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EU PROPOSAL DIRECTIVE ON TRANSPARENCY STANDARDS FOR THE USE OF SHELL ENTITIES IN EUROPE

On 22 December 2021, the European Commission released its proposal for a 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 commonly named "**ATAD 3**"). The aim of ATAD 3 is to prevent the misuse of so-called "shell companies" (i.e., legal entities with no – or only minimal – substance and economic activity) interposed to obtain tax advantages within the EU.

The proposal introduces a substance test (mainly related to personnel and premises) to help Member States identify entities that are ostensibly engaged in economic activity but do not comply with minimum substance standards. The proposal also sets rules regarding the tax treatment of those entities that do not meet the substance indicators and provides for automatic exchange of information and tax audits among Member States' tax authorities.

So far, the proposal provides that Member States are required to implement the ATAD 3 by 30 June 2023 and apply its provisions from no later than 1 January 2024.

Key takeaways

- New proposal directive introducing substance criteria for shell entities
- Regular reporting on substance via tax returns
- Exemptions available for regulated financial undertakings
- Applicable as from 1 January 2024

ENTITIES THAT ARE IN SCOPE OF ATAD 3

The proposal is broadly inclusive. It captures all entities that are resident in a Member State for tax purposes and can obtain a tax residency certificate from their tax authority regardless of their legal form. It would then also target legal arrangements such as partnerships.

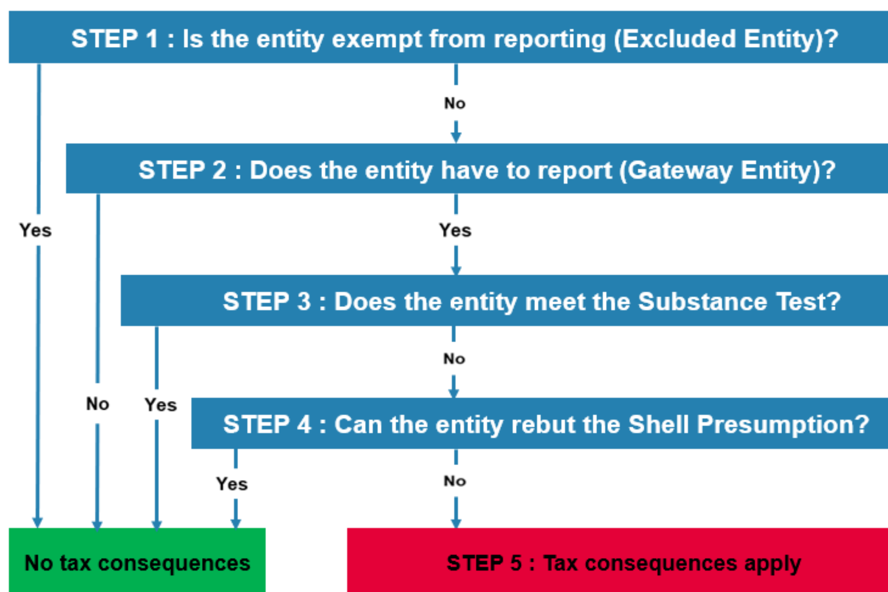
A carve-out is provided for entities that are established outside of the EU as well as so-called "**Excluded Entities**" that are not in scope of the ATAD 3. The list of Excluded Entities includes listed companies, regulated financial undertakings (such as banks, insurance companies, asset managers, investments funds (like UCITS or alternative investment funds ("**AIFs**")) and EU securitisation companies (i.e., companies subject to the European Securitisation Regulation only). It also includes holding companies that mainly invest in operational companies or are tax resident in the same Member State as their shareholders or the income-generating asset, as well as entities with sufficient employees (i.e., five own employees on a full-time basis).

It should be noted that a wholly owned subsidiary of an Excluded Entity does not qualify itself as an Excluded Entity and could therefore be in scope of the ATAD 3 if it crosses the gateway criteria (please see below). Similarly, in the presence of an AIF (being itself an Excluded Entity), the carve-out would not apply to the non-AIF subsidiaries part of the entire fund platform (which would, in principle, make the AIF carve-out useless).

ENTITIES THAT SHOULD REPORT ("GATEWAY ENTITIES")

The proposal introduces a step system to identify entities that are in scope of the Unshell Directive.

Entities that are not Excluded Entities (**Step 1**) and are found to be at risk of lacking substance are those that present several predetermined features (**Step 2**); these are commonly referred to as "**Gateway Entities**". Entities that do not pass those criteria are low-risk cases and, as such, considered to be irrelevant for the purposes of the Unshell Directive.

