News
Consultations begin on pillar one

Cases
Growth securities ownership plan fails

One minute with...
Lisa Wilson, head of tax, Cowgills

TAX JOURNAL

Insight and analysis for the business tax community

Issue 1563 | 11 February 2022

‘Am I a shell?’

The new question facing EU entities

Laura Hodgson | Travers Smith

Time for a disguised remuneration settlement opportunity?

Sarah Gabbai | McDermott Will & Emery

Allam: a case full of interest

Lynnette Bober | Gateley Legal

Tax and the City review

Mike Lane & Zoe Andrews | Slaughter and May

Tax hearings: giving evidence from overseas

Tolley report

EOTs: policy and practice

Pete Miller | The Miller Partnership

Plus **Basis period reform: further changes** |
***Drake*: CGT on forfeited deposits**

Analysis

'Am I a shell?' The new question facing EU entities

Speed read

A new EU draft directive (ATAD 3) could subject EU entities to additional reporting and, if ultimately 'unshelled', adverse tax consequences from as early as 1 January 2024. The rules are structured as a five-step process, with the first four steps filtering out entities that meet minimum substance requirements or do not result in a tax advantage, and step 5 imposing tax consequences on those that have not managed to escape under steps 1 to 4. If the directive is implemented, many businesses will need to take steps to bolster the substance of their EU holding companies to prevent additional reporting or adverse tax consequences.

Laura Hodgson
Travers Smith
Laura Hodgson is a knowledge counsel in the tax department at Travers Smith. She specialises in corporate tax issues and is a chartered tax adviser.
Email: laura.hodgson@traverssmith.com tel: 020 7295 3039.

'Substance' has been a hot topic in recent years. The OECD's BEPS project introduced the 'principal purpose test' into double tax treaties, tax havens have been pressured into introducing their own substance requirements, and most recently companies have been grappling with the implications of the 'Danish cases'. Now, a new EU draft directive has landed: ATAD 3. If enacted, ATAD 3 could subject EU entities to additional reporting and, if ultimately 'unshelled', adverse tax consequences from as early as 1 January 2024.

The rules are structured as a five-step process, with the first four steps filtering out entities that meet minimum substance requirements or do not result in a tax advantage and step 5 imposing tax consequences on those that have not managed to escape under steps 1 to 4. If the directive is implemented, many businesses will need to take steps to bolster the substance of their EU holding companies to prevent additional reporting or adverse tax consequences.

The gateway

The first step is a gateway intended to identify entities which have geographically mobile cross border activities and have outsourced their decision-making. To pass through the gateway, the entity must meet all three conditions and not qualify for any of the exclusions. If an entity does *not* pass through the gateway it is not 'at risk', does not have to consider the remaining steps and will not have any obligations under the proposed rules.

The three gateway conditions are assessed by reference to a two-year look back period (which means entities should start considering these sooner rather than later given the directive's proposed implementation date):

- Condition 1: In the previous two tax years, (i) more than 75% of the entity's revenue is 'relevant income' or (ii) more than 75% of the total book value of the entity's assets are real estate assets and specified high value private property or shares. Relevant income is essentially passive income, for example interest, dividends and rental income but also includes gains on disposals of shares.
- Condition 2: In the last two tax years, (i) more than 60% of the entity's immoveable property and specified high value private property is held offshore or (ii) at least 60% of relevant income is from cross-border transactions.
- Condition 3: In the previous two tax years, the entity has outsourced day to day administration and decision-making on significant functions.

Although a key concept, the draft directive doesn't define 'outsourcing' or 'decision-making on significant functions'. It is not clear whether only external outsourcing (for example, to a professional service company) meets the test or whether internal outsourcing (to employees of a group company) would also be caught. It is also not clear whether decision making on significant functions means the same or something additional to the decision making an entity may undertake in order to ensure it is centrally managed and controlled in a jurisdiction for tax residence purposes.

> It is proposed that the directive will take effect from 1 January 2024. However, the two-year look back period means that it would be advisable for businesses to begin considering the impact of the proposed rules now

Exclusions

There are five exclusions. If an entity qualifies for an exclusion it will not be 'at risk', will not pass through the gateway and will have no further obligations under the proposed rules.

