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From:	Commission services
To:	Working Party on Tax Questions (Direct Taxation – DAC)
Subject:	Examples and origin of the Hallmarks

Delegations will find attached a document from the Commission services in view of the meeting of the Working Party on Tax Questions (Direct Taxation - DAC6) on 27 September 2017.

Examples and Origin of the Hallmarks

In response to a number of requests by Member States, DG TAXUD put together the present document, with the aim to provide one example for each of the hallmarks as well as brief information on the origin of each hallmark.

"ANNEX IV
HALLMARKS

Generic hallmarks and specific hallmarks under category B may only be taken into account where they fulfil the "main benefit test".

Main benefit test

The test will be satisfied where the main benefit of an arrangement or of a series of arrangements is to obtain a tax advantage if it can be established that the advantage is the outcome which one may expect to derive from such an arrangement, or series of arrangements, including through taking advantage of the specific way that the arrangement or series of arrangements are structured.

[Origin: OECD Report – Action 12 : most generic hallmarks (with the exception of the US) have been designed to operate subject to a threshold requirement that considers **whether the transaction has features of a tax avoidance scheme or whether the "main benefit" of the scheme was to obtain a tax advantage**].

- The scheme would be unlikely to have been implemented if it were not for the expectation of obtaining a tax advantage.

A. **Generic hallmarks**

1. An arrangement or series of arrangements where the taxpayer undertakes to comply with a **condition of confidentiality** which may require them not to disclose how the arrangement could secure a tax advantage vis-à-vis other intermediaries or the tax authorities.

   [Origin: OECD Report – Action 12 quotes UK, IE, US & CA]

   - The scheme consists of sufficiently new and innovative elements that a promoter would not wish to disclose to competitors, in order to maintain a competitive advantage and ability to continue the use of the arrangement and earn fees.

     For this hallmark, it is irrelevant whether fees are charged at a premium level.

2. An arrangement or series of arrangements where the intermediary is entitled to receive a fee (or interest, remuneration for finance costs and other charges) for the arrangement or series of arrangements and this fee is fixed by reference to:

   (a) the amount of the tax advantage derived from the arrangement or series of arrangements; or

   (b) whether or not a tax advantage is actually derived from the arrangement or series of arrangements. This would include an obligation on the intermediary to partially or fully refund the fees where the intended tax advantage derived from the arrangement or series of arrangements was not partially or fully achieved.

   [Origin: OECD Report – Action 12 quotes UK, IE, US & CA]

- A fee agreement where the taxpayer has little or no upfront expenses and no payment to the adviser is required unless and until the taxpaying entity obtains or retains a tax benefit.

  A fee agreement where the taxpayer pays the adviser a percentage of the tax benefit/refund; so, a more aggressive tax stance may provide an additional upside potential payment.

  A premium fee may be due for the scheme, as opposed to a normal fee. This fee should be attributable to the advantage and not to other factors, such as the reputation of the adviser.

  Taxpayers are prepared to pay more for the scheme, as it is innovative.

3. An arrangement or series of arrangements that involves the use of **standardised documentation including standard forms**. The documentation is commonly available to more than one taxpayer and does not need to be tailor-made to enable a taxpayer to implement the arrangement or series of arrangements.

[Origin: OECD Report – Action 12 quotes Korea]

- The scheme is available generally, e.g. not tailored to only meet the needs of taxpayers with specific corporate features or personal income tax structures.
- The implementation of the scheme does not require that it be tailored to any material extent; so, there is no requirement for significant additional professional advice.
- The scheme would normally require little, if any, modications to suit the circumstances each time.
- The scheme is easy to replicate, so that it can be used by numerous taxpayers; the volume of take-up or how a scheme is made available can vary enormously and is irrelevant.

B. Specific hallmarks which may be linked to the main benefit test

** The arrangements below are only captured by the scope of the Directive if they have a **cross-border** element.

1. An arrangement or series of arrangements whereby the taxpayer uses losses to reduce their tax liability, including through the transfers of those losses to another jurisdiction or by the acceleration of the use of those losses.