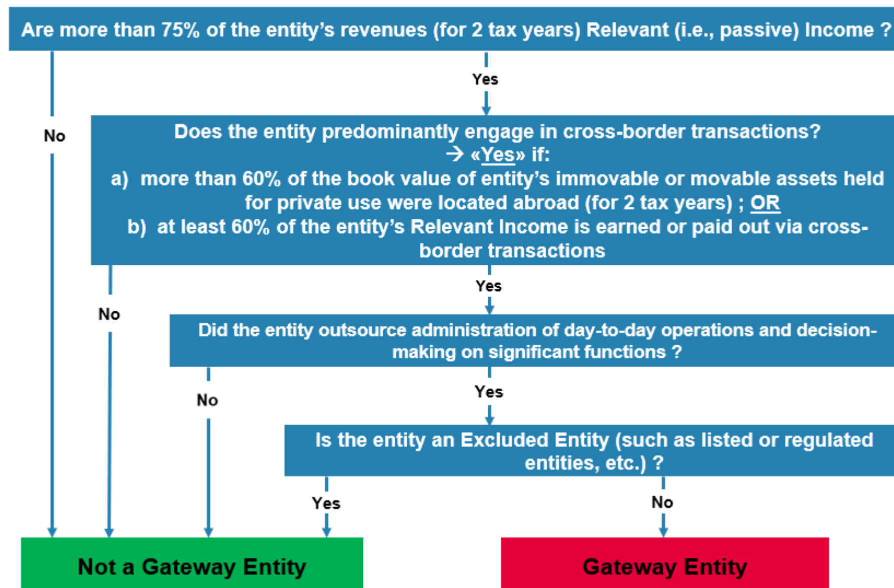


Step 1 requires checking if the entity is an Excluded Entity (which is out of scope of ATAD 3 and does not have to meet the Substance Test or document it – see above). In this case it is not necessary to proceed with the step-analysis as the entity is not in scope of the ATAD 3.

Step 2 defines whether an entity is to be considered a "reporting" or a Gateway Entity and is measured by (i) the nature of the entity's income, (ii) its cross-border transactions and (iii) the outsourcing of the entity's management. Only entities that fulfil those cumulative criteria will be asked to meet all substance indicators (i.e., the "**Substance Test**" – **Step 3**) and report on their substance via their annual corporate tax returns.

In this respect, an entity would be a Gateway Entity if:

- it earns more than 75% of passive income (notably dividends, interest, capital gains and income from immovable property) over the two preceding tax years (so-called "**Relevant Income**");
- it is predominantly engaged in cross-border transactions; and
- it has outsourced the administration of day-to-day operations and the decision-making on significant functions over the two preceding tax years (the outsourcing of ancillary services e.g., bookkeeping services – other than core services is not covered). The proposal does not specify whether an entity that does not outsource its decision-making because there are no decisions to make (e.g., a passive holding company) would be in scope.



ENTITIES THAT MUST REPORT ON THE SUBSTANCE TEST

Step 3 requires the Gateway Entity to declare each year in its tax return (and provide documentation in support of) whether it meets the Substance Test which is composed of three "substance indicators". Those indicators require the entity to (i) own premises for its exclusive use, (ii) have its own bank account and (iii) to be managed by qualified directors or have full-time employees who are tax resident in the entity's Member State.

While two of the substance indicators (own premises and bank account) seem to be feasible for most entities, the third indicator requiring the availability of qualified personnel can be problematic as directors are often provided by professional service providers who have them sit on several boards at the same time or are not resident in the same Member State (let alone within reach of the entity's place of establishment). The proposal explicitly denies the appointment of unqualified third-party directors who perform similar functions for other entities that are not related to the Gateway Entity.

If an entity is not an Excluded Entity (**Step 1**) but is considered a Gateway Entity (**Step 2**) and fails the Substance Test by (at least) one of the substance

indicators (**Step 3**), it will automatically be presumed to be a "**Shell**" but will always have the possibility to rebut this "**Shell Presumption**" by providing additional supporting evidence of its business activities. Conversely, Gateway Entities that declare to pass the Substance Test (i.e., that possess all the relevant substance indicators) and provide the required documentation should be presumed to have minimal substance for the relevant tax year.

REBUTTAL OF THE SHELL PRESUMPTION

Step 4 gives the Shell Company the opportunity to rebut the Shell Presumption by demonstrating that it carries out a genuine economic activity and – despite not passing the Substance Test – is not a Shell Company.

