LOYENS & LOEFF

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Will the Unshell Proposal affect your structure?

In this edition

Will the Unshell Proposal affect your structure?

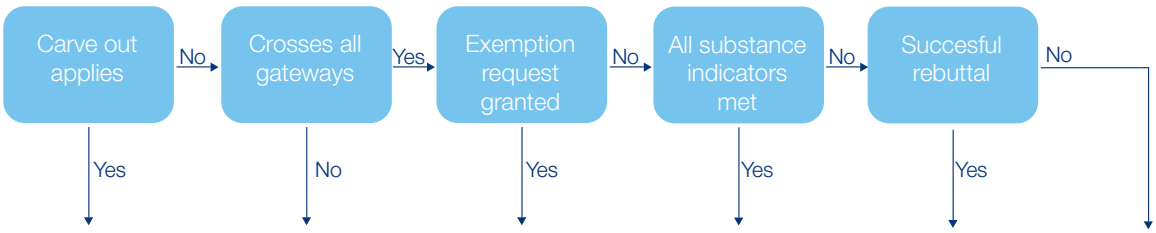
The European Commission has published a far-reaching proposal for a Council Directive laying down rules to prevent the misuse of European shell entities for tax purposes (hereinafter also referred to as **Unshell Proposal** or **ATAD 3**). The Unshell Proposal is one of the initiatives which aims to improve the current tax system with a focus on ensuring fair and effective taxation. If adopted, the Unshell Proposal could have a material impact on cross-border structures. The Unshell Proposal foresees 1 January 2024 as the date of entry into force, although it might have retroactive consequences as it proposes in some instances a 'reference period' of the two preceding years to assess whether a company presents a risk for being misused for tax purposes. This implies that the reference period may already have started as of 1 January 2022.

What is the general purpose of the Unshell Proposal?

According to the European Commission, using a shell in cross-border structures may enable businesses to take advantage of the current tax treaty network and EU tax directives based on which businesses could among others minimize withholding taxes on dividends, interest and royalties. The purpose of the Unshell Proposal is to counter situations where taxpayers evade or avoid taxes by misusing entities that have no or minimal substance and that do not perform any actual economic activity (so-called "shell entities"). To meet this objective, the Unshell Proposal contains a common set of rules, including substance indicators, to identify shell entities and to provide for adverse tax consequences.

The Unshell Proposal introduces various steps to assess whether there is a shell which is (at risk of) being misused for tax reasons. Each of the steps is decisive for the question whether (i) a reporting obligation, (ii) an information exchange and (iii) tax consequences apply. A reporting obligation and an automatic exchange of information must ensure that EU Member States have information readily available on the substance level of certain EU undertakings.

In summary, each of the steps would translate into the below flowchart:



Reporting obligation	No	No	No*	Yes	Yes	Yes
Information exchange	No	No	Yes	Yes	Yes	Yes
Tax consequences	No	No	No	No	No	Yes

*In case an exemption is requested, the undertaking shall have to provide evidence thereof.

Is being outside the Unshell Proposal a safe haven?

The Unshell Proposal clarifies that having minimal substance according to this proposal does not mean that a structure cannot be challenged anymore: "*where an undertaking has been found to have sufficient substance under this Directive, this should not prevent the Member States from continuing to operate anti-tax avoidance and evasion rules, provided that they are consistent with Union law.*"

This implies that, irrespective of the fact that the undertaking fulfills the (minimum) substance indicators laid down in the Unshell Proposal, tax authorities could upon a tax audit still challenge a structure based on, for example, the tax residency of the undertaking, national anti-abuse provisions and/or the concept of beneficial ownership. Having minimum substance would not automatically mean that the undertaking is the beneficial owner of dividends or interest it receives. Consequently, in addition to the attention to be paid to the substance criteria, one should also continue to among others monitor the cash-flows to ensure that the undertaking has the right to enjoy and use the income it receives.

How does the Unshell Proposal work?

In practice, the following questions should be answered within your structure:

Do I have a reporting undertaking?

