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Euro Tax Flash from KPMG's EU Tax Centre

European Commission proposes a directive to neutralize the misuse of shell entities for tax purposes

European Commission – Fair taxation – ATAD – Shell entities – Substance requirements

On December 22, 2021, the European Commission issued a proposal for a Directive aimed at fighting the use of shell entities and arrangements for tax purposes (the Directive). The proposal comes in the form of amendments to Council Directive 2016/1164/EU – the EU Anti-Tax Avoidance Directive (ATAD) and to Council Directive 2011/16 on administrative cooperation in the field of taxation (DAC).

The Directive (also described as "ATAD 3") sets out a list of features, referred to as "gateways", to filter entities at risk of lacking substance. High risk entities – meeting all three gateways based on a self-assessment and not benefiting from a carve-out – will be required to report on their substance through their annual tax return. Companies failing to meet all substance indicators, as set out under the Directive, would be deemed to be "shell entities" and, unless able to rebut this presumption, would be denied certain tax benefits otherwise available based on double tax treaties and EU directives. The data reported by entities in scope would be covered by the automatic exchange of information between Member States and could be subject to tax audits.

Background

On May 18, 2021, the European Commission unveiled its Communication on "Business Taxation for the 21st Century" (the Communication) – see ETF 448. The document sets out the

Commission's views on the EU's tax policy agenda and includes five targeted solutions that go beyond the OECD's two-Pillar solution.

The proposal regarding the use of shell entities (Action 2) is one of the two actions aimed at ensuring fair and effective taxation. Several legislative options were explored by the Commission, with the aim to ensure that companies and legal structures in the EU, with no or limited economic substance, would not benefit from tax advantages. A public consultation took place earlier this year, including an Inception Impact Assessment that was launched just two days after the initiative was announced, and a targeted questionnaire.

European Commission "shell entities" proposal

The Directive sets out a seven-step process – as detailed below, aimed at identifying entities lacking minimum economic substance and that are misused for the purpose of obtaining tax advantages.

Step 1: Determine if the entity needs to report on economic substance

The first step is focused on identifying companies at risk of lacking substance. For the purposes of the Directive, only EU entities are relevant, irrespective of their legal form or size. Entities are required to self-assess their profile against certain features outlined in the Directive, which are structured in three so-called "gateways":

- *How the revenue is generated*. This first gateway is met if: i) more than 75 percent of the overall revenue – for the previous two years, is not generated from the entity's business activity, or ii) 75 percent of the assets consist of real estate or other valuable private property.

- *Cross-border element*. The second gateway is met if a majority of the entity's revenue is generated from cross-border transactions, or the income is passed on to foreign entities.

- *Management and administration*. The third and last gateway is focused on whether the entity is managed by in-house personnel, as opposed to outsourcing the management function.

An entity that checks all three gateways is required to report on economic substance, as detailed under Step 2 below. Entities that present none or only some of these criteria (i.e. those that do not pass all three gateways) are considered low-risk cases and are not subject to the reporting requirement.

The Directive also provides for specific carve-outs for: companies listed on a regulated stock exchange, regulated financial undertakings, holding companies with no / limited cross-border elements (e.g. managing domestic operational businesses, provided their beneficial owners are tax resident in the same jurisdiction, or where its shareholder or ultimate parent entity is resident in the same state), entities with at least five full-time employees engaged exclusively in the activity generating the income. Entities falling within the scope of the carve-outs do no need to perform the self-assessment.

Step 2: Reporting on economic substance

Entities that are in scope of the reporting requirements under the first step, are required to include certain information regarding so-called "substance indicators" in their annual tax return. The Directive focuses on three objective elements, considered to be generally present for entities performing substantial economic activities:

a) existence of premises available for the exclusive use of entity;
b) own and active bank account opened in the EU;
c) adequate nexus to the Member State of claimed tax residence, demonstrated through the presence of relevant personnel being resident close to the entity – at least one dedicated director or a sufficient number of employees engaged in its core activity.

With regard to point c) above, a qualifying director would (i) be resident for tax purposes in the Member State of the entity or at a distance from that Member State that is compatible with the proper performance of their duties; (ii) be qualified and authorized to take decisions in relation to the activities that generate relevant income for the entity or in relation to the entity's assets; (iii) actively and independently use that authorization on a regular basis; and (iv) not be an employee or perform the function of director or equivalent of non-associated entities.

