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EU AND INTERNATIONAL TAX POLICY

The "Unshell Directive" under X-rays

On 22 December 2021, the European Commission presented the proposal for a Council Directive laying down rules to prevent the misuse of shell entities in order to obtain tax advantages within the EU (the "**Directive**"). The proposed measures envisage a seven-step analysis that is intended to be a serious deterrent against the use for tax purposes of entities without substance in cross-border situations and an instrument to provide readily available information to Member States to effectively apply existing domestic rules.

YOU ARE NOT A BAD ... VEHICLE

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 latter can serve several kind and fully legitimate commercial and business purposes" such as "ensure limitation of liability, protect investors and maintain the value of the portfolio, meet the requirements of third party lenders to ring-fence assets and liabilities, facilitate joint ventures between funds and other investors, streamline decision making by giving authority to the directors of holding entities, provide a convenient vehicle for sale or partial sale ... spreading financial risk and facilitating complex financing and project operations".
The issue, therefore, is not about distinguishing between legitimate and problematic shell entities, rather about distinguishing between the legitimate and problematic use of such entities.
This underlying principle is consistent with the tax consequences set forth by the Directive:

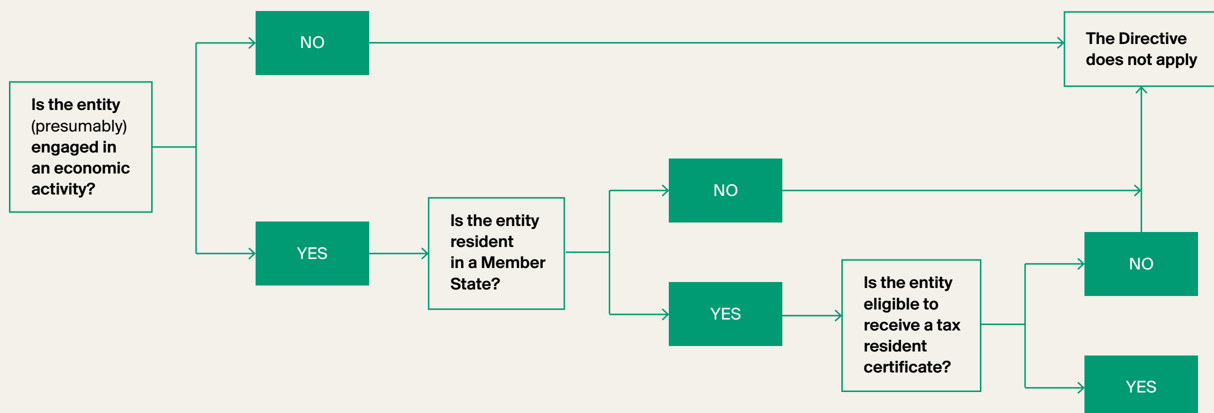
i. the shell entity keeps paying its own taxes in the State of establishment (more or less) as if the Directive were not in place; and
ii. the adverse tax consequences are mainly for the undertaking's shareholders, i.e. the ones who make use of the shell entity.

BUT THE (MIS)USES MIGHT BE

A problematic use or rather a misuse of shell entities for tax purposes is more common where they lack of substance in the State of establishment.
The Directive recognises that different activities may require different levels or types of substance, but "a common minimum level of resources would be expected under all circumstances". It then introduces a test to facilitate Member States to identify manifest cases of shell entities in a coordinated manner across the EU.
The Explanatory Memorandum states that "national rules shall continue to apply to identify shell entities not captured by this Directive". This may be the case of (i) entities established outside the EU that, as it will be clarified below, are outside the scope of the Directive, (ii) entities established in the EU that are not resident in a Member State, for instance being tax transparent, but also (iii) entities resident in the EU that meet the minimum level of substance required by the Directive but can still be regarded as shell entities under domestic laws.
In this respect, the Directive provides for a "minimum protection" and indeed the Preamble states that "where an undertaking has been found to have sufficient substance under this Directive, this should not prevent the Member States for continuing to operate anti-tax avoidance and evasion rules, provided that they are consistent with Union law".

ENTITIES CAPABLE TO QUALIFY AS "SHELL ENTITIES"

The Directive is broadly inclusive and applies to i) undertakings that ii) are considered tax resident in a Member State and iii) are eligible to receive a tax residence certificate in such State. No threshold is required as to a minimum turnover.



The term "undertaking" means "any entity engaged in an economic activity, regardless of its legal form":

i. the Directive does not define "economic activity", but having regard to the purpose of the Directive, it seems to be a synonymous for "business activity". This latter conclusion may in particular be drawn from Article 7, paragraph 2, of the Directive ("Indicators of minimum substance"), where for instance it is required documentary evidence of the "type of *business activities* performed to generate relevant income" or from Article 9 ("Rebuttal of presumption") where undertakings are required to provide evidence "of the *business activities* which they perform to generate relevant income";

ii. since the Directive targets entities which "are presumably engaged with an economic activity but that in reality do not conduct any economic activities" (Explanatory Memorandum page 8) what matters is the activity that is supposedly carried out;

iii. having regard also to the first gateway mentioned in Article 6 of the Directive ("The reporting undertakings"), the mere ownership (even potential) of income-generating assets should by itself qualify as an economic activity;

iv. in any event, the term “undertaking” implies the engagement in a business activity, thus excluding non-business entities like charities, foundations, trusts (not engaged in business activities) and non-commercial partnerships.

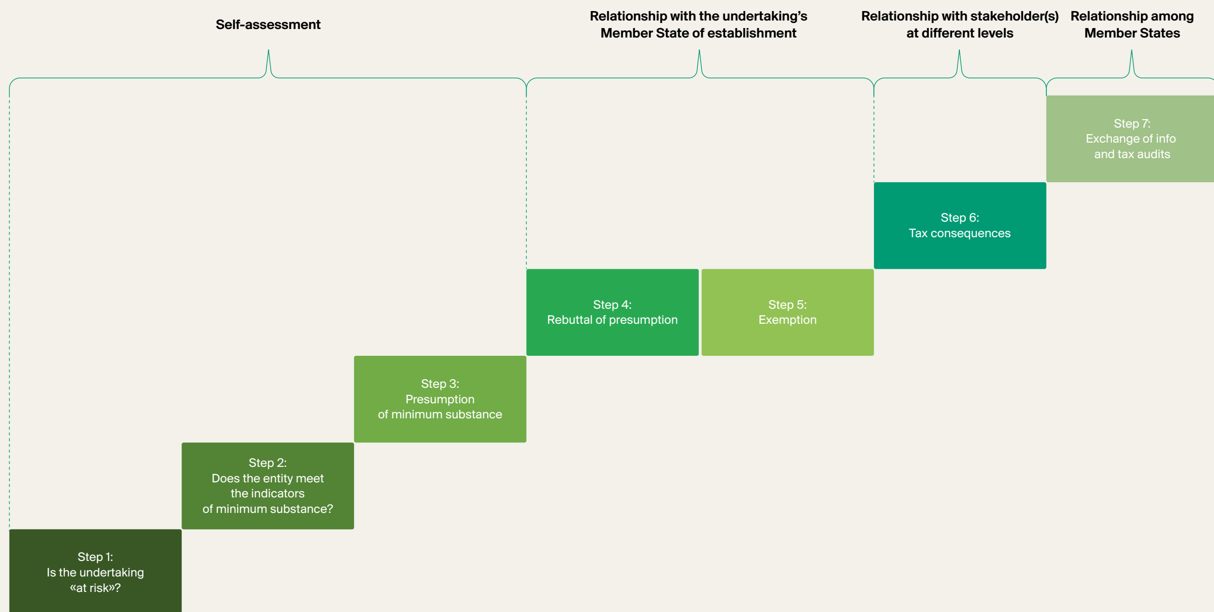
With reference to the undertaking’s tax residence in a Member State, the Directive does not refer to the place of establishment or incorporation of the undertaking but just at its tax residence. It does not require an exclusive tax residence in a State nor deals with situations where a company either 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 (a rare situation but still theoretically possible).
In addition, the undertaking must be eligible to receive a tax residence certificate in such State. The meaning of this requirement must be determined having regard to Article 12 of the Directive (“Tax consequences of not having minimum substance for tax purposes in the Member State of the undertaking”), which refers to “a certificate of tax residence [...] for use outside the jurisdiction of th[e] Member State” in respect of “agreements and conventions that provide for the elimination of double taxation of income and [...] capital, and of international agreements with a similar purpose” of the EU Parent-Subsidiary and Interest and Royalty Directives.
Having regard to the scope of the Directive,