When an undertaking is **in scope** and does not benefit from a **carve-out**, it must be verified whether it crosses all **gateways**. If so, this means that the undertaking in principle is "at risk" to be misused for tax purposes and has a reporting obligation. This reporting obligation entails that the undertaking specifies in its annual tax return whether it meets the minimum substance indicators discussed below and includes evidence thereof.

Can an undertaking at risk obtain an exemption from the reporting obligation?

An undertaking at risk can request for an **exemption from such reporting obligation**. To be granted such exemption, the undertaking must provide sufficient evidence to the relevant tax authorities that its interposition does not reduce the tax liability of its beneficial owner or of the group as a whole.

Does an undertaking at risk that secures a tax benefit meet the minimum substance indicators?

An undertaking at risk can demonstrate, through reporting and adequate documentation in its annual tax return, that it complies with the **minimum substance indicators** laid down in the Unshell Proposal. In such case, information exchange and the reporting requirement shall apply but not the direct tax consequences provided for in the Unshell Proposal. As mentioned above, this is however no "safe haven". If the minimum substance indicators are not met, the undertaking is presumed to be a shell.

Can the undertaking rebut the presumption of being a shell?

The tax consequences laid down in the Unshell Proposal can still be prevented through the **rebuttal of the presumption**. The undertaking will have to provide evidence demonstrating that it is used for "valid reasons". If the presumption is successfully rebutted, the undertaking shall still be obliged to report and information will be exchanged but the tax consequences will not apply. In absence of a request for a rebuttal or in absence of a successful rebuttal, tax consequences are attached to the qualification as a shell.

Scope and carve-out

The Unshell Proposal applies to so-called 'undertakings' which are entities that, regardless of their legal form, are (i) engaged in an economic activity and (ii) that are considered to be tax resident and (iii) eligible to receive a tax residency certificate in an EU Member State.

As such, the Unshell Proposal also captures a legal arrangement, such as a partnership that is deemed a resident for tax purposes in a Member State.
However, the Unshell Proposal should not apply to for instance (i) permanent establishments or (ii) tax transparent entities as they cannot obtain a tax residency certificate in a Member State. A series of undertakings are explicitly carved-out from the reporting obligations laid down in the Unshell Proposal as they are considered not to be at risk to be misused for tax purposes. These undertakings do not need to determine whether they cross the gateways.

The carve-outs - in short - include:

1. Companies which have a transferable security admitted to trading or listed on a regulated market or multilateral trading facility;
2. Regulated financial undertakings (such as AIF or AIFM's, UCITS and their management companies, investment firms, credit institutions, insurance and reinsurance undertakings, pension institutions, crypto asset service providers, securitization special purpose entities, etc.);
3. Undertakings that have the main activity of holding shares in operational businesses in the same Member State while their beneficial owners are also resident for tax purposes in the same Member State (i.e. domestic holding situations);
4. Undertakings with holding activities that are resident for tax purposes in the same Member State as the undertaking's shareholder(s) or the ultimate parent entity (i.e. sub-holding situations); and
5. Undertakings with at least five own full-time equivalent employees or members of staff exclusively carrying out the activities generating the Relevant Income (as defined below).

The gateways

Since the European Commission only intends to target "entities at risk", "gateways" are introduced to narrow the scope of the Unshell Proposal. Only the undertakings that are in scope, not-carved-out and that cross all gateways are considered at risk.

The undertaking that meets the following cumulative criteria (i.e. gateways) must proceed to the next step:

- more than 75% of the revenues of the undertaking in the preceding two tax years consists of passive income including interest, royalties, dividends and capital gains, income from financial lease or real estate (defined as "Relevant Income"). When the undertaking holds shares, immovable property or privately held movable property (other than cash, shares or securities) with a book value > 1 million EUR, this condition is deemed met if the book value of these assets represents more than 75% of the total book value of the undertaking's assets, irrespective of whether income from these assets has accrued to the undertaking in the preceding two years;
- the undertaking is engaged in cross-border activities when:
  - at least 60% of the Relevant Income is earned or paid out via cross-border transactions or
  - more than 60% of the book value of the undertaking's immovable property and/or privately held movable property (other than cash, shares or securities) with a book value > 1 million EUR are located outside the jurisdiction of the undertaking in the preceding two tax years;
- the undertaking outsourced the administration of day-to-day operations and the decision making on significant functions in the preceding two tax years.

