporting Standard (CRS) Avoidance Arrangements and Opaque Offshore Structures approved by the OECD on 8 March 2018 and associated commentary.

Hallmark D1: The consultation notes that an arrangement is not reportable solely because it results in no report being made under CRS. It provides the example of a UK resident buying a house overseas as an example which should not result in reporting, drawing a comparison to the example of a promoter advising people to move funds to non-CRS jurisdictions to avoid reporting. The consultation does note that a bank transferring money to the non-CRS jurisdiction in the above example would not have to make a report provided it did not have insight into the arrangement as a whole or its expected effect.

It is likely that further examples along this spectrum would be useful to the interpretation of the terms “undermine” and “circumvent.”

Hallmark D2 (Obscuring beneficial ownership): the consultation refers again to the hypothetical informed observer and whether they would “reasonably” conclude that the effect of an arrangement is to allow a person to be the beneficial owner of an asset, without being identified as the owner by the relevant tax authorities, including HMRC. This includes undisclosed nominee shareholders, exercising control indirectly over an entity, and arrangements which use jurisdictions which do not require the disclosure of ownership, which would include bearer shares. The consultation specifically excludes institutional investors such as regulated banks, insurers and collective investment vehicles and pension funds from this definition.

Category E (not subject to MBT)

The draft legislation specifies that this category of hallmark does not apply if the relevant taxpayer and any associated enterprise are exempted from the basic transfer pricing rule by Chapter 3 of Part 4 to the Taxation (International and Other Provisions) Act 2010. This applies to small- and medium-sized enterprises as defined in the relevant provision.

The draft legislation also stipulates that the category E hallmarks must be interpreted in accordance with the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations approved by the OECD on 22 July 2010 as revised by the report, Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports, published by the OECD on 5 October 2015.
The consultation document provides the following additional commentary on the category E hallmarks.

- **Hallmark E(1) (Unilateral safe harbors):** clarification is provided that Advance Pricing Agreements (APAs) are not unilateral safe harbors and hence are not caught by hallmark E(1).

- **Hallmark E(2) (Hard-to-value intangibles (HTVIs)):** the consultation document uses the concept of the hypothetical informed observer and asks whether they would reasonably conclude that at the time of their transfer (a) no reliable comparables exist and (b) the projections of future cash flows or income expected to be derived from the transferred intangible, or the assumptions used in valuing the intangible, are highly uncertain, making it difficult to predict the level of ultimate success of the intangible at the time of the transfer.

- The assessment of whether there is an HTVI must be made at the time the obligation to report would have arisen. The consultation document helpfully notes that where the projections or comparables used subsequently prove to have been incorrect or unreliable it will not necessarily follow that the decision not to make a disclosure was incorrect.

- **Hallmark E(3) (Cross-border transfers of functions/assets/risks):** The hypothetical informed observer would need to consider whether the earnings of the transferor during the three-year period after the transaction would, on the balance of probabilities, be less than 50% of what they would otherwise have been. It is recognized there is a degree of uncertainty attaching to projections, but the document considers it likely that there will be detailed contemporaneous projections of the planned costs and outcomes of the transaction.

- The projected earnings must be tested at the individual company level rather than at the level of the UK sub-group. However, the document notes that this is subject to further review by HMRC if a different approach, e.g., a group-level approach, is taken in other jurisdictions.

- The consultation document recognizes that the earnings before interest and taxes (EBIT) may not be a sensible operating profit measure for certain entities and proposes that in such cases an equivalent measure can be used on a reasonable basis.

**Reportable parties**

Under the Directive, the primary obligation to report arrangements to the tax authority rests with EU intermediaries. The Directive gives Member States the option to exempt intermediaries from the obligation to report where the reporting obligation would breach legal professional privilege (LPP). If there are no intermediaries which are obliged to report, the obligation will shift to taxpayers.

**Intermediaries**

The draft UK legislation defines intermediaries by reference to the same definition of “intermediary” included in the Directive. The term “intermediary” is defined to include “promoters” which “design, market, organize and make available implementation or manage the implementation of a reportable cross border arrangement” and “service providers” which “provide aid, assistance or advice” in relation to the design, etc. of a reportable cross-border arrangement.

