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How to Tackle DAC6, a Monumental New Challenge for Corporate Taxpayers

White Paper

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Corporate tax professionals have navigated relentless regulatory change in recent years as authorities worldwide pushed for greater digitalization, disclosure, and transparency in tax reporting.

DAC6, a mandatory disclosure regime that affects multinational companies with business activity in the European Union (EU), is the latest digital demand on a path that started 12 years ago in Latin America.

In 2008, Brazil introduced real-time, electronic invoicing and reporting requirements. In 2011, Mexico began requiring companies to digitally disclose value-added tax (VAT) activity in real time, and in 2018 Italy became the first EU country to enact e-invoicing and real-time VAT controls. This was followed a year later by the U.K.'s Making Tax Digital initiative[1], which required companies to use software to file VAT returns and ended the practice of cutting-and-pasting from spreadsheets.

Meanwhile, tax policy makers globally aligned behind the Organization for Economic Cooperation and Development's (OECD) tax base erosion and profit shifting (BEPS) initiative. Under BEPS, tax authorities automatically exchange taxpayer information between countries to better scrutinize and collect taxes on multinational business activity.[2]

DAC6, a mandatory disclosure regime that affects multinational companies with business activity in the European Union (EU), is the latest digital demand on a path that started 12 years ago.

"Since the final BEPS recommendations were endorsed by the G20 and EU in 2015, they have gradually been implemented in a phased approach that is set to continue to 2022 and in some cases even beyond," KPMG[3] noted. "The recommendations not only include substantive tax law changes but also new disclosure requirements for companies and automatic information exchanges between tax administrations. And, on top of that, public pressure continues to drive towards more corporate tax transparency to the public."

Deloitte labeled this era the Global Tax Reset[4]. It includes Country-by-Country Reporting (CbCR) laws that require multinational companies to report "profits made and taxes paid for every jurisdiction in which they have legal entities," the Tax Foundation explained[5]. "The information can then be examined by tax authorities to identify areas where companies may be designing their corporate structures or transactions to minimize their tax burden or evade taxation."

DAC6 compliance

Now comes the EU's Directive on Administrative Cooperation 2018/822 or DAC6. It is the latest example of countries' collaborating to mandate digital disclosure of corporate financial information so tax authorities can assess risk, close loopholes, and determine whether to conduct audits.

Deloitte[6] called DAC6 "one of the most significant changes for tax advisors, service providers, and taxpayers in recent years." Failure to comply can result in multimillion-euro fines, reputational damage, and criminal penalties.

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1 HMR&C, *Overview of Making Tax Digital* policy paper, updated March 19, 2020.
https://www.gov.uk/government/publications/making-tax-digital/overview-of-making-tax-digital

2 IMF, *Corporate Taxation in the Global Economy*, March 10, 2019.
https://www.imf.org/en/Publications/Policy-Papers/Issues/2019/03/08/Corporate-Taxation-in-the-Global-Economy-46650

3 KPMG, *Corporate Tax Transparency in the BEPS Era*, August 8, 2019.
https://tax.kpmg.us/articles/2019/tax-transparency-beps-era.html

4 Deloitte, *Global Tax Reset: The Changing World of Tax*, 2015.
https://www2.deloitte.com/me/en/pages/tax/articles/global-tax-reset-the-changing-world-of-tax.html

5 Tax Foundation, *The Trade-Offs of Tax Transparency Measures*, July 25, 2019. https://taxfoundation.org/trade-offs-tax-transparency-measures/

6 Deloitte, *DAC6: EU Mandatory Disclosure Regime*. https://www2.deloitte.com/uk/en/pages/tax/articles/dac6-eu-mandatory-disclosure-regime.html

The directive requires companies operating in the EU to provide comprehensive information about potentially aggressive cross-border tax arrangements.

Specifically, companies must:

- Retroactively report to the relevant EU member states certain cross-border arrangements that were implemented between June 25, 2018 and July 1, 2020.
- Report new arrangements within 30 days of their becoming ready to implement — which requires ongoing, year-round administrative management.

Which arrangements must be reported?

Cross-border tax arrangements must be reported when they involve at least one EU member state and meet one of the numerous DAC6 hallmarks, which are characteristics or features that indicate a potential risk of tax avoidance.

DAC6 hallmarks include any arrangement:

- In which a fee is based on tax savings.
- Involving a confidentiality agreement *not* to disclose transaction details to tax authorities.
- Using standardized documentation or a structure without substantial customization for implementation.
- Involving loss-buying, income conversion, or circular transactions to obtain a tax advantage.
- Including a wide range of cross-border tax deductions between different jurisdictions.
- Intended to undermine beneficial ownership and information exchange rules.
- Impacting transfer pricing, including the use of safe harbors and transfer of hard-to-value intangible assets.

Cross-border tax arrangements must be reported when they involve at least one EU member state and meet one of the numerous DAC6 hallmarks.

