EU Proposed Directive to prevent the misuse of shell entities for tax purposes ("ATAD 3"): ABBL comments

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Authors: Camille Seillès, Christian Daws

Executive summary

On 22 December 2021 the EU Commission published a proposed directive to prevent the misuse of "shell entities" for tax purposes. The rules are proposed to be applicable from 1 January 2024. The proposed directive applies to all undertakings that are tax resident in an EU Member State (MS) and are eligible for a tax residency certificate in a MS. The rules lay down indicators of minimum substance for undertakings in the EU and rules regarding the treatment for tax purposes of undertakings that do not meet the indicators.

The successive steps to be applied to determine whether an undertaking is a "shell entity" are summarized in Appendix.

The ABBL shares the concerns and supports the recommendations raised by the Luxembourg Employers' Association (UEL) and by the European Banking Federation (EBF) with respect to the proposed directive. While we acknowledge that regulated financial undertakings are excluded from the rules, we nevertheless have concerns and suggestions, which we may be summarized as follows.

1. We are concerned that the proposed rules would be overly costly and cumbersome for most entities to apply and for the tax authorities to administer and we doubt their necessity, given existing anti-avoidance and exchange of information rules. Furthermore, we fear that the proposed rules would be detrimental to the competitiveness of the EU if they are introduced without provisions applying to non-EU shell entities and without similar rules being simultaneously introduced in third countries.

2. Regulated financial undertakings are excluded from the rules, essentially due to the manner in which they are regulated and the prudential supervision, including capital requirements, to which they are subject. However, other affiliated entities of regulated financial undertakings are also included in the consolidated prudential supervision of regulated financial undertakings (including consolidated capital requirements) and would not benefit from the proposed exclusion. In our view, these affiliates should be included in the scope of the carve-out.

3. Investment fund and private asset holding structures, although structured as they are for mainly non-tax reasons, would nevertheless be hit, through these rules, with higher compliance costs and denial of tax relief, whether at entity level or at shareholders' or beneficial owners' level. The proposed carve-outs are quite limited in this respect, focusing for example on structures where beneficial owners, intermediate holding companies and operational entities

held are all located in the same jurisdiction. This in turn would have a detrimental effect on the competitiveness of the EU's financial services sector, compared to other jurisdictions whose combined offerings of financial services and legal structuring services may easily appear more attractive.

4. Several of the proposed substance-related criteria are not sufficiently clear or do not sufficiently recognize how affiliated entities are commonly organized and adapted to the economic environment in which they operate. This includes certain proposed criteria for an entity (i) to be excluded from the rules (e.g. the 5 own full-time-equivalent employees criterion) or (ii) to be required to report on substance indicators (e.g. the gateway criteria on outsourcing) or (iii) to qualify, through its reporting, as a non-shell entity by fulfilling minimum substance indicator tests (e.g. exclusive use of premises test, resident or "frontalier" director with no non-associated entity employment or directorships test, majority of employees residence test).

5. Finally, we are concerned that these rules would impede the efficient functioning of tax reclaim procedures. This furthermore potentially runs contrary to the EU's recently relaunched initiative aimed at achieving a more efficient withholding tax relief system throughout the EU. Indeed,tax authorities, particularly in small EU Member States such as Luxembourg, would certainly struggle to administer the verification and confirmation of entities' non-shell or shell status; certifications of residence, or of exclusion or exemption from the rules, would very likely be delayed and legitimate relief at source or through rapid reclaim procedures would inevitably be denied, for no reason other than delays in ascertaining entitlement.

Detailed comments

1 Necessity and proportionality

We are not totally convinced that the complex and far-reaching rules proposed are necessary, given other measures already introduced in recent years such as the general anti-avoidance and anti-abuse rules in ATAD1, in the Parent-Subsidiary Directive and the Interest and Royalty Directive and in the MLI, and the automatic exchange of information on potentially aggressive tax planning arrangements under DAC 6.

