USE IT OR LOSE IT: THE FUTURE OF SHELL ENTITIES IN THE E.U.

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INTRODUCTION

Shortly before Christmas,[1] the European Commission published a proposal for a Directive (the "Directive") laying down rules to prevent the misuse of shell entities for improper tax purposes and amending Directive 2011/16/E.U. – the directive on administrative cooperation (the "D.A.C.").

Given that the proposed rules are intended to enhance and complete two previous iterations of the anti-tax avoidance directive (the "A.T.A.D."), the proposed Directive is commonly referred to as "A.T.A.D. 3." In the view of the Commission, this extension of the A.T.A.D. is required to create a fair and effective taxation system in the E.U. However, the main purpose of the draft is to prevent the misuse of shell entities, and for that reason, it is commonly known as the "Unshell Directive."

Prior to the release of the Directive, on May 18, 2021, the European Commission published its 'Communication on Business Taxation for the 21st Century' (the "Communication") with the stated aim of setting out a long-term vision to provide a fair and sustainable business environment and E.U. tax system as well the E.U. Tax Policy Agenda, announcing actions that could potentially be taken to increase transparency and substance requirements for corporations used in implementing tax plans.

At that moment, it was clear that one of the most relevant proposals on the Commission's Agenda was the initiative regarding the fight against the perceived misuse of shell companies, which are companies with not more than minimal substance and without real economic activity. According to the Commission, initiative is necessary given the extent to which shell entities continue to be used, despite the measures taken at the E.U. level over recent years, including the two earlier iterations of the A.T.A.D. and various extensions of the D.A.C. Before launching the Unshell directive, the European Commission initiated a Public Consultation entitled "Fighting the Use of Shell Entities and Arrangements for Tax Purposes,' which takes the form of a questionnaire.

Within that context, less than four months after closing its Public Consultation, the Commission published a concrete proposal for a Directive. The purpose of A.T.A.D. 3 is to increase the level of scrutiny for shell companies within the E.U. in order to prevent them from being used for purposes of tax evasion and avoidance.

If adopted by the Council, the Directive would introduce certain reporting requirements for E.U. resident companies that generate largely passive income streams that are highly mobile and that lack adequate substance. Failure to submit a full or correct report will subject the company to severe penalties.

[1] December 22, 2021.

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In a nutshell, A.T.A.D. 3 lays down certain gateway indicators to determine which entities must report on their substance. In case such reporting indicates that the company is a shell entity which lacks adequate substance, the benefits of tax treaties and E.U. Directives may be denied, potentially resulting in an increased withholding tax burden and other tax disadvantages.

This article describes the relevant mechanism embodied in A.T.A.D. 3 and analyzes its potential impact.

OVERVIEW

Scope

The proposed Directive will apply to any company that is considered tax resident in a Member State of the E.U. and is eligible to receive a tax residency certificate, regardless of its legal form. For simplicity, use of the term "company" will include a company within the meaning of the proposed directive. The proposed Directive targets entities that have the following characteristics:

- They lack real economic activities.
- They are involved in certain cross-border arrangements forming a scheme to avoid and evade taxes.
- They allow their beneficial owners or parent company to access a tax advantage.

General Exemptions

In its Communication, the European Commission recognized that valid reasons may exist for the use of shell companies. Based on this notion, entities established to perform certain specific functions are explicitly carved out from the scope of the Directive. Included are

- certain regulated financial companies, such as investment funds;
- companies with transferable securities listed on a regulated market; and
- companies having at least five full-time equivalent employees or members of staff exclusively carrying out the activities which generate the relevant income.

Moreover, general exemptions apply to holding companies based in the same country as their beneficial owners or shareholder(s) – or the ultimate parent entity.

According to the impact assessment carried out within the context of this initiative, it is expected that less than 0.3% of all E.U. companies will fall within scope of the Directive.

Gateway Indicators

A.T.A.D. 3 provides three gateway indicators in the prior two years that are used to determine whether a company may be at-risk of being a shell company. If all gateway indicators are present, the entity is considered to be at-risk of being a shell company.

