REVIEW OF INTERNATIONAL & EUROPEAN ECONOMIC LAW

www.Rieel.com

Miscellanea

Presentation

ATAD III & Holding Structures; EU proposal re "shell entities"

Luis Viñuales Sebastián

URÍA MENÉNDEZ

Luis Viñuales Sebastián is attorney at law and partner in Uría Menéndez. Coordinator of the International Taxation section at the Catalan branch of AEDAF.

Vice-chair for Europe/Middle East/Africa of the Global Tax Committee in Lex Mundi (2012-2019) Lecturer on Corporate Income Tax at the AGT program in ESADE - Universitat Ramón Llull (2001-2005). Lecturer on International taxation at Universitat Pompeu Fabra (1998-2001).

Background: The beneficial ownership (BO) framework & BEPS Action 6

- OECD Model Tax Convention > BO concept on articles 10 and 11: legal and economic approach – right to use and enjoy the income -
- Differences with AML/CTF legislation (FATF Recommendations)
- BEPS Action 6 and MLI vary approach towards more sophisticated anti-abuse clauses > LOB and PPT
- EU tax law references to BO > Interest and Royalties Directive
- Significant court cases in the EU ("Danish cases")
- EU initiative 2021: fighting the use of shell entities and arrangements for tax purposes – in addition to GAAR, PPT, anti-hybrid rules, CFC rules.

European Commission's proposal to end the misuse of shell entities (22.12.2021)

European Commission's proposal to end the misuse of shell entities (22.12.2021)

What will the new rules do?

The proposed new measures will establish transparency standards around the use of shell entities, so that their abuse can more easily be detected by tax authorities. Using a number of objective indicators related to income, staff and premises, the proposal will help national tax authorities detect entities that exist merely on paper.

What are the standards and indicators used to determine if a company has real economic activity?

The proposal introduces a filtering system for the entities in scope, which have to comply with a number of indicators. These levels of indicators constitute a type of "gateway". Today's proposal sets out three gateways (explained below). If a company crosses all three gateways, it will be required to annually report more information to the tax authorities through its tax return.

How do these gateways work in practice?

The first level of indicators looks at the activities of the entities based on the income they receive. The gateway is met if more than 75% of an entity's overall revenue in the previous two tax years does not derive from the entity's business activity or if more than 75% of its assets are real estate property or other private property of particularly high value.

The second gateway requires a cross-border element. If the company receives the majority of its relevant income through transactions linked to another jurisdiction or passes this relevant income on to other companies situated abroad, the company crosses to the next gateway.

The third gateway focuses on whether corporate management and administration services are performed in-house or are outsourced.

European Commission

European Commission's proposal to end the misuse of shell entities (22.12.2021)

What happens if an entity crosses all gateways?

An entity crossing all three gateways will be required to report information in its tax return related, for example, to the premises of the company, its bank accounts, the tax residency of its directors and that of its employees. These are known as "substance indicators". All declarations need to be accompanied by supporting evidence.

If an entity fails at least one of the substance indicators, it will be presumed to be a 'shell'.

What happens if a company is deemed to be a shell?

If a company is deemed a shell company, 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. To facilitate the implementation of these consequences, the Member State of residence of the company will either deny the shell company a tax residence certificate or the certificate will specify that the company is a shell.

Moreover, payments to third countries will not be treated as flowing through the shell entity and will be subject to withholding tax at the level of the entity that paid to the shell. Accordingly, inbound payments will be taxed in the state of the shell's shareholder. Relevant consequences will apply to shells owning real estate assets for the private use of wealthy individuals and which as a result have no income flows. Such assets will be taxed by the state where the asset is located as if it were owned by the individual directly.

European Commission

Proposal for a Council Directive (22.12.2021)

Article 2. Scope

This Directive applies to all undertakings that are considered tax resident and are eligible to receive a tax residency certificate in a Member State.
This Directive is without prejudice to other legal acts of the Union.

Article 3. Definitions

1) *'undertaking' means any entity engaged in an economic activity, regardless of its legal form, that is a tax resident in a Member State;*

   (...)