In the UK consultation document, it is stated that a service provider can show that they are not an intermediary because they did not know and could not reasonably be expected to know that they were involved in a reportable arrangement. An example is provided where a bank is providing finance but may have no knowledge of the wider arrangements.

There is no equivalent defense for promoters who according to the consultation document can reasonably be assumed to understand the entire arrangements.

As emphasized in the consultation paper, the definition of service provider is intentionally broad to ensure all types of intermediaries involved in reportable arrangements are required to report. The consultation document comments that “advice, aid or assistance” could include providing finance, expertise or knowledge, sharing experience or offering accounting advice.

Paragraph 3.8 of the consultation document will be of particular interest to the financial services sector and confirms that the provision of financial services to clients who are engaging in activities which meet the hallmarks may bring them into the definition of a service provider, even if they are not providing any tax or structuring advice themselves:

...a bank providing finance to a company that was carrying out an arrangement that was being implemented by a third-party promoter would be providing aid in relation to the managing of the implementation of the arrangement.

This view is consistent with previous communications from the EU Commission.
Clarification is provided that the term “intermediary” does not cover a person who subsequently becomes aware of an arrangement, for example an auditor, but has had no part in the arrangement before that time.

Knowledge, possession and control
In order to have an obligation to report a particular arrangement, a service provider must have the relevant information in its knowledge, possession or control. There is no equivalent defense for a promoter to say that they did not know they were involved in a reportable arrangement.

For service providers, there is likely to be considerable focus on whether and, if so, when they have knowledge that they are involved in a reportable arrangement. The consultation document goes on to say that an intermediary is not expected to “trawl” through computer systems to determine if an arrangement is reportable, but they do have to take account of information that is available to them and should review documents and information to identify the information that is reportable.

The draft legislation gives HMRC the power to request information or documents to determine whether the obligations under the legislation have been complied with. This includes inter alia evidence that an intermediary did not have knowledge of an arrangement, or to provide any other document that HMRC may reasonably require. Documents must be provided within 14 days of the request by HMRC. Intermediaries will need to maintain a robust audit trail of the decisions they make and the process they have followed in order to comply with these provisions.

For service providers who conduct extensive due diligence on counterparties, such as banks and other financial services firms, the scope of this “reasonably expected to know” obligation is likely to be a key focus.

Residence
An intermediary will have to make a report to HMRC if it is resident in the UK or has a PE in the UK through which it provides services in respect of the arrangement, or, is incorporated in the UK or registered with a professional association relating to legal, taxation or consultancy services in the UK. An intermediary does not however need to make a report to HMRC if it has made a report to another Member State and has evidence that the report has been made elsewhere.

Legal professional privilege
The UK legislation does not require the reporting of privileged information. However, an intermediary claiming LPP must notify other intermediaries or the relevant taxpayer of the reporting obligation. The reporting obligation then passes to the other party.

The consultation document states that this does not exempt law firms from reporting information which is not legally privileged and that HMRC expects that much information that will need to be reported will not be legally privileged because it will be factual in nature. This could, for example, include a description of the transactions to be undertaken, even if elements of the related advice are exempt from reporting.

Employees
The draft legislation clarifies that employees of an intermediary are not personally subject to the reporting obligations.

Relevant Taxpayer
The UK draft legislation applies the definition of “relevant taxpayer” in the Directive.

The consultation document states that a “relevant taxpayer” does not have to be resident in the UK or paying UK tax. The definition is broad and captures any person to whom a reportable arrangement is made available to implement, or who is ready to implement or who has implemented the first step of such an arrangement. It is not necessary for a person to have implemented or have started to implement the arrangement, or to have decided that they will implement the arrangement, to be considered a “relevant taxpayer.”

A relevant taxpayer will have the reporting obligation for a particular arrangement if there is no intermediary that is obliged to report that arrangement, including because of LPP. Where a relevant taxpayer has reported in another Member State and has evidence to support this, they are not required to report in the UK.