i. what matters is just the claimed residence of the undertaking, regardless of where the “economic activity” is carried on. This is especially important where an undertaking acts through a permanent establishment;
ii. partnerships that are regarded as transparent for tax purposes should fall outside the scope of the Directive. Indeed, they may be regarded as resident of a Member State under its national legislation but not being entitled to treaty protection of themselves. This implies that partnerships are not subject to the reporting obligations imposed by the Directive and this may prevent other Member States from automatically receiving information as to their substance and to the risks they may pose to tax fairness (even though such partnerships cannot benefit of the provisions contained in the EU Parent-Subsidiary and the Interest and Royalty Directives);
iii. although the criteria laid down in the Directive may constitute a guidance to Member States for cases not falling within the scope of the same Directive, the overall framework seems unbalanced in favour of non-EU resident entities in non-EU States, including those established in the European Economic Area:
    a. non-EU shell companies cannot benefit from the provisions contained in the EU Parent-Subsidiary and the Interest and Royalty Directives, but in principle they may benefit from treaty provisions to the extent they are established in treaty countries and the relevant tax authorities are willing to grant treaty residence certificates;
    b. furthermore, non-EU shell companies may maintain a higher level of confidentiality vis-à-vis EU tax authorities;
    c. one of the measures contained in the Directive is the non-application of treaty provisions with respect to inbound income. This measure, however, literally applies vis-à-vis to income arising from any source, even if outside the EU. The moral commitment of the EU is very valuable but in the absence of reciprocity, instead of leading to a containment of the use of shell companies at all, the Directive may limit the use of shell companies incorporated in the EU only.

The Press Release of the European Commission anticipates that “in 2022 the Commission will undertake a new initiative to tackle non-EU shell companies”. This is a very welcome statement but implicitly confirms that the Directive on a stand-alone basis may give rise to collateral effects such as undermining company structures which are based only in the EU and not those with potential shell entities artificially located outside the EU.

THE MAGNIFICENT SEVEN ... STEPS

As mentioned, the Directive provides for a seven-step analysis to counteract the misuse of shell entities for tax purposes. Some of these steps require a self-assessment of the shell entity itself; others require an interaction of the shell entities with the tax authorities of the Member State where are established; others set new rules as to the taxation of relevant income in the source State or in the undertaking's shareholders State of residence and others finally imply an interaction between Member States.



STEP 1: UNDERTAKINGS "AT RISK"

Step 1 requires undertakings to self-assess whether they are "at risk" to be presumed shell entities. To this end, Article 6 of the Directive establishes three main gateways that should be crossed simultaneously:

i. the undertakings are engaged in geographically mobile activities, as the place where such activities are actually carried out is usually more challenging to identify (the "**First gateway**");

ii. such activities are mainly cross-border (the "**Second gateway**"). Purely domestic situations, indeed, would not pose a risk for the good functioning of the internal market and would be better addressed at domestic level;

iii. the undertakings must have no or inadequate own resources to perform core management activities and rely on other undertakings for their own administration (the "**Third gateway**").

First gateway: the engagement in geographically mobile activities

This First gateway is crossed if "more than 75% of the revenues accruing to the undertaking in the preceding two tax years is relevant income".
The Directive defines "tax year" as a "tax year, calendar year or any appropriate period for tax purposes". Such "tax year" should be relevant:

i. in the Member State of the undertaking's claimed tax residence. There is no indication or guidance for situations where the undertaking transfers the tax residence during the relevant years. Assume, for instance, the case of an undertaking which in 2022 is tax resident in Member State A and in 2023 in Member State B: can Member State B take into consideration year 2022 even though it was a year of not-residence? And what if in 2022 the undertaking was resident outside the EU: would the reference period start from 2023 only?

ii. for the purpose of taxes that may be caught by the Directive. These taxes are certainly income and corporate taxes but, depending on the circumstances, can also be taxes on capital. Instead, VAT and other indirect taxes, including inheritance and gift taxes, should not be relevant.

"Relevant income" is defined by the Directive in Article 4 and includes passive income but also items of active income for which the undertaking outsources the activity to associated enterprises. To this end, relevant income includes:

a. interest or any other income from financial assets;
b. royalties or any other income generated from intellectual or intangible property or tradable permits;
c. dividends and income from the disposal of shares. There is no carve-out for extraordinary gains arising from the disposal of core subsidiaries;
d. income from financial leasing;
e. income from immovable property;
f. income from movable property, other than cash, shares or securities, held for private purposes (provided that the book value exceeds one million Euro);
g. income from insurance, banking and other financial activities;
h. income from services which the undertaking has outsourced to other associated enterprises.

The Directive does not make a distinction between "income" and "capital gains", but the second ones should be reasonably qualified as "items of income" and therefore be included. However, "income from the disposal" is only expressly mentioned in letter (c) and thus it should be clarified whether income from the disposal of other assets (i.e., intangibles or real estate properties) falls or not within the definition of "relevant income".
As for the computation of the 75% threshold, the Directive does not clarify whether the crossing of the First gateway must be met in each of the two years or as an average of the two years. For instance:

i. year 1: relevant income equal to 100, being 70% of total income of 142;
ii. year 2: relevant income equal to 100, being 100% of total income of 100;
iii. in aggregate: relevant income is equal to 200 and represents 82.6% of aggregate income of 242.
iv. As a consequence, if the computation has to be considered:
 — separately for each year → the First gateway is not crossed;
 — on average → the First gateway is crossed.

This First gateway is considered crossed even in the absence of relevant income in any of the preceding two tax years if the book value of certain assets is more than 75% of the total book value of the undertaking's assets. The relevant assets are divided in two separate blocks:

i. assets under Article 4, points (e) and (f), namely immovable property, movable property other than cash, shares or securities held for private purposes and with a book value of more than one million euro;
ii. assets under Article 4, point (c), namely shares (but not loans granted to companies, even if participated by the undertaking).

The 75% threshold should be applied separately for each block, and therefore (literally) the First gateway should not be passed:

a. even if 100% of the book value of the assets is represented, for instance, by immovable property (e.g., 50%) and shares (e.g., 50%) provided that none of such assets autonomously exceeds the threshold; or
b. in one year more than 75% of the book value of assets falls under the case sub (i) and in the subsequent year under the case sub (ii).