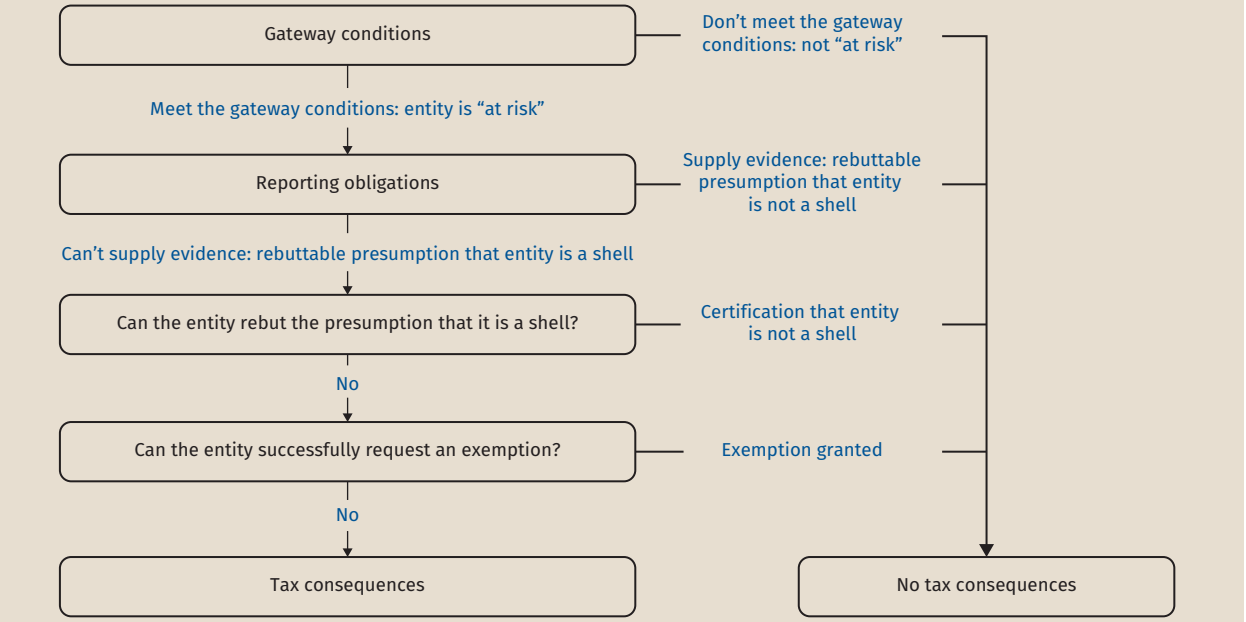
- The first exclusion is for entities that have securities that are listed or admitted to trading on a regulated market or multilateral trading facility.
- The second exclusion is for regulated 'financial undertakings' which includes banks, insurance undertakings, AIFs, UCITS, pension institutions and managers of AIFs. SPVs in fund structures are unlikely to qualify for this exclusion and would need to assess whether one of the holding entities exclusions was available.
- The third and fourth exclusions are for holding entities but are both limited by reference to the location of the entity's owners. The third exclusion applies to entities holding shares in operating businesses in the same member state and whose beneficial owners (natural person(s) beneficially owning the holding entity) are also located in the same member state. The fourth exclusion requires that the holding entity is tax resident in the same member state as its shareholders or its ultimate parent entity.
- Finally, there is an exclusion for entities with at least five full time equivalent employees exclusively engaged in carrying out activities which generate relevant income. There does not seem to be any requirement for these employees to be located in the same jurisdiction as the entity.

Entities that do not pass through the gateway are not regarded as being 'at risk'. Entities that pass through the gateway are characterised as 'at risk'.

Reporting obligations

The second step is for 'at risk' entities to make a declaration in their annual tax return as to whether they meet minimum substance requirements. There are three indicators of minimum substance, all of which must be met.

The rules in summary



First, the entity must own or have exclusive use of a premises in a member state. It is not clear whether use of premises owned by a group company would satisfy this requirement.

Second, the entity must have an active bank account somewhere in the EU – evidence of the bank account's activity must be supplied so a dormant bank account is unlikely to suffice.

And third, the entity must have at least one director, or a majority of its employees, locally resident and qualified to carry out their role. Locally resident means tax resident in the same member state as the entity or in another jurisdiction but close enough to 'properly carry out their duties or activities'. It is unclear what this means in the light of the changes to working practices following the covid-19 pandemic. 'Qualified' in the context of a director means having sufficient qualifications to allow them to take an active role in the decision-making process, be authorised to take decisions in relation to the activities that generate relevant income or in relation to the entity's assets and regularly, actively and independently use this authorisation. 'Professional directors' would not meet the test, as the director must not be an employee or director of an enterprise that is not an associated enterprise. In the context of employees 'qualified' means qualified to carry out activities which generate relevant income for the entity.

