ATOZ ALERT

Unshell Directive Proposal: the poisoned Christmas gift of the European Commission

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Yesterday, the European Commission released a Directive proposal (the so-called "**unshell proposal**") which aims to fight against the misuse of shell entities for tax purposes and ensure that EU entities with no or minimal economic activity are unable to benefit from certain tax advantages.

As we drafted this ATOZ Alert, as a Christmas gift to our clients and friends, we were conscious that on re-reading it, it was, to say the least, obscure. And that is a seasonal understatement. However in the interest of time, we thought we would send it out to you in its complete but somewhat impenetrable form and we will work diligently over the Christmas to distil it into something that's a little bit more understandable. Bear with us and keep an eye out for the next installment in the new year!

The unshell proposal would introduce the following three steps system:

(1) Undertakings considered as "at risk to be shell" based on certain criteria (mainly cross-border activities generating passive revenues) would have to report information on their substance to their local tax authorities. Some undertakings considered as commonly used for good commercial reasons (such as regulated financial undertakings) and those which do not bring any tax benefits to their shareholders or the group would be exempt from reporting.
(2) Tax benefits would be denied to the undertakings assessed as shell entities based on a list of substance indicators to the extent that they cannot evidence that they have substance and that they are not misused for tax purposes: no benefits under double tax treaties and EU tax directives, no certificate of tax residence for use outside of the jurisdiction of the undertaking and allocation of the income of the shell to other jurisdictions.
(3) Information received on all reporting entities (whether assessed as shell entities or not) would be exchanged automatically between the tax authorities of the EU Member States. The Directive on Administrative Cooperation ("**DAC**") would be amended in order to reflect these changes.

We will provide an overview of the rules to be introduced and some preliminary comments based on the unshell proposal in its current version. However, given the various potential issues raised by the proposal, these rules could evolve over the legislative process. In addition, the proposal would have to be adopted by all EU Member States (as unanimity is required) in order to enter into force and become effective as of 1 January 2024.

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Undertakings to be subject to the minimum substance test

The unshell proposal targets schemes involving the setting up of undertakings within the EU which are presumably engaged with an economic activity but that, in reality, do not conduct any economic activities and are in place to enable certain tax advantages to flow to their beneficial owners or to the group which they belong to, as a whole.

Should the proposal become a Directive, it would apply, in principle, to all undertakings (entities engaged in an economic activity, regardless of their legal forms) that are considered tax resident and are eligible to receive a tax residence certificate in an EU Member State. However, only entities identified as entities at risk to be shell and misused to obtain tax advantages by reference to a set of features common in such entities would have to report on their substance. In addition, specific entities would be carved out upfront as they would be considered as commonly used for good commercial reasons. Finally, other entities could be exempt from reporting upon request if they provide sufficient evidence that their interposition does not lead to a tax benefit for their beneficial owner(s) or the group as a whole.

Reporting undertakings

Only the undertakings (defined as "**reporting undertakings**") meeting the following specific criteria would have to report information on their substance to their local tax authorities:

a) More than 75% of revenues accruing to the undertaking in the preceding two tax years is "*relevant income*" (i.e. interest, royalties, dividends, income from the disposal of shares, income from financial leasing, income from immovable property, income from movable property, other than cash, shares or securities, held for private purposes and with a book value of more than one million euros, income from insurance, banking and other financial activities and income from services which the undertaking has outsourced to other associated enterprises, etc.);

b) The undertaking is engaged in cross-border activity (more than 60% of the book value of its assets that fall within the scope of income from immovable property and income from movable property other than cash, shares or securities, held for private purposes and with a book value of more than one million euros, was located outside the Member State of the undertaking in the preceding two tax years or at least 60% of the undertaking's relevant income is earned or paid out via cross-border transactions);

c) In the preceding two tax years, the undertaking outsourced the administration of day-to-day operations and the decision-making on significant functions.

An undertaking which holds assets that can generate income from immovable property and income from movable property other than cash, shares or securities, held for private purposes and with a book value of more than one million euros would also be deemed to meet the criterion set out in point a), irrespective of whether income from these assets has accrued to the undertaking in the preceding two tax years, if the book value of these assets is more than 75% of the total book value of the undertaking's assets.

