THE EU DIRECTIVE PROPOSAL COMBATING 'SHELL ENTITIES'

On 22 December 2021 the European Commission presented a proposal Directive to prevent the use of shell entities for improper tax purposes, hereafter: 'the Directive' (the full Directive can be found here). In short, the Directive targets EU Member State entities that mainly hold passive assets and that are involved in cross-border activities while their daily management and decision-making is outsourced. Under the Directive, such entities can no longer benefit from tax advantages between Member States. It is envisaged that Member States transpose the Directive into national law by 30 June 2023 for the rules to come into effect as of 1 January 2024. In this newsletter we will zoom in on the Directive by describing the in-scope entities, the substance requirements and the potential impact.

IN-SCOPE ('AT-RISK') ENTITIES

The Directive stipulates that entities are in principle required to report to the tax authorities (the '**Reporting Obligation**') if the following three criteria ('**Gateways**') are met:

1. More than 75% of the entities' revenues in the preceding two tax years consists of passive income such as interest, royalties, dividends and income from real estate ("**Relevant Income**");
2. In the preceding two tax years (i) at least 60% of the Relevant Income is received or paid out in the form of cross-border transactions, or (ii) more than 60% of the book value of the entities' assets consists of real estate that was located outside the Member State of the entity ; and
3. In the preceding two tax years, the entity outsourced the administration of day-to-day operations and the decision-making on significant functions (e.g. to trust-companies).

Please note, as the Gateways apply to the preceding two tax years and as it is envisaged that the Directive will enter into force from 1 January 2024, the tax years 2022 and 2023 would in principle be included in the assessment of the Gateways.

EXCEPTION: EXCLUDED ENTITIES

The Directive explicitly excludes the following entities from its scope:

- regulated financial entities (e.g. listed entities, Alternative Investment Funds, UCIITS);
- entities with holding activities that are resident for tax purposes in the same Member State as its shareholder(s) or the ultimate parent entity; and
- entities with at least five own fulltime employees or members of staff exclusively carrying out the activities generating the Relevant Income.

REPORTING OBLIGATION: MINIMUM SUBSTANCE INDICATORS

Entities that passed the three Gateways, and as such fall under the Reporting Obligation, are required to report in their annual tax returns whether they meet the following three cumulative minimum substance indicators (the '**Substance Requirements**'):

1. The entity has own premises in the Member State, or premises for its exclusive use;
2. The entity has at least one own and active bank account in the Union;
3. One of the following indicators:
   (i) the entity has at least one director:
   - who is tax resident in the Member State of the entity, or at no greater distance from that Member State insofar as such distance is compatible with the proper performance of its duties;
   - who is qualified and authorised to take decisions in relation to the activities that generate Relevant Income for the entity or in relation to the entity's assets;
   - who is actively and independently uses the authorisation referred to above on a regular basis; and
   - who is not an employee 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, or

   (ii) the majority of the full-time equivalent employees of the entity are resident for tax purposes in the Member State of the entity, or at no greater distance from that Member States 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 entity.

Please note, the reporting must be accompanied by satisfactory documentary evidence, which should be attached to the tax return.

QUALIFICATION AS SHELL ENITITY - PRESUMPTION

If an entity passes the Gateways and does not meet the cumulative substance indicators, such entity is presumed to be a shell entity. Vice versa, an entity that passed the Gateways but whose Reporting Obligation shows that it meets all Substance Requirements, should be presumed not to be a shell entity for the purposes of the Directive.

REBUTTAL OF THE PRESUMPTION

The entity that is presumed to be a shell entity may however rebut (the '**Rebuttal**') the presumption by providing additional supporting evidence that proves that the entity has performed and continuously has control over, and bears the risks of, the business activities that generated the Relevant Income (or in the absence of income, the entities' assets). The Rebuttal evidence is expected to include information on the commercial (i.e. non-tax) reasons for setting up and maintaining the entity which does not need own premises and/or bank account and/or dedicated management or employees. The evidence is also expected to include information on the resources that such entity uses to actually perform its activities. The evidence should also include information allowing to verify the nexus between the entity and the Member State where it claims to be resident for tax purposes, i.e. to verify that the key decisions on the value generating activities of the entity are taken there. Please note, in the case that a Rebuttal is accepted it is in principle valid for another 5 years.

TEMPORARY EXEMPTION

An entity that passed the three Gateways and/or does not meet the cumulative substance indicators, could request an exemption from its Reporting Obligation if it can evidence that its existence does not create a tax benefit for itself, the group of companies of which it is part of or for the ultimate beneficial owner(s). Such exemption is granted for 1 year and can be extended for an additional period of 5 years.