5) *'beneficial owner' means beneficial owner as defined in Article 3, point (6), of Directive (EU) 2015/849 of the European Parliament and of the Council;*

6) *'undertaking's shareholders' means the individuals or entities directly holding shares, interest, stakes, participations, membership rights, entitlement to benefits or any equivalent rights or entitlements in the undertaking and in the case of indirect holdings, those individuals or entities holding interest in the undertaking through one or a chain of undertakings none of which fulfils the indicators of minimum substance set out in Article 7 (1) of this Directive.*

European Commission

Proposal for a Council Directive (22.12.2021)

Article 4. Relevant income (passive income)

For the purposes of Chapters II and III 'relevant income' shall mean income falling under any of the following categories:

a) *interest or any other income generated from financial assets, including crypto assets, as defined in Article 3(1), point 2 of the proposal for a Regulation of the European Parliament and of the Council on Markets in Crypto-assets, and amending Directive (EU) 2019/1937;*
b) *royalties or any other income generated from intellectual or intangible property or tradable permits;*
c) *dividends and income from the disposal of shares;*
d) *income from financial leasing;*
e) *income from immovable property;*
f) *income from movable property, other than cash, shares or securities, held for private purposes and with a book value of more than one million euro.*
g) *income from insurance, banking and other financial activities;*
h) *income from services which the undertaking has outsourced to other associated enterprises.*

European Commission

Seven steps: "substance test", tax consequences & exchange of information

Step 1. UNDERTAKINGS THAT SHOULD REPORT

1. Gateway: > 75% passive income in preceding 2 years / > 75% assets
2. Gateway: ≥ 60% cross border income in preceding 2 years / > 60% foreign assets
3. Gateway: outsourced management in preceding 2 years

CARVE OUT OF HIGHLY REGULATED / LOW RISK CASES

EU listed, regulated financial entities, domestic groups, or ≥5 employees.

Step 2. ANNUAL REPORTING ON SUBSTANCE

a) Own premises
b) EU active bank account
c) Resident directors / employees

Step 3. PRESUMPTION OF LACK OF MINIMUM SUBSTANCE

- Consideration as shell entities

Step 4. REBUTTAL OF THE PRESUMPTION

a) Commercial rationale
b) Employee profiles
c) Decision making site

Step 5. EXEMPTION FOR LACK OF TAX MOTIVES

- No reduction of the tax liability of the “beneficial owner“ or the group
- AML definition as opposed to OECD tax definition
- Comparison overall tax due

Step 6. TAX CONSEQUENCES

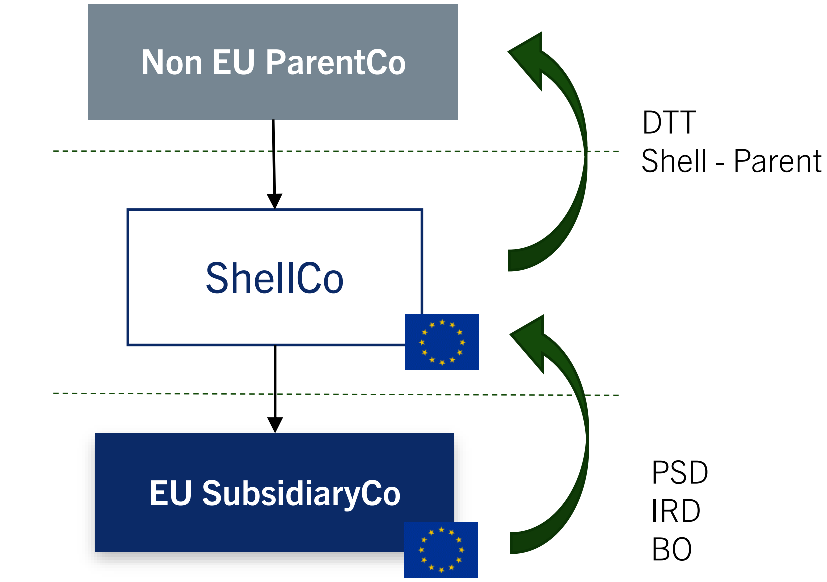
- No application of DTT to shell entity
- No aplication of PSD and IRD
- Look through shell entity.:
  - ✓Income obtained by shareholder
  - ✓Property owned by shareholder
- No certificate of tax residence or indication of not entitlement to DDT, PSD and IRD

