# The Adventure of the Mandatory Disclosure Directive

"*Never trust to general impressions, my boy, but concentrate yourself upon details*" was Sherlock Holmes' advice to Watson, in A Case of Identity. Examining a woman, Watson complained that Holmes "*appeared to read a good deal…which was quite invisible*". Holmes responds that the clues were "*not invisible but unnoticed [because he] did not know where to look, and so…missed all that was important.*" Holmes goes on to slowly reveal the details that he has pieced together from his observations, from the double line indented into the plush fabric of her sleeve left by typewriting, to the stain of violet ink on her finger that's visible through a tear in her glove. Following the introduction of the Mandatory Disclosure Directive (MDD), taxpayers and their advisers will take on the role of Holmes, guiding European tax authorities, playing the role of Watson, through the detail of arrangements that, in the EU's general impression, may have been put in place for tax avoidance purposes.

## Background

- The MDD comes into practical effect on 25 June 2018 as an amendment to Directive 2011/16/EU concerning the mandatory automatic exchange of information. It provides for two things: (i) a notification obligation on intermediaries (and in certain cases taxpayers) in relation to certain cross-border arrangements which represent "potentially aggressive tax planning"; and (ii) the exchange of that information between Member States. The purpose of the MDD is to allow tax authorities to obtain early knowledge of tax avoidance arrangements so they can counter them promptly.
- The MDD is the latest in a series of EU initiatives in the field of tax transparency which includes the Common Reporting Standard (CRS) (the automatic exchange of information on financial accounts), automatic exchange of information on advance cross-border tax rulings and advance pricing agreements and CbCR (the automatic exchange of information on country-by-country reporting of multinational enterprises).
- Member States must transpose the MDD into their domestic laws by 31 December 2019 such that the rules apply by 1 July 2020. However, the Directive comes into effect on 25 June 2018 and between that date and the date the rules are to apply, "reportable transactions" that have taken place will need to be disclosed to the tax authorities by 31 August 2020. After this transitional period, a 30 day time limit to notify will apply. The exchange of that first round of notified information between Member States must take place by 31 October 2020.
- While the 2020 reporting date is some way off, advisers and taxpayers will need to keep track of potentially notifiable transactions from now.
- Clarification of the UK position on the implementation of the MDD in light of Brexit is hoped for soon. In interim guidance, HMRC have said they will assess the consequences of this Directive for the UK and will issue further guidance as appropriate. The interim guidance suggested that the OECD's Mandatory Disclosure Rules are a useful source of illustration or interpretation. Whilst it is possible that - post Brexit - UK advisers may fall outside the definition of "intermediaries" and therefore fall outside the scope of these rules, for EU-based clients the reporting obligations will still apply and will instead shift from adviser to client.

## Detail of rules

A few key points to note in relation to the MDD:

- The MDD seems to be based on the UK Disclosure of Tax Avoidance Schemes regime (the DOTAS regime) and, like DOTAS, the MDD rules will be triggered by an arrangement that contains at least one of several "hallmarks" (referred to as a "reportable cross-border arrangement"). Some, but not all, of the hallmarks require a tax avoidance main purpose. However, as with DOTAS, the issue with the use of hallmarks is the difficulty in distinguishing between legitimate tax mitigation and aggressive tax avoidance. The MDD hallmarks are cast very widely, with the intention of capturing information on "potentially" aggressive arrangements even if they are not being used for an aggressive purpose in the relevant situation.
- The rules only apply to "cross-border arrangements" which are arrangements concerning more than one country (of which at least one is a Member State) and where: (i) at least one of the participants is resident for tax purposes in more than one jurisdiction or in a different jurisdiction to another participant; (ii) at least one of the participants has a related permanent establishment or otherwise carries on activities in another jurisdiction; or (iii) where the arrangement has a possible impact on CRS. Therefore a transaction between, say, the UK and the US would be within scope.
- The primary notification obligation is imposed on "intermediaries", meaning any person that designs, markets, organises or makes available for implementation, or manages the implementation of, a

reportable cross-border arrangement and any person who knew or should have known that they have undertaken to provide, directly or indirectly, assistance or advice with respect thereto. This is extremely wide and could include almost anyone involved in a transaction or arrangement, but is likely to particularly affect lawyers, tax and other financial advisers and bankers.

- The intermediary must have a nexus with a Member State and this includes being incorporated or resident for tax purposes, having a relevant permanent establishment, or being registered with a relevant professional association, in each case in a Member State.
- As noted above, the 31 August 2020 notification deadline applies to reportable arrangements occurring on or before 1 July 2020. Where the first step of a reportable cross-border arrangement is implemented between 25 June 2018 and 1 July 2020, intermediaries and relevant taxpayers will be required to file the reportable information by this deadline.
- For reportable cross-border arrangements occurring after this transitional period, intermediaries to which the MDD applies must file information within 30 days, beginning on the earlier of: (i) the day after the reportable cross-border arrangement is "made available" for implementation; (ii) the day after the reportable cross-border arrangement is "ready" for implementation; or (iii) when the first step in the implementation of the reportable cross-border arrangement has been taken. In addition, after 1 July 2020, "assisting" intermediaries are required to file information within 30 days beginning on the day after they provided, directly or by means of other persons, aid, assistance or advice.
- Member States must exchange information they are notified of quarterly.
- Where the intermediary is liable to file information on reportable cross-border arrangements with the competent authorities of more than one Member State, there is a hierarchy for determining which Member State to file in, starting with the Member State in which the intermediary is resident for tax purposes.
- Member States must respect legal professional privilege (LPP) under their domestic laws although an intermediary claiming LPP must notify, without delay, any other intermediary or, if there is no such intermediary, the relevant taxpayer of their reporting obligations.
- Where there is no intermediary, or the intermediary claims LPP, the obligation to file information on a reportable cross-border arrangement lies with the other notified intermediary, or, if there is no such intermediary, with the relevant taxpayer.
- The Directive requires Member States introduce "effective, proportionate and dissuasive" penalties for non-compliance.

