12 May 2022

Unshell - Laying down rules to prevent the misuse of shell entities for tax purposes

KEY MESSAGES

1 We welcome and support the European Commission's continued fight against tax fraud, tax evasion and aggressive tax planning both at the corporate and at the personal income tax level. A targeted and coordinated approach to fight the misuse of shell entities for tax purposes could be an effective step forward on the condition that both the current Unshell proposal and upcoming measures to address non-EU shell entities are enacted at the same time and valid commercial entities are not faced with significant additional administrative burdens.

2 The European Commission has rightly observed that while "shell entities as such are not the problem", some shell entities are indeed used for tax abusive practices. We believe it is important that the focus of Unshell is on identifying and sanctioning these type of entities.

3 We are however very concerned that valid commercial business entities may still be faced with cumbersome (administrative) procedures due to the proposed functioning of the rules in Unshell. A more targeted approach, including through further clarifications on the gateway test, would lower the administrative burden for businesses, without undermining the goals of the directive. Similarly, we regret that the impact of previous anti-tax abuse measures (such as ATAD) has not been fully evaluated.

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Unshell

This directive aims to target shell entities when they are used for aggressive tax purposes. The 'Unshell' initiative aims at ensuring that entities in the European Union that have no or minimal economic activity are unable to benefit from any tax advantages. The directive introduces a gateway test and a minimum substance reporting obligation requirement for those entities which are deemed to be at risk of being misused for tax purposes. The mechanism does allow taxpayers to rebut the presumption of being a shell, by providing evidence to their tax authority on the commercial, non-tax reasons for its entity.

Evaluation of previous measures

As we noted in our input to the public consultation leading up to this directive, a number of significant measures to fight Base Erosion and Profit Shifting (BEPS)-issues have only been recently implemented, such as the Anti-Tax Avoidance Directive (ATAD), the Directive on Administrative Cooperation (DAC) and its revisions, the BEPS-actions, …, with more to come through the worldwide adoption of Pillar 2. We welcome that the Commission’s impact assessment addresses this issue (Annex 9) and recognises rightfully that an evaluation of previous measures should be part of the debate when introducing additional measures so as to avoid excessive administrative burden on companies and tax administrations. The impact assessment broadly recognises the importance of ATAD, DAC, BEPS, …. Some of the rules in these initiatives are considered to be of ‘limited assistance’, while others are ‘essential tools’ to tackle abuse by shell entities.

However, the Commission draws the conclusion that Unshell is necessary as the current measures in place either lack substantive requirements, or when they do have criteria regarding substance, the criteria are criticised for not being ‘specific’ or ‘objective’ . We find this conclusion very pre-emptive. If specific objective criteria for shell entities, as in Unshell, are considered to be necessary, it is up to the Commission to show first that the current rules are ineffective as a result of their lack of specific substantive criteria. However, in the impact assessment, there are no data on the impact of the recent multiple layers of anti-abuse legislation.

Non-EU shell entities

While we welcome the Commission’s intention to also address non-EU entities, we believe it is essential that the current Unshell proposal is coordinated and enacted at the same time as the upcoming measures for non-EU shell entities. This can ensure an effective and targeted approach on the fight against the misuse of shell entities, without imposing stricter (administrative) requirements on EU businesses.

Both proposals should also consider how they can be closely linked to the upcoming proposal on withholding tax refund procedures and the wider objectives of the Capital Markets Union.