Step 7. AUTOMATIC EXCHANGE OF INFORMATION

- Information on substance of entities crossing gateways
- Information on rebuttal of presumption as shell entities

Comparative chart

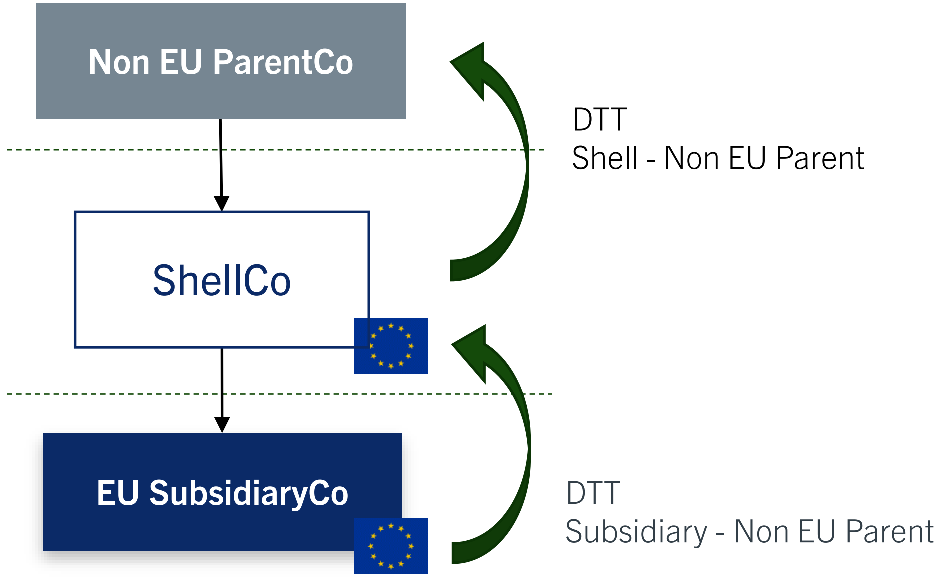
CURRENT (BO approach / GAAR)



Questions

- Exemption under PSD & IRD
- Is Shellco the BO of income paid by EU SubsidiaryCo?
- PPT? GAAR? Indicia of abusive situation?

