Milan, April 4th 2022

Object: Comments on the proposal for Council Directive no. *COM(2021) 565 final* laying down rules to prevent the misuse of shell entities for tax purposes and amending Directive 2011/16/EU

Gatti Pavesi Bianchi Ludovici, thanking the European Commission for opening the feedback period in relation to the proposal for Council Directive no. *COM(2021) 565 final* presented on December 22nd 2021 (hereinafter, the "**Directive**"), sets out below its observations.

1. GENERAL REMARKS

The Directive and all preparatory works clearly state that "*the problem to be addressed is not the existence of shell entities per se*". Indeed, the issue is not about distinguishing between legitimate and problematic shell entities, rather about distinguishing between the legitimate and problematic use of these entities. The Directive has in this sense provided a seven-step analysis in order to identify the entities without substance (mis)used in cross-border situations.

In our view, the overall framework seems unbalanced in favour of non-EU resident entities in non-EU States, including those established in the European Economic Area, for e.g. the following reasons:

- non-EU shell entities could in principle keep benefitting from treaty provisions (to the extent that they are established in treaty countries and the relevant tax authorities are willing to grant treaty residence certificates);
- non-EU shell entities could maintain a higher level of confidentiality vis-à-vis EU tax authorities.

With a Press Release the European Commission has already anticipated that in 2022 it will undertake a new initiative to tackle non-EU shell companies. This is a very welcome statement but, as previously mentioned, it implicitly confirms that on a stand-alone basis the Directive may give rise to collateral effects such as undermining company structures which are based only in the EU and not the ones with potential shell entities artificially located outside the EU. In the absence of reciprocity, then, the Directive might limit the use of shell companies incorporated only in the EU, instead of leading to a containment of the use of shell companies at all.

2. ENTITIES IN SCOPE

Article 2, paragraph 1, states that the "*Directive applies to all undertakings that are considered tax resident and are eligible to receive a tax residency certificate in a Member State*".

The meaning of "*undertaking*" includes "*any entity engaged in an economic activity, regardless of its legal form*" pursuant to Article 3, no. 1), of the Directive.

To this purpose, the term "*economic activity*" is not further defined by the Directive and thus it should be confirmed whether "*business activity*" might be used as its synonymous. In our view, this should be the case, taking into consideration that some additional documentary evidence is required for:

(a) the "*type of business activities performed* [by the undertaking] *to generate relevant income*" and the "*outsourced business activity*" in order to prove the three indicators of minimum substance pursuant to Article 7, paragraph 2, letters d) and f) of the Directive ("*Indicators of minimum substance*");

(b) the "*business activities which* [are performed by the undertaking] *to generate relevant income*", in order to rebut the presumption of being a shell entity because of the failure in meeting the three indicators of minimum substance pursuant to Article 9, paragraphs 1 and 2 ("*Rebuttal of presumption*").

The requirement of being engaged in a business activity should therefore bring out of scope of the Directive non-business entities like charities, foundations, non-commercial trusts and partnerships.

The Directive does not refer to the place of establishment or incorporation of the undertaking but just at its tax residence in a Member State. To this end, it would be appropriate to consider situations where an undertaking either does not declare itself resident in a Member State but it is so considered by reason of a subsequent tax audit, or vice-versa is retroactively no longer considered tax resident in a Member State.

3. THE REPORTING UNDERTAKING

Article 6, paragraph 1, of the Directive, states that:

"*Member States shall require that undertakings meeting the following criteria to report to the competent authorities of Member States in accordance with Article 7:*

(a) *more than 75% of the revenues accruing to the undertaking in the preceding two tax years is relevant income* (the "**First gateway**");

(b) *the undertaking is engaged in cross-border activity on any of the following grounds:*

(i) *more than 60% of the book value of the undertaking's assets that fall within the scope of Article 4, points (e) and (f), was located outside the Member State of the undertaking in the preceding two tax years* (the "**Asset test**"*);*