Such genuine economic activity shall be achieved if the Shell Company presents (i) additional evidence of the commercial and non tax-driven reasons for its establishment, as well as (ii) detailed information about employee profiles and (iii) evidence that decision-making about the activities generating Relevant Income (i.e., passive income) takes place in the Member State of the Shell Company.

The presumption shall be rebutted for one tax year if the above listed (cumulative) evidence proves that the Shell Company has performed and controlled, as well as borne, the risks of the activities generating the Relevant Income. After the end of the tax year, the period of rebuttal may be extended by the tax authorities for another five years provided that the factual and legal circumstances remain unchanged during that period.

If the entity cannot successfully rebut the Shell Presumption, it will reach **Step 5** and, as such, be exposed to a number of tax consequences.

CONSEQUENCES OF BEING A SHELL COMPANY

If an entity is considered a "**Shell Company**" it will notably have to report information and provide documentary evidence about its substance to its local tax authorities on a yearly basis.

More importantly, by reaching **Step 5**, a Shell Company will be exposed to tax consequences as it will not be able to receive a tax residency certificate from its local tax authorities for use outside its State of residence. Alternatively, Member States may also issue a certificate stating that the entity is indeed a Shell Company and, as such, not entitled to benefit from the European tax directives and double taxation treaties. In this respect, the Shell Company would not be eligible to the tax treatment provided under the Parent-Subsidiary and Interest and Royalties directives, as it would be disregarded for the granting of tax benefits under those instruments.

The direct tax consequences of the Shell Company's ineligibility for double taxation treaties and European directives could be threefold:

- At **source level**, the Shell Company would suffer from withholding taxes (if) applied in the source State on payments received by the Shell Company from its subsidiaries (disregarding applicable double taxation treaties or EU directive benefits).
- At **Shell Company level**, Luxembourg taxes would apply on payments received by the Shell Company (dividends would, for instance, not qualify for the Parent-Subsidiary Directive – "**PSD**" – exemption).

- At **Shell Company shareholder level**, Relevant Income of the Shell Company would be taxed in the hands of its shareholders as if it had directly accrued to the shareholders (i.e., the interposition of a Shell Company would entail a "look-through" approach), provided the shareholder is established within the EU.

If the shareholder of the Shell Company is established outside of the EU, the proposal requires the country of the payor to apply withholding taxes in accordance with its national law. This means that payments made to the Shell Company would not benefit from the PSD, which could ultimately result in the application of withholding taxes at source (that could potentially be mitigated under the applicable provisions of a double taxation treaty). However, most double taxation treaties will deny their benefits in case the recipient of the payment is not the beneficial owner of the payment. The source country could take the view that the shareholder of the Shell Company, as the supposed recipient, is not the beneficial owner of the payment and therefore not apply the treaty provisions to mitigate taxes withheld at source.

If, however, the shareholder is established within the EU, any payments received on a "look-through" approach would still benefit from European directives (such as the PSD) if the EU shareholder is a PSD-qualifying entity. This would then eventually result in the mitigation of withholding taxes at source.

EXCHANGE OF INFORMATION AND PENALTIES

Finally, the tax authorities of the Shell Company's State of residence shall communicate, via an exchange of information, (i) the fact that an entity is an Excluded Entity (**Step 1**), (ii) the Shell Company's substance declaration (**Step 3**), and (iii) the fact that the entity has successfully rebutted the Shell Presumption (**Step 4**), as applicable, to all other Member States within 30 days of receipt of the information.

Member States' tax authorities may also carry out audits to check whether entities in scope of the ATAD 3 satisfy the Substance Test (**Step 3**) and shall communicate the result of such audits to all other Member States via an automatic exchange of information.

The proposal leaves the fixing of penalties to the relevant Member State but obliges them to provide in any case for a minimum penalty of at least 5% of the entity's turnover in the relevant tax year. Such penalty would apply if a Gateway Entity that is required to report on its substance has failed to do so for a given tax year, or makes a false declaration in its tax return under the Substance Test.

While it would obviously be premature to anticipate how these rules will be transposed in Luxembourg (and interpreted by the Luxembourg tax authorities), it should be noted that the interpretation of the Substance Test (**Step 3**) will be key in practice and that documentary evidence should be gathered at an early stage to be able to support the position that each EU entity in a given structure has an adequate level of own resources to perform core management activities.

HOW CAN WE HELP?

The tax lawyers at Clifford Chance Luxembourg are at your disposal to further advise on the impact of the Unshell Directive on your current and/or contemplated operations by performing proper substance assessments of your investment companies.

C L I F F O R D

C H A N C E

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