The impact of DAC 6 on cross-border tax arrangements

Key considerations for asset managers
Asset managers need to take steps now to address the impact of DAC 6 for cross-border tax arrangements

Introduction

The most recent amendment to the Council of the European Union (EU) Directive 2018/822/EU (Directive on Administrative Cooperation 6 or DAC 6),¹ which entered into force on June 25, 2018, will have a significant impact on asset managers.

Under DAC 6, relevant reportable cross-border arrangements that were entered into between June 25, 2018, and June 30, 2020, initially needed to be reported by August 31, 2020. However, in response to the COVID-19 pandemic, the EU introduced an optional 6-month deferral to reporting deadlines and therefore in most EU Member States relevant reportable cross border arrangements now need to be reported by February 28, 2021 (although some EU Member States require the original reporting deadline of August 31, 2020). Under the deferred deadlines, where a transaction was entered into between July 1, 2020 and December 31 2020, it needs to be reported within the period of 30 days beginning on January 1, 2021. Arrangements that become reportable on or after January 1, 2021 need to be reported within 30 days. There can be significant penalties for failure to report, and an analysis of the various hallmarks that may trigger reporting is complex and needs to be evaluated under relevant Member State law. As such, impacted asset managers need to take immediate action to develop processes to analyze and implement DAC 6 compliance protocols.

The UK tax authorities, HM Revenue & Customs, have also confirmed that the UK will continue to apply international standards on tax aimed at tackling avoidance and evasion, including DAC 6, which the UK is obliged to implement during the EU withdrawal transition period. There are also a number of non-EU jurisdictions that are expected to implement rules similar to DAC 6. For example, Mexico has introduced a Mandatory Disclosure Regime that is effective for relevant transactions implemented since January 1, 2020, with live reporting starting January 1, 2021.

Steps to address the impact of DAC 6 can include working with advisors to perform an initial impact assessment to help identify key DAC 6 risk areas, obtaining assistance in implementing appropriate corporate governance procedures to help monitor DAC 6 compliance on an ongoing basis, the deployment of technology solutions to assist in-house tax and compliance teams independently analyze and document their DAC 6 obligations, and the use of managed service offerings for groups that don’t have the appropriate internal tax resources to manage DAC 6 risk independently.

Considering the broad approach of DAC 6, many common cross-border arrangements are impacted. This article provides an overview of the technical requirements of DAC 6, outlines some of the key trends and issues that are arising for businesses that operate in the wealth and asset management industry, and provides our insight into what practically taxpayers are doing to ensure compliance with the regime.
Background and evolution of the Directive on Administrative Cooperation

The Council of the EU introduced Council Directive 2011/16/EU (Directive on Administrative Cooperation or DAC) on February 15, 2011 to accommodate new initiatives in the field of tax transparency at the level of the EU.² The stated purpose of the DAC is to protect the financial interests of Member States, to strengthen the fight against cross-border tax fraud, evasion and avoidance and to ensure that profits are taxed where they are made, contributing to the proper functioning of the EU’s internal market and fair competition.³ In recent years since its inception, the EU has introduced a series of amendments to DAC to broaden its scope, including the introduction of the automatic exchange of financial accounts information, also known as the Common Reporting Standard (DAC 2),⁴ the automatic exchange of Country by Country reports (DAC 4)⁵ and access to anti-money laundering information by tax authorities (DAC 5).⁶ The most recent amendment to the directive, Council Directive 2018/822/EU (DAC 6),⁷ implements a new Mandatory Disclosure Regime (MDR) aimed at boosting fiscal transparency across the EU associated with defined reportable cross-border arrangements.

DAC 6, which entered into force on June 25, 2018, requires “intermediaries” based in EU Member States to report transactions and tax arrangements that are considered by the EU to be potentially “aggressive cross-border tax planning.”⁸ Where no EU intermediary has been involved in a reportable cross-border arrangement or where a relevant EU intermediary has Legal Professional Privilege (LPP) under local law, the obligation to file information on reportable cross-border arrangements transfers onto the relevant EU based taxpayer.⁹

Under the DAC 6 timetable, EU Member States were required to adopt and publish the required local law, regulations and administrative provisions necessary to comply with the Directive by December 31, 2019.