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Generally, a company is considered to be at risk where

- more than 75% of its revenue is characterized as mobile or passive income, referred to a relevant income;
- the company is mainly engaged in cross-border activity, meaning that more than 60% of its relevant assets are located abroad or at least 60% of its relevant income is earned or paid out via cross-border transactions; and
- the company has outsourced the administration of its day-to-day operations and decision-making on significant functions, while its own resources to perform core management activities are inadequate at best, and for that reason, are outsourced.

Where the three gateway indicators are present, a company faces a choice of two next steps:

- It becomes an at-risk company that is subject to further reporting requirements to determine whether it meets certain minimum substance requirements. If substance is not present, the company is a shell company. The scope of the reporting is addressed below.
- It may request an exemption from the reporting obligation if it can provide sufficient evidence that its existence does not reduce the tax liability of its beneficial owner or the group of companies to which it belongs. If the exemption is granted, it is not a shell company.

"The third test can be met in only two fact patterns."

Reporting Obligations

Where a company is considered to be at risk and the exemption is not applicable, the company must indicate whether it has adequate substance. For this purpose, adequate substance exists based on the cumulative presence of the following three factors:

- It has its own premises, meaning that it possesses an office space or the exclusive use of an office space,
- It has its own bank account located in the E.U. that has regular activity in the form of receipts and disbursements.
- It has qualified local management or employees.

The third test can be met in only two fact patterns. The first is that the company has at least one statutory director who is a resident in the jurisdiction of residence of the company or is a resident of a neighboring jurisdiction and his or her home is in relatively close proximity to the office of the company. Here, the term "director" is used in an operational sense rather than in the sense of being a representative of the shareholder group. The director must be qualified to carry out the responsibilities of his or her office and must be authorized to make relevant management decisions. Moreover, the director must exercise responsibility actively, independently, and on a regular basis. In addition, the duties of the local director must be performed on the basis of exclusivity, meaning that he or she cannot be an employee of an unrelated third party, such as a fiduciary trust company, and cannot function as a director of any other unrelated entity at the same time.

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The second fact pattern is that the majority of the company's employees are resident in the jurisdiction of residence of the company or are resident of a neighboring jurisdiction and live in relatively close proximity to the office of the company. An example is a frontier worker living in one Member State and commuting to an office in another Member State. The local employees must be qualified to carry out the activities that generate the relevant income.

If a company fails to meet any of the three substance indicators, it will be presumed to be a shell company for A.T.A.D. 3 purposes.

A company that is at risk of being a shell company must make a determination as to its substance and declare its status in its annual tax return. This entails a determination of whether the presumption can be rebutted.

REBUTTAL AND EXEMPTION

Rebuttal of Presumption

In principle, the above criteria only lead to the presumption of having inadequate substance. This implies that a company may still rebut the presumption by substantiating the business rationale of its activities within the relevant Member State. However, within the context of the rebuttal process, the burden of proof will be on the company, meaning that the right to rebut is subject to further evaluation by the tax authorities at the time of an examination.

Where a company that is deemed to be a shell company decides to rebut the presumption, it must produce concrete evidence of activities it performs. It must provide information with respect to the commercial reasons behind its existence, the human resources available to the company, and any other element that verifies the economic nexus between the company and the Member State of residence, typically where management decisions are taken in relation to the activities that generate value.

Moreover, within the context of a rebuttal, the taxpayer must be able to demonstrate that it has actually performed the business activities that generate the relevant income (or – in the absence of income – relate to the assets) and continuously had control over the related risk that it born.

If the tax authorities in the relevant E.U. Member State are satisfied, they must certify the outcome of the rebuttal for the relevant tax year. Provided the legal and factual circumstances remain unchanged, the validity of such certificate may be extended for another five years. Once the maximum period of six tax years has expired, the process would start all over again.

Exemption for Lack of Tax Motives

While a company that meets the three gateway indicators is generally considered to be at risk, it may request an exemption from the reporting obligation if it can provide sufficient evidence that its existence does not reduce the tax liability of its beneficial owner or its group of companies. If granted, the exemption applies for one year and can be extended up to five years.