Shell entity – Commercial & valid motivations

The discussion on shell entities is made more difficult by the lack of an internationally-established definition of what a shell entity is. This is why we consider it an important step in the on-going worldwide debate that the European Commission has acknowledged that some shell entities are entities set-up by a company for valid commercial reasons, while some other shell entities are (mis)used for tax abusive practices. As such, the debate should not focus so much on the existence of shell entities overall, but rather the reasons for which they exist and are used. While shell entities can be used for money laundering, tax fraud, tax evasion and aggressive tax planning, there is also a wide range of legitimate commercial reasons:

As stated in the Commission's impact assessment:

> *"shell entities can be used to: ensure limitation of liability; protect investors and maintain the value of the portfolio; meet the requirements of third party lenders to ring-fence assets and liabilities; facilitate joint ventures between funds and other investors; streamline decision making by giving authority to the directors of holding entities; provide a convenient vehicle for sale or partial sale.* ***As said, shell entities as such are not the problem."*** *(Impact assessment, p.5)*

It is not always easy to distinguish these uses and there are material challenges in designing an initiative which focuses exclusively on abusive practices, whilst not impacting legitimate business purposes. However, it is clear that an initiative that obstructs EU-companies from carrying out legitimate practices will lead to an unfair competitive disadvantage for EU companies. Commercial motivations behind the set-up of shell entities often relate to companies' access to finance, protection against currency exchange risk, regulatory considerations, access to new markets, and the set-up of new projects, organizational purposes (mergers, acquisitions, etc). Any proposal that would make it more burdensome for EU companies to establish such entities will eventually obstruct legitimate companies' growth and expansion. Therefore, it is essential that the proposal absolutely guarantees the continued existence and operation of commercial shell entities, without costly administrative obligations.

This is why we believe the proposal requires some further clarifications and targeted criteria to ensure that legitimate companies are not subject to excessive administrative obligations related to this proposal (see following chapters). Moreover, in some instances, the directive provides only for general definitions, which could lead to many divergent interpretations in the Member States. We consider that it is essential that these are clarified further, preferably in the directive. We foresee that explanatory notes, with illustrative examples, would be necessary.

We would also like to add some remarks regarding a statement in the introductory part of the directive. Recital (1) says: "In particular, multinational groups often create undertakings with no minimal substance, to lower their overall tax liability, including by shifting profits away from certain high-tax Member States in which they carry out economic activity and create value for their business.". We find this statement very troublesome and question what the evidence is for such a statement. The past decade saw the agreement on numerous anti-avoidance legislation at global, European and national level. To our knowledge, there has been no publication or scientific study or an impact assessment in order to assess the result of this wide range of legislation. We are very concerned that a general accusation is carried out against a whole category of enterprises. Multinational enterprises (MNEs), like other companies of different sizes, are first and foremost creating jobs and economic growth across Europe. While there have been certainly cases of tax fraud, evasion and aggressive tax planning, which the EU Commission is fully right to counter, we consider it to be important that the European Commission does not take these cases as a representation of all MNEs, nor businesses as a whole.

Criteria of gateway test (article 4 & 6.1)

Regarding the concept of relevant income, article 4c speaks of “dividends and disposal of shares”. However, the directive should clarify whether income an entity obtains through its permanent establishment abroad is considered equivalent to a dividend distribution. Our belief is that income an entity obtains by means of having a business active permanent establishment is deemed as operative income. In addition, the gateway states that “more than 75% of the revenues accruing to the undertaking in the preceding two tax years is relevant income”. It should be clarified whether this means that the company’s share of relevant income is at least 75% in each year of the two-year period or whether this should be interpreted as “cumulated over a 2-year period”?

Article 4h includes as relevant income “income from services which the undertaking has outsourced to other associated enterprises”. We believe such definition is unclear and could lead to confusion and increase the range of entities affected, even if they perform operational business transactions. It will be required to further elaborate such wording and better describe which kind of arrangements are taken into consideration under such paragraph. In particular, as long as intra-group transactions and their valuation leverages on the arm’s length principle, these income flows should not be considered per se as relevant income for the purposes of this directive.

Article 6c(1) notes that “in the preceding two tax years, the undertaking outsourced the administration of day-to-day operations and the decision-making on significant functions*”.* In terms of outsourcing, it should be clarified that this exclusively considers situations in which activities are externalised to a third party – i.e. to a service company specialised in providing corporate secretarial, accounting and tax services (among others) – and does not apply to intragroup agreements allowing group entities to receive support from an associated company.

