KPMG Meijburg & Co Tax & Legal

European Commission publishes proposal for a directive to tackle the misuse of shell entities

Summary

On December 22, 2021 the European Commission published a proposal for a directive aimed at preventing the misuse of shell entities and arrangements for tax purposes (hereinafter: the directive). The proposal is a result of the communication on "Business Taxation for the 21st century" (see ETF 448) released on May 18, 2021. The directive provides for the Anti-Tax Avoidance Directive (ATAD) and the Directive on Administrative Cooperation to be amended. The directive, also referred to as ATAD 3, contains a list of features ('gateways') for identifying entities that lack minimum substance. Entities that meet all three gateways and that cannot make use of a carve-out or exemption are regarded as high-risk entities and must report on their substance in their annual tax return. Entities that do not meet all the substance requirements referred to in the directive are presumed to be shell entities. These entities will be denied the various tax benefits available under directives and tax treaties, unless they are able to refute this presumption. The data reported by entities falling under the scope of the directive will automatically be exchanged between Member States and may be subject to tax audits.

The proposal for a directive on shell entities

The directive sets out a seven-step process for identifying entities that do not have minimal substance and that are misused in order to obtain tax benefits.

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

This first step is aimed at identifying entities that lack substance. Only entities that are resident in the EU fall under the scope of the directive, irrespective of their legal form or size. Entities should check whether they meet the following gateways:

- *Type of turnover*

  In short, the first gateway is met if more than 75% of the revenues in the last two years consists of certain passive income (this requirement is also met if more than 75% of the assets consist of certain assets that generate passive income).
- *Cross-border element*

  In short, the second gateway is met if at least 60% of the entity's passive income is realized with cross-border activities or if the income is passed on to foreign entities.
- *Day-to-day administration and management*

  The third and last gateway is aimed at whether the day-to-day administration of the activities and the management of the entity is outsourced.

An entity that meets all three gateways must report on its economic substance, as described under step 2. Entities that do not meet all three of these criteria are deemed to be low-risk entities and do not have to comply with the reporting obligation.

The directive also provides for specific exemptions (carve-outs) for certain listed companies, certain regulated financial institutions, holding companies with no or few cross-border elements and entities that have at least five full-time employees who are solely involved with the activities generating passive income. Entities falling within the carve-outs do not have to check whether they comply with the gateways.

Step 2: Reporting on economic substance
Entities that, on the basis of the first step, fall under the reporting obligation, must include certain information about the following substance requirements in their annual tax return. The directive focuses on three objective elements that are generally present in entities that perform substantial economic activities:

a) The presence of own premises in the Member State of which the entity is a resident or premises that are for the entity's exclusive use;
b) An own and active bank account in the EU;
c) An adequate nexus to the Member State of claimed residence. In short, this means that there is at least one director or a sufficient number of employees involved with generating passive income and who are authorized and sufficiently qualified and who live in the Member State or close enough to it to properly perform their activities.

This statement to the tax return must be accompanied by supporting documentation enabling the relevant tax authorities to verify this data and check whether a further tax audit is required. The evidence required includes:

- The address and type of premises;
- The type of gross turnover and the amount thereof;
- The type of business expenses and the amount thereof;
- The type of business activities performed to generate the relevant income;
- The number of directors, their qualifications, authorizations and their residence for tax purposes or the number of comparable full-time employees performing the business activities that generate the relevant income, their qualifications and place of residence for tax purposes.
- Outsourced business activities;
- The bank account number, any authorizations for accessing the bank account and for using or issuing payment instructions and evidence of the bank account's activity.

Step 3: Presumption of lack of minimal substance and abuse
The third step provides for an evaluation of the substance reported by the entity. An entity that meets the gateways – and thus is a high risk entity – and has provided satisfactory documentary evidence in Step 2, i.e. in support of its declaration that it meets all the indicators of minimum substance, is presumed to have substance for the tax financial year. Nevertheless, the tax authorities may conclude that the entity:

- is a shell entity for the purposes of the directive, because the documentary evidence produced does not confirm the information reported;

- is a shell entity within the meaning of national rules; or
- is not the ultimate beneficial owner of the income received.