We understand that the waterfall succession of exclusion criteria, gateways, exemption test, reporting of substance indicators and submission of other documentary evidence, and potential rebuttal of presumed shell status, may be intended to narrow down the intended tax consequences to an ultimately narrow set of shell entities, but we are concerned that going through this complex process is **costly and cumbersome for all entities**, including those that are not ultimately targeted as shell entities, **as well as for the tax authorities**.

Nevertheless, some changes or clarifications which could alleviate the burden without deviating from the proposal's objective are provided later in this note.

2 Level playing field and EU competitiveness

Our members are also concerned that the EU may be unnecessarily compromising its competitive position vis-à-vis other jurisdictions if it introduces the proposed rules without simultaneously including rules concerning the treatment of non-EU shell entities, let alone without other jurisdictions introducing rules with a similar effect.

3 Carve-outs (exclusions under art.6.1)

We recommend the following:

3.1 Add a de minimis rule

One measure which would be helpful at the outset in reducing the overall burden of these rules would be a de minimis rule excluding undertakings whose annual income is below a certain amount and whose interposition would therefore appear very unlikely to create material tax benefits to their beneficial owner(s) or group.

3.2 Expand the carve-out for regulated financial entities and their affiliates

Affiliates of certain regulated financial undertakings, including affiliates of credit institutions and investment firms, are included in the consolidated prudential supervision (including capital requirements) of the regulated financial undertaking and therefore indirectly subject to such prudential requirements. Those that are subsidiaries of such a regulated financial undertaking cannot be set up or become such a subsidiary without the financial undertaking first obtaining its regulator's approval. Such entities should be covered by the exclusion of article 6.2(b).

3.3 Modify and clarify the carve-out for undertakings with holding activities

The definitions of excluded entities with holding activities in art 6.2 (c) and (d) (and of "undertaking's shareholders" in art. 3(6)) should be amended so as to more clearly include companies with a holding activity (but not necessarily the sole activity – e.g. holding and financing) in a chain that includes (but is not necessarily limited to) direct or indirect shareholders or direct or indirect subsidiaries in the same MS.

3.4 Modify and clarify the carve-out for undertakings with at least 5 own full-time equivalent employees or members of staff exclusively carrying out the activities generating relevant income

The wording of this exclusion should be such that it is satisfied when, based on an economic analysis, the number of full-time equivalent employees reflects the nature of the activity and the nature and size of the assets managed and of the risks involved (e.g. as per LIR art 164 ter). It should be clarified that employees engaged in support activities that are required for the "activities generating the relevant income" to be undertaken, are included in this headcount. And "own employees" should be clarified as not excluding that an employee may be allocated by his/her employer to perform functions in several entities of the same group or otherwise closely related entities within the same jurisdiction (e.g. with related ultimate owners).

3.5 Add an exclusion for undertakings in liquidation, bankruptcy proceedings or administration

We understand that such entities would appear to fulfill the gateway conditions of art 6.1(c) if the devolution of powers to the liquidator, bankruptcy curator or administrator is considered to be an “outsourcing” by the undertaking. We recommend a new section (f) of art. 6.2 to specifically exclude such entities from the scope. Failing that, article 6(1) should at least explicitly clarify that the decision-making on significant functions and the administration of day-to-day operations by the liquidator, bankruptcy curator or administrator or in such person’s name by persons to whom such person delegates execution of certain tasks, will not be considered to be outsourced by the undertaking, for the purposes of the proposed directive.

4 Modification and clarification of the gateway criteria on outsourcing

The third gateway whose fulfilment (cumulated with fulfilment of the relevant income and cross-border tests) leads to an entity being a reporting entity (unless exempted by the “no tax benefit” test of art. 10) is that “in the preceding two tax years, the undertaking outsourced the administration of day-to-day operations and the decision-making on significant functions” (art.6.1(c)).

Most of these terms require clarification. In our view, it should be clarified, preferably in the text, that:

1. Decision-making by an independent director (of a S.A.) or an external manager (in a S.à r.l.) should not be considered to be “outsourcing” of decision-making. The Board of Directors and the Board of Managers are an integral part of the S.A. and the S.à r.l. respectively. This remains true also where a local director is simultaneously employed by a domiciliation service company. The director or member of the Board of Managers has a personal mandate and is required to have the competence, skills and experience necessary to perform his role personally.