Finally, an undertaking which holds assets that can generate dividends and income from the disposal of shares would also be deemed to meet the criterion set out in point a), irrespective of whether income from these assets has accrued to the undertaking in the preceding two tax years, if the book value of these assets is more than 75% of the total book value of the assets of the undertaking.

Undertakings always exempt from reporting - Commonly used for good commercial reasons

The following undertakings would be carved out and thus exempt from reporting because they are considered as commonly used for good commercial reasons:

- Companies which have a transferable security admitted to trading or listed on a regulated market or multilateral trading facility;

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- Regulated financial undertakings within the meaning of the relevant EU Directives and Regulations (including credit institutions, investment firms, undertakings for collective investment in transferable securities ("**UCITS**"), management companies of UCITS, alternative investment funds managed by an alternative investment fund manager ("**AIFM**"), AIFMs, insurance undertakings, reinsurance undertakings, institutions for occupational retirement provision, certain pension institutions, securitisation special purpose entities, insurance holding companies, payment institutions, electronic money institutions, crowdfunding service providers, crypto-asset service providers);
- Undertakings that have the main activity of holding shares in operational businesses in the same Member State while their beneficial owners are also resident for tax purposes in the same Member State;
- Undertakings with holding activities that are resident for tax purposes in the same Member State as the undertaking's shareholder(s) or the ultimate parent entity;
- Undertakings with at least five own full-time equivalent employees or members of staff exclusively carrying out the activities generating the relevant income.

<u>Undertakings exempt from reporting upon request - Lack of tax motives</u>

Finally, an undertaking that would meet the criteria for being considered as a reporting undertaking would still be able to request an exemption from its reporting obligations if its existence does not reduce the tax liability of its beneficial owner(s) or of the group, as a whole, which the undertaking is a member of. This exemption would be granted provided that the undertaking provides sufficient and objective evidence that its interposition does not lead to a tax benefit for its beneficial owner(s) or the group as a whole.

While the possibility for an undertaking to be exempt from reporting on this basis is positive as an undertaking that might not fulfil the minimum substance requirements of the unshell proposal could be used for genuine business activities without creating a tax benefit for itself, the group or its beneficial owners, it is questionable how an undertaking will be able to demonstrate that it does not bring any kind of tax benefit and it is also unclear which evidence will be assessed as sufficient by the tax authorities.

Minimum substance indicators to be reported

Undertakings defined as reporting undertakings and not benefiting from a carve-out or an exemption would have to declare in their annual tax return, for each tax year, whether they meet the following indicators of minimum substance:

a) the undertaking has its own premises in the Member State, or premises for its exclusive use;

b) the undertaking has at least one own and active bank account in the Union;

c) one of the following indicators:

- One or more directors of the undertaking (1) are resident for tax purposes in the Member State of the undertaking, or at no greater distance from that Member State insofar as such distance is compatible with the proper performance of their duties; (2) are qualified and authorised to take decisions in relation to the activities that generate relevant income for the undertaking or in relation to the undertaking's assets; (3) actively and independently use the authorisation referred to in point (2) on a regular basis; (4) are not employees of an enterprise that is not an associated enterprise and do not perform the function of director or equivalent of other enterprises that are not associated enterprises;
- the majority of the full-time equivalent employees of the undertaking are resident for tax purposes in the Member State of the undertaking, or at no greater distance from that Member State insofar as such distance is compatible with the proper performance of their duties, and such employees are qualified to carry out the activities that generate relevant income for the undertaking.

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All information reported on the minimum substance indicators would have to be accompanied with documentary evidence. The evidence required is aimed at allowing the tax administrations to verify directly the truth of the reported information as well as to form a general overview of the situation of the undertaking so as to consider whether to initiate a tax audit.

Rebuttable presumption of (lack of) minimum substance for tax purposes

Undertakings which would declare to meet all the indicators of minimum substance and provide the satisfactory supporting documentary evidence would be presumed to have minimum substance for the tax year while undertakings that declare not to meet one or more of the substance indicators or do not provide satisfactory supporting documentary evidence would be presumed not to have minimum substance for the tax year.

However, this presumption would be rebuttable, meaning that undertakings presumed not to have minimum substance would be able to demonstrate that they have substance or in any case are not misused for tax purposes.

