

# EU Commission releases draft Directive proposing measures to prevent the misuse of shell entities for tax purposes

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## In brief

The European Commission (EC) has published the [text of a draft Directive](#) laying down rules to prevent the misuse of shell entities for tax purposes and to amend Directive 2011/16/EU on Administrative Cooperation (DAC). This proposed Directive, published on 22 December, provides indicators of minimum substance for undertakings in Member States and rules regarding the tax treatment of those undertakings that do not meet the indicators. The proposed Directive would apply to all undertakings that are considered tax resident and are eligible to receive a tax residency certificate in a Member State (subject to some specific exclusions), including SMEs, partnerships, trusts and other legal arrangements. It is likely to result in additional reporting requirements and in some cases, additional tax liabilities for those impacted.

## In detail

### Background

In May 2021 the EC published its ‘Communication on Business Taxation for the 21st Century’ with the stated aim to provide a fair and sustainable business environment and EU tax system (see our previous [Tax Policy Alert](#)). As part of this Communication, the EC pledged to tackle the abuse of entities and arrangements that have no or little substance. This latest proposal is designed to address this. It is one of the short-term targeted initiatives proposed by the EC to ensure fair and effective taxation in the European Union and to make sure the tax burden is shared evenly across taxpayers, in such a way that does not distort internal competition.

This proposal stems from a European Parliament request to counter the misuse of shell entities, in addition to more general requests from some Member States, business, and civil society to deal with tax avoidance.

The EC undertook a public consultation during summer 2021. All respondents noted that tax avoidance and tax evasion remain issues, including through the misuse of shell entities. However, some respondents consider that new targeted measures are premature. Based on feedback from respondents, the EC has noted that entities can be set up with low economic substance for valid reasons and that the proposed directive is designed only for entities set up for the purposes of tax avoidance and evasion and that do not perform any actual economic activity.

**Observation:** In PwC's [submission](#) to the consultation, we suggested that the EC consider whether recent anti-avoidance legislative changes (such as ATAD I and ATAD II, BEPS and the MLI) would be enough to tackle any remaining abuse of low-substance arrangements. However, it is clear from this proposal that the EC believes that specific legislation is required to deal with entities and arrangements set up solely for purposes of tax avoidance and evasion. We welcome the recognition from the EC that there can be legitimate business reasons for creating entities with lower economic substance (which comes through via the exemption and exclusions from scoping rules), and that entities formed for these valid reasons should not be adversely impacted by any new legislation.

### Entities in scope

The proposed Directive's provisions apply to all entities, regardless of their legal form, that are engaged in an economic activity and that are considered to be tax resident and eligible to receive a tax residency certificate in a Member State. It also captures legal arrangements, such as partnerships, that are deemed residents for tax purposes in a Member State. The proposal does not apply to entities in third countries. In the case of payments to/from a deemed shell entity and a third country, the allocation of taxing rights should be determined by existing double tax agreements. Third country entities may be asked to look through the EU shell entity for the purposes of determining the payer/payee of any payment. However, an entity that meets any of the following criteria will not be subject to the requirements set out in relation to the Minimum Substance Test (see further below):

- A company with a transferable security listed on a regulated market or multilateral trading facility,
- An entity that is a regulated financial undertaking (as defined in the proposed Directive),
- Undertakings that hold shares in operational businesses located in the same Member State as the undertaking's shareholders or ultimate parent entity, or
- An undertaking that has at least five full-time employees exclusively carrying out the income-generating activities of the undertaking.

### Minimum Substance Test

The 'Minimum Substance Test,' which will determine whether an entity should be regarded as a 'shell,' along with the implications of such classification, involves seven steps:

1. **Undertakings that should report:** The first step involves determining whether an undertaking passes a set of **'gateway'** criteria that would indicate whether the entity is at risk of being a low-substance entity that could be misused for tax purposes. The relevant gateway criteria indicators are:
  - Entities that are **geographically mobile** on the basis that 75% of their revenue in the preceding two years is 'relevant income'. Such relevant income is, generally speaking, passive income but is defined in the proposal. Anti-avoidance rules apply such that this criteria is also met where income has not recently flowed from the holding of specific assets.
  - Entities **engaged in cross-border activities** (either more than 60% of the book value of specific assets was located outside of the Member State in the preceding two years or more than 60% of the undertaking's 'relevant income' is earned or paid out via cross-border transactions).
  - Entities that **outsource the administration** related to day-to-day administration and decision-making on significant functions to others.