2. Outsourcing of certain phases of core income generating activities to a service provider should not be considered “outsourcing of decision-making on significant functions” nor “outsourcing of day-to-day administration of operations” provided control and supervision of these activities is performed by the undertaking itself, if only through its Board (provided the competence requirements of directors/managers are met). This should be the case where, for example:

    - administrative services, legal and tax compliance services and bookkeeping services are obtained from third-party service providers or from intragroup service providers, including through cost sharing or allocation of employee costs;
    - third party service providers provide financial advice or discretionary portfolio management.

3. Any look-back period for assessing the outsourcing gateway (and indeed the relevant income/assets and cross-border activity gateways) – such as the currently proposed 2-year look-back period – should not encompass any period before the date the rules become

applicable, or at the very least not before the date the rules become law. Furthermore, clarification of how to assess the criteria "in the (…) period" is required.

5 Clarification of the minimum substance indicators test

5.1 Own premises or premises for the undertaking's exclusive use (art. 7.1(a))

Own premises or premises for an undertaking's exclusive use are required by the proposed directive (art. 7.1(a)) as a condition for the undertaking to be treated as a resident for the purposes of tax treaties and relevant EU directives.

In our view, an undertaking only needs access to premises that is sufficient for it to perform its activity; depending on the nature and size of its activity and the physical and human resources required to perform it fully, access as and when required to premises that are (generally speaking) shared may well suffice for this purpose. In practice, in our view, this is all the more adequate (as it is all the more manageable) where entities are sharing premises with other entities of the same group, or where entities are part of an investment fund structure with a common management company or AIFM, or where entities holding and managing assets for private investors have rented premises from a common service provider providing facility management services.

5.2 Director tax resident of the entity's Member State (or "frontalier") who is neither an employee nor a director of a non-associated entity (art. 7.1(c)(i))

In our view, limiting a director's mandates to a single group of entities is arbitrary, unnecessary and an unreasonable criterion of an entity's sufficient substance. As long as the director's experience, competence and skills are appropriate and the time spent performing his/her duties are commensurate with the mandate, the director's contribution to the substance of the entity is appropriate. This does not generally require that a director have no employment or directorships in an unrelated group.

5.3 Majority of full-time equivalent employees must be tax resident of the entity's Member State (or "frontaliers") and qualified to carry out the activities that generate relevant income (art. 7.1(c)(ii))

This alternative to the above conditions in relation to a director seems equally unnecessary as a quantitative threshold; that the number of adequately qualified full-time equivalent colleagues is sufficient for the entity to carry out its activities in the MS should be sufficient.

6 Delays in the issuance of tax residence certificates for non-shell entities

Furthermore, we fear that the application of these rules would seriously impede the efficient release of certificates of tax residence to those entities that the rules *do* consider to be entitled to them.

- Not only would the timing aspects inherent to the proposed rules inevitably cause delays which would lead to legitimate tax relief not being recognized at source or as soon thereafter and as close thereto as possible (given, for example, that certain entities' status for a given tax year is proposed to be based on information and documentation provided with their annual tax return for the year concerned),

- but we also fear that tax authorities, especially in smaller jurisdictions, would struggle to rapidly assess companies' non-shell or shell status on a large scale and to issue certificates of residence and/or confirmations of exclusion (article 6.2) or exemption (article 10) by the time they are needed.

Financial institutions acting as paying agents would have serious difficulties to determine, at the time of a payment or attribution to entities, the non-shell or shell status of such entities and whether the financial institutions should apply the proposed look-through approach to them.

These certification delays and related difficulties would not only be detrimental to the realization of the EU Commission's goal of a more efficient withholding tax relief system in the EU but would even worsen the performance of the existing processes which the EU wishes to improve.