Second gateway: the engagement in cross-border activities

The Second gateway is crossed if any of the following "Asset Test" or "Income Test" is passed. It is therefore sufficient to meet one of these tests only.
The Asset Test is passed if 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. To this end not all assets are material but just (i) immovable property and (ii) movable property, other than cash, shares or securities, held for private purposes and with a book value of more than one million euro.
Instead, 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:

i. the Directive does not define the meaning of "cross-border transactions": for instance, for services under letter (g) of Article 4 of the Directive, would the residence of the customer be the key driver? For immovable property, would it be material the place where the property is situated or the lessee established or the income generating activity performed? And what about movable properties such as pleasure yachts, pieces of art, jewellery or aircraft? Are yachts established in the flagship State, or in the State where they are habitually situated?

ii. for the purpose of the Income Test, the Directive does not make reference to the preceding two tax years, but it is not clear whether this was the real intention;

iii. the test is considered as being met even if the undertaking does not generate relevant income;

- *a.* if more than 75% of the total book value of the undertaking's assets is represented by (i) immovable property and (ii) movable property, other than cash, shares or securities, held for private purposes and with a book value of more than one million euro. No reference is made here to a two-year period;
- *b.* if more than 75% of the total book value of the undertaking's assets is represented by shares. Apparently, loans to participated entities do not fall within the scope of this presumption. No reference is made here to a two-year period and therefore the doubt arises as to the application of this presumption even in those situations where in one year the situation under letter a) is met whilst in the other the situation under letter b) is met.

The application of the cross-border requirement needs further interpretative support in those cases where an entity owns (Company A) a sole asset (i.e., 100%) of the share capital in another entity (Company B) that is resident in the same Member State but qualifies itself as a shell entity. It seems unfit to the purpose if the qualification of an undertaking (Company A) may be affected by the implementation of a chain of entities all qualifying as shell entities (in the example, Company B) but resident in the same State. As it will be further described, the Directive is clear in stating that the tax consequences would be determined disregarding all the shell entities in the chain and a similar outcome might reasonably be reached for the qualification of the relevant undertakings as shell entities.

The Third gateway: the outsourcing of the day-to-day operations and the decision making

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. This requires that in the preceding two tax years the undertaking outsourced the decision making on significant functions and the administration of day-to-day operations. It is a very factual test for which some guidance should be found in the principles laid down in the third indicator of minimum substance listed in Article 7 of the Directive, concerning the qualified directors as declined under Step 2, even though the latter principles are limited to the relevant income generating activities whilst the Third gateway seems to apply to the undertaking as a whole.

STEP 1 (CONTINUED): UNDERTAKINGS NOT “AT RISK”

Step 1 also requires checking if the undertakings are carved-out by the Directive because they are presumed to be at “low risk” either normally having adequate substance or not giving rise to tax benefits and being commonly used in essence “for good commercial reasons” (Explanatory Memorandum page 5).
Such undertakings include those with at least five own full-time equivalent employees or members of staff exclusively carrying out the activities generating the relevant income. To this end:

i. the employees should be employees of the undertaking: it is important to understand whether this is a formal or a substantial requirement. Indeed, an undertaking may have its employees seconded to third parties or it can actually enjoy the services performed by persons employed by associated enterprises but actually seconded to the undertaking itself. In addition:
- what would be the impact of employees working from home from other Member States?
- should the determination whether a person is or not an employee be based on the domestic laws of the undertaking and not of any other Member State (for instance, the source State)? This point is particularly relevant for board members, who in certain States always qualify as employees whilst in other States, under certain circumstances, do not qualify as employees even if they have a concurrent employment agreement;

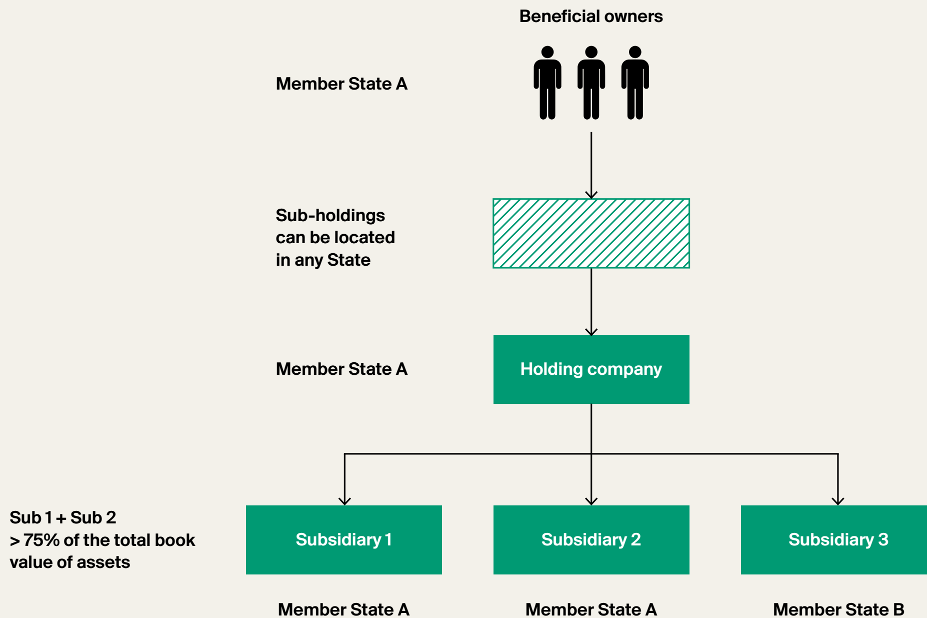
ii. the employees must be engaged in the activities generating the relevant income. Therefore, not all employees should be considered but only those engaged in the relevant income generating activities;

iii. the dedication to such activities must be on an exclusive basis: this requirement is difficult to be met in those situations where the undertaking is engaged in different types of activities and only a few employees qualify for the purpose of the Directive.

Other undertakings presumed not “at risk” include:

a. companies that have a transferable security admitted to trading in an EU regulated market. Such securities include bonds and, in certain jurisdictions, such bonds are listed even if they are owned by a very restricted number of investors;

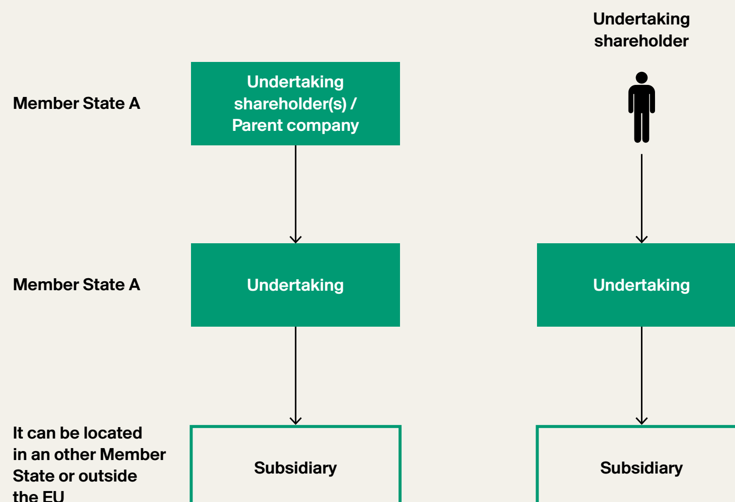
b. undertakings that have the main activity of holding shares in operational businesses in the same Member State while their beneficial owners are also resident of the same Member State. This is the case of pure holding undertakings which are situated in the same Member State of the subsidiaries and their beneficial owners (but not necessarily the undertaking’s shareholders). What matters is the “main activity of holding shares in operational businesses in the same Member State”, which means that the requirement is 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.