Entities must supply prescribed documentary evidence in support of their declaration. For example, an entity that declares a majority of its employees are qualified and locally resident must supply information about the type of business activities that generate the relevant income, the number of full-time equivalent employees generating this income, their qualifications and place of tax residence.

Rebutting the presumption

If the entity is unable to supply evidence that it satisfies the minimum substance requirements, it is presumed to be a shell and proceeds to step 3. However, because not all entities with substance will be able to meet the required indicators, this third step gives entities the opportunity to provide their local tax authority with additional information to rebut the shell entity presumption. The entity will need to supply specified evidence proving that it performed and controlled the activities that generated its relevant income. In particular, concrete evidence must be provided that the decision making relating to the activity that generated the relevant income took place in the entity's member state.

If the relevant tax authority is satisfied that the entity has rebutted the presumption, it will issue a rebuttal certificate for the tax year. This can be extended for up to a further five years if the facts and circumstances don't change.

Exemptions

The fourth step is an exemption for entities which do not reduce the tax liability of its beneficial owners. To claim the exemption, the entity must produce evidence to its local tax authority comparing the overall tax position of the group or the beneficial owners with, and then without, the entity in the structure. Exemptions may be issued for up to six years.

Tax consequences

The fifth step (for entities unable to 'escape' under steps 1 to 4) is tax consequences for shell entities. The rules do not change the shell entity's tax residence or prevent that member state from taxing it. However, it will not be eligible for benefits under double tax treaties or EU tax directives. To ensure that the shell entity cannot qualify for treaty benefits, the member state in which it is tax resident must either refuse to issue the shell entity with a certificate of tax residency or must include a health warning on such certificate.

EU member states will be required to partially look through shell entities, such that relevant income and certain gains received by the shell are deemed to be received by its shareholders. Where those shareholders are tax resident in the EU, they are taxed on the deemed receipt of relevant income paid to the shell entity. Tax charged on the relevant income in the shell entity jurisdiction is deductible from the tax payable in the shareholder jurisdiction. Where the payer of relevant income is tax resident in an EU member state, the payer must deduct domestic withholding tax from the payment unless the shell entity's shareholders are tax resident in the EU.

There are several aspects of the tax consequences article that are not entirely clear. Firstly, the application of double tax treaties, especially where a non-EU country is involved. The directive aims to by-pass shell entities for payments of relevant income such that the treaty between the source jurisdiction and the shareholder jurisdiction is applicable but, as the EU does not have jurisdiction over third countries, there is nothing to require a non-EU payer to do this. It is also unclear how treaty provisions that require direct holdings in voting stock etc. by shareholders in order to access the lowest treaty withholding tax rates should be applied in a look-through scenario. Secondly, it would be helpful to have commentary on how the taxation of gains sub-article is intended to operate. Other areas that could usefully be addressed are: (a) clarification that shareholders will only be taxed on their fractional entitlement to income received by the shell entity; (b) tax consequences where there are multiple shell entities in a holding structure; and (c) clarification that shareholders will not be subject to double taxation as a result of subsequent actual payments to shareholders by shell entities.

Policing the Directive

There are two ways in which the intentions of the directive could be thwarted: non-compliant behaviour by taxpayers and improper characterisations of entities by member state tax authorities.

The first issue is addressed by a requirement for member states to include a minimum penalty of 5% of the shell entity's turnover if it makes a false declaration or fails to submit an annual return when required to do so.

To tackle the second issue, the draft directive contains provisions for the automatic exchange of substance information and a right for member states to request audits of entities located in other member states. This mechanism would allow member states to challenge the characterisation of entities as not being shell entities. Member states will also be required to make an annual report to the Commission on the operation of the directive, which would give the Commission visibility of numbers of entities which a member state has treated as having rebutted the presumption and so on.

Timelines

It is proposed that the directive will be implemented by member states by 30 June 2023, and take effect from 1 January 2024. However, the two-year look back period means that it would be advisable for businesses to begin considering the impact of the proposed rules now.

Conclusions

It is hoped that the areas of uncertainty will be clarified before the draft directive passes into law. Failure to do so would leave the door open for member states to take different approaches when implementing the rules into domestic law.

If passed into EU law, which seems likely due to political will, the unshell rules are likely to have a significant impact on structures involving EU entities. The rules may result in a competitive advantage for non-EU entities, although as a proposal is expected to be published in 2022 to tackle non-EU shell entities, any advantage may be temporary only. ■

For related reading visit www.taxjournal.com

- ATAD 3: how will private equity measure up? (A Howard, 2.2.22)
- The war on holding companies and the return of withholding taxes (G Price & S Ling, 29.9.21)
- The Danish conduit cases (A Howard, 21.3.19)