(ii) *at least 60% of the undertaking's relevant income is earned or paid out via cross-border transactions* (the "**Income test**") (jointly, the "**Second gateway**"*);*

(c) *in the preceding two tax years, the undertaking outsourced the administration of day-to-day operations and the decision-making on significant functions* (the "**Third gateway**"*).*

An undertaking which holds assets that can generate income falling within the scope of Article 4, points (e) and (f), shall also be deemed to meet the criterion set out in point (a) of the first subparagraph, irrespective of whether income from these assets has accrued to the undertaking in the preceding two tax years, if the book value of these assets is more than 75% of the total book value of the undertaking's assets (the "**Asset test no. 2**").

An undertaking which holds assets that can generate income falling within the scope of Article 4, point (c), shall also be deemed to meet the criterion set out in point (a) of the first subparagraph, irrespective of whether income from these assets has accrued to the undertaking in the preceding two tax years, if the book value of these assets is more than 75% of the total book value of the assets of the undertaking" (the "**Asset test no. 3**").

3.1 The First Gateway

The First gateway is crossed if

(i) more than 75% of the revenues accruing to the undertaking

(ii) in the preceding two tax years

(iii) is relevant income.

3.1.1 <u>75% Threshold</u>

The Directive should clarify whether the First gateway must be crossed in each of the two-year period or as an average of the two years.

For instance, if in:

- year 1, the relevant income is equal to 100, being <u>70%</u> of the total income of 142;
- year 2, relevant income is equal to 100, being <u>100%</u> of the total income of 100,

the 75% threshold (and thus, the First gateway) is not crossed when applying the test separately for each year, while it is passed when the test applies on the average of the income of the two-year period (relevant income is equal to 100 + 100 = 200, being 200/242 = 82,64% of the total income > 75%).

3.1.2 *Reference Period*

The passing of the First gateway in a certain fiscal year must be analysed taking into account "*the preceding two tax years*". Article 3, no. 2, of the Directive defines "*tax year*" as a "*tax year, calendar year or any other appropriate period for tax purposes*", which should reasonably be the one relevant for the Member State of the undertaking's claimed tax residence.

In our view, it would be appropriate that the Directive rules also situations where the undertaking transfers its tax residence during the two-year period in order to avoid uncertainty in its application. For instance, if an undertaking in 2022 is tax resident in Member State A and in 2023 in Member State B it might be uncertain if:

(i) Member State B can take into consideration year 2022 for the purposes of the First gateway, even though it was a year of not-tax residence; or

(ii) in the previous year (i.e., 2022) the undertaking was tax resident outside the EU, the reference period starts only from 2023.

3.1.3 *Relevant Income*

Article 4 of the Directive defines "*relevant income*" any income falling under the following categories:

(c) *"interest or any other income generated from financial assets, including crypto assets, as defined in Article 3(1), point 2 of the proposal for a Regulation of the European Parliament and of the Council on Markets in Crypto-assets, and amending Directive (EU) 2019/193713;*

(d) *royalties or any other income generated from intellectual or intangible property or tradable permits;*

(e) *dividends and income from the disposal of shares;*

(f) *income from financial leasing;*

(g) *income from immovable property;*

(h) *income from movable property, other than cash, shares or securities, held for private purposes and with a book value of more than one million euro;*

(i) *income from insurance, banking and other financial activities;*

(j) *income from services which the undertaking has outsourced to other associated enterprises".*

It should be noted that "*income from the disposal*" is only expressly mentioned in letter (c) with reference to shares. Thus, in our view, it would be appropriate to clarify

whether income from the disposal of other assets (i.e., intangibles or real estate properties) falls or not within the definition of "*relevant income*".

3.2 Second Gateway

The Second gateway is crossed whether the Income Test or, alternatively, the Asset Test is passed.

3.2.1 Income Test

In particular, the Income Test is passed if more than 60% of the undertaking's relevant income is earned or paid out via cross-border transactions. In this respect, it should better specify:

(i) whether the Income Test applies to both the preceding two tax years, since in this case there is no reference to the two-year period;

(ii) what is intended for "cross-border transactions".