One of the most relevant gateways concerns the **outsourcing** of the administration of day-to-day operations and the decision making on significant functions.

The proposal provides that this criterion focusses on "*undertakings which have no or inadequate own resources to perform core management activities*" and therefore engage service providers. The third gateway tries to capture undertakings that have no or inadequate own resources and therefore engage third parties to perform day-to-day operational activities and management services. In addition, the explanatory notes to the Unshell Proposal include wording that seems to indicate that this gateway may also be met if an entity enters into relevant intra-group agreements for obtaining administration and management services. Given the nature and background of the Unshell Proposal it would in our view be more proportionate that this gateway would only relate to services outsourced to a third-party supplier and that intra-group sourcing should not qualify as outsourcing. We expect this will be clarified in the updated version of the Unshell Proposal. Outsourcing of certain ancillary services only, such as bookkeeping services, while the core activities remain with the undertaking, would not in itself suffice to pass this gateway.

Whether an undertaking crosses all gateways is determined considering the situation in the two preceding years. Interesting question is how this rule is to be applied to newly incorporated undertakings. So far there is no guidance available on this.

Exemption upon request

An undertaking that crosses the gateways could be used for genuine business purposes without creating a tax benefit for its beneficial owner(s) or of the group as a whole. These undertakings have the possibility to ask for an exemption of the reporting obligation. The undertaking must then provide sufficient and objective evidence to the relevant tax authorities that its existence does not lead to tax benefits by including information about the group and its activities. A comparison must be made between the amount of overall tax due by the beneficial owner(s) or the group as a whole, with and without the undertaking.

If sufficient evidence if provided, this exemption is granted by the Member State of the undertaking concerned for the tax year under review. Provided that the factual and legal circumstances remain unchanged, this exemption can be extended for another five years. Note that an information exchange with the other Member States applies even if the exemption is granted.

Substance indicators

When the undertaking crosses all gateways and cannot benefit from an exemption, the undertaking is subject to a reporting obligation, and it must declare in its annual tax return whether it meets the following substance indicators and provide satisfactory supporting evidence:

- the undertaking has own premises or premises available for its exclusive use;
- the undertaking has at least one own and active bank account in the EU; and
- (i) at least one qualified director of the undertaking that is authorized to take decisions in relation to the activities generating the Relevant Income, is: (a) a tax resident in the Member State of the undertaking (or resides sufficiently close to the Member State to perform the duties); and (b) is not employed by a non-associated enterprise and does not perform the function of director in another non-associated enterprise, or (ii) alternatively, the majority of the full-time employees of the undertaking is tax resident in the Member State of the undertaking (or reside sufficiently close to the Member State to perform their duties) and are qualified to carry out the activities that generate the Relevant Income.

The first substance indicator, i.e., having own premises or premises available for exclusive use, is a topic of debate, especially in a scenario where several undertakings of the same group share the same premises. At this stage, it is advised to lease (or own) dedicated premises and, in a group scenario, to have (sub-)leases in place at market conditions.

Attention should also be paid to the local qualified director requirement. The Unshell Proposal requires such director not to be employed or to perform the same function in a non-associated enterprise. Undertakings should also ensure that they are able to demonstrate that such director performs the duties actively and independently. Review of corporate documents such as articles of association is recommended.

If the undertaking fulfils these substance indicators and provides satisfactory supporting documents, it is presumed to have minimum substance for that tax year. If the undertaking declares not to meet all the minimum substance indicators, or does not provide sufficient supporting evidence, it is presumed to be a shell.

Rebut the presumption of being a shell

When an undertaking crosses all gateways, cannot benefit from an exemption and does not meet all the substance indicators, it can still rebut the presumption of being a shell. The explanatory notes acknowledge that there can be valid reasons for the use of shell entities. Stakeholder consultations also reveal that undertakings that may be considered to be shell companies, have not necessarily been put in place to obtain tax advantages but can be put in place for valid commercial reasons, including: ensuring the limitation of liability, protecting investors and maintaining the value of the portfolio, meeting the requirements of third-party lenders to ring-fence assets and liabilities, facilitating joint ventures, streamlining decision making, and providing a convenient vehicle for sale or partial sale..