EU-based asset managers and the definition of intermediaries

As noted, DAC 6 primarily seeks to impose reporting obligations on persons who meet the definition of an “intermediary.” In order to be an intermediary, a person has to be either resident in a member state, have a permanent establishment in a member state otherwise connected with the arrangement, be incorporated or governed by a member state or be registered with a professional association in a member state.¹⁰ Where there is no EU intermediary required to report, the obligation to report typically falls back onto the relevant EU taxpayer.

Under DAC 6, an intermediary is any person that designs, markets, organizes or makes available for implementation or manages implementation of a reportable cross-border arrangement, also known as a “promoter intermediary”.¹¹ Intermediaries such as this will typically include tax advisors, accountants and lawyers who design and/or promote reportable cross-border arrangements. However, wealth and asset managers based in the EU which provide investment management services for funds are also likely to be considered intermediaries under the adoption of DAC 6 in various EU Member States.

Where an EU-based asset manager does not fall within the “promoter” definition of an intermediary, possibly due to the nature of their activity being limited to conducting very narrow investment management activities (e.g., marketing and distribution only), managers may also need to consider whether they potentially meet the threshold of “service provider” intermediaries, where it is determined they could reasonably be expected to know that they have provided aid or assistance in respect of a reportable cross-border arrangement, for example where an asset manager isn’t taking the lead on an investment but is reviewing or otherwise supporting such investment activity.

As such we are seeing a lot of activity from asset managers with EU or UK investment management entities and functions to determine their intermediary status under various jurisdictions’ law, and then determine whether they have obligations to report information or can rely on other intermediary reporting disclosures.
In addition, if asset managers in any jurisdiction have any kind of EU presence (e.g., if a Special Purpose Vehicle (SPV) in a fund complex is located in an EU Member State), those asset managers are also ensuring that an intermediary to the arrangement is undertaking any relevant reporting required under DAC 6, such that the onus of reporting does not fall on the EU entity/SPV itself.

**Where and how should EU-based asset manager or taxpayers report**

Some EU Member States include exemptions for intermediaries, who would otherwise have a reporting obligation under the local implementation of the Directive, where another EU intermediary has been involved in the arrangement and has reported the required information to a relevant tax authority in another EU Member State. However, there is generally a requirement under such exemptions to have appropriate evidence (such as a reporting number) that the appropriate arrangement has been reported in the other EU Member State.

It is therefore important for EU intermediaries (such as EU-based asset managers) who intend to rely on other reporting to have appropriate processes in place to determine whether there are other intermediary or third-party MDR reports they intend to rely on and to ensure they have documentary evidence in place to support this in the event of a tax enquiry.

As DAC 6 provides a minimum standard for MDR that should be implemented into the local law of all EU Member States and the UK, each jurisdiction has the potential to interpret the Directive differently when introducing the rules into local law, and we have seen exactly this happen as each EU Member State has released its own local legislation and associated guidance.

EU-based asset managers who are intending to rely on exemptions (such as those outlined above) introduced in one EU Member State should not assume that they can rely on a similar exemption in another jurisdiction.

In respect to reporting issues, we would specifically note the concept of LPP that is acknowledged under DAC 6 and that can operate to exempt certain intermediaries from the requirement to report (e.g., law firms). Certain EU Member States have expanded the scope of LPP to include a wide variety of intermediaries (e.g., accounting firms). As such it is important for asset managers to determine whether they can rely on third-party intermediary reporting or whether due to issues such as LPP they may be the only intermediary to a given arrangement.

An added complication for the asset management industry can arise where asset management groups hold EU investments; however, due to the nature of those investments (e.g., secondary investments, co-investments, participations) they may not be in a position to make an independent determination of whether the fund or any of its investments are party to any reportable cross-border arrangements under DAC 6.

Under such a scenario, it can be difficult for groups to understand, firstly, whether they have any requirements to report under DAC 6 as either an EU-based intermediary or potentially as an EU-based taxpayer; and, secondly, whether another EU-based intermediary or EU-based taxpayer is reporting information to EU tax authorities in respect to an investment. In addition, a number of jurisdictions have introduced secondary annual reporting obligations for EU taxpayers, even where an EU intermediary has reported an arrangement to a relevant tax authority. As such, we are seeing a rise in requests from asset managers for information flows and information needed for DAC 6 disclosure purposes to be included within, for example, fund documentation and side letters.