For this purpose, the undertaking would need to provide the following additional supporting evidence of the business activities which they perform to generate relevant income:

- documents allowing to ascertain the commercial rationale behind the establishment of the undertaking;
- information about the employee profiles, including the level of their experience, their decision-making power in the overall organisation, role and position in the organisation chart, the type of their employment contract, their qualifications and duration of employment;
- concrete evidence that decision-making concerning the activity generating the relevant income is taking place in the Member State of the undertaking.

An undertaking would be considered as having rebutted the presumption if the evidence that the undertaking has provided proves that the undertaking has performed and continuously had control over, and borne the risks of, the business activities that generated the relevant income or, in the absence of income, the undertaking's assets.

Since the rebuttal process is likely to create a burden for both the undertaking and the tax administration, it would be possible to extend the validity of the rebuttal for another five years after the relevant tax year, provided that the legal and factual circumstances evidenced by the undertaking do not change. After this period, the undertaking would need to renew the process of rebuttal if it wishes to do so.

The possibility for undertakings to demonstrate that they should not be considered as shell despite an apparent lack of substance is positive as there is no "one-size fits all" approach and the right level of substance has to be tailored to each individual case. However, here again, it remains to be seen how and how quickly the tax authorities will assess the information provided and, pending this assessment, the undertaking will be in a situation of legal uncertainty.

Tax implications in case of lack of minimum substance

Tax implications in the Member State of the undertaking

Where undertakings do not have the minimum substance for tax purposes, the Member State where it is resident for tax purposes would have to take either of the following decisions:

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- deny a request for a certificate of tax residence to the undertaking for use outside the jurisdiction of this Member State;
- grant a certificate of tax residence which prescribes that the undertaking is not entitled to the benefits of agreements and conventions that provide for the elimination of double taxation of income, and, where applicable, capital, and of international agreements with a similar purpose or effect and of Articles 4, 5 and 6 of Directive 2011/96/EU ("EU Parent-Subsidiary Directive") and Article 1 of Directive 2003/49/EC ("EU Interest and Royalty Directive").

It should be noted that not issuing a tax residence certificate or issuing a special certificate, including the warning described above, would not set aside the national rules of the Member State of the undertaking qualified as a shell entity with regard to any tax obligations linked to the shell. It would only serve as an administrative practice to inform the source country that it should not grant the benefits of its tax treaty with the Member State of the shell (or of applicable EU directives) to payments towards the shell.

Tax implications in other Member States

Undertakings presumed not to have minimum substance and which do not rebut the presumption of lack of substance would be denied tax benefits under double tax treaties in force with the Member State, as well as under the EU Parent Subsidiary Directive and the EU Interest and Royalty Directive.

In addition, the Member State of the undertaking's shareholder(s) would tax the relevant income of the undertaking in accordance with its national law as if it had directly accrued to the undertaking's shareholder(s) and, to avoid double taxation, deduct any tax paid on such income at the Member State of the undertaking, provided that both the undertaking's shareholders and the payer are resident for tax purposes in a Member State.

Where the payer is not resident for tax purposes in a Member State, the Member State of the undertaking's shareholder(s) would have to tax the relevant income accruing to the undertaking in accordance with its national law as if it had directly accrued to the undertaking's shareholder(s), without prejudice to any agreement or convention that provides for the elimination of double taxation of income, and, where applicable, capital, in force between the Member State of the undertaking's shareholders and the third country jurisdiction of the payer.

Where the undertaking's shareholder(s) is/are not resident for tax purposes in a Member State, the Member State of the payer of this income would have to apply withholding tax in accordance with its national law, without prejudice to any agreement or convention that provides for the elimination of double taxation of income, and, where applicable, capital, in force with the third country jurisdiction of the undertaking's shareholder(s).

Where property is owned by an undertaking that is presumed not to have minimum substance and does not rebut this presumption, the Member State where the property is situated would have to tax such property according to its national law, as if such property was owned directly by the undertaking's shareholder(s) and the Member State of the undertaking's shareholder(s) would have to tax such property in accordance with its national law as if the undertaking's shareholder(s) owned it directly.

Finally, it should be noted that the Member State of the shell would still remain free to continue to consider the shell as resident for tax purposes in its territory and apply tax on the relevant income flows and/or assets as per its national law.