The Unshell Proposal therefore includes a rebuttal mechanism whereby the undertaking can challenge the outcome of the previous steps, by evidencing the commercial, non-tax motives, underlying a certain structure. The presumption of being a shell may indeed be rebutted, in the Member State of the undertaking, with additional evidence on

- information on the commercial rationale behind the establishment of the undertaking;
- information on the employee profiles; and
- concrete evidence that decision-making concerning the Relevant Income generating activity takes place in the Member State of the undertaking.

This evidence should demonstrate that the undertaking has performed and continuously had control over, and borne the risks of, the business activities that generate the Relevant Income or, in absence of such income, the assets of the undertaking.

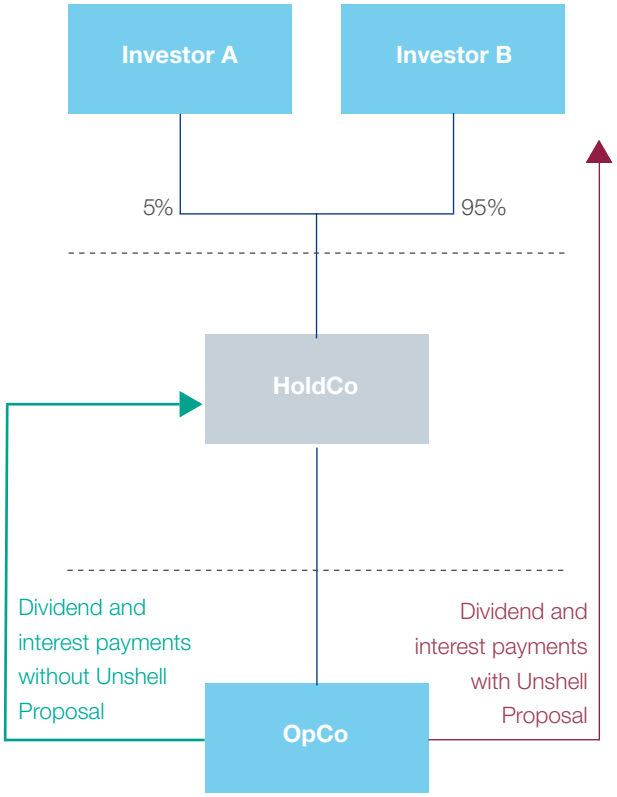
If the undertaking successfully rebutted the presumption, the Member State of the undertaking will confirm this for the tax year concerned and the validity of the rebuttal can be extended for another five years if the legal and factual circumstances do not change.

Tax consequences of being a shell

Once an undertaking is a shell for purposes of the Unshell Proposal, tax consequences apply at various levels within the structure which can be summarized as follows:

State	Tax Consequences
Residence State **shareholder** of the shell	**If the shareholder is established in the EU:** - The EU Member State shall disregard the tax treaty concluded with the EU Member State of the shell and the Parent-Subsidiary Directive/Interest-Royalty Directive. - The EU Member State shall tax the Relevant Income of the shell in accordance with national law as if it directly accrued to the shareholder. - The EU Member State shall tax the property held in the source state in accordance with national law as if the shareholder owned the property directly and shall apply the tax treaty concluded with the source state. - The EU based shareholder shall deduct any tax paid on Relevant Income in the EU Member State of the shell and may claim relief for tax paid at source in accordance with the tax treaty concluded with the source state or the Parent-Subsidiary Directive/Interest-Royalty Directive. **If the shareholder is established outside the EU:** - No direct tax consequences apply since the Unshell Proposal does not apply to an entity that is a tax resident outside the EU.
Residence State **shell**	- No look through approach is applied: the shell entity remains tax resident in its EU Member State and should fulfil all obligations as per national law. - The Member State will not issue a tax residence certificate to the shell for use outside this EU Member State or will issue a tax residence certificate which prescribes that the shell is not entitled to tax treaty benefits or benefits under the Parent-Subsidiary Directive/Interest-Royalty Directive.
Residence State **subsidiary** or State where property is located (i.e. source state)	**If the subsidiary (property) is established (located) in the EU:** - The EU Member State shall disregard the tax treaty concluded with the EU Member State of the shell and the Parent-Subsidiary Directive/Interest-Royalty Directive. - The EU Member State shall apply withholding tax as if the Relevant income was paid directly to the shareholder in accordance with the tax treaty concluded with the residence state of the shareholder, the Parent-Subsidiary Directive/Interest-Royalty Directive or national law. - The EU Member State shall tax the property in accordance with national law as if the property is owned directly by the shareholder and shall apply the tax treaty concluded with the residence state of the shareholder. **If the subsidiary (property) is established (located) outside the EU:** - No direct tax consequences apply since the Unshell Proposal does not apply to an entity that is a tax resident outside the EU.