No reference is made to a two-year period also in relation to the application of the Asset test no. 2 and 3. Thus, some doubts arise as to the outcome of these tests, especially where in the first year the Asset test no. 2 is passed, whilst in the next year the Asset test no. 3 is not passed.

3.3 Third Gateway

The Third gateway is crossed if the undertaking has no (or inadequate) own resources to perform core (i.e. not ancillary) management activities and relies on other undertakings for its own administration.

In our view, the Directive should offer some guidance on understanding what is intended for outsourcing the administrative functions.

4. CARVED-OUT ENTITIES

Article 6, paragraph 2, of the Directive, states that the list of the following undertakings are carved-out from the scope of the Directive and thus not even subject to the reporting obligations and to the adverse tax consequences:

(a) "(…);

(b) regulated financial undertakings;

(c) 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;

(d) 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, as

defined in Section I, point 7, of Annex III to Directive 2011/16/EU;

(e) *undertakings with at least five own full-time equivalent employees or members of staff exclusively carrying out the activities generating the relevant income".*

4.1.1 *Regulated Financial Undertakings*

The Directive does not carve-out special purpose vehicles (the "**SPVs**"), which are owned by carved-out undertakings, such as UCITS and alternative investment funds. We maintain that SPVs are simple tools set up for business reasons and therefore they should be considered at "low risk" anyway and included in the carved-out undertakings.

4.1.2 *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*

This is the typical case of pure holding undertakings which are situated in the same Member State of the subsidiaries and their beneficial owners.

First of all, the term "*beneficial owner*" is defined by Article 3, no. 5, of the Directive, which refers to Article 3, point 6, of Directive (EU) 2015/849 of the European Parliament of the Council. However, the Directive does not address cases where there are no beneficial owners at all, for instance when each unrelated investor owns less than 25% of the undertaking. In our view, the carve-out should apply anyway in such cases and the undertaking should not be subject to the obligations dictated by the Directive.

Moreover, the Directive refers to the "*main activity of holding shares in operational businesses in the same Member State*", but does not provide for a definition of "*main activity*".

In our view, this requirement should be considered as met even in presence of subsidiaries established in other States, provided that the majority of the subsidiaries is established in the same Member State of the undertaking. The same logic regarding the application of a prevalence test should be also used in the case where the undertaking has more than one beneficial owners, who are resident in different Member States.

In order to reduce uncertainty, the Directive should address also such definitions.

4.1.3 *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, as defined in section i, point 7, of annex iii to directive 2011/16/EU*

This is the typical case of sub-holdings or top-holding companies where the undertaking's shareholders are individuals, or trusts, or foundations, or even companies that do not control the undertaking.

In this regard, the Directive provides that the undertaking, its shareholder(s) or its ultimate parent company have to be resident for tax purposes in the same Member State.

It is not taken into consideration the case of an undertaking with multiple shareholders which are resident for tax purposes in different Member States. Such case should be however ruled affirming that, in order to meet the requirement of the tax residence of the undertaking's shareholders in the same Member State of the undertaking, is sufficient to look at the majority of them. Indeed, in this situation we don't see any abusive intent which the Directive aims to counteract.

Also, in the situation where an individual owns an entity in, e.g., Luxembourg, which in turn owns an, e.g., Italian entity, it would be appropriate to clarify who is the shareholder(s) of the Italian entity between the Luxembourg entity and the individual, since the middle entity is disregarded for tax purposes when qualifying as shell entity.

4.1.4 Undertakings with at least five own full-time equivalent employees or members of staff exclusively carrying out the activities generating the relevant income

The Directive should clarify whether the employment of five people by the undertaking is a formal or a substantial requirement. An undertaking may indeed have its employees seconded to third parties, or it can actually enjoy the services performed by persons employed by associated enterprises.

In our opinion, the Directive should also state that the determination whether a person is or not an employee of the undertaking is based on the domestic laws of the Member State in which the undertaking is situated.