It is therefore important that the application and local implementation of DAC 6 is appropriately assessed by EU-based asset managers to determine the potential risk associated with any reporting obligations arising under EU MDR, as the penalties for noncompliance with the regime in many EU jurisdictions can be significant.
As noted, DAC 6 initially required reportable cross-border arrangements entered into from June 25, 2018, to June 30, 2020, to be reported by August 31, 2020. Reportable arrangements entered into after July 1, 2020, would need to be reported within 30 days of the relevant arrangement becoming reportable. However, on June 3, 2020, a political agreement was reached by the Committee of the Permanent Representatives of the Governments of the Member States to the European Union (COREPER II) to provide Member States the option to grant a six-month extension to the existing deadlines for DAC 6.

On June 24, 2020, the EU announced that it had adopted amendments to DAC 6 allowing Member States an option to defer by up to 6 months the time limits for the filing and exchange of information on cross-border arrangements due to the COVID-19 pandemic. Under the deferral, arrangements where the first step of implementation took place between June 25, 2018, and June 30, 2020, need to be reported by February 28, 2021 (instead of by August 31, 2020, as originally required). Arrangements made available for implementation, that were ready for implementation or where the first step in the implementation takes place between July 1, 2020, and December 31, 2020, need to be reported within the period of 30 days beginning on January 1, 2021. Arrangements that become reportable on or after January 1, 2021 need to be reported within 30 days.

While the majority of EU Member States decided to accept the optional deferral proposed by the EU, Germany and Finland chose to not defer their deadlines, and therefore DAC 6 and the relevant penalties for noncompliance in those jurisdictions are now fully operational. Similarly, Austria also chose to not adopt the full six-month deferral; however, due to technical delays it has postponed reporting until October 31, 2020. Poland has also chosen not to fully defer reporting obligations under DAC 6; however, it has postponed reporting deadlines until the COVID-19 situation improves.

As such, we are seeing significant focus from clients on any arrangements entered into with a nexus to these countries since June 25, 2018 as a matter of urgency to determine whether any reporting obligations exist, as a first step to implementing an EU MDR compliance program.
Key trends in the wealth and asset management sector: arrangements and hallmarks

Cross-border arrangements under DAC 6 may concern either more than one Member State or a Member State and a third country and must contain one or more “hallmarks” to qualify as reportable. The hallmarks are grouped under five broad categories, A–E, and contain features or characteristics that are perceived to be seen in aggressive tax planning arrangements. A number of the hallmarks, however, also have a “main benefit test” associated with them, which will only be satisfied where it can be established that a tax advantage was the main benefit or one of the main benefits of the arrangement.

The following diagram provides a high-level overview of the key hallmarks:

<table>
<thead>
<tr>
<th>Hallmarks</th>
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<tbody>
<tr>
<td><strong>A</strong></td>
</tr>
<tr>
<td>Confidentiality clause (A1)</td>
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<tr>
<td>Success fee (A2)</td>
</tr>
<tr>
<td>Standardized documentation and/or structure (A3)</td>
</tr>
<tr>
<td><strong>B</strong></td>
</tr>
<tr>
<td>Acquisition of a loss-making company acquired, main activity discontinued and losses utilized to reduce tax liability (B1)</td>
</tr>
<tr>
<td>Income converted into capital/other categories of revenue taxed at a lower level or exempt from tax (B2)</td>
</tr>
<tr>
<td>Round-tripping of funds using conduits/entities without other primary commercial function (B3)</td>
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<tr>
<td><strong>C</strong></td>
</tr>
<tr>
<td>Deductible cross-border payments to associated enterprises that are resident in a jurisdiction that does not impose corporate tax or imposes corporate tax at the rate of 0% or almost 0% (C1(b)(i))</td>
</tr>
<tr>
<td>Deductible cross-border payment that benefits from full exemption from tax or a preferential tax regime for the recipient (C1(c), C1(d))</td>
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<td><strong>D</strong></td>
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<tr>
<td>EU legislation or any equivalent agreements on the automatic exchange of financial account information circumvented (D1)</td>
</tr>
<tr>
<td>Nontransparent legal or beneficial ownership chains used (D2)</td>
</tr>
<tr>
<td><strong>E</strong></td>
</tr>
<tr>
<td>Unilateral transfer pricing safe harbor rules used (E1)</td>
</tr>
<tr>
<td>Transfers of (rights to) hard-to-value intangibles (E2)</td>
</tr>
<tr>
<td>Restructuring resulting in decrease of projected annual EBIT by more than 50% following the transfer of functions and/or risks and/or assets (E3)</td>
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</table>