Some entities will be explicitly carved out as they are considered low risk (see *Entities in Scope* above). If the gateway is crossed (i.e. an entity meets all three criteria above), these 'high-risk' entities must report on indicators related to substance in their tax return.

2. **Reporting:** Specific information must be disclosed in the annual tax return that will indicate whether an entity has the required minimum substance, including having **premises** available for the exclusive use of the undertaking, having a **bank account** open and active in the European Union, and having at least one **qualified director who is tax resident in the same Member State** or sufficiently close to the undertaking and who is dedicated to its activities. As an alternative to having at least one qualified director, an entity may demonstrate that a majority of **full-time employees** engaged with the undertaking's core income-generating activities are tax resident in the same Member State as the undertaking or sufficiently close by.

The undertaking also must provide documentary evidence with the tax return to allow the tax administration to verify the truth of the reported information and draw general conclusions.

3. **Presumption of lack of minimum substance and tax abuse:** This step involves the making of a decision as to whether the entity is a 'shell' or not. While the reporting entity is entitled to declare that it does or does not have the required indicators set out in Step 2, the tax administration apparently will have the final say on whether these indicators are established.

If the required indicators (premises, active EU bank account and qualified, tax resident director(s) or staff) are demonstrated and backed up by documentary evidence, then there is a presumption that the entity is not a 'shell' for the purpose of the proposed Directive. However, even where the required indicators are demonstrated, the entity may still be a 'shell' for the purpose of the Directive in the event that the accompanying documentary evidence does not support the stated position.

According to the explanatory memorandum, if the undertaking is not a shell according to the proposed directive, the Member State's tax administration remains free to classify it as a shell or low substance undertaking under the Member State's domestic provisions and / or to consider that it is not the beneficial owner of any stream of income paid to it.

4. **Rebuttal:** Under this step, the burden of proof is on the undertaking that has been presumed as a shell to prove that it has minimum substance, or it is not misused for tax purposes. This stage accounts for the specific facts and circumstances of the existence of the entity. A positive rebuttal by the undertaking, certified by the tax administration in the Member State in which the undertaking is tax resident, is valid for that tax year and can be extended for another five years (six years in total) under the condition that the legal and factual circumstances evidenced by the undertaking do not change.

Evidence that the undertaking is required to provide for its rebuttal includes information on the reasons for setting up and maintaining the entity and information on the resources that it uses to actually perform its activity. Information to be provided is also likely to include verifications that the key decision-making happens in the Member State such that nexus is established between the undertaking and the Member State in which it claims tax residence.

5. **Exemption for lack of tax motives:** Recognising that undertakings may operate in such a way that crosses the gateway criteria in Step 1, and that they may not meet the substance indicators in Step 2, those undertakings may nonetheless have been set up for genuine business activities without creating a tax benefit, or with no tax avoidance or evasion purpose for itself, for its beneficial owner(s) (as defined by reference to Directive 2015/489 - anti-money laundering rules) or for the group of companies of which it is a part. Where this is the case, such entities can request a certification of exemption from the obligations of this proposal. This can be done at any time, including prior to reporting the information in Step 2 in their tax

return. If successful in obtaining an exemption, the tax administration certification will be valid for the tax year in question and the following five years, similar to Step 4, provided that the legal and factual circumstances do not change.

6. **Consequences:** Consequences associated with being regarded as a 'shell' entity as a result of the above steps include:
- The Member State in which the shell entity claims to have tax residence will either not issue a tax residence certificate at all or will issue the certificate with a warning statement to prevent its use for the purposes of claiming relief from double taxation. This does not mitigate the entity's pre-existing tax obligations with regards to that jurisdiction.
  - The Member State of residence of a shell entity (one which is presumed not to have minimum substance, and which does not rebut this presumption) will continue to exercise taxing rights over the entity's income in accordance with national laws. However, various tax advantages shall be denied by Member States other than the Member State of residence to an entity which is presumed to be a shell, such as the denial of access to measures that eliminate double taxation (e.g., withholding tax relief under the Parent-Subsidiary Directive or the Interest and Royalties Directive). Accordingly, some income flows to and from the shell and/or assets may be taxable in other jurisdictions.