5. INDICATORS OF MINIMUM SUBSTANCE FOR TAX PURPOSES

Article 7, paragraph 1, of the Directive states that the undertakings which cross the three gateways laid down in Article 6, paragraph 1, must fulfil reporting obligations in their annual tax return, "*for each tax year*", declaring whether they meet some certain indicators of minimum substance:

(a) *"the undertaking has own premises in the Member State, or premises for its exclusive use;*

(b) *the undertaking has at least one own and active bank account in the Union;*

(c) *one of the following indicators:*

(i) *One or more directors of the undertaking:*

(1) *are resident for tax purposes in the Member State of the undertaking, or at no greater distance from that Member State insofar as such distance is compatible with the proper performance of their duties;*

(2) *are qualified and authorised to take decisions in relation to the activities that generate relevant income for the undertaking or in relation to the undertaking's assets;*

(3) *actively and independently use the authorisation referred to in point (2) on a regular basis;*

(4) *are not employees of an enterprise that is not an associated enterprise and do not perform the function of director or equivalent of other enterprises that are not associated enterprises;*

(ii) *the majority of the full-time equivalent employees of the undertaking are resident for tax purposes in the Member State of the undertaking, or at no greater distance from that Member States insofar as such distance is compatible with the proper performance of their duties, and such employees are qualified to carry out the activities that generate relevant income for the undertaking".*

5.1.1 Reporting obligations

The Directive does not clarify whether the reporting obligations in tax return is related to the first year after the two-year reference period or to the last year of such reference period. For instance, if an undertaking qualifies as a "shell entity" looking back at the two-year period 2022 – 2023, at this stage is not clear which is the annual tax return which one should be using to declare the "shell entity" (the choice falls between the tax return for 2023 to be filed in 2024, or the one for 2024 to be filed in 2025).

In our view, the first alternative seems the most consistent with the purpose of the Directive, as it would allow tax authorities to anticipate the awareness of a potential qualification of the undertaking as a "shell entity".

5.1.2 Own premises

In our view, the notion of "*own premises*" would need to be better defined, especially giving an indication of e.g. the minimum size or equipment required.

5.1.3 Qualified Directors

The indicator of minimum substance related to the qualified directors requires, among the other conditions, that one or more directors are qualified and authorised to take decisions in relation to the activities that generate relevant income for the undertaking or in relation to the undertaking's assets.

The Directive should clarify whether such assets are only those capable to generate relevant income or not. In our view, the answer should be negative since the Explanatory Memorandum at page 9 refers to the undertaking's "*core income generating activities*" and not just to the relevant income generating activities.

Moreover, the qualified directors should not be employees of an enterprise that is not an associated enterprise and do not perform the function of director or equivalent for

other enterprises that are not associated enterprises.

This latter requirement is quite problematic, for instance, for entities which do not either employ their own directors nor recur to the ones of other associated companies, but to directors with multiple mandates from companies of different groups which are not related to the undertaking under analysis. On the contrary, it should be appropriate to confirm whether the case where a company employs directors of other group companies is not problematic.

5.1.4 Qualified Employees

In our view, it should be clarified how many employees the undertaking should have in order to meet such test.

6. REBUTTAL OF THE PRESUMPTION OF NOT HAVING THE MINIMUM SUBSTANCE

Article 9, paragraph 1, of the Directive states that "*Member States shall take the appropriate measures to allow undertakings that are presumed not to have minimum substance* (…) *to rebut this presumption*".

From a literal interpretation the rebuttal can be sought once the undertaking is presumed not to have minimum substance. However, it would be paramount that the Member States could also allow the undertakings to receive a sort of clearance in advance, without having to wait an actual failure of any of the indicators required by the Directive.

The Directive should therefore confirm that:

- in order to obtain the rebuttal, relevant information and evidence could be related also to previous years, even beyond the ones that are included in the two-year reference period;
- in the case of transfer of residence from one Member State to another during the next five-year period in which the rebuttal is effective, the information provided to the departing Member State should be taken into consideration by the Member State of arrival.