[Origin: OECD Report – Action 12 quotes US, UK, CA, IE & PT]

- A profitable company which is tax resident in a jurisdiction that consolidates foreign PE income (incl. losses) buys another company which maintains a loss-making PE and makes use of accumulated losses of the PE to set off profits in future years.

** Under the UK and IE regimes, the transaction should be such that **it can be reasonably concluded that the main benefit** of the transaction is the provision of losses which can be used to **reduce the tax liability** of the taxpayer.

2. An arrangement or series of arrangements that has the effect of converting income into capital, gifts or other categories of revenue which are taxed at a lower level.

[Origin: OECD Report Action 12 quotes IE & PT]

- In an employment scheme, part of the remuneration package of a Chief Executive Officer (CEO) is given in the form of shares in a company (which is a non-financial entity) of the same group that is tax resident in a jurisdiction where the distributions of dividends are not subject to withholding tax. For this scheme to be tax efficient, the CEO should be tax resident in a jurisdiction that exempts foreign dividends from taxation when those are received by individuals.

** Under the PT regime, this hallmark covers insurance and financial transactions that may give rise to a reclassification of the income or to a change in its recipients. Areas primarily targeted include finance leasing, hybrid instruments, derivatives or contracts on financial instruments. There is a partial overlap with the UK regime on finance leasing.

The IE legal framework provides for a distinction between income and capital gains. On this premiss, the hallmark addresses schemes which convert income into capital or gifts with the aim of taxing the gain at a lower rate or providing for a relief or exemption from tax.

3. An arrangement or series of arrangements which includes 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.

[Origin: South Africa]

- Companies A, B and C are members of a direct investment group; companies A and C are tax residents in the same jurisdiction and company B is a non-resident Special Purpose Entity (SPE). This group structure will be conducive to round tripping if:

  (a) Company B is wholly-owned by Company A; and

  (b) Company B does not own any company other than company C.

  Foreign direct investment (FDI) funds received by company C from Company B may in fact have been provided by Company A, i.e. round-tripping. It is therefore essential to find out, via company C, the source of FDI funds provided by Company B, i.e. whether the funds come from Company A or have been borrowed from other companies.

- **Examples**

  1) Some jurisdictions provide preferential regimes to attract FDI, including low taxation, favourable land use rights, convenient administrative support, etc. If local businesses find it difficult to attract foreign investment, they may first channel capital abroad, which is then disguised as foreign capital and returns to fund local investment and take advantage of the preferential treatment that is only available to foreign investors.

  2) Businesses in jurisdictions which do not protect property rights sufficiently are motivated to park their wealth in affiliated enterprises set up in overseas jurisdictions that have better legal and institutional settings for property right protection. Some investors may also prefer to keep their identities anonymous.

     Capital will then be brought back in the form of FDI if there are profitable investment opportunities.

  3) Financial markets may not be well developed in some jurisdictions. Businesses may have to access overseas financial markets for obtaining better financial services, such as to become listed on overseas stock markets. If the raised funds are brought back in the form of FDI, it cannot be excluded that round tripping occur as part of this process.

C. Specific hallmarks related to cross-border transactions

[The OECD Recommendation regarding cross-border schemes is to develop hallmarks that focus on **BEPS related risks** and that are sufficiently wide to **capture different and innovative tax planning** techniques.]

1. An arrangement or series of arrangements that involves deductible cross-border payments made between two or more related parties where at least one of the following conditions occurs:

(a) the recipient is not resident for tax purposes in any tax jurisdiction;

(b) although the recipient is resident for tax purposes in a jurisdiction, that jurisdiction either:

i. does not impose any corporate tax; [Origin: OECD Report - Action 12] or

ii. imposes corporate tax at zero rate or at a statutory corporate tax rate lower than half of the average statutory corporate tax rate in the Union, as it stands at the end of the previous calendar year [Origin: OECD Report - Action 12 & PT]; or

iii. is included in a list of certain third-country jurisdictions which have been assessed by Member States collectively or within the framework of an international organisation as having harmful tax regimes. [Origin: PT]

(c) the payment benefits from a partial or full exemption from tax in the jurisdiction where the recipient is resident for tax purposes; [Origin: PT]

(d) the payment benefits from a preferential tax regime in the jurisdiction where the recipient is resident for tax purposes; [Origin: TAXUD public consultation]

A preferential tax regime may include **patent boxes or special economic zones, etc**.