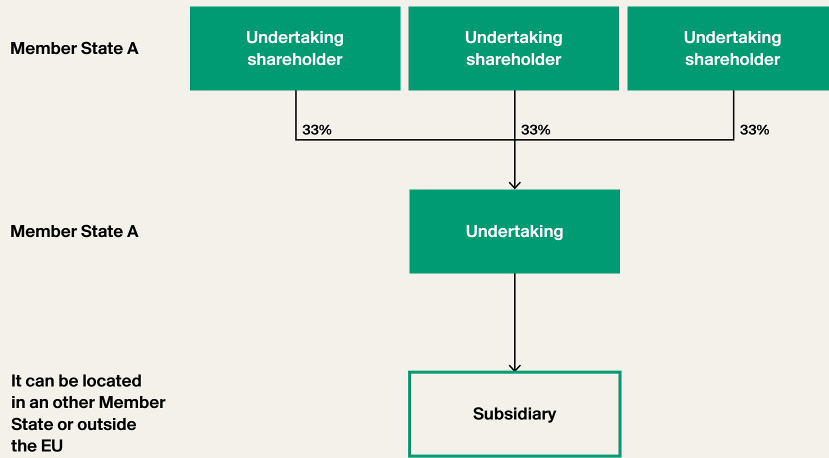


It can easily be appreciated that some areas of uncertainties may arise. For instance:

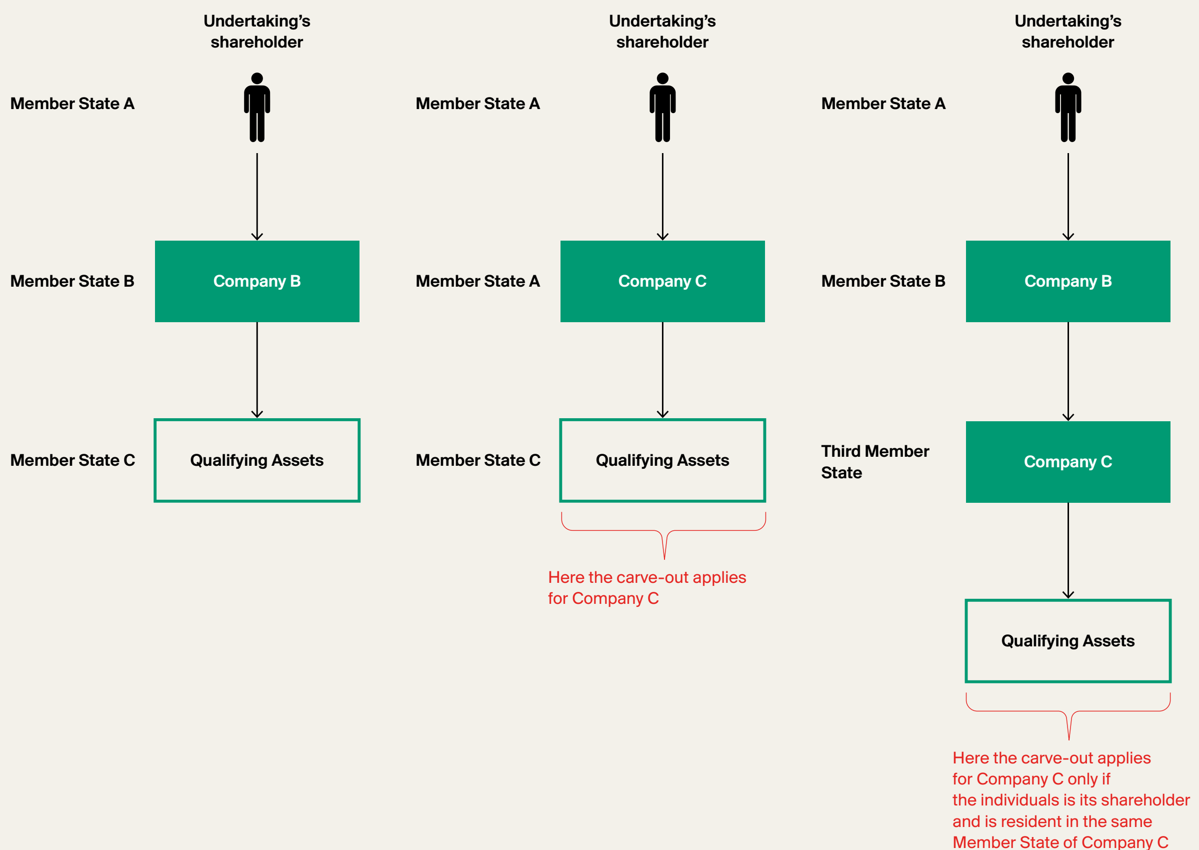
- when is a business operational? Would it be for the Member State of claimed residence to argue?
- which is the place where the business is operational? Would tax residence of a subsidiary be a sufficient indicator?
- what if another Member State claims that the business is mainly conducted in its jurisdiction?
- what if the beneficial owners are resident in different Member States? Would it be sufficient a prevalence test looking at the tax residence of the majority of the beneficial owners?
- what if the beneficial owners are dual resident or are deemed to be resident in another Member State (either EU or not EU) as a consequence of a specific audit, which may also be compatible with the treaty breaker rule?

c. undertakings with holding activities resident in the same Member State as the undertaking's shareholders or the ultimate parent company. This is typically referred as the case of sub-holdings but can also be the case of top-holding companies in cases where the undertaking's shareholders are individuals or trusts or foundations or anyway are companies that do not control the undertaking. For the purpose of this letter, relevance shall be given no longer to the place whether the beneficial owners are resident but simply to the State of the undertaking's shareholders (all of them or simply the majority?) or of the ultimate parent company.

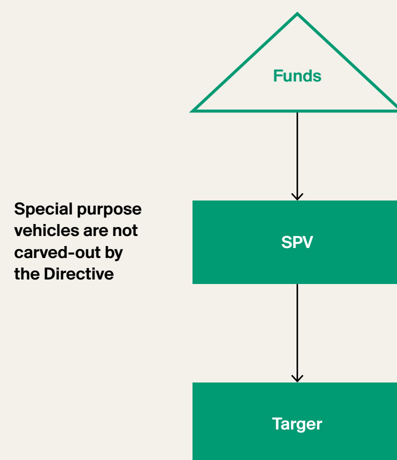




The Directive does not clarify how to define the undertaking's shareholder in a situation of chain of potential shell entities.
Assume, for instance the case of an individual resident in Member State A who holds the entire share capital of an undertaking resident in Member State B (Company B), that holds qualifying assets established in Member State C: Company B definitively may qualify as shell entity.
Assume, now, that the undertaking (Company C) owned by the individual is resident in the same State where the individual is resident: the carve-out applies and Company C is not considered "at risk".
Finally, assume that the individual owns Company B, that owns Company C that owns assets established in a third Member State: Company C would not be considered "at risk" only if the "undertaking's shareholder" is the individual him/herself (and not Company B) and it is resident in the same Member State of Company C (which would be Member State A in relation to the picture below).



d. regulated financial undertakings; these include credit institutions, investment firms, alternative investment fund managers, management companies of UCITS, insurance and reinsurance companies, securitisation vehicles, pension funds but also UCITS and alternative investments funds. In this respect what strikes is that:
- the definition of "relevant income" includes income from insurance and banking activities, which normally is generated by insurance companies and banks that benefit from the carve-out;
- UCITS and alternative investment funds are not normally entitled to treaty protection and should fall out of the scope of the Directive anyway. In this respect, the qualification of such entities as "low risk" should prevail even where they do not fall into the scope of the Directive. In any event, the Directive does not carve-out special purpose vehicles owned by such investment funds, even though they should logically be considered at "low risk" anyway. Probably such vehicles can seek the exemption under Article 10 of the Directive (the "**Exemption**") as described under Step 5;



