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Global Tax Alert

Czech Government publishes revised draft legislation on Mandatory Disclosure Rules: A detailed review

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Executive summary

On 20 August 2019, the Czech Government published revised draft legislation (accompanied by explanatory notes) implementing the European Union (EU) Directive on the mandatory disclosure and exchange of cross-border tax arrangements (DAC6 or the Directive). The revised draft legislation follows an earlier draft published in March 2019.[1]

The Czech draft legislation is still subject to the formal legislative process (subject to approval of the Parliament and the President) and is likely to be amended before final enactment.

The exact timing of the draft law legislative approval process is not known at this point.

If implemented as currently proposed, the Czech Mandatory Disclosure Rules (MDR) legislation will be substantially aligned to the requirements of the Directive.

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Detailed discussion

Background

The Council of the EU Directive 2018/822 of 25 May 2018 amending Directive 2011/16/EU regarding the mandatory automatic exchange of information in the field of taxation (the Directive or DAC6), entered into force on 25 June 2018.[2]

The Directive requires intermediaries (including EU-based tax consultants, banks and lawyers) and in some situations, taxpayers, to report certain cross-border arrangements (reportable arrangements) to the relevant EU member state tax authority. This disclosure regime applies to all taxes except value added tax (VAT), customs duties, excise duties and compulsory social security contributions.[3] Cross-border arrangements will be reportable if they contain certain features (known as hallmarks). The hallmarks cover a broad range of structures and transactions. For more background, see EY Global Tax Alert, *Council of the EU reaches an agreement on new mandatory transparency rules for intermediaries and taxpayers*, dated 14 March 2018.

EU Member States are to adopt and publish national laws required to comply with the Directive by 31 December 2019.

The key similarities and differences between the revised draft Czech legislation and the Directive are summarized below.

Scope of taxes covered

The scope of the taxes covered under the Czech draft legislation does not go beyond the scope of the Directive and thus should apply to all taxes except VAT, customs duties, excise duties and compulsory social security contributions.

Reportable arrangements

Under the Directive, an arrangement is reportable if:

- The arrangement meets the definition of a cross-border arrangement; and
- The arrangement meets at least one of the hallmarks A-E specified in Annex IV of the Directive.

Under DAC6, cross-border arrangements are defined as arrangements concerning more than one Member State or a Member State and a third country. The hallmarks can be distinguished as hallmarks which are subject to the main benefit test (MBT), and those which by themselves trigger a reporting obligation without being subject to the MBT.

The overall definition of reportable arrangements and the hallmarks included in the draft Czech legislation are aligned with DAC6.

Hallmarks A-E of the Directive

Most elements of the hallmarks included in DAC6 are not expressly defined.

The Czech draft legislation and explanatory notes provide limited clarification on the elements of the hallmarks – the following notable examples are provided with specific reference to the application of the MBT as discussed further below:

- Hallmark A.1 – This hallmark aims to capture arrangements where the participant in the arrangement undertakes to comply with a condition of confidentiality which may require them not to disclose how the arrangement could secure a tax advantage. This may include, for example, exploiting a newly identified weakness in tax administration procedures, which can only be exploited until the tax authority becomes aware of it and takes appropriate counter measures. The explanatory notes indicate that, if an arrangement makes it possible to obtain tax advantages, regardless of whether it is publicly known or not, then the MBT should not be met in relation to Hallmark A1 even if a condition of confidentiality exists.
- Hallmark B.1 – This hallmark aims to capture arrangements where the participant uses contrived steps to acquire a loss-making company, discontinues the main activity and then uses the losses to reduce its tax liability. The explanatory notes state that it is possible to imagine an arrangement where the goal is to purchase, at low cost, intangible property held by various companies. Where a low-valued company is purchased at a low price (e.g., due to actual or expected losses) the respective intangibles will be transferred to the acquirer and the target's activities will be subsequently discontinued. Although involving contrived steps, the arrangement is not focused on obtaining the access to the losses and thus, the MBT should not be met.

Main benefit test

In accordance with DAC6, the MBT will be satisfied if 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."

