New rules to prevent the misuse of "shell companies" for tax purposes

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The EU is currently in the legislative process for another Anti-Tax-Avoidance Directive (ATAD III). From January 1st, 2024, the Directive should be applicable to all undertakings that are tax resident in an EU Member State. EEA and other states are also affected if participations in undertakings based in the EU are held. Should the Directive come into force as planned, there may already be a need for action today.

Overview

The EU Commission understands "shell companies" to be legal entities that do not perform any actual economic activity and could be misused, in particular, for the purpose of tax avoidance. The possibility of this alone is sufficient and should be assessed by using a specified two-stage "substance test". Unlike the global minimum taxation, which is primarily linked to the tax rate, ATAD III focuses on the tax base. The substance test is mandatory and serves to identify undertakings with minimum substance and therefore at risk to be misused according to the understanding of the proposed Directive.

If the undertaking has minimum substance, it not only has to submit new declarations to the respective national tax authorities, but is also denied the right to extensive tax benefits (such as those in the Parent-Subsidiary and Interest and Royalty Directives).

Substance test

On the 1st level, potential shell companies are to be identified based on three cumulative characteristics that must be fulfilled:

1. More than 75% of the undertaking's revenues comes from passive income. In addition to interest, royalties, dividends and capital gains, this also includes real estate income and other income from financial assets, including crypto assets.
2. The undertaking operates across borders. This is fulfilled if the book values of the immovable property located abroad and the movable property not serving business purposes (with the exception of cash, shares or securities) have accounted for more than 60% of the undertaking's assets in the last two years or if at least 60% of the revenues has been obtained from cross-border structures.
3. The undertaking's management has been outsourced over the last two years in terms of decision-making related to key corporate functions and day-to-day operations. The outsourcing of ancillary services (e.g. bookkeeping), while the core activities remain with the undertaking, is assessed to be harmless in itself.

Since both the type of revenues and cross-border activities are usually inherent components of a business model or are directly linked to the purpose of the undertaking, the focus will presumably be on the third criterion. Nevertheless, the 60% threshold can also be of some relevance.

The draft assumes that undertakings with minimal substance, which do not have sufficient resources of their own, are inclined to commission third parties with the provision of administrative, management, correspondence and legal services or conclude contracts with affiliated enterprises for such services in order to establish and maintain a legal and tax presence.

Among other things, the absolute degree of harmless outsourcing and the question of how the list of criteria and, in particular, the third criterion will be designed with regard to its temporal scope are still undetermined.

If the Directive applies as planned on January 1st, 2024, this could lead to a recourse to the reporting, proof and documentation requirements until January 1st, 2022. There is already a need for action for potentially affected structures and companies.

If the criteria on the first level are fulfilled, **the exclusions from the scope** of the Directive belonging to the first level must be checked. Exemptions include:

- companies listed on a regulated market;
- regulated financial undertakings;
- purely domestic structures;
- legal entities that have at least five employees of their own (Full-Time Equivalents) or employees who exclusively perform those activities that generate the relevant income;
- investment funds (UCITS, AIF and AIFM) and securitization special purpose entities, crowdfunding and crypto-asset service providers.

If no exclusion from the scope of the Directive can be claimed, there is an annual requirement to inform the national tax administration, which forms the basis for the second stage of the substance test. The requirement to provide information and documentary evidence must be fulfilled by providing additional information in the tax return of the legal entity. Documentary evidence must be submitted, inter alia, for:

1. the use of own or exclusively used third-party or rented premises;
2. at least one own and active bank account with a bank located within the EU;
3. the tax residency and qualifications of the employees and of at least one member of management.

The third criterion above is fulfilled, if either

- a member of management is tax resident in or near the border of the entity's member state, is qualified and authorized to make decisions relating to the assets of the company or to the activities that generate relevant income for the company and does this regularly and is further not employed by any affiliated enterprise or performs equivalent functions in other undertakings that are not affiliated enterprises of the legal entity

or

- the majority of the Full-Time Equivalent employees of the legal entity are tax resident in or close to the border of the same Member State and are qualified to perform the activities that generate the relevant income for the undertaking.

If the three aforementioned criteria are not fulfilled or if they cannot be proven, it is presumed that the entity has minimum substance.

Evidence to the contrary

The presumption of an entity with minimum substance can be rebutted by proving that economic reasons and not obtaining a tax benefit are originally the ground for the interposition of the undertaking (Principle Purpose Test). If evidence to the contrary can be successfully provided, it must be renewed every five years.

Legal consequences

If the three criteria of the 2nd stage cannot be fulfilled and the Principle-Purpose Test fails, the following legal consequences arise:

- The tax residency of the legal entity is not recognized by all other Member States in which the legal entity is not resident, with the result that all Double Taxation Agreements and certain EU Directives (in particular the Parent-Subsidiary and Interest and Royalty Directives) are no longer applicable.
- The Member States no longer issue certificates of residence or only with a warning that the undertaking concerned is not entitled to the benefits under a Double Taxation Agreement or Directive.
- The shareholder's state of residence taxes the assets and income of the legal entity as if the shareholder itself had earned the income of the undertaking. If a shareholder is not resident in a Member State, its national withholding tax law applies in the Member State of the source of income, regardless of Double Taxation Agreements or the aforementioned EU Directives.

Expansion of the Automatic Exchange of Information

If a legal entity does not pass the two-stage substance test, the affected legal entity must be reported to the EU tax authorities as part of the Automatic Exchange of Information due to the mere appearance that it does not have the minimum required substance, regardless of whether a legal entity actually has minimum substance or this presumption could be rebutted by counter-evidence. Whether the legal entity was able to successfully provide documentary evidence is also communicated.

The aim of this approach is to ensure that all Member States can obtain timely knowledge of the discretion exercised by the other national tax authority and the reasons for each individual assessment. Member States should also be able to require the Member State of the entity to carry out tax audits, if they have reason to believe that the entity may lack minimum substance within the meaning of the Directive.

Practical implications

The Directive is currently in the process of being agreed between the Member States. Changes in the legislative process are therefore to be expected and welcomed in view of the numerous undefined legal terms in the current draft directive, which, in particular, concern the decisive criteria of the substance test at the 1st and 2nd level. The definition of the legal terms that require interpretation is otherwise the responsibility of the tax policy of the individual Member States. Nevertheless, it is not advisable to calculate with a certain disharmony of the national application modes, since they are open to cross-checking by other Member States as a result of the exchange of information. Rather, it is advisable to analyze potentially affected legal entities and structures for possible effects and to take appropriate precautions.

It cannot be excluded that the planned directive will still fail politically or at least be softened in the interest of certain EU member states at crucial points, which is indicated by initial positions from the committees of the European Parliament.

Outlook

The draft directive continues the trend of ever increasing tax compliance requirements for cross-border structures that has been going on for years, which, as a result, are reducing the attractiveness of cross-border structures due to continuously increasing compliance costs and the extent of legal uncertainty, especially in comparison to structures that can be construed purely nationally.

We therefore recommend examining international issues in good time for potential effects and appropriate response options. This can also include bundling material and personal substance and "cementing" the recognition of tax residency in the respective country of residence with the help of a passed substance test.

Another possibility is to check international structures for so-called onshoring, so that after restructuring they are purely domestic structures.

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