Furthermore, the exact scope and meaning of the concept of outsourcing of the “administration of day-to-day operations” and the “decision-making on significant functions” should be further clarified.

Carve-out (article 6.2)

We welcome the immediate carve-out for regulated financial undertakings, including funds that are subject to certain defined levels of regulation. This exclusion recognises that the directive should not impose administrative or fiscal burdens on this type of valid shell entities.

However, we consider that the carve-out can be further clarified and widened. For example, in the OECD’s recent Model Rules on Pillar 2, investment entities are excluded from the scope of Pillar 2, including entities that are at least 95% (and in some cases 85%) owned directly by investment funds or real estate investment vehicles, recognising that such entities are a fundamental part of an investment fund structure (Model Rules, article 1.5.2). We consider that a similar exclusion should be provided for in the Unshell directive.

We also believe a criterion based on a minimal number of employees could be included as part of the carve-out in order to make the directive more targeted, thus easing compliance burden for both businesses and tax authorities. It is possible that a company, for historic reasons, earns a large share of cross-border dividend income and would thus fail the gateway test, despite having a large number of employees and genuine other operating business. Similar to the substance-based carve-out in Pillar 2, it is very unlikely that BEPS practices would flourish in entities where there is a significant number of employees. Therefore, a safe harbor regarding a sufficient number of employees should be provided for in the Unshell directive.

Similarly, we encourage policymakers to see how the carve-out could be further considered from a country-wide perspective. The directive looks more at individual entities, without taking into account the overall presence of a company in the country. A large multinational may have multiple entities in a country with significant substance, while 1 entity may not meet the substance requirements.

Reporting on minimal substance (article 7)

We are very concerned about the “burden of proof” requirements (article 7.1 & 7.2), which we consider to be unbalanced. The criteria under article 6 (see above), in particular if further criteria are not added or clarified, are not sufficiently targeted to give any real indication as to whether there is tax avoidance or evasion happening and many valid companies would thus be subject to an automatic reporting requirement. Moreover, the documentary evidence required at the end of each fiscal year through the tax return is disproportionate: this creates a quasi “tax audit” situation whereas it is far from certain based on the evidence provided through the gateway test that there is tax abuse going on. Furthermore, it appears that the level of information requested seems to go beyond what would be necessary to demonstrate that minimum substance requirements are met.

In our view, some of the criteria in article 7 are outdated. Article 7a requires undertakings to certify in the annual tax return that “the undertaking has own premises in the Member State, or premises for its exclusive use”. For this requirement, it is necessary to confirm that an arrangement under which each undertaking on a group located in the same address is met, although the premises are hired by one of them and cost included within the referred administrative service place in intercompany agreements, all in line with arm´s length rules. It is common that associated enterprises share the same offices and do not sign leases separately. Groups often hire premises and may sublease them to other group companies. A divergent interpretation would lead to the need that each undertaking would have a sole rental agreement over the same premises, which would imply significant higher costs and administrative burden.

Regarding article 7.1(b), many MNEs have a treasury company that acts as an inhouse bank removing the need for subsidiaries to have their own accounts. In fact, the world is moving even further in this direction with the possibility of virtual bank accounts and payment on behalf of structures.

Article 7c(ii) states that "the majority of the full-time equivalent employees of the undertaking are resident for tax purposes in the Member State of the undertaking, or at no greater distance from that Member State insofar as such distance is compatible with the proper performance of their duties, and such employees are qualified to carry out the activities that generate relevant income for the undertaking." It is required to clarify how the term "full-time employees" should be understood. Is a segmentation of functions required for this assessment? For example, do only employees working for the relevant function count? How does it work together with the "day to day operations" criterion? Could an employee performing only administrative tasks be considered as an employee qualified to "carry out the activities that generate relevant income for the undertaking"?

