HMRC's final guidance on DAC 6: a good first attempt?

Summer 2020 saw the publication of HMRC's final guidance on the application of DAC 6. Taxpayers and advisers will find much that is welcome in the tone and approach of that guidance. They may, however, be forgiven for having hoped for greater detail and for examples that could more easily be applied to novel situations. If HMRC's aim was to forestall taxpayer enquiries ahead of the start of reporting in early 2021, then they may find that they have met with only limited success. Taxpayers will also need to bear in mind that, however helpful HMRC's views may be, they are no guarantee that other member states will take the same approach.

At the end of June 2020, HMRC finally published its long-awaited guidance on the UK implementation of the mandatory disclosure rules contained in the Directive on Administrative Cooperation (2011/16/EU) as amended by Directive 2018/882/EU (***DAC 6***). Coming as this did only days before live reporting under DAC 6 was originally scheduled to commence, taxpayers and advisers can be grateful that (in common with most member states) the UK has taken the decision to defer the implementation of DAC 6 by six months. Generally speaking, as we explain below, the guidance is helpful and pragmatic in tone but still leaves many unanswered questions and areas where further elaboration would be helpful.

Background

By way of brief recap, DAC 6 requires 'intermediaries' (a category which will usually include advisers such as lawyers and accountants) or, in some situations, taxpayers to report cross-border arrangements which satisfy certain criteria referred to as 'hallmarks' to tax authorities. In broad terms these hallmarks are thought to be indicators of undesirable tax planning that tax authorities might wish to investigate or challenge. The UK has implemented DAC 6 (and all indications are that it intends to continue to apply it notwithstanding Brexit) via the International Tax Enforcement (Disclosable Arrangements) Regulations, SI 2020/25, (the ***regulations***) which largely adopt the language and definitions of the directive.

As required under DAC 6, the regulations initially provided for a 'catch up' reporting deadline in August 2020 for arrangements implemented between 25 June 2018 and 1 July 2020 (often referred to as 'backlog' matters), with a 30-day rolling window for live reporting of new arrangements thereafter. However, in June 2020 (in response to the COVID-19 pandemic), the EU announced an optional six-month delay to reporting deadlines and exchange of information until the beginning of 2021, which has been reflected in amendment of the regulations. (Most of the member states, with Germany a notable exception, have also adopted some degree of deferral.)

We are now approximately halfway through that deferral period (which itself came at the last minute), and taxpayers and advisers should therefore be well-advanced with their analysis of the backlog and their preparations for live reporting. It is probably fair to say, however, that this has been no easy task: DAC 6 (and in particular the Annex containing the hallmarks) is drafted in very broad terms, and in many key respects the regulations do little to clarify its scope.

HMRC have been alive to the risk of intermediaries over-reporting, and in July 2019 published their views on some of the areas of difficulty for consultation. While the transparency as to HMRC's thought process was welcome it was no substitute for definitive views on the issues, so the final guidance has been eagerly awaited.

Overview

The guidance that has now been published (and which forms a new section in HMRC's *International Exchange of Information Manual*) is based on the original views expressed by HMRC in July 2019, but (as one might hope) the consultation process has clearly resulted in some developments in HMRC's thinking. It is understood that HMRC regards this guidance as essentially final, although it is open to receiving feedback which may be incorporated in revisions to the manual in due course.

Before delving into the detail of the guidance, it is worth making the (obvious) point that this is only the UK tax authority's interpretation of the rules. The nature of DAC 6 is that, on many cross-border matters, reporting in multiple member states may need to be considered and it cannot be assumed that the authorities elsewhere will take the same view as HMRC. In other words, a conclusion that the UK does not require disclosure will not necessarily mean that the arrangement does not need to be disclosed in another jurisdiction.

Knowledge

There are two broad categories of intermediary, 'promoters' (those who design, market, organise, make available or implement a reportable arrangement) and 'service providers' (who provide aid, assistance or advice in relation to such activities). Promoters will almost invariably have a full understanding of the material aspects of the arrangement. However, service providers are only treated as intermediaries if they know (or could reasonably be expected to know) that they are involved in a reportable cross-border arrangement.