Reporting deadlines
Under the draft legislation and aligned with DAC6, the trigger events for reporting under the Directive (from 1 July 2020) are when the reportable arrangement is made available for implementation; or when the reportable arrangement is ready for implementation or when the first step of implementation has been made, whichever is earliest.
The consultation document indicates that the reporting process will be consistent with the EU General Data Protection Regulation (GDPR), but there are likely to be questions for intermediaries over the extent of coverage that the proposed legislation gives for GDPR purposes, in particular where there is a disagreement between the taxpayer and the intermediary as to whether an arrangement was reportable, and the ability of multiple intermediaries to exchange information about a relevant taxpayer.

**Penalties**

The draft legislation contains detailed penalty provisions, largely modelled on the existing DOTAS provisions, including for failures by intermediaries and relevant taxpayers to make returns of reportable information and to respond to requirements to provide information. For failures under these headings there is a maximum penalty of £600 per day and for certain other failures a flat rate penalty of up to £5,000. A relevant taxpayer who fails to comply with the requirement to make an annual report is liable to a penalty of up to £5,000 and up to £10,000 where there have been previous such failures.

Penalties are determined by the First Tier Tribunal which also has the power to increase penalties up to a maximum of £1 million if the penalty as otherwise calculated appears to them inappropriately low. In some circumstances HMRC will also have the power to determine penalties. The consultation document states that the penalty provisions are intended to encourage compliance and act as an appropriate and proportionate deterrent even for wealthy individuals and large businesses.

The draft legislation includes a right of appeal against a penalty determination as well as time limits for penalty proceedings and provides that no liability to a penalty will arise where a person has a reasonable excuse for failure to comply. Reasonable excuse does not include relying on advice from another intermediary who is also involved in the arrangement, meaning that a service provider cannot rely on advice from another intermediary as to whether a transaction is reportable or not.
Next steps
The UK draft legislation and consultation document has addressed some questions with respect to the UK interpretation and implementation of DAC6, although many questions remain unanswered. Responses to the public consultation are due by 11 October 2019, after which the draft legislation may be reviewed and revised to effect any proposed changes. Guidance will be published at that point. The Government intends to lay the regulations, which are in the form of a Statutory Instrument, before Parliament in advance of 31 December 2019.

EY expects to engage with HMRC throughout the process to provide detailed input on the draft legislation and consultation document.

Determining if there is a reportable cross-border arrangement raises complex technical and procedural issues for taxpayers and intermediaries. Taxpayers and intermediaries who have operations in UK should design processes for collating and assessing the necessary information and to enable logging and reporting of arrangements where necessary so that they are fully prepared for meeting both the UK and other local country obligations.

Endnotes
1. For background on MDR, see EY Global Tax Alert, EU publishes Directive on new mandatory transparency rules for intermediaries and taxpayers, dated 5 June 2018.
2. DAC6 sets out a minimum standard. Member States can take further measures; for example, (i) introduce reporting obligations for purely domestic arrangements; (ii) extend the scope of taxes covered; (iii) bring forward the start date for reporting.
Should you require help assessing how your organisation will be impacted by the draft legislation or wish to discuss responding to the public consultation, please get in touch with your regular EY contact or one of the individuals below.

**Ernst & Young LLP (United Kingdom), Financial Services, London**
- James Guthrie jguthrie@uk.ey.com
- Richard Milnes rmilnes@uk.ey.com
- Mark Persoff mpersoff@uk.ey.com
- Jenny Coletta jcoletta@uk.ey.com
- Dan Thompson dthompson2@uk.ey.com
- David Wren dwren@uk.ey.com

**Ernst & Young LLP (United Kingdom), London**
- Jo Myers jmyers@uk.ey.com
- Alison Christian achristian@uk.ey.com
- James Hume james.hume@uk.ey.com
- Helen Childers helen.childers@uk.ey.com
- Erica Fitchie erica.fitchie1@uk.ey.com
- Nigel Thavasi nigel.thavasi@uk.ey.com

**Ernst & Young LLP (United States), UK Tax Desk, New York**
- Matthew Williams matthew.williams1@ey.com
- Pamela Collie pamela.collie1@ey.com
- Graham Shaw graham.shaw@ey.com

**Ernst & Young LLP (United States), UK Tax Desk, San Jose**
- Graham Nattrass graham.nattrass@ey.com

**Ernst & Young LLP (United States), FSO Tax Desk, New York**
- Michael Bolan michael.bolan@ey.com
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