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Shell entities: The European Commission's proposals

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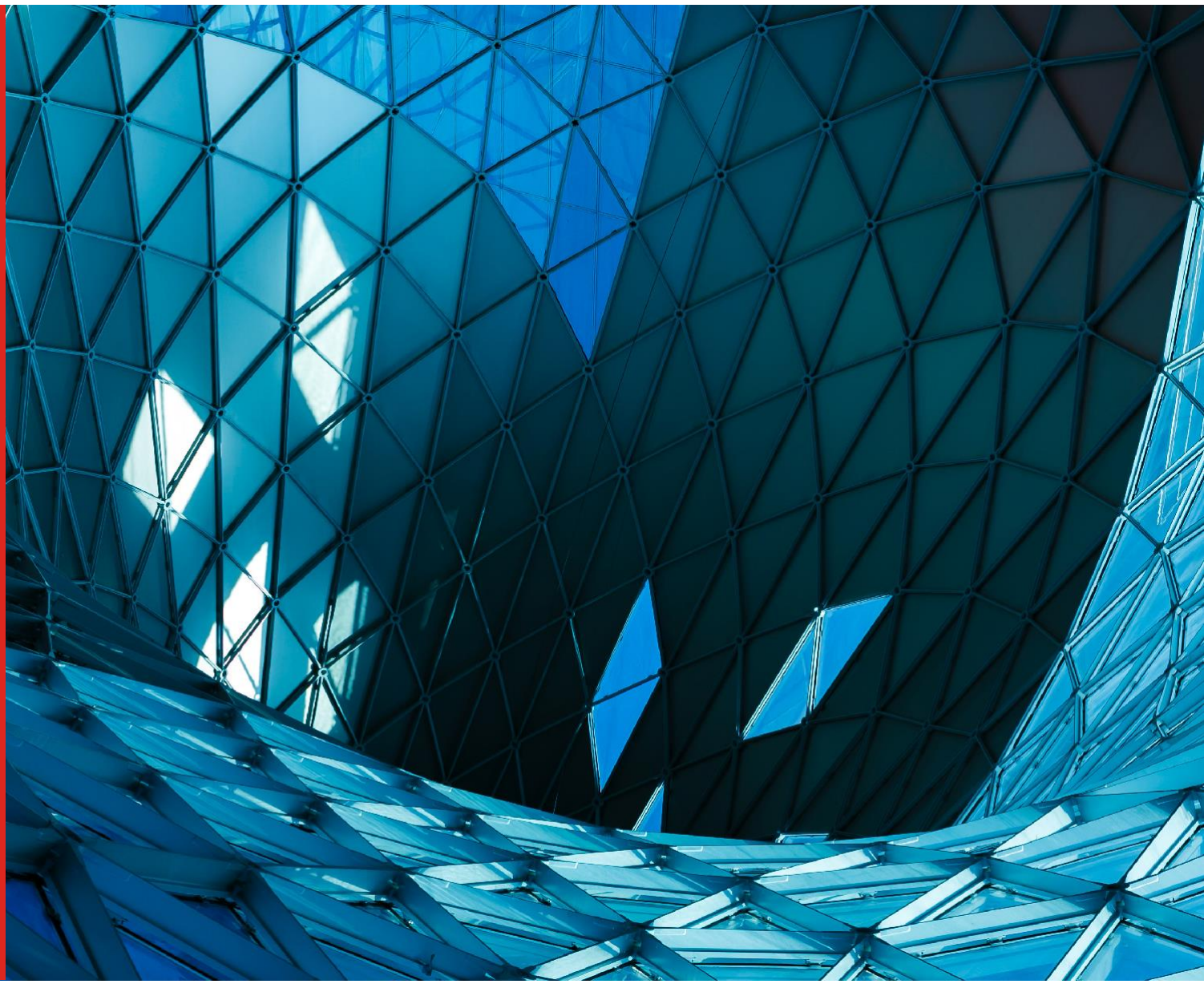

Introduction

On December 22, 2021, the European Commission published a proposal for a Directive to prevent the misuse of what it sees as shell entities.

The Directive has far-ranging consequences for groups with entities which are deemed to be shell entities under the proposals and are resident in any Member State. Most importantly, it potentially denies the benefit of double tax treaties and the EU Directives and allows Member States to tax shareholders on a look-through basis. If the Directive is adopted – and it is probable that it will be – many EU non-operational companies owned by multinational groups and private equity companies (notably those established in the context of investment funds structures) will potentially be within its scope. These will include:

- Real estate owning companies
- Finance companies
- Leasing and IP companies
- Holding companies

For international groups and private equity funds, it is likely that unless the entity is itself regulated or holds listed securities, it will be necessary to prove managerial and operational substance. The standards proposed seem to go beyond what is currently required to show that the entity has beneficial ownership of its income and is not established for tax avoidance purposes. While there has been a focus on these requirements following the so-called Danish CJEU cases held in February 2019, the Commission proposal will now force the concerned groups to look at the role and activities of their intermediate entities.