- [Example with implications that could take the shape of points (b), (c) or (d)]

  Company A is tax resident in Member State A, which is a high-tax jurisdiction. It is licensed to use intellectual property (IP) of an MNE group headquartered in a major trade partner of the EU. The licensing is given via the group´s IP centre, tax resident in a third country **with zero corporate tax rate.**

  To avoid paying the high withholding tax (WHT) of 15% on royalties from Company A to the group's IP Centre (due to the absence of a tax treaty), the group sets up a NewCo in an EU Member State where outflows in the form of dividends, interest and royalties are subject to no WHT.

  NewCo is given the function of sub-licensing the group IP across the EU.

  Company A pays royalties to NewCo under a tax treaty which follows the OECD Model and provides for no WHT on royalties.

  Further, when NewCo passes the royalties to the IP centre, there is no WHT because the Member State where NewCo is tax resident has unilaterally abolished WHT on outflows.

  NewCo is taxable on the royalties that it receives from Company A but its tax base is significantly reduced by the fact that it pays out most of these amounts to the IP centre.

  This scheme allows the group to direct royalties tax-free to its IP Centre outside the EU where this income is taxable at zero rate.

(e) there is a mismatch within the scope of Council Directive amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries, which was adopted by the Council of Ministers on 23 May 2017.

[Origin: OECD Report – Action 12 which describes a situation of Deduction/Non-Inclusion; the wording in the Commission's Proposal is broader because it refers to the full scope of hybrid mismatches, as addressed in ATAD 2]

** Although ATAD 2 has been adopted, it will start applying, in connection with most of its items, a year later (1 January 2020) than the proposal on Intermediaries (1 January 2019). The rule on reverse hybrids is due to start applying even later, i.e. 1 January 2022. So, if the current proposal on Intermediaries goes for speedy adoption in Council, there may be a year during which cases of hybrid mismatches may not yet be neutralised.

- **Example - Deemed PE** – there is a divergent interpretation of the same set of facts by two (or more) affected Member States. As a result, the income allocated to a PE is left untaxed.

  Company A is tax resident in Member State A and also commercially active in Member State B. The tax authorities of Member State B do not see sufficient commercial presence of company A for creating a PE in their territory. Therefore, based on the tax treaty between Member States A and B, the income earned in the latter is not taxed there. Accordingly, Member State A assumes that company A maintains a PE in Member State B and that the income allocated to the PE has already been taxed in Member State B. On this premiss, Member State A treats the PE income as exempt in its jurisdiction.

  Outcome: **the income allocated to the PE remains untaxed**.

2. The same asset is subject to depreciation in more than one jurisdiction.

[Origin: OECD Report – Action 12]

- Two jurisdictions operate different rules on who has the right to depreciate leased assets: in one jurisdiction, the right to depreciate is with the legal owner whilst in the other, with the economic owner.

  In such situations, the same asset may turn out to be depreciated in both jurisdictions (i.e. by both the legal and economic owner).

3. More than one taxpayer can claim relief from double taxation in respect of the same item of income in different jurisdictions.

[Origin: OECD Report – Action 2 refers to securities lending - double tax relief is claimed because one of the jurisdictions allows for a credit for the whole of the WHT, despite the fact that there is a manufactured payment which reduces the net taxable income. Art 9, para 6, covers the situation where a hybrid transfer is designed to produce a double WHT relief on a payment derived from a transferred financial instrument.] There are more situations in which taxpayers may claim double tax relief.

- See example under category C.2 above.

4. There is an arrangement or series of arrangements that includes transfers of assets and where there is a material difference in the amount being treated as payable in consideration for the assets in those jurisdictions involved.

- Divergent valuations of the market price of the same asset by two or more Member States may cause double taxation or double non-taxation if the involved jurisdictions do not coordinate amongst themselves, to agree the payable amount. For instance, if an asset is sold to another company across the border, it is possible that the departing Member State uses a different discount rate from the destination Member State in computing the net present value of expected future profits.

