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Client Alert

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European Union: The 'Unshell' Proposal

Although you may have had your say, swift action by all groups that hold European affiliates with low substance remains required

In brief

Interested parties could, until Wednesday last week (6 April 2022), provide their views to the EU Commission regarding the so-called Unshell proposal or ATAD 3 ("**Proposal**"). Many will have flagged the uncertainties about certain concepts and the need for more clarifications while others will also have indicated more substantial issues such as possible non-compatibility with EU Law. It remains to be seen whether the EU Commission will take (some of) these comments on board. Meanwhile, international groups should not rest on their laurels because it is likely that the Proposal will be adopted (as is or in an amended form) but rather start screening the European affiliates in their corporate structure, to identify possible issues under ATAD 3 and look for possible remedies.

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Key takeaways

- The European Commission has at the end of last year issued a Proposal for a new Directive to target tax avoidance through the use of **EU shell entities**. Another proposal is expected to come out in the course of 2022 to target the use of **non-EU shell entities**.
- The Proposal goes **beyond the improper tax use** of shell entities so that vehicles (this includes companies, partnerships, trusts) with little substance may enter into scope even if set-up with valid investment purposes.
- **Regulated/supervised funds** (UCITS, AIFS, AIFMS, etc.), companies with listed securities, holding companies with shareholders in the same EU Member State and companies with at least 5 FTEs carrying on certain activities **are out of scope**. The exception does not include holding companies held by regulated funds or by companies with listed securities however.
- Entities at risk of being considered a shell need to comply with an **annual reporting obligation** in which they should demonstrate minimal substance. Failing to do so will qualify the entity as a shell, which will entail amongst others the **loss of tax benefits under the EU Directives and the tax treaties between EU members**.
- This could lead to the **loss of withholding tax exemptions in the source state** and **taxation of the shell's income in the shareholder state**.
- Non- or late compliance with the reporting obligation could entail a **penalty of at least 5% of the entity's turnover**.
- The Proposal provides for a **lookback period of 2 years** to determine whether an entity is at risk of being considered a shell. Under the Proposal's current timeline (with an intended effective date of 1 January 2024) this would mean that the assessment whether an entity is at risk of being considered a shell will be based on the facts and figures of 2022 and 2023. The current situation within a group may therefore already impact the application of ATAD 3.
- **Action is hence immediately required** by international groups with respect to their European affiliates. Key action items include holding your structures against the light of the Proposal, determining how you will establish and demonstrate towards the tax authorities that the relevant entities are not shells at risk of tax abuse, and by establishing the adverse tax consequences in case this cannot be demonstrated as well as appropriate restructuring.

In depth

At the end of last year, the European Commission has issued a Proposal for a new Directive aimed at curtailing the use of legal entities in the EU with no or minimal substance and economic activity (so-called "shell entities"). A similar proposal regarding entities outside the EU is expected later this year. Although the Proposal (also called ATAD 3) is targeted at the use of shell entities for tax evasion and avoidance purposes, the relevance of the Proposal goes beyond improper tax use of such structures, with valid investment-driven structures possibly entering into the scope of this Proposal as well.

Which entities are in scope?

The Proposal targets **any legal entity** (irrespective of its legal form, so including companies, partnerships, trusts…) that is a **tax resident in an EU Member State** and that qualifies as a **shell**.

Three cumulative 'gateways' determine whether an entity is at risk of being considered a shell: **(i)** more than 75% of the entity's income is **passive income** (e.g. interest or other income from financial assets (including crypto assets), royalties, dividend income, capital gains, income from real estate), which is called **'relevant income'** in the Proposal; **(ii)** the entity is engaged in a **cross-border activity**; and **(iii)** the entity **outsources** the administration of day-to-day operations and the decision-making on significant functions.

The gateways under (i) and (iii) as well as part of the gateway under (ii) must be assessed over a **two-year lookback period** which creates, apart from a possible retroactive effect till 1 January 2022 with no ability for taxpayers to have timely reorganized themselves, uncertainties as to whether meeting these gateways at any time during the two year period suffices or not to be in scope. It is also unclear whether outsourcing of administration and decision-making covers only outsourcing to third parties or also to related entities (e.g. shared service centers).

A long list of **entities that are out of scope** is provided in the Proposal, which includes amongst others **(i) regulated and supervised entities** (such as credit institutions, pension funds, (re)insurance undertakings, regulated investment funds such as UCITS, AIFS, AIFMS, securitisation vehicles etc. - importantly, however, this exclusion does not include non-regulated holding companies held by regulated entities); (**ii**) companies with **listed securities** (such as shares or bonds); (**iii**) holding companies with shareholders in the **same EU Member State**; and (**iv**) companies with **at least 5 own FTEs** or members of staff exclusively carrying out the activities generating the relevant income.

Annual reporting requirement

If all gateways are met, the entity is at risk of being considered a shell and will need to comply with **an annual reporting obligation** in its Member State of residence through which it should demonstrate, with documentary evidence, that all minimal indicators of substance are met in order not to be qualified as a shell. The reported information will be automatically exchanged between Member States through the Common Communication Network (CCN).