Example: An investor A established in the EU and an investor B established outside the EU (together referred to as the investors) invest in an EU operational company through an EU holding company. The latter is assumed to be a shell.



In this example, investor A must ignore HoldCo and include the dividend/interest received by HoldCo in its taxable basis as if it received the payment directly. It should be verified whether investor A can still apply a participation exemption on this dividend. In this respect, it is expected that we may assume that the investor holds the shares in Opco directly. In such case, investor A would in this example only hold a direct participation of 2.5% (5%x50%) in Opco. Depending on the conditions under national law in the investor's state of residence, it can or cannot apply a participation exemption for corporate income tax purposes.

HoldCo will be taxed on the interest/dividend it receives in its Member State. Arguments are available to defend that the Unshell Proposal does not prevent the shell itself from applying the participation exemption laid down in the Parent-Subsidiary Directive. However, it should also be verified in HoldCo's Member State whether other anti-abuse provisions could still prevent the application of the participation exemption for corporate income tax purposes.

Opco will need to ignore HoldCo and levy withholding tax as if the dividend/interest is paid directly to the investors. Opco must thus consider the investors and may apply a reduction/exemption of withholding tax available under national law, EU Directives or a tax treaty concluded between the residence state of respectively Opco and the investors.

In this example, various important issues remain unclear at present, for example the following:

- To avoid double taxation, investor A may deduct the taxes paid by HoldCo on the dividend/interest income (if any). It is currently not clear whether these taxes also include the withholding tax levied at source, how this tax is calculated (e.g. on gross or net income) and whether such tax should be divided on a proportionate basis.
- Investor A needs to include the dividend/interest received by HoldCo in its taxable income. The question arises whether this investor can rely upon an exemption if it receives actual dividend/interest income from HoldCo. Although it would be fair to expect that the actual distribution is not taxed if the investor is able to demonstrate that this income has previously been included in its taxable income, the Unshell Proposal does not address the tax treatment of Relevant Income distributed from a shell to its EU investors.
- Withholding taxes are usually levied upon attribution or payment of the dividend/interest. The question arises what Opco will do as it may not know yet at that time whether HoldCo qualifies as a shell or not. Assume for example that a dividend is paid in 2024 and the Unshell Proposal enters into force on 1 January 2024. HoldCo will need to report its substance indicators in its annual tax return and may ask a rebuttal for the year 2024. Although the procedure is not further elaborated on in the Unshell Proposal, it can be expected this does not occur earlier than 2025. Will Opco take a prudent approach and levy withholding tax, resulting in refund procedures either by HoldCo if it does not appear to be a shell or by the investor if HoldCo appears to be a shell? Will Opco be subject to penalties if it would not levy a withholding tax? Investor A will also be confronted with a similar timing issue, as it might not know whether HoldCo qualifies as a shell when its income tax return must be filed for a given year.

Procedural aspects

Exchange of information

Information will be exchanged among Member States through a central directory – by way of an update of the EU Directive on Administrative Cooperation – when undertakings fall within the gateways. Information exchange will also apply where the tax administration of the Member State decides to certify that an undertaking has rebutted the presumption of being a shell or that it should be exempt from the obligation under the Unshell Proposal.