While the DAC 6 hallmarks apply to various arrangements and should be individually assessed by EU-based asset managers who have nexus to any reportable cross-border arrangements, we have noted below a (non-exhaustive) summary of a number of arrangements and associated hallmarks that we frequently see being of potential relevance in the context of the wealth and asset management industry:

- **Hallmark A3** – Focuses on arrangements that use substantially standardized documentation and/or structures available to more than one relevant taxpayer without the need to be substantially customized for implementation. Subject to the adoption of DAC 6 into local Member State law, this hallmark may be particularly relevant to asset management groups that use “off the shelf”
structures without substantial standardization to invest within the EU. This hallmark may also be relevant where groups use standardized documentation and agreements to make EU investments, where a tax advantage is considered a main benefit of that arrangement.\textsuperscript{15} For example, certain jurisdictions may consider the use of standardized documentation for dividend arbitrage trading or certain contracts for differences as potentially triggering this hallmark.

\begin{itemize}
\item **Hallmark B2** – Deals with arrangements that have the effect of converting income into capital, gifts or other categories of revenue that are taxed at a lower level or exempt from tax may be relevant to funds with SPVs and their funding/profit repatriation methods. Similarly, the structuring of “carry” within asset management groups may also be relevant for this hallmark.

\item **Hallmark B3** – Focuses on circular transactions resulting in the round-tripping of funds, namely through involving interposed entities without other primary commercial function or transactions that offset or cancel each other or that have other similar features. This hallmark may apply, for example, 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.\textsuperscript{16}

\item **Hallmark C1** – Divided into five subcategories, each related to deductible cross-border payments made between two or more associated enterprises. The subcategories consist of hallmarks that deal with: recipients not resident anywhere for tax purposes; recipients in low-tax jurisdictions (zero or almost zero); recipients in jurisdictions that have been assessed as noncooperative; recipients that benefit from a full exemption from tax; and recipients that benefit from a preferential tax regime. The C1 hallmarks are potentially relevant to asset managers both through the structuring of EU-based entities within the corporate management group and also through the structuring and launch of funds including EU entities. A number of these hallmarks do not have a main-benefit test associated with them, such that they may be triggered in situations where no tax advantage is derived from an arrangement.

\item **Hallmark C2** – Focuses on situations where the same asset is subject to depreciation in more than one jurisdiction and is therefore particularly relevant to US-headquartered asset management groups that have EU-based subsidiaries both on the corporate management and fund side of an organization that are considered “disregarded” for US federal income tax purposes.\textsuperscript{17}

\item **Hallmark D2** – Looks at arrangements that involve the use of nontransparent legal or beneficial ownership chains that, for example, may make the beneficial owners of a structure unidentifiable through the use of undisclosed nominee shareholders, or where control is exercised indirectly rather than by means of formal ownership. Beneficial ownership may also be obscured where arrangements use jurisdictions where there is no requirement to keep information on beneficial ownership.\textsuperscript{18}

\item **Hallmark E3** – Deals with arrangements involving intragroup cross-border transfers of functions and/or risks and/or assets, if the projected annual earnings before interest and taxes (EBIT) during the three-year period after the transfer are less than 50\% of the projected annual EBIT of the transferor or transferors if the transfer had not been made. This hallmark may be relevant where businesses restructure their EU-based corporate management groups, which may have been required in response to the UK’s decision to withdraw from the EU.
\end{itemize}

**Practical example**

The following example on page 8 illustrates the potential impact of DAC 6 and hallmarks that may need to be considered in the context of a generic master feeder structure with the master fund set up in a jurisdiction that does not have a definition of tax residency. The example fund has a US advisor with an EU-based sub-advisor. The purpose of the framework is to indicate how broad the hallmarks potentially are and, accordingly, how wealth and asset management groups should consider the hallmarks in respect of each respective investment under local member law.
Key trends in the wealth and asset management sector: compliance with the regime

Groups that operate in the asset management industry and have EU-based entities within their fund structures and/or corporate management group, or that have EU-based investors and/or EU investments, should ensure that they have appropriately assessed their exposure to DAC 6 for any arrangements entered into since June 25, 2018, by reference to the appropriate hallmarks, as implemented in each relevant EU/UK jurisdiction.