These indicators of substance are: **(i)** the availability of **premises** in the EU Member State for **exclusive use**; **(ii)** the availability of at least one **active bank account** in the EU; **(iii) qualifying directors or personnel**.

Like most of the 'gateways', all these indicators still raise questions (e.g. what qualifies as exclusive use of premises, when is a bank account considered active), but the main question will be whether the entity has qualifying directors or personnel available. In this context, the Proposal requires **at least one director** who **(i)** is **tax resident** in the Member State of the entity or at a distance which is "compatible with the proper performance of his/her duties"; **(ii)** is **qualified** and **authorised** to take decisions; **(iii)** is **actively and independently using** such authorization; and **(iv)** is not performing a function as **director or employee** in a **non-associated enterprise** (i.e. not a "professional director"). Alternatively, the Proposal requires that the **majority of the entity's FTEs (i)** are **tax resident** in the Member State of the undertaking or at a distance compatible with the performance of their duties; and **(ii)** are qualified to carry out the activities. It may be obvious that determining whether or not a distance is compatible with the performance of one's duties can be interpreted very differently and lead to difficult discussions.

Note that the entity can request its Member State of residence to be **exempt** from the reporting obligation if it is able to demonstrate that the structure does not reduce the tax liability of the beneficial owner or of the group as a whole. Such exemption may be granted for 1 year with a possible extension for 5 years.

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Qualification as a shell and adverse tax consequences

The entity that does not meet **all** of the above-mentioned indicators, will be **presumed to be a shell**. Such presumption can only be rebutted by providing additional supporting evidence demonstrating that the entity has **performed**, had **control** over and bore the **risk** of the business activities by providing: **(i)** evidence regarding the **commercial rationale** behind the undertaking's establishment; **(ii)** information about **employee profiles**; and **(iii)** evidence that **decision-making** is taking place in the entity's Member State of residence.

If such additional supporting evidence is not provided, the finding of the entity being considered a shell will lead to the following adverse tax consequences:

i. the source country may apply **(higher) withholding tax**, as the benefits under the Parent-subsidiary Directive and the Interest and Royalty Directive as well as under the tax treaties between EU Member States are no longer available;

ii. the entity will **no longer receive a certificate of tax residence** from its Member State of residence or will obtain a certificate which states that it is no longer entitled to the benefits of the EU Directives and tax treaties;

iii. the **shell's shareholder's country may tax the relevant income as if it had accrued directly to the shareholder** (in other words, apply a look-through approach) and deduct the tax paid on such income at the level of the shell.

Many questions arise on the exact tax consequences and implications of a shell finding, both in EU situations and in situations involving a third country. As mentioned, the Proposal currently suggests the application of a look-through approach, but is unclear how this will be applied in practice. For example it is unclear, in an EU situation, whether the source country may take into account the EU Directives and/or tax treaties with the Member State of the shell's shareholder when determining the applicable withholding tax rate. It also appears that situations where a payer to the shell or a shareholder of the shell are outside the EU may be less impacted by ATAD 3 as the tax treaties with such third countries can obviously not be set aside by ATAD 3, even though the Proposal nevertheless seems to imply that tax treaties between EU payers to a shell and the EU shareholders of the shell cannot be invoked on the basis of a look through.

It can also be questioned whether the reversal of the burden of proof that follows from the process currently laid down in the Proposal does not run contrary to the CJEU's position that general abuse presumptions are not permitted as they appear to prevent the exercise of an EU fundamental freedom (i.e. freedom of establishment) beyond situations of proven abuse on a case-by-case basis.

Penalties

The Proposal determines that the Member States will lay down rules on penalties, which are **effective, proportionate and dissuasive**. This wording is quite standard and gives Member States some discretion on determining the appropriate level penalties (which can lead to quite some considerable differences between Member States, as we have seen with DAC 6 for example). However, the Proposal also states that the penalties should include an administrative pecuniary sanction of at least 5% of the undertaking's turnover in the relevant year in case of non- or late compliance with the reporting obligation.

Next steps

In addition to the many uncertainties that remain in terms of application of the rules under the Proposal, it is currently also unclear if and when the Proposal will actually make it into law. The Proposal first has to be adopted by the EU Council and the EU Member States then need to implement the Directive into their domestic law. The current envisaged timeline indicates that the Directive should be implemented by 30 June 2023 and take effect as of 1 January 2024.

Even if this seems like an ambitious timeline, international groups should nevertheless gear up considering that the proposal provides for a **lookback period over the 2 prior years** (i.e. 2022 and 2023) to determine whether an entity is at risk of being a shell. Mindful of DAC 6, where a lookback period was also introduced, action should hence be taken as soon as possible. Key action items include holding corporate structures and particularly European affiliates with little substance against the light of the Proposal, determining how one will establish and demonstrate towards the tax authorities that the relevant entities are not shells at risk of tax abuse, establishing the adverse tax consequences in case this cannot be demonstrated as well as appropriate restructuring.

Please reach out for further information or if you like to discuss your specific corporate structure in light of the Proposal.

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