The guidance reiterates HMRC's longstanding position that a service provider is not expected to do additional due diligence to establish whether there is a reportable arrangement; if the normal due diligence that they would do for a transaction/client of the relevant type does not give them the necessary knowledge to qualify as an intermediary then they are under no reporting obligation. This is a sensible position which will be welcomed by many entities with more marginal involvement in transactions (the example given is a bank that is simply providing finance) that might otherwise have needed to consider their reporting obligations more thoroughly. The guidance is, however, careful to spell out that intermediary status cannot be avoided by wilful ignorance or a failure to ask the usual questions.

The guidance is less clear on the precise level of knowledge required to qualify as an intermediary in the service provider category. There are hints that a person needs to have knowledge of the relevant tax implications to have the requisite degree of knowledge (which would potentially act as a significant filter), but if this is indeed HMRC's view it would be helpful to have spelt that out with greater prominence.

There is also some commentary on the position where knowledge is fragmented across a particular organisation: leaving aside attempts to artificially fragment knowledge (which get no sympathy) HMRC appears content to accept that, in certain situations, it may not be reasonable to attribute the knowledge of individual staff members to the organisation as a whole (most obviously, where those team members have no reason to know of the other's role or that the other might hold relevant information).

Main benefit test

Many (but not all) of the hallmarks incorporate a 'main benefit test' (***MBT***) which means that the hallmark in question can only be satisfied if one of the main benefits a person may reasonably expect to derive from the arrangement is the obtaining of a tax advantage. Helpfully, the regulations define a tax advantage as meaning only a tax benefit that cannot reasonably be regarded as consistent with the principles/policy of the relevant legislative provisions.

This language is reminiscent of some of the language adopted by the UK general anti-abuse rule, and it was hoped therefore that it would represent a similarly high hurdle. The guidance does not expressly address this question but, taken as a whole, the tenor of HMRC's commentary suggests that they do regard this approach as likely to filter out many 'standard' commercial transactions or structures. For example, the guidance confirms that claiming a relief (such as R&D relief) does not necessarily involve a tax advantage, but it may do so where an arrangement attempts to manufacture an entitlement to the relief that is not consistent with the policy/principles of the legislation conferring that relief.

The guidance also stresses that it is important to look at an arrangement as a whole. Even if a cross-border transaction has results in jurisdiction A that are consistent with its policy objectives, and results in jurisdiction B that are consistent with that jurisdiction's policy objectives, if the arrangement takes advantage of a mismatch between the tax rules of the two jurisdictions it seems that it may, overall, still give rise to a tax advantage. HMRC appears to have in mind here the example of a (deductible) payment from an EU member state that flows to a low (or no) tax jurisdiction. Perhaps deliberately, the guidance on this subject is rather ambiguous but (at least on one reading) it seems that HMRC will normally expect a tax advantage to arise in this situation, with the real question being whether that advantage is a main benefit of the arrangement.

Other points made in this section of the guidance include that:

- the test is an objective one, so it does not matter whether a person was actually seeking a tax advantage from the arrangement or what other reasons they might have had for entering into the arrangement; and
- whether a tax advantage is a main benefit requires consideration of the value of the expected tax advantage compared to the value of any other benefits likely to be enjoyed.

Hallmarks

One of the greatest areas of uncertainty with DAC 6 concerns the interpretation of the individual hallmarks. The guidance addresses this with specific pages for each hallmark, setting out some general observations about scope and in many cases illustrating with examples. Taken in the round the tone of the guidance is quite helpful and one gets the sense that HMRC is keen to limit the number of 'unnecessary' disclosures. Unfortunately, it is often very difficult to discern the reasoning behind HMRC's statements. This in turn makes it difficult to apply the guidance beyond the specific situations with which it deals, which obviously limits its utility. Linked to this, the guidance on many of the hallmarks that are subject to the MBT seems to focus on the MBT as the primary filter, at the expense of guidance on what the hallmark in question actually means.

