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THE PROPOSED EU "SHELL COMPANIES" TAX DIRECTIVE: WHY THE INVESTMENT MANAGEMENT INDUSTRY SHOULD ACT NOW

The European Commission has published a draft Directive aimed at curbing the use of corporate vehicles to obtain tax advantages within the EU (the "Directive"). The Directive mainly attempts to prevent non-EU investors from interposing vehicles within the EU to hold their investments and take advantage of the favourable tax regimes available to EU entities on intra-EU dividends and interest.

According to the timing set out in the Commission's draft, the Directive would apply from 1 January 2024. However, when implemented, the Directive will determine the status of affected undertakings by looking at the two preceding years (i.e., on the assumption that the Directive is implemented on 1 January 2024, the period starting from 1 January 2022 – this is similar to the position under the DAC 6 Directive).

The Directive may significantly affect the ways in which international investment houses which are active in private equity, private debt, infrastructure and real estate, structure their investments in Europe: for non-EU investors local EU management platforms will just become indispensable and certain regulated investment funds established outside the EU may be better off relocating to the EU.

Key issues

- The European Commission has proposed a new Directive to tackle tax avoidance by shell companies set up by non-EU entities.
- The Directive could apply as soon as 1 January 2024, with a two-year lookback.
- Undertakings that meet the criteria set out in the Directive will have to report annually, and may be considered a "shell entity", thus losing the benefits of European Directives and (intra-EU) tax treaties.
- Captured undertakings will be confronted with (higher) withholding taxes in the source country and EU tax resident shareholders of the shell company will be taxed on the relevant income of the shell as if that income had accrued to them directly.
- International investment houses active in private equity, private debt, infrastructure and real estate should therefore act now.
- The draft Directive must still be adopted by the Council of the EU, a process that can take 18 months or longer.
- Interested parties have until 16 March 2022 to submit views on the draft Directive to the European Commission.

WHICH ENTITIES ARE AFFECTED?

The Directive applies to so-called "reporting undertakings", i.e., EU resident entities, partnerships or other entities without legal personality that:

- earn predominantly, i.e., more than 75% in the two preceding tax years, passive income (Gateway 1), such as dividends, interest, capital gains and income from immovable property;
- are mainly active cross-border (Gateway 2);
- outsource the administration of day-to-day operations and the decision-making in respect of significant functions (Gateway 3); and
- are not an excluded entity.

The list of excluded entities is very long and includes listed entities, regulated financial entities (such as banks, insurance companies, investment funds) and securitisation companies (but only if these are subject to the European Securitisation Regulation). It also includes holding companies which mainly invest in operational companies that are tax resident in the same Member State while their beneficial owners are also tax resident there, as well as holding companies that are tax resident in the same Member State as their shareholders or ultimate parent. Most importantly, the list of excluded entities includes undertakings that have at least five full-time equivalent employees or members of staff of their own who exclusively carry out those activities which generate the passive income. Importantly, the 100% subsidiary of an excluded entity is not itself an excluded entity. Therefore, an investment holding vehicle of an insurance company, bank or investment fund will, for example, be in scope.

AFFECTED "REPORTING UNDERTAKINGS" WILL BE SUBJECT TO ANNUAL REPORTING OBLIGATIONS

A reporting undertaking that meets the above criteria would have to annually report information and submit documentary evidence about its substance to the Member State in which it is resident. Information will be exchanged with other Member States through an easily accessible centralised information exchange facility.

AND, MORE IMPORTANTLY, MAY END UP BEING CONSIDERED A "SHELL ENTITY" MEANING THAT IT CAN NO LONGER BENEFIT FROM EUROPEAN DIRECTIVES AND (INTRA-EU) TAX TREATIES

A "reporting undertaking" will end up being considered a "shell entity", and will no longer be able to benefit from European Directives and intra-EU tax treaties (details set out in the next paragraph), if it does not meet <u>all of</u> the <u>three</u> following minimum substance requirements:

- it has local premises available on an exclusive basis;
- it has at least one own active bank account in the EU; and
- it has qualified, and empowered personnel available.