Some of hallmarks apply only when an additional condition is met — a "main benefits" test that indicates the transaction's primary motive was to secure a tax advantage.

The DAC6 hallmarks target well-known characteristics of certain tax-avoidance schemes such as loss buying, circular transactions, confidentiality agreements, and transfer pricing.

On the other hand, the directive requires companies to report transactions that are legal and yield no tax benefit — including a number of common corporate financing mechanisms, cross-border leasing arrangements, multi-country reinsurance deals, and other tax-neutral business arrangements.

For example, the hallmark involving standardized documentation can be triggered by activities that multinational companies engage in routinely, including employee contracts, stock options, employee secondment, intercompany agreements, and contracts with vendors. And a hallmark involving the conversion of highly taxed income to lower-taxed or tax-exempt status could cover any type of tax planning — including increased shareholding to take advantage of participation exemption rules and structures designed to avoid forgiveness of debt income.

Who must report?

The corporate taxpayer is liable for non-compliance, but reporting responsibility also lies with intermediaries — including banks, tax advisors, and law firms that designed, marketed, organized, or managed the implementation of the cross-border arrangement.

Imposing a reporting obligation on intermediaries may, in certain circumstances, create a breach of legal professional privilege under a member state's national law. In such cases, an intermediary may receive a waiver from filing.

Significant challenges

To comply with DAC6 going forward, taxpayers or their intermediaries need to:

- Comply with disclosure requirements in the more than 25 EU member states.
- Navigate deviations in these countries' regulations, deadlines, and reporting systems.
- Overcome significant data management challenges.
- Devise and implement, on an ongoing basis, new workflows.

The need to coordinate with intermediaries — to manage information and determine whether an arrangement must be reported and by whom — creates additional complexity.

DAC6 doesn't follow the traditional reporting path in which a taxpayer accounts for something after it happened. Instead, it requires transactions to be reported as they're unfolding.

As a result, companies need systems and processes that identify internal business activity that may meet DAC6 definitions of reportable arrangements — and to be prepared to file disclosures within 30 days of an arrangement being ready or available to implement.

Given the 30-day reporting requirement, it's unlikely the data needed for this task will have been entered into an existing system, such as the company's Enterprise Resource Planning (ERP) system, in time for DAC6 reporting.

The data, in fact, probably is scattered across the multinational enterprise because reportable arrangements involve a wide range of activities managed in different parts of the company — including mergers and acquisitions, cross-border payments, movement of personnel, various treasury activities, and business activity that impacts transfer pricing.

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Strategy and best practices

DAC6 compliance requires a reporting strategy, policy, and guidance that details how to recognize reportable arrangements, establishes responsibilities for taxpayers and intermediaries, and includes repeatable workflows that span from data collection to analysis to reporting.

Given the intense workload, tight deadlines, digital filing requirements, and high cost of failure, this cannot be accomplished manually or easily outsourced.

To ensure compliance, tax departments need to:

- **Flag reportable arrangements**: First, identify people within the organization who manage the relevant data across regions and functions — including tax, treasury, strategy, human resources, and operations. Next, create a set of questions that will surface information needed to identify relevant tax arrangements. Solicit answers monthly so reports can be filed within the 30-day window, as needed. Analyze the information provided to determine whether an arrangement needs to be reported and, if so, to manage submission to the appropriate tax authorities. Finally, establish clear workflows to efficiently complete these steps on an ongoing basis.
- **Automate:** Establish an automated process built upon a database of country-by-country rules and the ability to automatically apply hallmarks, identify reportable cross-border arrangements, and filter reporting requirements by jurisdiction and due date.
- **Coordinate:** Ensure all stakeholders are informed about DAC6 and its requirements and tax teams have the technical knowledge to meet reporting requirements. Nurture strong, collaborative relationships between taxpayers and intermediaries to ensure effective processes are in place, understood, and effectively managed. Carefully monitor arrangements in which there are multiple intermediaries to ensure efforts aren't duplicated and details aren't missed.

This is just the beginning. DAC6 is the EU's implementation of a BEPS action item which other countries are now in the process of enacting.

- **Execute:** Establish a repeatable process for managing reporting obligations that addresses multi-country reporting formats, reporting timetables, the ability to meet 30-day reporting requirements, secure information storage, and annual reporting obligations.
- **Document:** Track arrangements that have been reported and those that have not and retain relevant documentation in a centralized repository to be prepared for future inquiries and audits.

Finally, be aware that this is just the beginning.

DAC6 is the EU's implementation of a BEPS action item (No. 12) which other countries are now in the process of enacting. Mexico, for example, has scheduled implementation in 2021 with requirements similar to DAC6 — including retroactive reporting and stiff penalties for non-compliance.

That's more reason to ensure your solution is scalable and adaptable as the rules overseeing disclosure of cross-border arrangements expand and evolve.

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