The proposed Directive provides for a CFC-type taxing right over the 'relevant income' of a shell entity such that the entity's shareholder(s) shall tax this income, less any tax already paid by the shell. This is conditional on the shareholder(s) and payer of the 'relevant income' to the shell being resident in a Member State. If the shareholder(s) is not resident in a Member State, the payer of the 'relevant income' must operate withholding tax in accordance with their national law, ignoring any convention/agreement that would eliminate such withholding tax.

The extent to which taxing rights are allocated to other jurisdictions will therefore depend on the source, destination, and owner of the payment. Re-allocation of taxing rights can only affect EU Member States and not third countries. Situations involving third countries will pay due respect to double taxation agreements between Member States and third countries. The proposed Directive illustrates how it would view the rules as applying in likely scenarios impacting third countries.

7. **Exchange of information:** The proposal foresees timely and extensive information sharing between Member States of data pertaining to shell entities in the European Union. This will involve the Member States reporting to a central directory (using the existing systems already set up for the purposes of information exchange). This will require amendments to Directive 2011/16/EU (DAC). Information exchanges will include information from Steps 1, 4 and 5. Member States' competent authorities will be required to report information no later than:
- Within 30 days from receiving a tax return;
  - Within 30 days from the issuing of a certification that an undertaking has rebutted the presumption of a lack of minimum substance and tax abuse or where an exemption has been certified by the tax administration (including reasons for the certification);
  - Within 30 days from the conclusion of an audit into an undertaking at risk for the purposes of the proposed Directive, if the outcome of such audit has an impact on the information already exchanged or that should have been exchanged for this undertaking.

The information required to be reported will include the undertaking's tax identification number, its VAT number (if applicable), the identification of its shareholders and beneficial owner(s), identification of other Member States likely to be concerned by this reporting, identification of any person (including individuals) in other Member States likely to be affected by this reporting, the declaration it provided to the tax administration regarding Step 2, and a summary of the evidence it provided regarding Step 2.

8. **Penalties:** Penalties for non-compliance with the domestic rules transposing this proposal will be at the discretion of the Member States but they must be effective, proportionate and dissuasive. The proposed Directive provides that penalties shall include, at a minimum, an administrative pecuniary sanction of at least 5% of the undertaking's turnover.

## Timeline

Once adopted, this proposed Directive should be transposed into national law by the Member States before 30 June 2023 to come into effect from 1 January 2024. Given the EC's packed legislative agenda for 2022, and the significant time required to consider the international tax reforms proposed by the OECD Inclusive Framework, this appears to be an ambitious timeline.

## The takeaway

Given the wide scope of this proposed Directive, it likely will have a large impact on both commercial and personal undertakings that are in scope. Given the purpose of the proposal, the EC has made no exclusion of the groups within the scope of the OECD's Pillar Two Model Rules that meet the €750 million revenue threshold. Where an undertaking does not meet the minimum substance requirements and cannot demonstrate its genuine business purpose, it may serve to limit the current benefits that the undertaking and/or its shareholders enjoy under the Parent-Subsidiary Directive or the Interest and Royalties Directive and any relevant double tax treaty upon which it may rely. While we welcome the fact that undertakings set up for genuine business reasons have the chance to prove this fact to tax authorities, we highlight the significant additional administrative burden this process will place on both the taxpayer and the tax authorities. This administrative burden is in addition to recent anti-avoidance legislation and the forthcoming changes under the OECD international tax reform proposals. In short, while this proposed Directive may work well in limiting the use of shell entities for tax avoidance and evasion, it will create an added layer of complexity that all EU resident, and many non-EU resident, entities will need to consider.

## Let's talk

For a deeper discussion about how the draft Directive might affect your business, please contact:

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