Exchange of information

All Member States would have access to information on all undertakings defined as reporting entities and subject to reporting under the unshell proposal at any time and without a need for recourse to request for information. To this effect, information would be exchanged among Member States from the first step, when an undertaking is classified as being at risk for the purposes of the proposal. Exchange would also apply where the tax administration of a Member State makes an assessment based on facts and circumstances of individual cases

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and decides to certify that a certain undertaking has rebutted the presumption of being shell or should be exempt from the obligations under the unshell proposal. Member States would also be able to request the Member State of the undertaking to perform tax audits where they have grounds to suspect that the undertaking might be lacking minimal substance for the purposes of the Directive.

The information would be exchanged automatically through a central directory by deploying the existing mechanism of administrative cooperation in tax matters under the DAC. Member States would have to exchange the information within 30 days from the time the administration has such information at its disposal. Automatic exchange would also take place within 30 days from the conclusion of an audit to an undertaking at risk for the purposes of the Directive, if the outcome of such audit has an impact on the information already exchanged or that should have been exchanged for this undertaking.

Where a Member State's administration assesses a rebuttal of presumption or an exemption from the obligations of the Directive, the information exchanged would need to allow other Member States to understand the reasons for this assessment. Other Member States would always have to be able to request from another Member State a tax audit on any undertaking that passes the gateway of this Directive, if they have doubts on whether or not it has the minimal substance required. The requested Member State would have to perform the tax audit within a reasonable timeframe and share the outcome with the requesting Member State. If there is a finding of 'shell' entity, the exchange of information would be automatic.

Penalties for non-compliance

The unshell proposal leaves it to Member States to lay down penalties applicable against the violation of the reporting obligations which shall be effective, proportionate, and dissuasive. Member States shall ensure that those penalties include an administrative pecuniary sanction of at least 5% of the undertaking's turnover in the relevant tax year, if the undertaking that is required to report does not comply with such requirement for a tax year within the prescribed deadline or makes a false declaration in its tax return.

Next steps and implications

The unshell proposal did not come as a surprise as it is one of the initiatives already announced by the European Commission in its Communication of May 2021 on Business Taxation for the 21st century. However, it came earlier than expected since a public consultation was launched less than four months ago in order, among others, to assess whether there was a need to handle in this area (given the various tools already at the disposal of tax authorities to tackle aggressive tax planning schemes) and whether it was really the right time to handle (given that the impact of the tools available could not be assessed yet). Obviously, the European Commission came to the conclusion very rapidly that an additional layer of transparency (this time on substance) and the introduction of substance driven anti-abuse rules (through the denial of certain tax benefits for entities considered as shell) were needed despite the anti-abuse rules already in force, i.e. general anti-abuse rules ("**GAAR**") of the EU Parent-Subsidiary Directive and the EU Anti-Tax Avoidance Directive ("**ATAD**"), Principle Purpose Test ("**PPT**") in double tax treaties, case law of the Court of Justice of the European Union ("**CJEU**").

While bringing tax transparency up to the next level by means of reporting information on substance could be an additional useful tool for tax authorities to assess the potential application of existing anti-abuse provisions, it is doubtful whether there is really a need to introduce additional provisions denying benefits under double tax treaties and EU tax directives based on substance criteria. The GAAR of both the EU Parent-Subsidiary Directive and the ATAD, the PPT in tax treaties and the case law of the Court of Justice of the European Union already define the conditions under which tax benefits could be denied. In addition, it remains to be seen whether the criteria set in the unshell proposal would be considered as in line with the EU fundamental freedoms, as interpreted by the CJEU. The CJEU has already defined the limits of anti-abuse legislations in an EU context and taxpayers are free to rely on their EU freedoms when organising their investment and business activities as long as the underlying contractual arrangements are not "wholly artificial arrangements".

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To become a Directive, the unshell proposal will have to be adopted at unanimity, meaning that all EU Member States will have to approve it. Thus, it remains to be seen whether all EU member States will agree on the fact that existing anti-abuse rules are currently not sufficient and that it is worth increasing the administrative burden of EU undertakings and introducing an additional level of legal uncertainty.

Do you have further questions?

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