SHELL DIRECTIVE + BO + GAAR

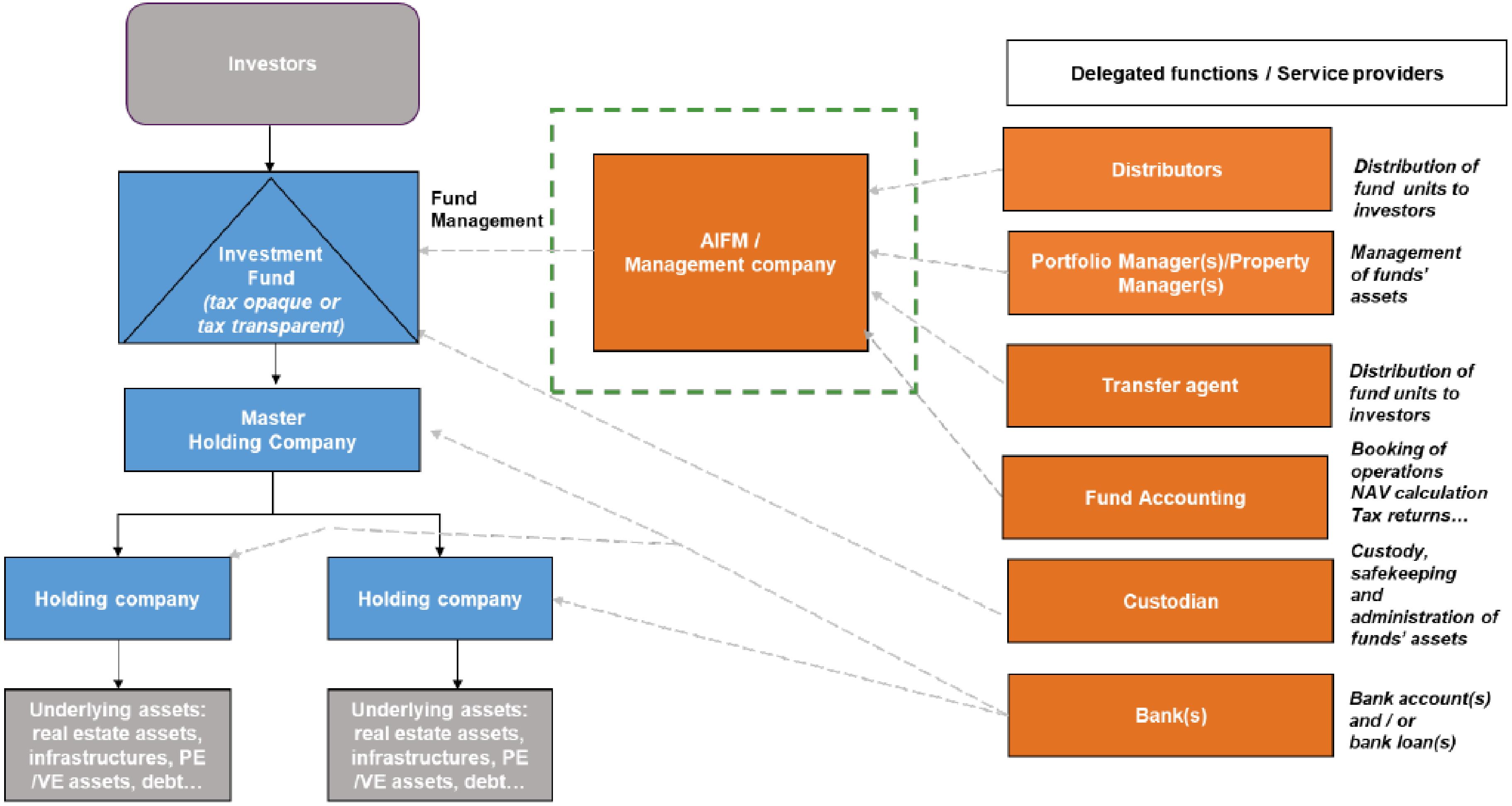


Explanatory memorandum

In this case only the source and the shell jurisdiction are bound by the Directive while the shareholder jurisdiction is not.

- EU source / payer: will tax the outbound payment according to treaty in effect with the third country jurisdiction of the shareholder(s) or in the absence of such a treaty in accordance with its national law.
- EU shell: will continue to be resident for tax purposes in a Member State and will have to fulfil relevant obligations as per national law, including by reporting the payment received; it may be able to provide evidence of the tax applied on the payment.

Funds Industry concerns



alfi association of the luxembourg fund industry

Source: Association of the Luxembourg fund industry (ALFI) views on the proposed Council Directive laying down rules to prevent the misuse of shell entities for tax purposes and amending Directive 2011/16/EU (the "Unshell Directive" or the "Directive") (6 April 2022).