As part of a request for exemption, a company must provide evidence of comparable tax treatment in two fact patterns. The first is the combined tax due for the company, its owner, and the group resulting from the actual fact pattern. The second is the combined hypothetical tax that would have been due for the owner and group if the transaction were carried on without the participation of the company. To meet the burden of proof, the combined hypothetical tax in the latter fact pattern must not be greater than the actual tax in the actual fact pattern.

As is the case for the procedure regarding the rebuttal of presumption, if the tax authorities in the relevant E.U. Member State are satisfied that the existence of the company does not create any tax benefits, they may grant an exemption for the relevant year. Again, provided the legal and factual circumstances do not change, the validity of the exemption can be extended for another five years.

CONSEQUENCES OF FAILING THE TEST

If, on the basis of its self-assessed reporting or a failed rebuttal process, a company that is resident in a particular E.U. Member State is presumed to be a shell company, several adverse tax consequences will follow:

- Other Member States are to disregard the application of tax treaties, the Parent-Subsidiary Directive, and the Interest and Royalties Directive in relation to transactions with the shell company.
- If the shell company has a shareholder established in an E.U. Member State, the shell company should be treated as if tax transparent so its income will be taxed by the Member State of residence of the owner, as if the income accrued to the owner directly with a foreign credit for any taxes paid by the shell company.
- The tax authorities of the E.U. Member State where the shell company is resident cannot issue a certificate of tax residence for the company or may issue a conditional tax residence certificate stipulating that the shell company is not entitled to the benefits of an income tax treaty or any E.U. Directive.

Since the Member State of residence of the shell company may issue only a tax residence certificate including a warning that the company is a shell, the introduction of A.T.A.D. 3 may have an effect on the shell company's transactions with third countries. However, as regards the allocation of taxing rights between source countries and home countries, for the time being A.T.A.D. 3 should have an effect on transactions only between E.U. Member States. Nonetheless, it is anticipated that the Commission contemplates extending the Unshell Directive to cover transactions with third countries.

CERTAIN FORMAL ASPECTS

Penalties

The draft Directive provides that Member States may impose penalties for failure to comply with the reporting obligations arising from A.T.A.D. 3. Such penalties must be effective, proportionate, and dissuasive. It is anticipated that the penalties for failing to report or for filing incorrect reports will not exceed 5% of annual revenues.

Tax Audits

In addition to domestic sanctions, the draft Directive provides that a Member State may also request another Member State to initiate a tax audit if there is suspicion that a company resident in that other Member State is not complying with the provisions of A.T.A.D. 3.

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Exchange of Information

The proposed Directive aims to amend the D.A.C. so that information gathered pursuant to A.T.A.D. 3 will be exchanged between the Member States automatically. Consequently, a robust exchange of information program will exist and will include information on taxpayers that have rebutted the presumption or applied for exemption. Consistent with earlier amendments of the D.A.C., the information that is reported by taxpayers in accordance with A.T.A.D. 3 will be stored in a central databank accessible to all Member States.

Implementation

If A.T.A.D. 3 is adopted by the Council, E.U. Member States will be required to implement the Directive by June 30, 2023, for the new rules to apply with effect from January 1, 2024.

To some extent, A.T.A.D. 3 has retroactive effect from January 1, 2022, because of the two-year look-back rule that applies to Gateway Indicators. This suggests that presumed shell companies may want to implement appropriate actions in 2023 in order to be in position to prevent application of the Gateway Indicators in a 2024 filing.

OBSERVATIONS

It follows from the above description of the mechanics that A.T.A.D. 3 creates a filter system for shell companies throughout the E.U. The trigger for the filter system is that that any entities resident for tax purposes in the E.U. that qualifies for a residence certificate issued by an E.U. Member State, is covered by A.T.A.D. 3., no matter the form taken by the entity.