TAX CONSEQUENCES

Once an undertaking is considered to be a shell entity for purposes of the Directive (and the Rebuttal failed), other Member States will disregard any double tax treaty agreements concluded with the resident Member State of the shell entity and/or the access to EU Directives. The tax consequences as stipulated in the Directive could be distinguished as follows:

- Tax consequences for shell entities <u>in other Member States:</u>

  -In case both the shareholder of the shell entity and the payer of the Relevant Income are tax resident of a Member state, the Relevant Income will be allocated directly to the shareholder and will be taxed in the shareholder Member State in accordance with its national law (similar to the CFC approach). The source Member State will not have a right to tax the payment but may apply domestic tax on the outbound payment to the extent it cannot identify whether the shareholder is resident in the EU. Furthermore, the shareholder may be able to claim relief for any tax paid at source under EU Directives, and any tax paid in the Member State of the shell entity should be deducted at the level of the shareholder.

  -In case the payer of the Relevant Income is not tax resident of a Member State and the shareholder is resident of a Member State, the Relevant Income will be allocated directly to the shareholder and the Member State of the shareholder will tax the Relevant Income in accordance with its national law and may be able to claim relief for any tax paid at source, in accordance with the applicable tax treaty with the third country payer jurisdiction. The third country payer jurisdiction may in such case apply withholding tax on the Relevant Income or may decide to apply the tax treaty in force with the Member State of the shareholder.

  -In case the shareholder of the shell entity is not resident of a Member State, the Member State of the payer of the Relevant Income should apply withholding tax in accordance with its national law taking into account the tax treaty in force with the third country jurisdiction of the shareholder. While in such case the third country jurisdiction of the shareholder is not compelled to apply any consequences, it may decide to apply the tax treaty in force with the Member State of the payer of the Relevant Income for a relief of the withholding tax at the level of the shareholder.

  - In case the shell entity holds real estate that is located in another Member State, such real estate should be taxed in that other Member State as if the real estate was held by the third country jurisdiction shareholder of the shell entity directly, taking into account a tax treaty between the Member State where the real estate is located and the third country jurisdiction of the shareholder. Vice versa, in case the shareholder of the shell entity is resident of a Member State and the real estate is located in a third country jurisdiction, the Member State of the shareholder should tax the property in accordance with its national law as if the shareholder holds the property directly, taking into account any tax treaty in force with the third country jurisdiction where the property is situated.

- The tax consequences in the Member State of residence of the shell entity. Such Member State should either refuse to issue a tax residence certificate to the shell entity, or provide a tax residency certificate which prescribes that the shell entity is not entitled to the benefits of tax treaties or the relevant Directives.

  Please note, the shell entity will remain subject to normal taxation in the Member State where it is resident (and as such should have access to the tax facilities in its Member State, e.g. the Dutch participation exemption).

EXCHANGE OF INFORMATION

Information will be exchanged among Member States in case an entity passed the three Gateways. Hence, the Directive provides for the automatic exchange of information of entities between Member States regardless of whether these entities are qualified as shell entities or not. Exchange of information will also apply in case the tax administration of a Member State makes an assessment based on facts and circumstances of individual cases and decides to certify that a certain entity has rebutted the presumption of being a shell entity or should be exempt from the obligations under the Directive.

PENALTIES

The Directive leaves it to Member States to lay down in national law the penalties against the violation of the rules that transpose the Directive into domestic law. It is further stipulated that a minimum level of coordination should be achieved amongst Member States through the set of a minimum monetary penalty. In this respect, the Directive states that penalties should include an administrative sanction of at least 5% of the turnover of the shell entity.

REMARKS

The Commission envisages that the Directive enters into force in the Member States from 1 January 2024, however therefore it first needs to be adopted unanimously by all Member States. It is unclear if all Member States will support the proposal, but we do not expect the Directive to be accepted easily as it could potentially harm genuine commercial activity. It should be noted that the Directive sets minimum standards and that the Member States have the freedom to implement more stringent measures into domestic law.

We expect that the Directive will mainly impact collective investment funds that invest via a holding company in a Member state (e.g. the Netherlands, Luxembourg). Although one of the exceptions is particularly designed for the fund/ PE industry, it should be noted that this exception only excludes entities that are regulated themselves. Hence, the exception would not include the non-regulated holding entities within the fund structure. In case such holding company would be considered a shell entity, it would be denied access to any tax treaty (and the relevant EU Directives) under the Directive.