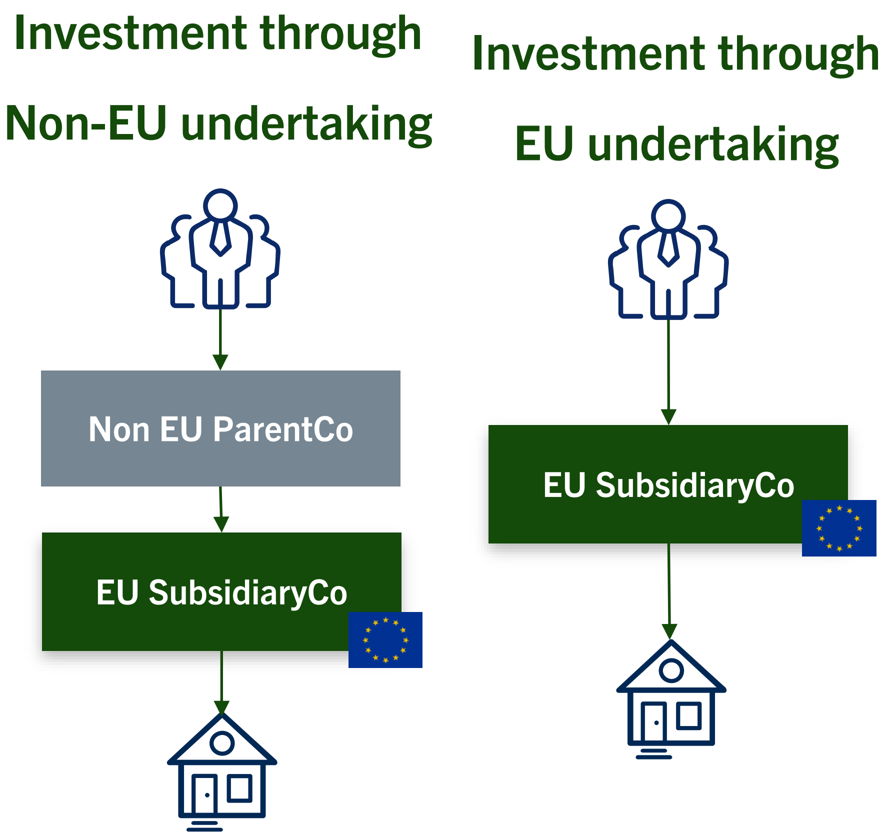
Impact on foreign structures holding assets for private use

Article 11.3

Where property referred to in Article 4 is owned by an undertaking that is presumed not to have minimum substance and does not rebut this presumption:

a) *the Member State <u>where property referred</u> to in Article 4, pint (e) <u>is situated shall tax such property according to its national law, as if such property was owned directly by the undertaking's shareholder</u> (s), without prejudice to any agreement or convention that provides for the elimination of double taxation of income, and where applicable, capital, in force with the jurisdiction of the undertaking's shareholder(s);*

b) *the Member State of the undertaking's shareholder(s) shall tax such property in accordance with its national law <u>as if the undertaking's shareholder(s) owned it directly</u>, without prejudice to any agreement or convention that provides for the elimination of double taxation of income, and where applicable, capital, in force with the jurisdiction where the property is situated.*



European Commission

Penalties and Tax audits

Article 14. Penalties

(...)

Member States shall ensure that those penalties include an administrative pecuniary sanction of at least 5% of the undertaking's turnover in the relevant tax year, if the undertaking that is required to report pursuant to Article 6 does not comply with such requirement for a tax year within the prescribed deadline or makes a false declaration in the tax return under Article 7.

Article 15. Request for tax audits

Where the competent authority of one Member State has reason to believe that an undertaking which is resident for tax purposes in another Member State has not met its obligations under this Directive, the former Member State may request the competent authority of the latter to conduct a tax audit of the undertaking.

The competent authority of the requested Member State shall initiative it within one month from the date of receipt of the request and conduct the tax audit in accordance with the rules governing tax audits in the requested Member State.

The competent authority which conducted the tax audit shall provide feedback on the outcome of such audit to the competent authoriry of the requesting Member State as son as posible and no later tan one month after the outcome of the tax audit is known.

Considerations

- Directive intended to be transposed into EU member states legislation and be applicable as from 01.01.2024
- Doubts on final version of the Directive as technical questions raised by stakeholders need to be addressed
- Review of existing structures to verify:
  - (i) Gateways criteria in 2022 and 2023. No transitional period and retroactive impact deriving from the "2 preceding years" rule
  - (ii) 5 employees for carve out purposes
  - (iii) Directors and full-time employees tax resident in the undertaking's member state for reporting on substance purposes
  - (iv) Potential effects of being considered as "shell entity"


TAX