The Commission's aim is that legislation implementing the directive in each Member State will be in effect from January 1, 2024. Because many of the tests have a two year look-back period, it is important that groups and asset managers consider immediately whether they may become impacted by the proposals.

Disclosure criteria: The Gateways

The proposal sets out three cumulative gateways. If an entity passes all three gateways, it will be required annually to report additional information to the tax authorities as part of its corporation tax return and will run the risk of being deemed to be a shell entity:

- **Passive Income:** The first gateway is designed to identify entities engaged mainly in geographically mobile economic activities. It is met if more than 75% of the entity's revenue in the preceding two tax years consists of "relevant income", namely passive income, dividends and income from the disposal of shares, income from financial leasing, income from immovable property and real estate, income from movable property, income from insurance, banking and other financial activities, as well as income from services which the entity has outsourced to other associated enterprises. If more than 75% of the book value of the assets of the undertaking consists of real estate or other private property with a value of more than €1m or if more than 75% of the book value of the undertaking consists of shares, the first gateway is deemed to be met, even if they are non-income generating.
- **Cross-border income and assets:** This gateway is satisfied if the entity receives at least 60% of its relevant income from non-domestic income or remits more than 60% outside its jurisdiction. For real estate owners, this gateway is met if more than 60% of the book value of the real estate (or other private property of high value) is located outside the jurisdiction of the entity.
- **Outsourced management and administration:** The third gateway focuses on whether corporate management (i.e. decision making) and administration services (i.e. day-to-day administration) are performed in-house or are outsourced. It is met if in the preceding two tax years, the entity outsourced the administration of day-to-day operations and the decision-making on significant functions.

Impact of passing through the Gateways

If the gateways are passed, unless a Safe Harbour applies (see below), the consequences are as follows:

- the entity will need to demonstrate whether it satisfies the minimum substance requirements. These are:
  - it has its own premises;
  - it has an active EU bank account; and
  - it has at least one director qualified and authorised to take decisions relating to the income generating activities of the entity or in relation to the undertaking's assets who actively exercises that authority, is not an employee of any entity which is not an associated enterprise and is tax resident in that Member State or living close enough to the entity to perform their duties; and/or the majority of its full time employees are tax resident in the entity's member State or live close enough to properly perform their duties and are qualified to carry out the income generating activity within that entity.
- the entity has to supplement its annual tax return by including additional information regarding its premises, directors, revenue and activities. As the Directive provides for automatic exchange of information, it is likely that this will be sent to all Member States and will be of particular relevance to jurisdictions of shareholders in and persons paying income to the entity.

Consequence of failing the minimum substance requirements

There are two main consequences if an entity fails the substance test and is therefore deemed to be a "shell entity":

- **Shell entity ignored for tax and tax treaty purpose:** It will not be able to access tax relief and the benefits of the tax treaty network of its Member State and/or to qualify for the treatment under the Parent-Subsidiary and Interest and Royalties Directives. No (or only a limited) certificate of residence can be issued by the Member State of residence of the entity. As a result, payments of income to and from the entity may become subject to withholding tax. If a financing structure is to be put in place, the parties should consider which party should take this risk. If the shell entity is a lender, it is arguable that it should take the risk. However, this would be contrary to the normal allocation of withholding tax risk, where change of law risk is taken by the borrower. Where the lender is a significant financial institution, this is not likely to be an issue (as the Directive is not likely to apply), but it may be where any funding is provided by special purpose vehicles.
- **Look through basis:** A Member State of the entity's shareholder(s), taxes relevant income of the entity as if it had directly accrued to the shareholders.

Safe Harbours

There are a number of safe harbours that can apply:

Regulated, Domestic and Listed Entities

The following are excluded:

- regulated entities: the aim is that most, if not all regulated financial institutions will be exempt. These include many collective investment vehicles, insurance and reinsurance vehicles, securitisation SPVs and AIFMs;
- entities with listed securities;
- entities that invest in domestic operations and are owned by local shareholders;
- holding companies with local shareholders;
- companies that have at least 5 employees exclusively engaged in generating the relevant income.

Entities with substance

An entity will be able to rebut any presumption that it is a shell entity for the purposes of the Directive by:

- evidencing its commercial rationale, the relevant qualifications of its employees and that decisions are taken in the relevant Member State;
- demonstrating that it bears the risks and has continuous control over the activities that generate the relevant income.

Lack of tax motivation

A renewable exemption (of up to five years) can be requested if the presence of the undertaking in the structure does not lower the tax liability of its beneficial owner or of the group as a whole.

Next Steps

Multinational groups and asset managers that may potentially be within the scope of the Directive should look carefully at its provisions to see how they may be affected. Because many of the safe harbours have a two year look back period, it is important to review the current structure in light of these new rules. Whilst the Directive has not yet been adopted and Member States generally still have some time to issue their own proposals on how they intend to implement it, it would appear unwise to wait for its actual implementation before considering its actual impact on current holding structures and the standard to establish new structures of intermediary entities within the EU.

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