7. EXEMPTION

Article 10, paragraph 1, of the Directive states that "*A Member State shall take the appropriate measures to allow an undertaking that meets the criteria laid down in Article 6(1)* [The reporting undertakings] *to request an exemption from its obligations under this Directive if the existence of the undertaking does not reduce the tax liability of its beneficial owner(s) or of the group, as a whole, of which the undertaking is a member*".

The evidence which the undertaking has to provide in order to prove that its

interposition does not lead to a tax benefit for its beneficial owner(s) or the whole group shall include information about the structure of the group, its activities and a comparison of the amount of the overall tax due by the beneficial owner(s) of the whole group, having regard to the interposition of the undertaking, with the amount that would be due under the same circumstances in the absence of the undertaking. In this respect, it should be considered that it is not so easy to identify the tax ramifications until the ultimate beneficial owners, considering also that, in certain circumstances, they do not even exist at all (for instance, this is the case where each unrelated investor owns less than 25% of the undertaking);

Moreover, in order to apply correctly the provisions of the Directive, it would be useful a confirmation on the relevance of the following points:

- other taxes than the corporate ones are taken into consideration in comparing the two scenarios (with or without the shell entity);
- the comparison between the two scenarios is not only limited to the actual tax disbursement in a particular year but it also takes into account the deferred taxation;
- non-EU taxes are also relevant in the computation.

8. TAX CONSEQUENCES

Articles 11 and 12 of the Directive envisage a number of tax consequences at different levels for those investment structures involving shell entities. However, there seem to be some issues of coordination with other provisions of the Directive.

In particular, we refer to the lack of coordination with the rules provided by Articles 7 and 8, in order to determine the appropriate timing for being considered as a shell company. For instance, as already mentioned at point 3.1.2, it should be clarified whether the undertaking has to report all information in the tax return related to the first tax year following the two-year reference period (tax return for 2024 to be filed in 2025 if the reference period is 2022-2023) or in the tax return related to the last year of the two-year reference period (tax return for 2023 to be filed in 2024).

In our opinion, the second case is the best solution, since the former would imply a significant timing gap between the date in which the undertaking receives income from foreign sources and the Member State of the undertaking acknowledges to be obliged to deny the certificate of residence (or release a certificate that would limit intra-EU treaty or EU benefits).

There is lack of coordination also between the provision ruling: (i) the tax consequences in the case when the Source State is a Member State; and the undertaking's shareholder(s) is tax resident outside the EU; and (ii) the treaty entitlement. The Directive requires to consider the undertaking's shareholder(s) as the

direct owner of the relevant income generating assets; however, under the laws of the State of source, income belongs directly to the undertaking's shareholders, and this may allow the application of the relevant treaties: a coordination among such rules would help uncertainty. For instance, it is not clear what happens if under the rules of the State of the undertaking's shareholder, such latter entity is not the beneficial owner of income, as this will be identified in the undertaking itself.

In our view, if the shell company is disregarded by the State of source it would be logical to consider the undertaking's shareholder as the beneficial owner regardless of any qualification made by its State of residence.

9. PENALTIES

Article 14 of the Directive requires Member States to provide for effective, proportionate and dissuasive penalties of at least 5% of the undertaking's turnover. The term "turnover" is not defined by the Directive.

Thus, it seems to us that the penalties are not limited to the relevant income but are potentially applicable to all the undertaking's turnover, resulting not proportional and, to a certain extent, dependent on facts which are not decisive for the Directive itself. As a matter of fact, the undertaking could realise the rest of its turnover (besides the relevant income) through an actual structure in the Member State or in other State through a permanent establishment situated therein.

In our view, it would then be appropriate to define the scope of application of the penalties.

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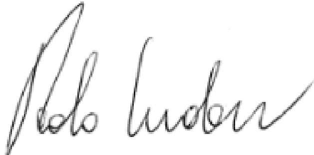

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