Groups should also consider whether the activities of EU-based asset managers give rise to the definition of an intermediary under local jurisdictional adoption of DAC 6, whether there are any external EU-based intermediaries that may already be reporting arrangements entered into by the group to local tax authorities and, if so, what they are reporting, and, therefore, whether there are any residual DAC 6 reporting obligations for EU intermediaries within the group.

Consideration should also be given to any secondary reporting obligations required by EU taxpayers within the group where no external EU intermediary has been engaged for an arrangement, or where the EU intermediaries engaged for an arrangement are able to rely on LPP under local law, in which case reporting obligations will likely fall back on the relevant EU taxpayer within the group.
From July 1, 2020, in the case of Germany and Finland; October 31, 2020, in the case of Austria; and from January 1, 2021 otherwise, asset management groups should look to implement appropriate internal governance procedures to help capture and report any cross-border arrangements that trigger hallmarks within the 30-day reporting window to minimize the risk of penalty exposure. Such procedures should involve key internal stakeholders charged with governance and any employees who may be exposed to reportable cross-border arrangements. Groups should also ensure they have a process in place to help maintain an audit trail of the reportability of cross-border arrangements.

The following diagram outlines a potential approach to a DAC 6 implementation framework that groups should consider. Such a framework should encompass an overall strategy, the plan for the analysis of the impacted transactions and the plan to engage relevant advisors and intermediaries responsible for the report of impacted arrangements.

**DAC 6 implementation framework**

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Engage</th>
<th>Analyze</th>
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<tbody>
<tr>
<td><strong>MDR planning</strong></td>
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<tr>
<td>Develop a strategy, policy and guidance for MDR reporting:</td>
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<tr>
<td>▶ Set up an in-house process for recognizing arrangements that need to be reported.</td>
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<tr>
<td>▶ Establish clear MDR responsibilities and reporting lines.</td>
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<tr>
<td>▶ Ensure that tax and other key personnel are trained to recognize arrangements that are likely to be reportable.</td>
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<tr>
<td>Create an overview of advisors used in various countries and engage with them to agree on an approach:</td>
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<tr>
<td>▶ Monitor what you and your advisors are planning to disclose for consistency and accuracy.</td>
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<tr>
<td>▶ If possible, reduce the number of disclosures by agreeing on who will file and by ensuring that other intermediaries have the required proof they need for non-reporting under relevant local law.</td>
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<tr>
<td>▶ Ensure you understand where national legislation (for each EU Member State in the arrangement) departs from the EU directive in terms of additional disclosure criteria (e.g., application to domestic arrangements and broad or narrow interpretation of terms).</td>
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<tr>
<td>▶ Ensure that you have robust and complete documentation on transactions or arrangements to meet audit challenges.</td>
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</table>

EY teams are currently assisting a wide variety of clients in the wealth and asset management industry assess DAC 6 risk. Our clients range from non-EU-headquartered groups with EU investments to EU-focused businesses with numerous legal entities based in the EU. Such support can include the provision of initial impact assessments to help identify key DAC 6 risk areas, assistance in implementing appropriate frameworks and corporate governance procedures to help monitor DAC 6 compliance on an ongoing basis, technology solutions to assist in-house tax and compliance teams independently analyze and document their DAC 6 obligations, and outsourced managed services for groups that don’t have the appropriate internal tax resources to manage DAC 6 risk independently.
Conclusion

As outlined in this article, compliance with the DAC 6 regime is important for all businesses that operate in the wealth and asset management industry. Asset management groups should be proactively analyzing where they have exposures under the regime and ensuring they document appropriately whether they are reporting any EU arrangements they have entered into since June 25, 2018. Where groups are required to report under DAC 6 either as an EU-based intermediary, or where there is no EU-based intermediary or the relevant EU-based intermediary has LPP as an EU taxpayer, they should ensure such reports are filed with the relevant tax authority by the appropriate reporting deadline in the relevant EU Member State to mitigate any penalty exposure.

In particular, asset management groups should prioritize analyzing arrangements entered into since June 25, 2018, with a nexus to either Germany, Finland, Austria or Poland. Where asset management groups have yet to analyze their exposure to DAC 6, they should consider seeking specialist advice to ensure they are compliant with the rules moving forward and are not exposed to penalties or reputational risk for noncompliance with MDR.

Compliance with the DAC 6 regime is important for all businesses that operate in the wealth and asset management industry.
Endnotes