It is obviously unclear how third countries will react to an entity which is considered a shell entity (in most cases, such shell entity will be a shareholder of an entity in the third country), however, as the shell entity can in principle no longer obtain a residency certificate (or one with a statement that it concerns a shell entity) access to the tax treaty with the third country may become more difficult.

As the implementation of the Directive may significantly impact international investment and holding structures, we strongly recommend to review EU entities that mainly hold passive assets, are involved in cross-border activities and whose daily management and decision-making is outsourced.

Please find attached a flow chart to help you identify whether your entity is at risk.

FOR MORE INFORMATION, PLEASE CONTACT:

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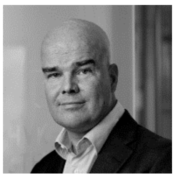

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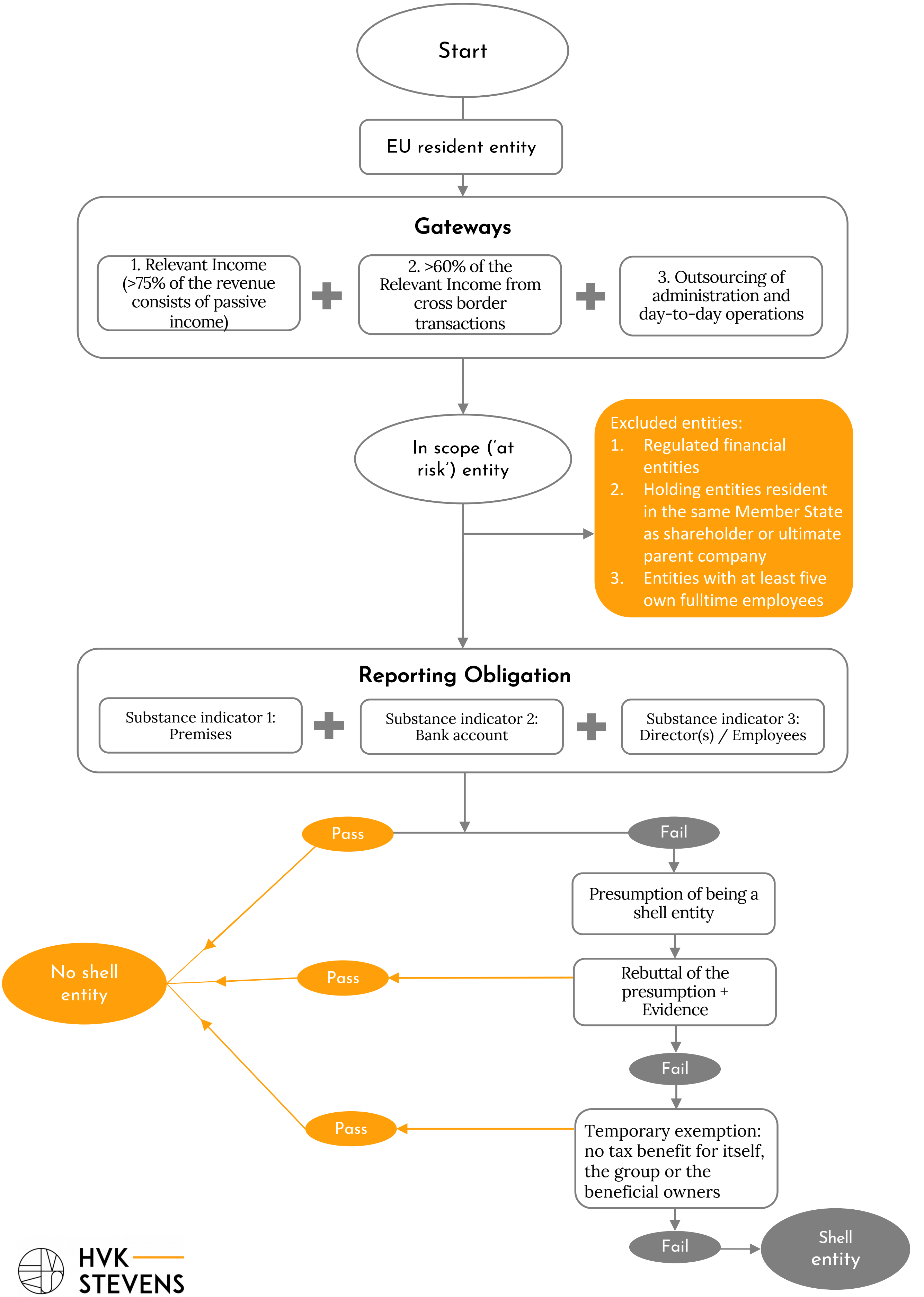
FLOW CHART



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