D. Specific hallmarks concerning automatic exchange of information agreements in the Union

An arrangement or series of arrangements which circumvent Union legislation or agreements on the automatic exchange of information, including agreements with third countries, and that have the effect of avoiding the reporting of income to the State of tax residence of the taxpayer. These arrangements may include:

(a) the use of jurisdictions that are not bound by the Union legislation or agreements on the automatic exchange of information;

[UK public consultation on tackling offshore tax evasion – Dec. 2016 - Feb. 2017]

- Capital is moved to a custodial account set up in a jurisdiction outside the network of participating jurisdictions..

  Outcome: **the jurisdiction of tax residence of the account holder/beneficial owner would not receive information on that account.**

(b) the re-classification of the types of income into categories that are not subject to the automatic exchange of information;

- The salary of the employees of a company (which is a non-financial entity) is partly given in the form of shares or bonds in that company. These shares or bonds are held directly by the employees (investors) without the intervention of a custodian.

  Outcome: **the income generated by those financial assets will not be captured by the automatic exchange of information requirement of Article 8(1) DAC**. In addition, there is no reporting obligation under the CRS because the shares or bonds are held directly by the employees (investors) without the intervention of a custodian (financial institution).

(c) the use of legal entities and structures that are not captured by either the Union legislation or agreements on the automatic exchange of information;

[UK public consultation on tackling offshore tax evasion – Dec. 2016 – Feb. 2017]

- A taxpayer who is tax resident in Member State A sets up a professionally managed trust (which qualifies as an 'investment entity' under the Section VIII(6)(b) of the CRS) in a third-country jurisdiction B. The trust opens a bank account in Member State C. Member State C has a bilateral CAA with third country B, which is therefore treated as a participating jurisdiction for CRS purposes by Member State C. Member State C will not look through the investment entitiy (trust) in B. However, there is no CAA between Member State A and the third country.

Outcome: **the structure is left unreported to Member State A**; **Member State A will not know of its taxpayer's trust structure and related financial account.** (If there was no CAA between Member State C and the third country, Member State C would treat the trust as a "Passive Non-Financial Entity" (PNFE) and would look through it to identify the beneficial owners and report the information on the financial account to their country of residence).

(d) the use of jurisdictions with inadequate or weak regimes of enforcement of anti-money laundering legislation. This includes where there are a lack of rules for identifying the beneficial ownership of legal entities, including trusts, foundations and special purpose vehicles or where there is a use of nominees or powers of attorney to conceal the identity of the beneficial owner.

[UK public consultation on tackling offshore tax evasion – Dec. 2016 – Feb. 2017]

- In addition to its list of 2 non-cooperative countries and territories in the field of anti-money laundering and terrorist financing (AML/FT), the Financial Action Task Force (FATF) has also identified **seven countries which operate systems with strategic deficiencies in this field.** For instance, they do not sufficiently identify beneficial owners in legal arrangements such as trusts or operate arrangements which have the effect of obscuring or distancing legal and beneficial ownership, e.g. through the use of a power of attorney or nominees.

E. Specific hallmarks concerning transfer pricing

1. An arrangement or series of arrangements which does not conform with the arm's length principle or with the OECD transfer pricing guidelines, including the allocation of profit between different members of the same corporate group.

[Origin: TAXUD public consultation]

- Businesses of a limited size which provide low-risk manufacturing, research and development or distribution services may go for **safe harbours**, instead of transfer pricing at arm's length.

2. An arrangement or series of arrangements which falls within the scope of the automatic exchange of information on advance cross-border rulings but which is not reported or exchanged."

[Origin: TAXUD public consultation]

- If an advance cross-border ruling under DAC 3 concerns the tax affairs of a natural person exclusively, it shall **not be reported or exchanged** (Article 8a(4)).
- Advanced pricing arrangements (APAs) under DAC 3 shall **not be exchanged automatically** if the APA was negotiated under an international agreement with a third country which does not permit disclosure to third parties.