The tax return declaration should be accompanied by supporting documents, allowing the relevant tax authorities to assess the accuracy of the data, as well as to determine if a tax audit is required. The documentary evidence required includes:

a) address and type of premises;
b) amount and type of gross revenue;
c) amount and type of business expenses;
d) type of business activities performed to generate the relevant income;
e) the number of directors, their qualifications, authorisations and place of residence for tax purposes or the number of full-time equivalent employees performing the business activities that generate the relevant income and their qualifications, their place of residence for tax purposes;
f) outsourced business activities;
g) bank account number, any mandates granted to access the bank account and to use or issue payment instructions and evidence of the account's activity.

Step 3: Presumption of lack of minimal substance and tax abuse

The third step prescribes the appropriate assessment of the information on substance indicators reported by the entity in the second step.

An entity that has crossed the gateways – a risk case - that has provided satisfactory documentary evidence in Step 2, i.e. in support of its declaration that it meets all the indicators of minimum substance, should be presumed to have minimum substance for the tax year. However, tax authorities may nevertheless conclude that the entity:

- is a "shell" under the Directive, if the evidence produced does not uphold the information reported; or

- is a “shell” or lacks substantial economic activity under domestic rules; or
- is not the beneficial owner of any stream of income paid to it.

A risk case that fails at least one of the three substance indicators under Step 2, is deemed to be a “shell entity” for the purpose of the Directive, i.e. an entity that lacks substance and is misused for tax purposes.

Step 4: Rebuttal

Under this step, entities deemed as “shells” can challenge this presumption based on the facts and circumstances of each individual case. The claim should be backed up by additional supporting evidence, which could include the commercial (non-tax) reasons for setting up and maintaining the entity that does not need own premises and/or bank account and/or dedicated management or employees. The concrete evidence to be presented is expected to also include information on the resources that the entity uses to actually perform its activity and information allowing tax authorities to verify nexus with the Member State where it claims to be resident for tax purposes, i.e. to verify that the key decisions on the value generating activities of the undertaking are taken in that Member State. Affected entities may produce evidence beyond the requirements of the Directive.

The additional evidence submitted will then be assessed by the tax administration of the entity’s Member State of tax residence. Where the tax administration is satisfied with the information provided and agrees that the entity is not a shell for the purposes of the Directive, it will certify the outcome of the rebuttal process for the relevant tax year. It will be possible to extend the validity of the rebuttal for another five years (i.e. for a total maximum of six years), provided that the legal and factual circumstances evidenced by the undertaking do not change. After the expiry of the maximum six-year period, the entity wishing to rebut the presumption will need to go through the process again.

Step 5: Exemption for lack of tax motives

An entity that crosses the gateways (Step 1) and that does not meet the minimum substance requirements (Step 2) is still entitled to claim exemption from the scope of the Directive on the grounds that it does not create a tax benefit for the group of companies of which it is part or for the ultimate beneficial owner(s). For this purpose, the entity would be required to provide evidence allowing the tax authority to compare the tax liability of the overall group or of the beneficial owner(s), with and without its interposition. In this regard, the Explanatory Memorandum accompanying the Directive refers to the similar exercise recommended in the Commission’s Recommendation of 6 December 2012 on aggressive tax planning.

If the tax authority is satisfied that a tax benefit is not created, it should be able to certify that the undertaking is not at risk of being deemed a “shell” for a tax year. The exemption can be extended for five years, i.e. apply for a maximum period of six years.

Step 6: Tax consequences

The Directive sets out anti-abuse measures for companies deemed as “shells” and that do not rebut this presumption. The tax consequences include denial of benefits otherwise available under double tax treaties or the Parent-Subsidiary and Interest and Royalties Directives. In practice, this means that the Member State where the shell entity is resident would have to either deny the issuance of a tax residence certificate, or issue a certificate with a warning, i.e. including an explicit statement to prevent its use for the purposes of obtaining advantages under relevant agreements and the above-mentioned EU Directives. This is an administrative step that does not render obsolete the national rules of the Member State where the shell is tax resident with regard to any of its own tax obligations.

The Directive sets out rules on how the tax advantages available to the entity (that does not have minimum substance and does not rebut the presumption that it is a shell) can be disallowed in various scenarios involving payments to a shell entity where either the payor or the shell entity's shareholder are resident in another EU Member State or a third country:

- The Member State of the shareholder is bound to tax the payments received by the "shell entity" as if they had been directly received by the shareholder, and allow deductions for the taxes paid in the Member State where the "shell entity" is located.

- In cases where the payer (of relevant income to the shell) is resident in a third country, the Member State of the shareholder shall apply the abovementioned rule without prejudice to any treaty it has concluded with the third country.

