TAX ALERT | EUROPEAN COMMISSION PUBLISHES A LEGISLATIVE PROPOSAL TO PREVENT THE MISUSE OF SHELL ENTITIES FOR TAX PURPOSES

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On December 22, 2021 the European Commission published a legislative proposal to prevent the misuse of shell entities for tax purposes (“Proposal”). The Proposal is part of a wider ambitious agenda to combat tax avoidance and tax evasion. It has far-reaching consequences for multinational group-, private equity-, and investment fund structures having established an (intermediate) undertaking in an EU Member State engaged in real property owning, financing, leasing, service, IP- as well as holding activities, unless satisfactory managerial and operation substance indicators are met.

The Proposal goes further than present beneficial ownership or tax avoidance practices developed in past years. Subject to unanimous approval by Member States the effective date of the Proposal is 1 January 2024. It is noted that some elements of the Proposal have a two year look back period. Therefore, it is recommended to perform a preliminary analysis of the possible consequences of the Proposal for existing- and future corporate- and investment structures.

The Proposal in short

In summary the Proposal creates a reporting obligation for undertakings, sets out substance indicators, potentially denies access to the benefits of double tax treaties between EU Member States and EU Directives and allows Member States to include the income of an undertaking qualifying as a shell in the Member State of its shareholder(s). The Proposal provides for a comprehensive step approach that shall have to be performed by any undertaking that is defined as an entity engaged in economic activities, regardless of its legal form and having its tax residency in a Member State. This means that partnerships, corporations as well as other contractual arrangements are in scope.

Step 1 : Gateways

On the basis of three cumulative criteria (‘gateways’) the undertaking first has to determine if it is at risk.

These gateways are:

- more than 75% of the revenues accruing to the undertaking in the preceding two tax years consist of relevant income, such as interest, royalties, dividends, capital gains income from financial lease, real estate or income from services outsourced to associated enterprises. In the event that more than 75% of the book value of the assets of the undertaking consists of real estate or other property (other than cash, shares or securities) with a book value of more than EUR 1,000,000 or if more than 75% of the book value of the undertaking’s assets consists of shares, the first gateway is deemed to be met, irrespective of whether income from these assets has accrued to the undertaking in the preceding two years.
- At least 60% of the relevant income is earned or paid out via cross-border transactions or more than 60% of the book value of the undertaking’s real estate or other private property of high value are located outside the jurisdiction of the undertaking in the preceding two years.
- The undertaking outsourced the administration of day-to-day operations and decision making on significant functions in the preceding two tax years.

When all of the gateways are passed the undertaking is at risk. This may result in tax consequences.

Carve outs are provided for undertakings with listed securities, regulated financial undertakings (such as collective investment vehicles, securitization SPV’s and AIFMs), domestic holding situations and undertakings with at least 5 own full-time employees or staff members exclusively carrying out the relevant income generating activities.

It is noted that even when the gateways are passed by an undertaking a (renewable) exemption for 5 years from the reporting obligations may be requested by an undertaking if the presence of the undertaking in a corporate structure does not lower the tax liability of its beneficial owner or of the group as a whole.

Step 2 : Substance indicators

When the gateways are passed the undertaking shall have to report (and include satisfactory supporting documentary evidence thereto) in its tax return if it meets the following minimum cumulative substance indicators:

- it has (own) premises available for its exclusive use;
- it has at least one own and active bank account in the EU;
- at least one qualified director of the undertaking that is authorized to take decisions in relation to the activities generating the relevant income is a tax resident in the Member State of the undertaking (or resides sufficiently close to the Member State to perform the duties) and is not employed by a non-associated enterprise and does not perform the function of director in another non-associated enterprise, or, alternatively, the majority of the qualified full-time employees of the undertaking are tax resident in the Member State of the undertaking (or reside sufficiently close to the Member State to perform their duties).

Step 3 : Rebuttal

If the undertaking does not meet the cumulative substance indicators, or does not provide satisfactory supporting documentary evidence, it is presumed to be a shell and tax consequences shall apply.

An undertaking is allowed to rebut such presumption by providing supporting evidence with respect to (i) information on the commercial (non-tax) reasons for setting up and maintaining the undertaking explaining why it does not need own premises, a bank account or management and employees, (ii) information on the employee profiles, including the level of their experience, their decision-making power in the overall organization, role and position in the organization chart, the type of their employment contract, their qualifications and duration of employment, and (iii) concrete evidence that decision-making concerning the activity generating the relevant income is taking place in the Member State of the undertaking.

If successfully rebutted, the validity of the rebuttal can be extended for another 5 years if the legal and factual circumstances do not change.

Step 4 : Tax consequences

After it has been established that the undertaking is meeting the gateways and not able to obtain an exemption, information shall be exchanged among Member States. Other tax consequences shall apply when the undertaking does not meet the substance indicators and is not able to successfully invoke the rebuttal rule.

Exchange of information

Information will be exchanged among Member States through the already existing DAC6 directory when undertakings fall within the gateways. Information exchange will also apply where the tax administration of the Member State decides to certify that an undertaking has rebutted the presumption of being a shell or should be exempt from the obligation. Only if an undertaking does not fall within the gateways no information will be exchanged.

Impact on tax residency certificate

The Member State where the undertaking is resident will either deny a tax residency certificate or the certificate will specify that it is a shell. According to the explanatory notes to the Proposal this will serve as an administrative practice to inform the relevant source country that it should not grant tax treaty benefits or apply EU directives towards the shell. The Member State of such undertaking would remain free to continue to consider the undertaking as a resident for national tax purposes and apply tax on the relevant income flows and/or assets.

Undertaking ignored for tax purposes

A fundamental consequence of not being able to successfully invoke the rebuttal rule is that the undertaking will be disallowed access to the benefits under the tax treaties of its Member State concluded with other EU Member States and/or of the EU directives.

The following situations must be distinguished:

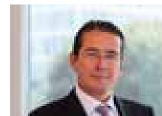
- **EU source** jurisdictions shall ignore the undertaking for tax purposes and will tax or exempt the outbound payment according to the tax treaty or EU directive in effect with the country of the shareholder(s) of the undertaking, or in the absence of such treaty in accordance with its national law.

- **EU shareholder** jurisdictions shall include the payment received in the shareholder's taxable income and may allow relief for any tax paid at source, but will also deduct any tax paid by the shell in its Member State.
- **Third country source** jurisdictions may apply domestic tax on the outbound payment or may decide to tax according to the tax treaty in effect with the jurisdiction of the shareholder(s) of the shell.
- **Third country shareholder** jurisdictions are not compelled to apply any consequences but may consider applying a tax treaty in force with the source jurisdiction to provide relief.

Penalty
Each Member State shall have to lay down rules on penalties applicable against a violation of the reporting obligations. Penalties should be effective, proportionate and dissuasive and include an administrative pecuniary sanction of at least 5% of the undertaking's turnover in the relevant tax year. Member States will be able to request the Member State of the undertaking to perform tax audits when it has reason to believe that an undertaking has not met its obligations under the Proposal.

Closing
Subject to having reached political consensus by Member States the Proposal – targeting at an effective date of 1 January 2024 - shall have to be implemented in national laws of each Member State. It is noted that some of the gateways use a reference period that has already started on 1 January 2022. Therefore, it is recommended to perform a preliminary analysis of the possible consequences of the Proposal for existing corporate- and investment structures. A separate similar legislative proposal aiming at non-EU shells is expected in 2022.

Key contacts



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