STEP 2: REPORTING INDICATORS OF MINIMUM SUBSTANCE

Undertakings identified to be "at risk" under Step 1 have specific reporting obligations, that aim to "facilitate the assessment of the activity performed by the undertaking".
The relevant information must be reported in the "annual tax return". Such undertakings may well be obliged to file multiple tax returns in different Member States, but for the purpose of the Directive the only relevant tax return should be the one of the State of claimed tax residence.
The Directive clarifies that the reporting obligations relate to the annual tax return "for each tax year" without giving further guidance. The issue is whether the 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, assume that the first year of reference period is 2022, the second year of reference period is 2023, the first year of qualification as shell company is 2024: would the annual tax return be the one for 2023 (to be filed in 2024) or the one for 2024 (to be filed in 2025)? 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 shell company.
The reporting should include whether the following indicators of minimum substance are met:

a. the undertaking has in the Member State own premises or premises for its exclusive use. The notion of "own premises" would also need to be better defined especially since there is no indication as minimum size or equipment;

b. the undertaking has one or more own active bank accounts in the EU, and not just in the Member State of claimed residence. Having a bank account outside the EU, such as Switzerland, UK or the US should not be enough/sufficient (although it may be relevant for the rebuttal of the presumption as for Step 4);

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 such Member State);
      2. are qualified and authorised to take decisions in relation to the activities that generate relevant income or in relation to the undertaking's assets. The Directive does not require that such assets are only those capable to generate relevant income, but probably this should be implied, even though the Explanatory Memorandum at page 9 refers to the undertaking's "core income generating activities" and not just to the "relevant income generating activities";
      3. actively and independently use the authorisation 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 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, the case where a company employs directors of other group companies should not be problematic;
   ii. the majority of the full-time equivalent employees are resident for tax purposes in the Member State of the undertaking or at no greater distance from that Member State and are qualified to carry out the activities that generate relevant income:
      – logically this should be the case of undertakings with less than five employees dedicated to the relevant income generating activities, because otherwise the automatic carve-out should apply (provided that they are resident in the Member State of claimed residence of the undertaking or at no greater distance from that Member State);
      – it is not clarified how many employees the undertaking should have in order to meet such test;
      – which authority should determine whether they are "qualified"? As mentioned above, this evaluation should be conducted by the tax authorities of the Member State of claimed tax residence;
      – it may be difficult to figure out the "qualification" with respect to undertakings owning assets held for private purposes or for merely "static" holding companies.

The reporting entities should accompany their tax return declaration with documentary evidence that should include the following information:

a. address and type of premises;
b. amount of gross revenue and type thereof;
c. amount of business expenses and type thereof;
d. type of business activities performed to generate the relevant income;
e. the number of directors, their qualifications, authorisations and place of residence for tax purposes or the number of full-time equivalent employees performing the business activities that generate the relevant income and their qualifications, their place of residence for tax purposes;
f. outsourced business activities;
g. bank account number, any mandates granted to access the bank account and to use or issue payment instructions and evidence of the account's activity.

STEP 3: PRESUMPTION OF MINIMUM SUBSTANCE

Step 3 requires the undertaking to carefully self-assess the information reported under Step 2. In

other words, the analysis is construed as a self-assessment conducted by the same undertaking.
The Directive states very clearly that the entity is presumed to have minimum substance only if it meets all the three indicators listed under Step 2 and provides the satisfactory evidence.
Failure to meet even only one of such indicators or to provide the satisfactory evidence implies that the undertaking is presumed not to have minimum substance.
Alarm bells start to ring!

STEP 4: REBUTTAL OF THE PRESUMPTION

Step 4 gives the undertaking the opportunity to rebut the presumption of not having minimum substance under Step 3 by demonstrating that it carries out a genuine economic activity and it is not a shell entity.
Compared to the latter, Steps 1 to 3 are quite mechanical being based on "indicators". If the outcome is "negative", i.e. the undertaking is "at risk" and does not have the minimum substance required, but under Step 4 it is possible to start a dialogue with the tax authorities based on specific facts and circumstances of each (individual) case and try to avoid the detrimental effects of being considered a shell company through Step 4 and/or to demonstrate of not having been misused for tax purposes through Step 5.
In particular, the Directive does not set a specific procedure but simply states that "A Member State shall take the appropriate measures to allow an undertaking [at risk] to request an exemption from its obligations". From a literal interpretation it seems that the rebuttal can be sought once the undertaking is presumed not to have minimum substance, although in practice entities may wish to receive a sort of clearance in advance, without having to wait an actual failure of any of the indicators required by the Directive (and described in Step 2). This matter can probably be handled by each Member State in a separate manner.
The rebuttal under analysis implies the submission of additional supporting evidence of the business activities that the undertaking performs to generate relevant income. As mentioned earlier, what matters is the relevant income generating activity, rather than the overall activity of the undertaking. The "additional evidence" required by Article 9, paragraph 2, of the Directive concerns the following:

i. a document allowing to ascertain the commercial rationale behind the establishment of the undertaking. The rationale should be "commercial" without further guidance as to meaning of this term, although probably a "commercial reason" is simply a "non-tax reason" (Explanatory Memorandum, page 11). In addition, the rationale seems to refer to the "establishment" of the undertaking rather than to the ownership of the qualified relevant income generating assets or the performance of the activities generating relevant income, although the Explanatory Memorandum refers to "reasons for setting up and maintaining the undertaking";
ii. information about the employee profiles, including the level of their experience, their decision-making power in the overall organisation, role and position in the organisation chart, the type of their employment contract, their qualifications and duration of employment;
iii. concrete evidence that decision-making concerning the activity generating the relevant income is taking place in the Member State of the undertaking. This is the only part of the provision which specifically refers to the relevant income rather than to the overall activity of the undertaking.

The tax authorities in charge for analysing such rebuttal are those of the Member State of claimed residence for the particular year for which the tax return has been filed. Such authorities must evaluate whether "the undertaking has performed and continuously had control over and borne the risks of the business activities that generated the relevant income or, in the absence of income, the undertaking's assets". These principles are useful guidelines also for the application of domestic laws for cases not falling within the scope of the Directive or where tax authorities wish to claim that the company is a shell entity even though formally has the minimum substance.

Reasonably, in order to obtain the rebuttal, relevant information and evidence should relate also to previous years, even beyond the years that are included in the two-year reference period.
The rebuttal can be effective for the relevant year and for the subsequent five years, on the condition that the factual and legal circumstances of the undertaking remain unchanged during this period. If in such five-year period the undertaking transfers the residence to another Member State, such latter Member State may require the process to start again but one should expect that due weight will be given to the information provided to the departing Member State and to the final judgment of its tax authorities.

STEP 5: POSSIBILITY OF GAINING EXEMPTION

Step 5 gives the undertaking the opportunity to request an exemption from reporting obligations by proving that 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 "**Exemption**"). Whilst the rebuttal under Step 4 relates to the substance of the undertaking, pursuant to Article 10 of the Directive, the Exemption refers to the "misuse" of the undertaking for tax purposes.
Similar to the case of rebuttal:

i. competent tax authorities are those of the Member State of claimed tax residence;
ii. the exemption can be granted for up to five additional tax years.