An example of this problem comes with the guidance on hallmark B2, which captures arrangements that convert income into capital (or other categories of revenue which are taxed at a lower level) but only if the MBT is satisfied. This hallmark is potentially very broad indeed — there are many situations where a sum might be received in two or more different forms with different incidences of tax on each, and so the question of whether there is 'conversion' is likely to require frequent consideration. Does HMRC's guidance offer much assistance with this?

The guidance first confirms that the conversion of income into capital in ways which are entirely consistent with the underlying intent of the legislation upon which such conversions rely will not satisfy the hallmark. This appears to be another way of saying that the MBT will not be met in these circumstances, and while it is a useful clarification it probably does not add a great deal to the legislation.

The guidance then purports to address the question of whether there is a conversion of income into capital, which it says must be evaluated from the point of view of a hypothetical informed observer and by asking whether they would reasonably conclude that income had been converted into capital. There then follow a series of examples (which deal, amongst other things, with remuneration in the form of shares, pre-liquidation and pre-sale dividends, and share buybacks). The broad thrust of the commentary is that these sorts of arrangements are standard commercial transactions which, absent any element of contrivance, should not be regarded as involving a conversion of income and so should not fall within the hallmark.

On its face this is a helpful position for HMRC to take, which should normally have the effect of taking the transactions used in the examples out of scope. It is not, however, entirely clear why HMRC takes this view or where the boundaries of this reasoning end: the implication of the guidance is that some element of contrivance needs to be present for all of the category B hallmarks but (to the authors) this raises at least two questions: (i) what exactly does 'contrivance' mean in this context (the guidance says little on this point beyond postulating another objective test); and (ii) how does this interact with the application of the MBT (presumably many transactions which fail the MBT will also have an element of contrivance so what does this add)?

There is one other clear statement in the guidance on hallmark B2, namely that there does not have to be a pre-existing entitlement to income in order for there to be a conversion of income into capital. While it is understandable that HMRC would wish to take this approach (for example, to counter arguments that a structure was always set up to deliver a capital return instead of income), it is unfortunate that, if anything, this statement leaves the boundaries of hallmark B2 even more uncertain.

Turning to some of the other hallmarks that have prompted widespread discussion, hallmark A1 captures arrangements where a participant undertakes to comply with a condition of confidentiality which may require them not to disclose how the arrangement could secure a tax advantage. It is clear from the guidance that HMRC considers that a general confidentiality condition preventing disclosure may trigger this hallmark, and it is this aspect of the hallmark that has given rise to concerns around 'standard' non-disclosure and confidentiality clauses.

HMRC attempts to address this concern by observing that the hallmark specifically looks at confidentiality around how the arrangements could secure a tax advantage. While a broadly drafted generic confidentiality condition may well cover this aspect of disclosure (along with everything else), the guidance contains the rather gnomic reassurance that if the clause does not 'in practice' prevent the disclosure of information in relation to tax matters, it will not be viewed as triggering this hallmark. (Apparently, a generic confidentiality clause in a client engagement letter would normally fall on the right side of the line on this basis.) This seems to go beyond a recognition that the literal words of a confidentiality clause do not necessarily determine its scope and to invite interrogation of how the clause is, or would be, actually operated by the parties. Leaving aside the legal niceties of HMRC's position, such a test seems likely to be extremely difficult to apply and to evidence in practice. It will be interesting to see whether practitioners are content to rely on HMRC taking a benign approach or whether a practice of cumbersome US-style carveouts from confidentiality conditions develops. (The LMA, for one, has published a carveout for consideration for inclusion in its standard form loan documents.)