A risk case that does not meet at least one of the three substance indicators listed under step 2 is deemed to be a shell entity for the purposes of the directive proposal, i.e. an entity that lacks sufficient substance and is misused for tax purposes.

Step 4: Rebuttal evidence
Under step 4, entities that are presumed to be a shell entity can challenge this presumption on the basis of the facts and circumstances of their specific case. In challenging this presumption, they must provide additional evidence including commercial (non-tax) reasons for setting up and maintaining an entity without own premises and/or bank accounts and/or directors or employees. The evidence provided must also include information which the tax authorities can use to verify the nexus with the Member State of claimed residence (i.e. in order to verify that the most important decisions about the activities generating the passive income are taken in that Member State).

Any additional information provided will be reviewed by the tax authorities of the Member State of which the entity is a resident. If that tax authority agrees that the entity is not a shell for the purposes of the directive, then the rebuttal provision has been met for the relevant tax year. It is possible to extend the validity of this rebuttal evidence for another five years, provided that the relevant legal and actual circumstances do not change. After these six years have ended, an entity that wishes to challenge the presumption will have to go through the entire process again.

Step 5: Exemption due to lack of tax motives
An entity that meets the gateways from step 1 (and thus is a high-risk entity) but does not meet the minimum substance requirements (step 2) can nevertheless be exempt from the obligations of the directive. The entity must prove that its existence does not lead toa tax benefit for the group of companies of which it is a member or for its ultimate beneficial owner(s). To this end, the entity must provide evidence which the tax authorities can use to assess what the tax liability for the group as a whole or for its ultimate beneficial owner(s) is with and without the interposition of the entity. If the tax authorities agree, this exemption will apply for the relevant tax year and may be extended for another five years provided the factual and legal circumstances remain the same.

Step 6: Tax consequences
Entities designated as shells and that cannot refute this presumption, will be confronted with the denial of directive benefits, such as those in the Parent-Subsidiary Directive, the Interest and Royalties Directives and treaty benefits. In essence this denial means that the tax treaties and directives will have to be applied as if the shell entity had not been interposed. The Member State of which the shell entity is a resident should therefore refuse to issue a certificate of residence to this entity or issue a statement with a ‘warning’ (i.e. a prescribing that the entity is not entitled to the

relevant directive and treaty benefits). The Member State of the shell remains free to continue to consider the shell as resident for tax purposes.

The directive describes how the tax benefits must be denied in various scenarios where payments are made to a shell entity and where either the payor or the shareholder of this entity is a resident of another EU Member State or of a third country. If, for example, the source state is an EU Member State and the shareholder's state of residence is a third country, the source state will have to tax the payments to the shell entity in accordance with a tax treaty with the particular third state or, if there is no treaty, in accordance with its national legislation. If the source state is a third country and the shareholder's state of residence is an EU Member State, the shareholder's state of residence will tax the payments received by the shell entity as if these were received directly by the shareholder and any reduction of withholding tax may be claimed under the treaty with the source state.

Step 7: Exchange of information
All the data collected under step 2 will automatically be exchanged between the Member States by means of a central database within 30 days of the tax authorities receiving the information, i.e. within 30 days of the receipt of the tax returns or within 30 days of the tax authorities stating that an entity has refuted a presumption or is exempt. To achieve this, the directive proposal provides for an amendment of the Directive on Administrative Cooperation.

Other aspects
In principle, the directive leaves it up to the Member States themselves to decide on effective, proportionate and dissuasive penalties for non-compliance, thereby noting that the Member States must introduce an administrative pecuniary penalty of at least 5% of the entity's turnover. The Member States must also send a set of data to the European Commission annually, for example regarding the number of entities that meet the reporting conditions, the number of entities that have reported, the penalties imposed, etc.

Meijburg & Co comments
The European Commission has proposed that the Member States transpose the directive into national law before June 30, 2023 and that the provisions in the Directive should apply as of January 1, 2024. However, the directive proposal will first be presented to the EU Parliament for consultation and then will have to be unanimously adopted by the Council (i.e. all the Member States must agree to it). It is therefore possible that the proposal will undergo changes in the meantime or that the implementation date will be moved. Should you have any questions about the above, Meijburg's advisors would be pleased to use their expertise to help you.

KPMG Meijburg & Co
December 24, 2021

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