However, in order to obtain the Exemption, the undertaking does not need to be presumed with no adequate substance under Step 2.
The Exemption requires providing information about the structure of the group and its activities, and a comparison of the amount of the overall tax due by the beneficial owner(s) of the group as a whole 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:

i. sometimes it is hard to identify the tax ramifications until the ultimate beneficial owner(s) and 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);
ii. the comparison relates to two scenarios, with and without the undertaking, but does not seem to allow Member States to consider anti-abuse principles applicable to the intermediate structures, if any, in foreign States. This requires some further consideration. First of all, if a structure envisages the use of a shell structure established in Member State A and an additional structure is established in Member State B, can Member State B consider the overall implications as if also the company established in Member State A were not in existence? Would it require a strict cooperation with the tax authorities of Member State A?

This being said, some other questions may arise. For instance:

- would the comparison take into consideration income/corporate taxes only?
- would the comparison be limited to the actual tax disbursement in a particular year or would deferred taxation be also taken into consideration?
- would a cooperation be needed with foreign States to assess the accuracy of the information given by the applicants to their tax authorities?
- would non-EU taxes be considered as well?

STEP 6: TAX CONSEQUENCES

Step 6 envisages a number of tax consequences at different levels for those investment structures involving shell entities (i.e. undertaking which does not have the minimum substance as described under Step 2, does not rebut the presumption under Step 4 or does not get the Exemption under

Step 5). Tax consequences may vary depending on the Member State at stake but what is sure is that the same consequences apply whenever there is a chain of shell entities.

Member State of claimed tax residence of the shell entity

The Member State of claimed tax residence shall continue to apply its own rules as if the Directive was not applicable. This is clearly meant by Article 11, paragraph 1, of the Directive which refers to Member States "other than the Member State of the undertaking". Income generated by the undertaking will therefore be subject to taxation under ordinary rules and payments made by the undertaking will be subject to withholding taxes under ordinary rules, including those set forth by EU Directives and tax treaties. In a nutshell, this State will not either reduce or increase the taxes due by the undertaking under its own laws, with one exception: a credit will be granted for additional taxes due in the source States (see below). This may lead to a potential conflict of interest for the Member State of the undertaking: applying the Directive may not just constitute an incentive for the undertaking to leave the country but might also reduce the revenue for the Member State itself. Moreover, the mere approval of the Directive may induce taxpayers to eliminate the main cause of the "shell entity" status through a group restructuring, for instance, by assigning qualified personnel to the entity or through other actions such as dissolution, relocation of simple transfer of the assets to a foreign entity with adequate substance. Such actions should not be regarded *per se* abusive but depending on the circumstances may give rise to taxation in the State of the undertaking's establishment under its own ordinary rules. This is an odd result as one could argue (i) on one side that the Directive aims at inducing taxpayers to dissolve or relocate the entities potentially qualified as shell entities, or transfer their assets to other group companies with substance but (ii) on the other side that all these activities may trigger taxation in the State of the undertaking's establishment thus creating a disincentive to remove the very reason of being a "shell entity".
Vis-à-vis foreign States, pursuant to Article 12 of the Directive such Member State, however, has the obligation to take any of the following decisions:

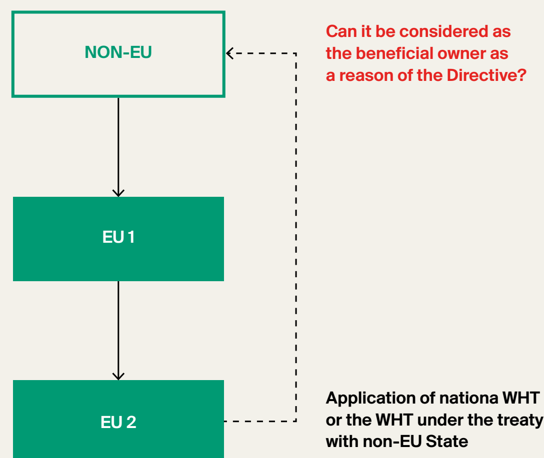
a. deny a request for a certificate of tax residence; or alternatively
b. grant a certificate of tax residence which prescribes that the undertaking is not entitled to the benefits of treaties and Directives.

This implies either an additional taxation in the Member States of source on income flowing to the undertaking or a potential additional taxation in the State of residence of the undertaking's shareholder(s), wherever the exemption of foreign source income is subject to the delivery of a certificate of tax residence of the payer.
There might be situations in which the tax residency certificate is sought for the application of domestic laws of another EU State and this situation is potentially addressed by the Directive, but only if the first option is chosen and the certificate of tax residency is denied at all.
Pursuant to the above-mentioned Article 12, such obligation applies whenever "an undertaking does not have minimum substance for tax purposes in the Member State where it is resident for tax purposes". There is no mention of the rebuttal of the presumption under Step 4 or of the Exemption under Step 5 because the latter can be sought regardless of the outcome of Steps 2 and 3.
The application of this provision should be coordinated with the rules explicated under Step 2 and 3, in order to determine the appropriate timing for being considered as a shell company. For instance, as already mentioned, would the undertaking have 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 reference period (tax return for 2023 to be filed in 2024)? In the first case, there might be 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).

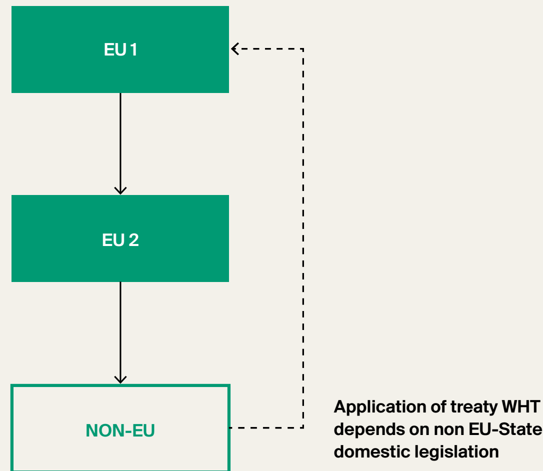
Member State of source

Member States of source will be entitled to deny the benefits provided by EU treaties and the EU Directives to payments made to the undertaking.
Few different combinations can be envisaged:

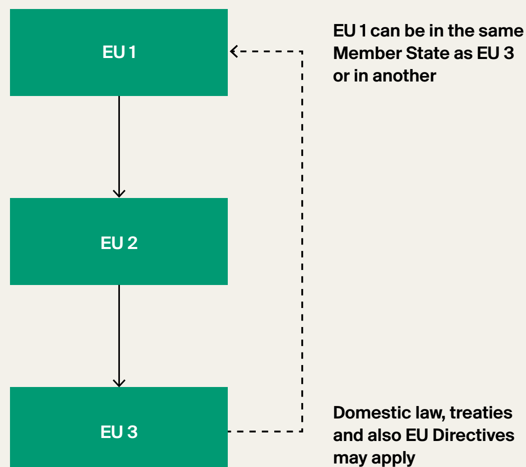
1. the Source State is a Member State and the undertaking's shareholder(s) is tax resident outside the EU: where the undertaking's shareholder(s) is not resident for tax purposes in a Member State, the Member State of the payer shall apply the withholding taxes under its national law "without prejudice to any agreement or convention [...] in force with the third country jurisdiction of the undertaking's shareholder(s)". Without prejudice means that such agreement or convention may apply as if the payment was made directly to the undertaking's shareholder(s), as confirmed by the Explanatory Memorandum. In this latter respect, this requires to consider the undertaking's shareholders as the direct owners of the relevant income generating assets: 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. This provision should however be coordinated with other provisions regarding treaty entitlement. For instance, what if under the rules of the State of the undertaking's shareholder such undertaking is not the beneficial owner of income, as this will be identified in the undertaking itself? Probably, 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 but this might lead to unintended consequences.