### Hallmarks

- There are two categories of hallmarks – those which, where they exist, are sufficient to trigger a notification obligation and those which also need the "main benefit test" to be met.
- The main benefit test applies where 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.

### Hallmarks also requiring the main benefit test is met

- Generic hallmarks under category A
  - A participant or the taxpayer gives an undertaking of confidentiality requiring that they do not disclose the tax aspects of the arrangements to other intermediaries or a tax authority.
  - The intermediary is entitled to an "amount of tax advantage" or "success of arrangement" linked fee.
  - Standardised tax products, i.e. where there is standardised documentation or structure which can be made available to multiple taxpayers without the need for substantial customisation.
- Specific hallmarks under category B
  - Loss buying through contrived steps involving acquiring a loss making company and ceasing its main activities.
  - Income into capital (or other lower taxed form) schemes.
  - Circular transaction schemes.
- Those specific hallmarks below **in red**

### Specific hallmarks (those in red also require the main benefit test to be met)

- An arrangement that involves deductible cross-border payments made between associated enterprises where:
  - the recipient is not resident for tax purposes in any tax jurisdiction; or
  - although the recipient is resident for tax purposes in a jurisdiction, that jurisdiction either:
    - does not impose any corporate tax or imposes corporate tax at the rate of zero or almost zero; or
    - is a non-cooperative jurisdiction; or
  - the payment benefits from a full exemption from tax or a preferential tax regime in the jurisdiction where the recipient is resident for tax purposes.
- Deductions for the same depreciation on an asset are claimed in more than one jurisdiction.
- Relief from double taxation in respect of the same item of income or capital is claimed in more than one jurisdiction.
- There is an arrangement that includes a transfer of assets where there is a material difference in the amount being treated as payable in consideration for the assets in the transferor and transferee jurisdictions.
- An arrangement which may have the effect of undermining CRS or equivalent rules or which takes advantage of the absence of such legislation or agreements.
- An arrangement involving a non-transparent legal or beneficial ownership chain.
- An arrangement which involves the use of unilateral transfer pricing safe harbour rules, the transfer of hard-to-value intangibles or an intragroup cross-border transfer of functions and/or risks and/or assets, if the projected annual EBIT during the three-year period after the transfer, of the transferor or transferors, are less than 50 % of the projected annual EBIT of such transferor or transferors if the transfer had not been made.

**Guidance**

The European Commission's Department on Taxation and Customs Union prepared a briefing note for the Commission in late 2017 that gives brief details of both the origin of each hallmark and the type of arrangement targeted. The document does not entirely reflect the final MDD but provides some useful background, although not enough to provide meaningful practical guidance. Of particular note:

- it is evident that the MDD is a collation of the disclosure regimes of the UK, Ireland, Portugal and South Africa, combined with a response to the OECD's BEPS Action 12 report on the disclosure of aggressive tax planning, which explains why the MDD is so wide ranging but also means that some of the hallmarks are reasonably country-specific, for example the circular payments hallmark, which is taken from South Africa;
- the specific cross-border hallmarks are designed to be sufficiently wide to capture different and innovative tax planning techniques, which goes some way to explain their breadth but also suggests that in some instances the European Commission don't necessarily have particular activities that they are aiming to target but are using these hallmarks to gather information;
- disappointingly, neither an origin nor an example is provided in relation to the deductible payment made to a partnership hallmark, which is particularly relevant to those working in the investment management industry; and
- it is accepted that some of the activity will be prevented under the anti-hybrid mismatch legislation brought in under ATAD 2 but that some of this legislation will not come into effect until 2022, meaning that there may be a period in which "hybrid mismatches may not yet be neutralised". It is unclear what the benefit of disclosing such arrangements will be if they are not at the time prohibited and where counteractive legislative changes have already been proposed.

**Comment**

- It is likely that those specific hallmarks which do not require the main benefit test to be met will be particularly problematic in practice as their existence, even in the most tax benign arrangements, will trigger a notification. In particular, there is a concern that the payment of interest on shareholder debt to a limited partnership fund would be caught by the first specific hallmark on the basis that the recipient is not resident for tax purposes in any jurisdiction. In relation to the fourth specific hallmark (cross-border asset transfers), a transfer at book value combined with different tax rules in the transferor and transferee jurisdictions could easily produce a "consideration mismatch" outcome even if there is no tax advantage gained.
- Furthermore, even where the main benefit test applies, this will not help in relation to tax led reorganisations even where the tax advantage is "routine" and perhaps unconnected with the hallmark in question.
- Overall, advisers and taxpayers will have to review transactions entered into on or after 25 June 2018 to determine whether or not they trigger notification obligations.
- We're not even sure Sherlock Holmes would declare this to be "elementary".

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**April 2019**

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