In cases where the "shell entity" shareholder is tax resident in a third country, the Member State of the payer of the income (to the shell) is bound to charge withholding tax as per the domestic legislation / double tax treaty concluded with the country of residence of the shareholder. Whilst third countries would not be bound by the provisions of the Directive, the Explanatory Memorandum accompanying the Directive includes suggestions on the treatment that third countries that are either source or recipient countries in a structure involving a shell may wish to apply.

This will not affect any tax that may apply at the level of the shell itself, i.e. the Member State of the shell 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 according to domestic law. Specific provisions apply where a shell entity holds immovable or other property of very high value for private purposes alone or of pure equity holdings.

Step 7: Exchange of information

Under this step, all data collected under Step 2 would be subject to the automatic exchange of information between Member States by making data available on a central directory, within 30 days from the time the administration has such information, i.e. within 30 days from receiving tax returns or within 30 days from when the administration issues a decision to certify that an undertaking rebutted a presumption or should be exempt. Furthermore, Member States would be allowed to ask the Member State where the "shell entity" is based to perform tax audits, provided they have sufficient grounds to suspect a lack of minimum substance.

The Directive therefore proposes amendments to Directive 2011/16/EU on administrative cooperation between Member States, setting out the deadlines and information to be communicated by tax authorities. The European Commission is tasked with developing the relevant forms and to develop and provide with technical and logistical support a secure Member State central directory for the purposes of exchanging the information collected under the Directive.

Other aspects

The Directive leaves it to the Member States to lay down penalties for non-compliance. However, for the purpose of achieving a level of coordination, the Directive notes that an administrative pecuniary penalty of at least five percent of the entity's turnover should be introduced by each Member State.

Member States are required to communicate to the Commission for each tax year a set of data on the entities that have been subject to the various steps set out in the Directive, e.g. the number of entities that meet the conditions for reporting, the number of entities that have reported, penalties imposed by the Member State for non-compliance with the requirements of the Directive, etc.

Next steps

The Commission proposes that Member States should transpose the rules into domestic law by June 30, 2023 and that the provisions of the Directive should apply as of January 1, 2024.

The legal basis for the Commission's proposal is Article 115 of the Treaty on the Functioning of the EU (TFEU), which requires unanimity in the Council. The legislative proposal will now be submitted to the European Parliament for consultation and to the Council for adoption by all Member States. The legislative procedure for amendments to ATAD and the DAC is consultation, meaning that the Council will adopt the text once the Parliament and any relevant Committees have given their (non-binding) opinions.

EU Tax Centre Comment

In light of the documentary requirements and penalties for non-compliance, this Directive appears to show a step-change in approach by the Commission, which is evidenced in the statement of Commissioner for an Economy that Works for People, Valdis Dombrovskis, that today's announcement represents the Commission "moving to the next level in our longstanding fight against abusive tax arrangements and in favour of more corporate transparency".

The proposal outlined above is likely to undergo changes as the political debate develops. Whilst the European Parliament has been advocating for measures aimed at tackling tax avoidance and has been pushing for substance requirements for EU entities, it is difficult to predict the outcome of the discussions and if a final solution would be reached. The requirement of full unanimity means any single Member State may obstruct the adoption. As an example, the carve out from the scope of Step 1 of entities with at least five full time employees are likely to have a greater impact on small Member States with a reduced workforce, and therefore might face challenges.

Additionally, the timeline for approving the draft Directive might be pushed back as the new French Presidency would be focused on the EU implementation of the model rules on Pillar Two. The detailed work program has not been made public yet, but French President Emanuel Macron did not mention the Directive as one of the key priorities for the duration of their mandate (January – June 2022). As a side note, the Commission's Q&A document issued for the "shell entities" proposal also refers to the other action item on efficient taxation included in the Communication

– a proposal for the public disclosure of effective tax rates. As such, the Commission clarifies that a proposal is to be expected in 2022.

If Member States are not able to reach unanimous agreement, the Commission may choose to publish the rules in the form of a recommendation – a soft law instrument that was considered as a possible option as part of the Inception Impact Assessment and that is not binding on Member States.

The Commission's press release mentions that a new initiative would be published in 2022, targeting non-EU shell entities. It will also be interesting to see if that initiative would be made in the context of the reform of the Code of Conduct Group (Business Taxation) mandate, or as a separate Directive / soft law proposal. The EU economic substance requirements could potentially be stricter than the criteria under OECD's BEPS Action 5. Several "no or only nominal tax" jurisdictions have announced or already implemented new domestic laws intended to meet the OECD's substance requirements. It remains to be seen if such countries would have to implement further reforms in order to meet the criteria to be proposed by the Commission for third countries.

Should you have any queries, please do not hesitate to contact KPMG's EU Tax Centre, or, as appropriate, your local KPMG tax advisor.

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