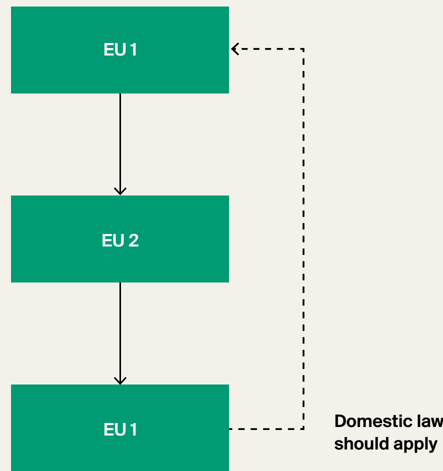
2. the Source State is a non-EU Member State: such State is not subject to the obligations under the Directive but reasonably should deny treaty benefits to the undertaking itself lacking a certificate of tax residence. Whether this State would allow application of treaties as if payments were flowing to the undertaking's shareholder(s) depends on the domestic tax laws of such non-EU Member State and of the relevant treaties with the Member State of the undertaking's shareholders. Indeed, the latter shall include non-EU source income in their own tax base as if the payments were received without the interposition of the shell company and thus might be enough for treaty eligibility.



3. the Source State is a Member State and the undertaking's shareholder(s) is tax resident in another Member State: the Directive does not explicitly address this scenario but the Explanatory Memorandum states that the Source State "may apply domestic law on the outbound payment to the extent it cannot identify whether the undertaking shareholder(s) is in the EU" and the latter undertaking's shareholder(s) "may be able to claim relief for any tax paid at source, including by virtue of EU Directives". It seems therefore that the Source State must consider the payment as directly flowing to the undertaking's shareholders, for the purpose of domestic legislation, treaties (as mentioned, income is directly included in the taxable base of the undertaking's shareholders) but also EU Directives. In this latter respect, this requires to consider the undertaking's shareholders as the direct owners of the relevant income generating assets;

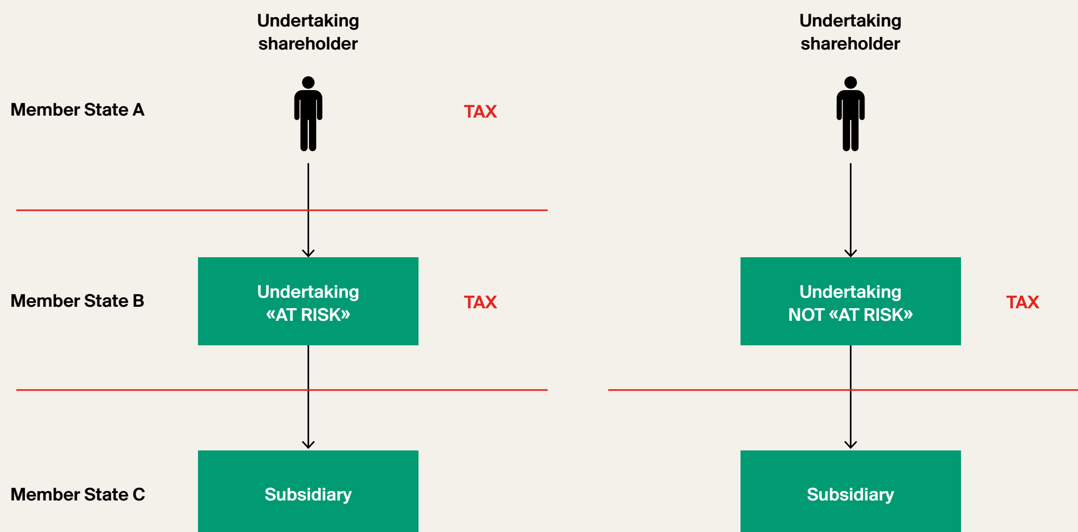


4. the Source State is a Member State and the undertaking's shareholder(s) is tax resident in the same Member State: domestic laws should apply as if the payments were not flowing through the undertaking qualifying as shell company.



Member State of residence of the undertaking shareholder(s)

The Member State of residence of the undertaking's shareholder(s) must deny the application of any provisions for the elimination of the double taxation provided by EU Directives or treaties with respect to relevant income flowing from the undertaking. The Directive does not preclude the application of national laws having similar effects.
If both the undertaking's shareholder(s) and the payer are resident for tax purposes in a Member State, the Member State of the undertaking's shareholder(s) shall tax the relevant income of the undertaking as if it had been received by the shareholder(s) directly. A credit shall be granted also for taxes due in the Member State of the undertaking. The same rule applies if the payer is resident outside the EU.
The application of these rules lead to very practical consequences that aim to be harmful for those who misuse the shell entities.

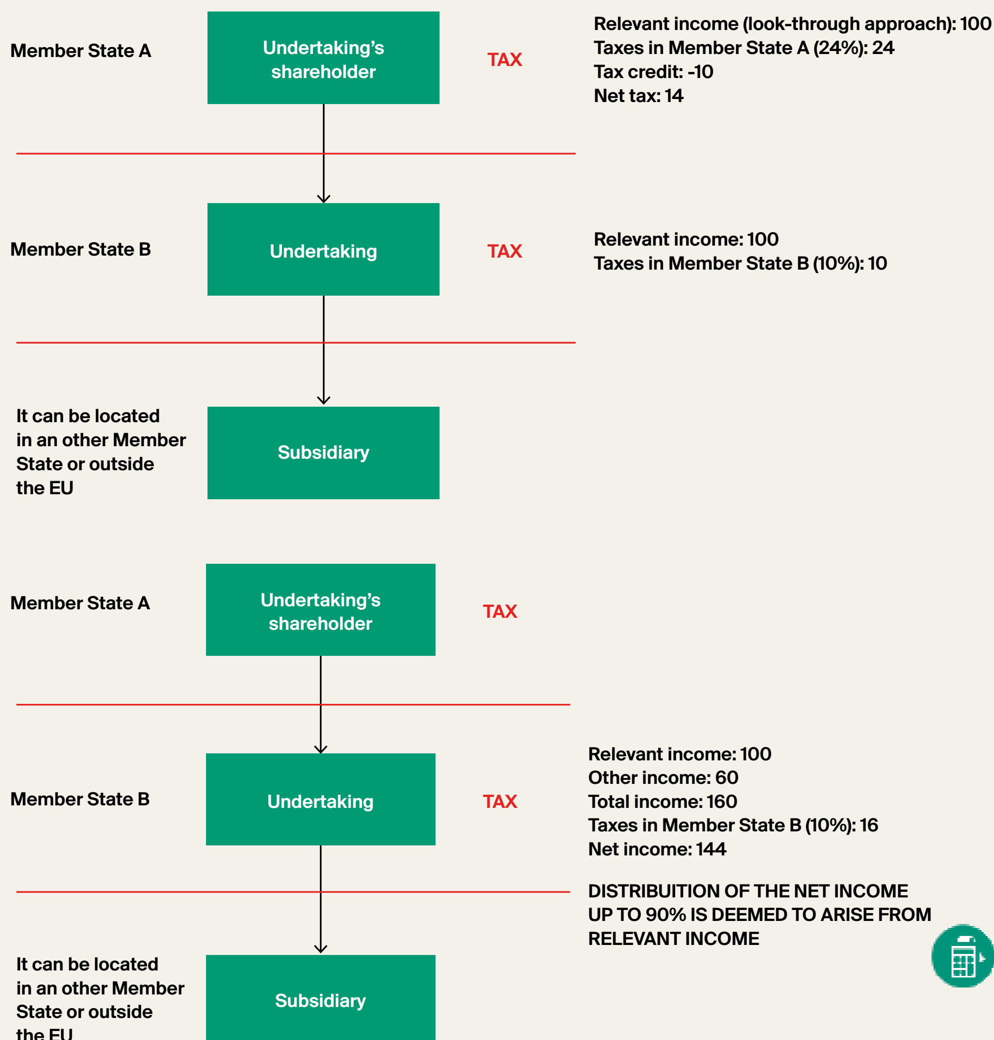


First, if the undertaking is "at risk" and qualifies as a "shell entity", income paid by the Source State is imputed:

- to the undertaking for the purpose of taxation in its own Member State, and
- to the undertakings' shareholder(s) in their own Member States. Such latter State should grant a credit for taxes paid in the source State but also in the undertaking's State (which in its turn should grant a credit for taxes due in the Source State). In some jurisdictions, however, credit is not allowed if relevant income is subject to a substitutive tax;

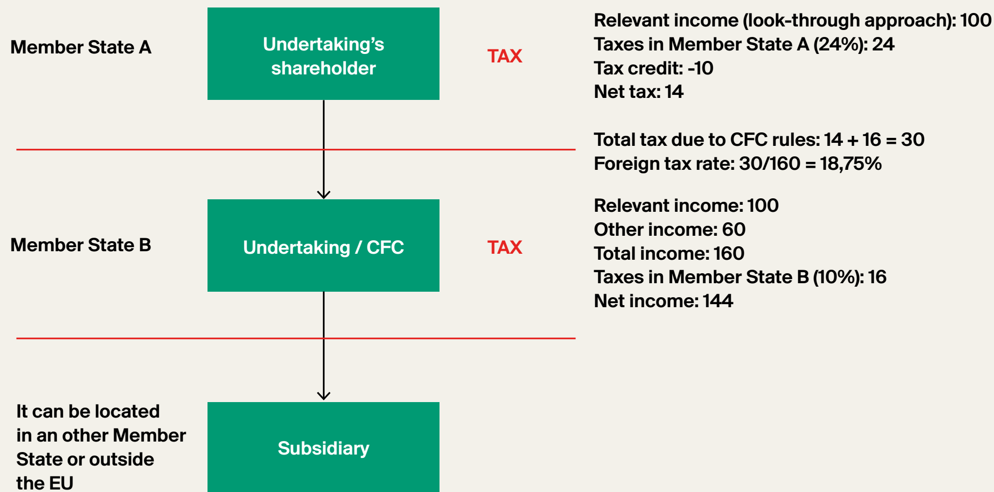
— when income from the undertaking is further distributed, reasonably there should be no further taxation provided with respect to the portion of profits arising from relevant income that has already been imputed to the shareholder(s). With respect to other income not qualifying as "relevant income" ordinary rules should apply. The issue, however, is to determine which income is distributed first and a reasonable outcome would be that relevant income is deemed to be distributed first (regardless of the residence and tax rules of the shareholders).

Compared to a situation where the undertaking is not "at risk" and does not qualify as a "shell entity", the tax ramifications may be significantly different as income from the Source State is taxed only at the undertaking's level (and potentially eligible for participation exemption).



The above tax ramifications should be coordinated with the applicable CFC legislation, at the level of the undertaking's shareholder(s) or even up to the shareholder(s) chain. Two situations can be envisaged:

— CFC only applies with respect to "relevant income": in this situation the application of the Directive may lead to the same results as the CFC legislation;
— CFC applies to all the undertaking's income; in this situation, reasonably taxes paid by the undertaking's shareholder on relevant income should be considered as taxes paid by the undertaking itself for the purpose of determining whether the undertaking qualifies as a CFC for any persons along the shareholder(s) chain. If the undertaking is a CFC for an indirect shareholder, the latter should grant a credit for taxes paid by the undertaking's shareholder(s) as well.



STEP 7: AUTOMATIC EXCHANGE OF INFORMATION

Step 7 provides that Member State of claimed tax residence of the undertaking is obliged to an automatic exchange of information with all other Member States in the following situations:

i. the undertaking is at "risk" of being a shell entity, has not rebutted the presumption or has not obtained the exemption: in such a case the exchange will be carried out within thirty days from receipt of that information shall concern the following data:
- *a.* the tax identification number (TIN) of the undertaking;
- *b.* the VAT number of the undertaking;
- *c.* the identification of the undertaking's shareholders and the beneficial owner(s) of the undertaking;
- *d.* the identification of the other Member States, if any, likely to be concerned by the reporting of the undertaking;
- *e.* the identification of any person in the other Member States likely to be affected by the reporting of the undertaking.

ii. the undertaking has rebutted the presumption in accordance with Article 9: the exchange of information will concern the certification released to the undertaking and will be carried out within thirty days from such certification;

iii. the undertaking has obtained the exemption under Article 10: the exchange will concern the certification released to the undertaking and will be carried out within thirty days from such certification;

iv. the undertaking has been audited and the conclusion is that the undertaking does not meet the substance requirement: the exchange will concern the outcome of the audit and will be carried out within thirty days from the date when the outcome of the audit becomes definitive.

STEP 7 (CONTINUED): REQUESTS FOR TAX AUDIT

Step 7 authorizes Member States, other than the Member State of the undertaking, to request the competent authority of the latter Member State to conduct a tax audit on the undertaking pursuant to Article 15 of the Directive. This request can only be submitted where there is "reason to believe that an undertaking [...] has not met its obligation under this Directive".
Based on the wording of the provision, the request cannot be made for other reasons, such as to ascertain whether the undertaking is resident in the requesting Member State, or has a permanent establishment therein or is the beneficial owner of an income stream. Similarly, it seems that no request can be made with respect to undertakings presumed not to be "at risk" as they are not subject to any obligation under the Directive.

STEP 7 (CONTINUED): PENALTIES

Step 7 also requires Member States to provide for effective, proportionate and dissuasive penalties. The amount of such penalties should not be lower than a minimum amount, determined as 5% of the undertaking's turnover.
As for the rate, it is reasonable to expect than this is minimum statutory rate and the actual rate can be less than 5% if the domestic laws of a Member State provide a reduction of statutory penalties in case of settlement or spontaneous late compliance.
As for the base, the Directive indicates the "turnover" which is no further defined. Nevertheless, few comments can be made. First, (literally) the penalties are not limited to the relevant income but potentially to all the turnover, even if realised through an actual structure in the Member State or in other State through with a permanent establishment situated therein. In this respect, the amount of the penalty may result in not being proportionate and to a certain extent may be dependent on facts not decisive for the Directive itself. For instance, if the relevant income is 100% of the turnover, the penalty is 5% of the relevant income; but if the relevant income is 50% of the turnover, the penalty is 10% of the relevant income.
Second, it should be clarified whether all relevant income qualifies as turnover. The doubt arises also because "revenues" are defined by Article 3 of the Directive as "the sum of the net turnover, other operating income, income from participating interests [...]". It seems therefore that most of relevant income although included in the "revenues" does not necessarily qualify as "turnover".

ENTRY INTO FORCE

The Directive should apply from 1 January 2024. This implies that the two-year reference period for identifying undertaking at risk includes years 2022 and 2023 thus requiring an immediate action to avoid tax costs and reputational issues.

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