The MBT included in the Czech draft legislation appears to be aligned with the MBT in DAC6.

According to the explanatory notes, the "essence" of the MBT is to examine whether there is causal link between the existence of the characteristics of the hallmark and the tax benefit that may be expected if an arrangement is implemented. If a given arrangement leads to a tax benefit precisely because it satisfies the hallmark under consideration, and if it did not, then it would not lead to a tax advantage, then the MBT is met. If, on the other hand, the arrangement leads to a tax advantage, regardless of the existence of the characteristics of the hallmark, then the MBT is not satisfied because it is not precisely these features that lead to the tax advantage.

Intermediaries

Under the Directive, intermediaries with EU nexus have the primary obligation to report arrangements to the tax authority. The Directive gives Member States the option to exempt intermediaries from the obligation to report where the reporting obligation would breach legal professional privilege (LPP). If there are no intermediaries which can report, the obligation will shift to the taxpayers.

Under the Czech draft legislation, intermediaries are exempt from the obligation to report when obliged to maintain confidentiality pursuant to the *Act on Tax Advisory*, the *Act on Advocacy*, the *Act on Notaries*, the *Act on Auditors*, or the laws of another EU Member State to the extent that the intermediary is bound by professional confidentiality in the other EU Member State in relation to the reportable cross-border arrangement. The intermediary that is exempt due to LPP is obliged to inform the other "known" intermediaries and the relevant taxpayer that the intermediary is exempt based on professional privilege.

DAC6 defines two categories of intermediaries: promoters and service providers. The Czech draft legislation defines intermediaries by reference to the same two categories and follows DAC6 parameters. The draft legislation also defines intermediaries by reference to the same nexus conditions contained in Article 3, Paragraph 21 of the Directive. The provisions of points (a) to (d) of the cascade provisions which mirror Article 8ab, Paragraph 3 of the Directive, indicate that only intermediaries with nexus in the Czech Republic (as defined) are expected to have a reporting obligation in the Czech Republic.

Furthermore, according to the explanatory memorandum, where an arrangement is designed "in house" and is implemented by the entity for its own use, the entity should not be regarded as an intermediary. However, if an arrangement is designed within a group by another of its member entities, whether parent or subsidiary, that other member entity should be regarded as an intermediary in respect of that specific arrangement.

The explanatory memorandum also indicates that an employee working for a company while designing, promoting or implementing a cross-border arrangement should not be an intermediary.

Reporting deadlines

Under DAC6, for intermediaries (and relevant taxpayers), the trigger events for reporting under the Directive (from 1 July 2020) are when the reportable arrangement is "made available for implementation"; or when the reportable arrangement is "ready for implementation" or when "the first step of implementation has been made." The same triggering events are included in the Czech draft legislation.

Under the Directive, reporting starts from 1 July 2020 and exchanges between jurisdictions from 31 October 2020. However, reports will retroactively cover arrangements where the first step is implemented between 25 June 2018 and 1 July 2020.

The Czech reporting deadlines are aligned with DAC6.

Penalties

The revised draft legislation indicates that the Czech Tax Administrator may impose fines up to CZK500,000 (up to approx. €20,000) on intermediaries or relevant taxpayers for failures to comply with their obligations under the MDR legislation.

Next steps

Determining if there is a reportable cross-border arrangement raises complex technical and procedural issues for taxpayers and intermediaries. Taxpayers and intermediaries who have operations in the Czech Republic should review their policies and strategies for logging and reporting tax arrangements so that they are fully prepared for meeting their obligations.

Endnotes

1. See EY Global Tax Alert, *Czech Republic publishes draft proposal on Mandatory Disclosure Rules*, dated 17 April 2019.
2. For background on MDR, see EY Global Tax Alert, *EU publishes Directive on new mandatory transparency rules for intermediaries and taxpayers*, dated 5 June 2018.
3. DAC6 sets out a minimum standard. Member States can take further measures; for example, (i) introduce reporting obligations for purely domestic arrangements; (ii) extend the scope of taxes covered; (iii) bring forward the start date for reporting.

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