While securing premises and bank account(s) is easily achievable and fairly common, arrangements around making personnel available vary and not all of them

may be apt to pass the test. Where investment structures are based on a minority of fly-in-fly-out decision makers belonging to the sponsor and the majority of local directors, with little or no independent power and adequately indemnified (often provided by independent service providers and sitting professionally on several unrelated boards), these arrangements will in all likelihood not pass the test. The draft Directive requires that at least one director is at the same time (i) resident within reach of the company, (ii) qualified and authorised, and regularly active using the authorisation, and (iii) not employed by, or acting as director of, entities that are not associated enterprises. In other words, hire-out directors would not qualify. However, where investments are managed by one or more of the company's key investment professionals from a certain jurisdiction, then this test would potentially be satisfied.

What it really means to be considered a "shell company"

The consequences of an undertaking being considered a shell company are twofold: (i) the shell company would no longer be able to benefit from European Directives and (intra-EU) tax treaties and would hence be confronted with **(higher) withholding taxes in the source country** (i.e. where the company making payments to the shell company is established) and (ii) **the shareholders** of the shell company that are EU tax residents **will be taxed on the relevant income of the shell as if such income had directly accrued to them**.

Based on the examples in the explanatory memorandum to the Directive, the principle seems to be that Member States should disregard the existence of the shell company and tax the relevant income as if it had been paid directly to the shareholder of the shell company, thereby applying the European Directives and intra-EU tax treaties on a look-through basis. This means that where a shell company is being disregarded, the Member State of the payor should apply the withholding tax rate as foreseen under the relevant treaty with the state in which the shareholder is incorporated.

However, the text of the Directive (Article 11) may need to be further clarified to accurately reflect this look-through approach and questions remain. For example, it seems that the shell company Member State can continue to tax the relevant income but that those taxes should be deducted from the taxable basis in the shareholder's Member State. Is this the intention? And why is such credit only foreseen if the payor is an EU resident (and not if the payor is outside the EU)? This seems contrary to the EU freedom of establishment. In addition, one should not forget that the Directive cannot oblige non-EU states to follow the same look-through approach. A non-EU shareholder of a shell company may therefore not be able to credit withholding taxes that were levied by the EU state of the payor on a look-through basis.

Ad hoc exemptions

Reporting undertakings which do not meet the minimum substance requirements may nevertheless apply to their local authorities to be relieved from the consequences of the Directive (both in terms of reporting and in terms of actual tax consequences) on either of two grounds:

- they may rebut the presumption that they do not have sufficient substance by demonstrating that they do perform actual business activities that generate the relevant income; or
- they may provide evidence that the existence of the undertaking does not reduce the tax liability of its (ultimate) beneficial owners of the group as a whole.

In both cases, the exemption is granted for one year, at the end of which it may be renewed for a period of five years, on the condition that the factual and legal circumstances of the affected entity remain the same.

The exemption route may be particularly helpful for those investors, such as EU-based collective investment undertakings, that in certain jurisdictions (such as France and Italy, to name just a couple) would have access to a regime comparable to the one available under the Parent Subsidiary Directive (PSD) or the Interest and Royalties Directive (IRD) but may nevertheless favour the interposition of corporate entities between the fund and the investment. The exemption route will be more difficult for funds and capital market affected entities where ascertaining the identity of the ultimate investors is not straightforward.

What happens next

In order to become law, the Commission's proposal must now be adopted by the Council of the EU, following consultation of the European Parliament. Interestingly, the European Commission is running a consultation on the proposed Directive. Interested parties have until 16 March 2022 to submit their views which will feed into the legislative process. We will be actively engaging in this process.

Because the Directive will potentially determine the status of undertakings with reference to the period 1 January 2022 to 1 January 2024, affected businesses should consider acting swiftly to review their existing structures and plan new structures accordingly. Non-European fund managers are likely to be affected the most, albeit also European managers may have to reconsider their structures and the relevant tax assumptions.

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