With respect to directors, article 7c(4) states that one or more directors of the undertaking "are not employees of an enterprise that is not an associated enterprise and do not perform the function of director or equivalent of other enterprises that are not associated enterprises". Question here is to clarify whether directors, not employees of the undertaking can only develop such role in a certain group of entities, as it is a standard that highly skilled independent directors perform their duties in diverse groups.

Another crucial concern is the lack of a "grandfathering" rule for legacy structures with a pre-clearance procedure. Many entities exist for historical reasons and cannot be easily eliminated due to cost and complexity. It can be difficult and almost impossible to eliminate a European holding company without triggering exit tax charges in third countries. Some foreign jurisdictions have domestic rules that allow them to charge an exit tax based on the uplift in value created over many years. Such exit tax could therefore be high. Furthermore, the two-year look back period foreseen in article 6 creates a retroactive application of the rules which will create legal uncertainty for taxpayers.

Rebuttal of presumption and exemption (article 9 & 10)

To minimize the risk of fully legitimate companies being subject to severe tax consequences, it is crucial that a legislative proposal related to substance requirements always contains straightforward robust safeguard mechanisms that allows taxpayers to further show that there are business reasons for the existence of such an entity, in line with ECJ case law and EU principles. We welcome that the proposal includes a safeguard mechanism, the so-called "rebuttal of the presumption" in article 9.

It is essential that the criteria used to rebut the presumption in the event that an entity fails the substance test do not cause a multitude of disputes. Therefore, more clarity should be provided around the administrative burden of such a rebuttal, and to what extent there could arise arbitrary assessments in the Member States. In this regard, we recommend to further clarify the "commercial rationale" element stated in the article 9.2(a). Furthermore, while this provision should be a "second chance", for the taxpayers that are unable to demonstrate that the minimal substance requirements are met, the level of information requested to rebut the presumption in article 9.2(b) and 9.2(c) seems to be somewhat similar to what is requested under article 7. Our recommendation would be to rather limit the rebuttal evidence to a general demonstration of the economic (non-tax) rationale of the company.

In terms of timing, it is unclear how a company would receive confirmation that the presumption has been rebutted. The process of rebuttal should be possible throughout the whole year, with a fixed time-period within which the tax authority would need to decide on the rebuttal. While leaving it up to the tax authorities to decide a suitable time period itself, it is clear that taxpayers cannot be subject for a long period of time to on-going certainty regarding their tax status. Moreover, an absence of correspondence from the tax authority beyond the time period should be considered as an acceptance that the presumption has been rebutted.

Application of article 12 requires that an undertaking has successfully requested for an exemption, which implies approval by the relevant Member State (article 10). The procedure for requesting, considering and granting exemption may take time and potential objection and appeal procedures. In order to reduce legal uncertainty, we recommend including a provision according to which the tax authorities will have to provide their position on a request made by a taxpayer to benefit from the exemption within a certain time period. Additionally, we would recommend clarifying what constitutes “appropriate measures” in the context of the exemption as well as “the tax benefit” in order to ensure an identical approach by local tax authorities in the different Member States.

Tax residency certificates

A major concern is that the current provisions of the proposal may create obstacles to the issuance of tax residency certificates and give rise to timing mismatches. This issue could happen as the proposal requires an ex-post assessment of the minimum substance of an entity (as article 7 of the proposal foresees that reporting undertakings must declare in their annual tax return, for each tax year, whether they meet the minimum substance indicators for the relevant tax year). Therefore, we fear that some tax authorities may potentially refuse in practice to grant tax residency certificates for a given year until when the substance report is filed and assessed (which will only occur, by definition, the following year). We further anticipate that tax authorities might take time to assess any request for a tax residency certificate made by any entity possibly falling within the scope of the proposal (even if this entity might benefit from a carve-out). This could create huge delays in the issuance of tax residency certificates for non-shell entities, at least for the first year of application of the proposal. It is important that such developments are followed closely and, if needed, subject to appropriate review by the Commission and the Member States.

We call on policymakers to see how an ex-ante procedure could be set-up and ensure that there are no timing mismatches.