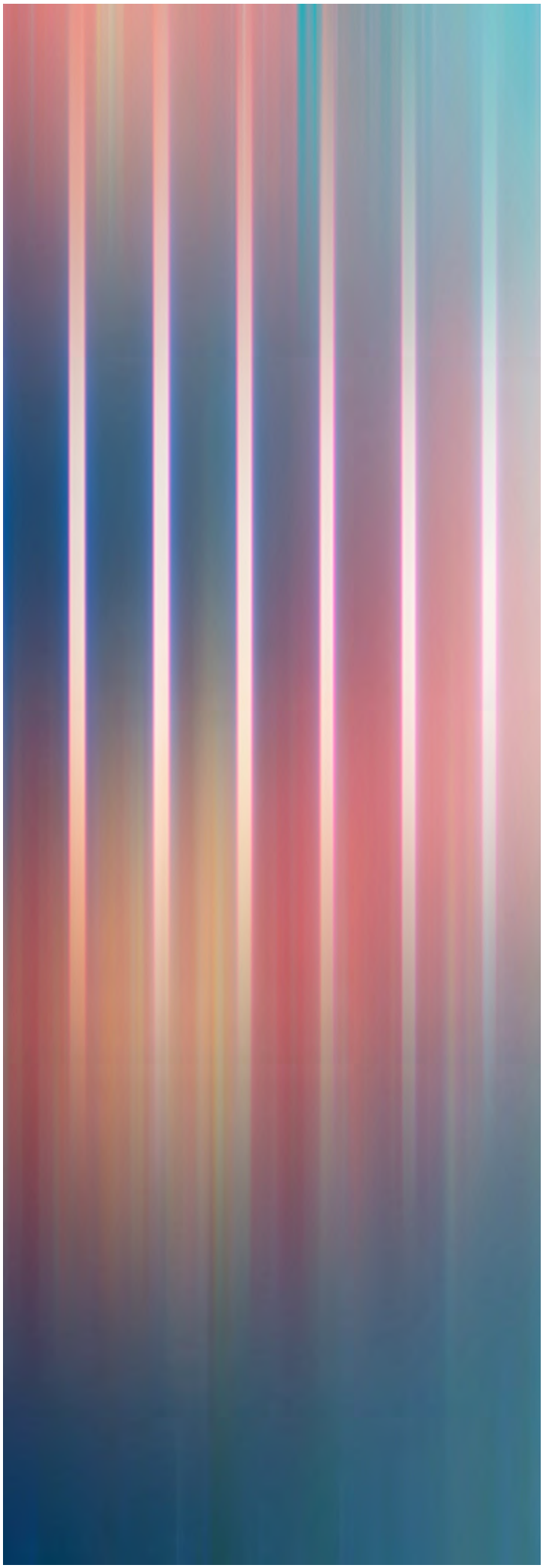
In other words, no exchange of information shall take place (i) when an undertaking is carved-out from the scope of the Unshell Proposal or (ii) when an undertaking does not cross all gateways.

Administrative penalties

The Unshell Proposal leaves it to the Members States to lay down the rules on penalties applicable to infringements of the national provisions implementing the Unshell Proposal. Those penalties should include an administrative pecuniary sanction of at least 5% of the undertaking's turnover in the relevant tax year in case the reporting obligations are not complied with in a timely manner or the undertaking makes a false declaration in its annual tax return.

Request for tax audits

Member States will be able to request the Member State of the undertaking to perform a tax audit when it has reason to believe that an undertaking has not met its obligations under the Unshell Proposal.



Next steps

The Unshell Proposal was open for feedback until 6 April 2022. Various stakeholders provided their feedback, expressing worries about amongst others the additional compliance, the vague wording and its use of criteria referring to physical presence to define abuse, especially in the current remote working culture.

Some Member States have in the meantime also questioned the need for such proposal and have provided comments which are currently being discussed in the Council. However, considering the broad support for this proposal in the Council, it can be expected that the Unshell Proposal will still be adopted, albeit that the effective date of 1 January 2024 may be delayed a bit. Further, it can be expected that the Unshell Proposal will be adopted in an amended form.

Amendments that are being considered by the Council include (i) broadening the scope of (some of) the carve-outs by excluding from the Unshell Proposal subsidiaries that are (almost wholly) controlled by a carved out undertaking and (ii) reducing the compliance burden.

The European Commission also still intends to present a new initiative to respond to the challenges linked to non-EU shell entities in 2022.

We will keep you informed on all further developments.

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