All these entities enter a funnel, with the first stop being exemption. Where an intermediate vehicle is used within a regulatory framework or in a truly active manner, it is removed from the filter system. Those entities that are not removed, enter the second step of the filter, which concerns the three cumulative gateways. In principle, any company that meets all three gateways has an obligation to report on substance. It then moves to the next step, which is to rebut the presumption of being a low substance conduit vehicle by proving additional evidence. That evidence will be entity specific, requiring bespoke solutions. Those entities having proper rebuttals are removed from immediate effect of shell company classification, but their information is maintained in a central database.

In principle, each entity based in the E.U. falls within scope of the Directive. However, this element of overkill is addressed through the filter system. Nonetheless, one of the main concerns is that not all special purpose entities having a business purpose for its insertion into a particular business transaction will be able to adequately rebut the presumption that would result from the three gateway indicators. Though it would

seem that A.T.A.D.3 is not intended to hit special purpose entities that have been set up for completely valid reasons, such as asset protection or simply because legal separation is required by a bank, it would be useful if concrete examples would be provided by the Commission or within the context of implementation into domestic law.

From the outset, it would appear that A.T.A.D. 3 is aimed to tackle the typical type of shell entities managed by fiduciary trust companies. The European Commission indicates that pure holding companies established in the same country as their operating subsidiaries and beneficial owners are unlikely to be affected by the Directive, since these are normally not set up to derive an abusive tax benefits. Nevertheless, it cannot be ruled out that tax authorities may apply a broader interpretation of the Unshell Directive.

It is noteworthy that A.T.A.D. 3 is not yet a fait accompli. The European Parliament and the Member States must still respond to the draft. Even if the draft Directive were to be adopted in its current form, Member States must still transpose it into national law, which provides an opportunity to add some couleur locale where possible. This means that the political game is only just beginning. The general expectation is that the proposal will not be adopted without changes.

This raises the question parts of the proposed filtering system can be revised during the remaining steps of the process. In principle, several provisions can still be revised, such as the exemption categories and the criteria for the three gates. These are all political decisions which eventually will have an impact on the entities that will be caught up in the A.T.A.D. 3 funnel.

It is also conceivable that the various minimum substance requirements may be adjusted. For over a decade, the Netherlands has applied a system which is comparable to A.T.A.D. 3 to service entities functioning as a conduit for interest and royalty payments. The relevant legislation contains a more extensive list of substance requirements, including the criteria listed in the proposed Directive as well as others.

For the Netherlands, the open issue is whether the government will replace its own criteria with the requirements of A.T.A.D. 3 or attempt to operate with two sets, each used for its own purposes. It is conceivable that within the context of the decision-making process at E.U. level, the Netherlands would make a case for its extensive set of criteria to be implemented within the framework of A.T.A.D. 3. Even though the number of criteria would increase, the focus on the three substance criteria laid down in the draft Directive – office space, bank account and location of management or key personnel – would be expanded to address other aspects. That might open the door for somewhat more nuanced approach to substance.

Finally, it will be interesting to see how the same-country approach in the Directive will develop. If a country-by-country approach would become the guiding principle, a group of companies could have many entities with different economic activities in one single Member State without having to worry about the fact that an entity which has a pure holding function is set up with somewhat leaner in terms of substance. If by contrast an entity-by-entity approach would eventually prevail, such holding company may well qualify as a shell entity, even though it has access to an organization with extensive substance in the country where it is based. In sum, the same country approach clearly has the benefit that it immediately recognizes the fact that there may well be commercial or legal reasons to use multiple entities in one and the same country, without the need to go through a cumbersome rebuttal process.

Even though the political game of playing with the various elements of A.T.A.D. 3 has not yet begun, the general expectation is that the proposed Directive will eventually make it across the finish line. That said, even though tackling tax avoidance continues to be high on the E.U.'s agenda, at this moment the proposed timing seems somewhat optimistic, particularly now that the E.U. clearly has other geopolitical issues to face.

As mentioned, the draft assumes the Member States will implement the Directive in their national legislation prior to July 1, 2023, with January 1, 2024, as the intended date of entry into force. It remains to be seen whether this timeline will be met. If a corporate group believes it will be adopted at some point, management may find it prudent to adopt indicia of substance in all group members sooner rather than later.

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