Moving on, there is helpful guidance in relation to hallmark A3 (standardised documents or structures) which suggests that standardised market documents (such as an ISDA master agreement) or use of legal precedents will not trigger the hallmark — but seemingly only where they are subject to 'considerable amendment' as a result of negotiations or specific circumstances. This suggests the hallmark is not intended to be engaged where the documents are shaped by genuine commercial negotiation or other external factors, but it leaves open the key questions of: (i) how much amendment of the starting documents is enough to fall outside of scope; and (ii) whether this test is qualitative, quantitative, or a combination of both. While it seems likely that, taken together with the MBT, this hallmark will rarely need serious consideration in the case of a genuine commercial transaction, borderline situations will surely be encountered where additional guidance would be welcome.

The guidance on the category E (transfer pricing) hallmarks is particularly disappointing. For example, there is no attempt to engage meaningfully with the scope of 'unilateral safe harbours' (***E1***) other than confirming that advance pricing and thin capitalisation agreements are not caught.

Penalties

Unsurprisingly, the regulations impose penalties for failure to comply with a reporting obligation. In a taxpayer-friendly move, however, the regulations contemplate that having reasonable procedures in place to identify and report transactions as required under the regulations may allow any penalty that would otherwise arise to be mitigated or eliminated. (To paraphrase, you may get away with the odd failure if your procedures are generally robust.)

Given the novelty, complexity and uncertainty of DAC 6, errors in reporting seem highly likely. Businesses of any size that need to consider large numbers of potentially disclosable matters are therefore likely to be interested to understand what 'reasonable procedures' consist of, to give themselves the best chance of being able to rely on the defence to penalties if required.

Those businesses will probably be pleased with statements in the guidance that procedures do not have to be new or specifically designed for DAC 6 to be taken into account — in other words, leveraging off existing reporting procedures may be acceptable — and unsurprised to be told that what is reasonable must be assessed in the context of the business in question. They are likely to be more disappointed that the guidance on this topic offers little else beyond clues as to what reasonable procedures might cover (training, escalation routes for potentially reportable arrangements, governance around decisions on what is reportable) and uninformative statements such as needing to consider what backup procedures may be needed.

Finally on this subject, the guidance affirms HMRC's previous indications of leniency for reporting failures relating to arrangements implemented before the consultation on guidance was published in July 2019 (although this comment is rather hidden away in the section of the manual dealing with commencement).

It does not, sadly, extend this leniency to the point of publication of the final guidance, although the point must be arguable in an appropriate case.

Privilege

One area of real interest to lawyers is the treatment of privilege. The regulations provide an effective exemption from reporting for information covered by legal professional privilege (although a lawyer relying on this may then have to notify other intermediaries or the relevant taxpayer that they need to consider their own DAC 6 obligations; the significance of privilege comes largely down to who makes a report, rather than whether a report is made at all).

The guidance on this difficult subject is disappointingly brief and, crucially, offers no guidance on when HMRC considers that privilege will not apply beyond saying that a lawyer who is 'marketing' a scheme (whatever that means) will not be able to assert privilege. On the plus side, the guidance has seemingly moved away from HMRC's original position (that most reportable information would not be covered by privilege), and indeed it is understood that HMRC broadly accept the position on privilege and DAC 6 set out in a Law Society publication from June 2020 (although it would be helpful if the guidance confirmed this expressly).

It may also be worth noting that, in this guidance, HMRC explicitly accepts that a client may waive privilege only to the extent necessary to enable their lawyer to report under DAC 6 (thereby preserving privilege for other purposes), although any clients considering that course will wish to take great care to ensure that the scope of any waiver is clear and appropriately limited.

Final thoughts

As the above discussion illustrates, the published guidance is a good first attempt but still leaves many key questions around the scope of DAC 6 reporting obligations. Nevertheless, it is also the best guidance available and intermediaries will need to scrutinise it carefully to determine which of their backlog matters will require reporting, and to design their procedures for live reporting, from the beginning of next year.

If (as seems likely) this process throws up additional questions, time is running out to approach HMRC for clarification on particular points of uncertainty. Affected businesses should accelerate this process as much as resources and other commitments allow.

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