7 Alignment of the exemption clause, and of the rebuttal conditions, with existing EU GAAR

7.1 Article 10 exemption

Article 10 allows an entity that has passed the 3 gateways (i.e. fulfilled the 3 gateway criteria) to request exemption from the substance reporting obligations if it can provide evidence that its interposition does not reduce the tax liability of its beneficial owner(s) or its group as a whole "as the case may be".

In order to limit compliance costs and for the sake of consistency, we would recommend that the wording of this article be aligned with the "main benefit test" in DAC 6. This would ensure the same test is to be applied for both sets of rules. If this is not possible, the wording should at least refer to "not *significantly* reduce the tax liability…".

Furthermore, "of its beneficial owner(s) or of the group as a whole" is not clear; and no timing, process or availability of a right to appeal is specified.

7.2 Article 9 rebuttal of shell entity presumption

Similarly, an undertaking that has not requested or obtained the above exemption and has reported that it does not meet one of the 3 substance indicators (or has provided insufficient evidence that it does meet all of them), may rebut the presumption that it is a shell entity, essentially by providing additional evidence of its "commercial rationale" and of its continuous control over its income and assets. The wording should be aligned with existing EU GAAR such as that in article 6 of ATAD 1 which refers to "valid commercial reasons which reflect economic reality".

8 Other: Sanctions, Tax Audits and Exchange of Information

Having required that MS provide for penalties that are effective, proportionate and dissuasive, which is totally understandable, we would question why the proposed directive also requires an "administrative pecuniary sanction of at least 5% of the undertaking's turnover" if an entity required to report fails to do so or makes a false declaration (art. 14). This additional requirement appears unnecessary and disproportionate.

The obligation for the MS of residence of an entity to initiate a tax audit, and to do so within a month, if another MS so requests on the basis that the requestor claims to have "reason to believe that the undertaking… has not met its obligations under this directive" (art. 15) appears excessive, disproportionate and unnecessary. Existing EU law already provides for a significant amount of exchange of information and other forms of cooperation between MS in tax matters.

The amount of information which the national tax authorities would be required to exchange automatically with other MS as a result of the proposed directive appears to be disproportionate (art.13) and therefore disproportionately costly for national authorities such as Luxembourg's.

About the ABBL

The ABBL is the largest professional association in the financial sector, representing the majority of financial institutions as well as regulated financial intermediaries and other professionals in Luxembourg, including law firms, consultancies, auditors, market infrastructures, e-money and payment institutions. This makes us truly representative of the diversity of the Luxembourg financial centre, placing us in a unique position, able to give the entire sector a voice at both national and international level.

We provide our members with the intelligence, resources and services they need to operate in a dynamic financial market and in an increasingly complex regulatory environment. We facilitate an open platform to discuss key industry issues and to define common positions for the entire sector.

APPENDIX

Summary of the successive steps in the proposed shell entity rules

Summary of the proposed rules

Each EU tax resident entity must first determine whether it is a "**reporting entity**"; if so, it is required to report its position with respect to three specified indicators of minimum substance; if it does not meet one of the indicators, it is presumed to be a "**shell entity**", which implies that

- it cannot obtain a certificate of tax residence in its MS that would entitle it to the benefits of double taxation agreements, similar international agreements and EU taxation directives, and
- MS of the entity's shareholder(s) must treat the entity's relevant income and financial assets as if directly accruing to or owned by the shareholder(s) and also deny treaty benefits except if the payer is outside the EU.

Steps to determine whether an entity is a reporting entity and potentially a shell entity

To determine whether it is a "**reporting entity**", each entity must check whether it is an "excluded entity" (art. 6.2); if not, whether it passes through (all of) three "gateways" (art.6.1); and, if so, whether it can justify an exemption (art.10) based on a "no tax benefit" test.

Excluded entities (art. 6.2) essentially include **regulated financial undertakings**[1], listed companies, holding companies with no or limited cross-border features (same MS as shareholder(s) or ultimate parent; or as businesses held and beneficial owners), and undertakings with at least 5 own full-time equivalent employees or members of staff exclusively carrying out the activities generating the relevant income.

The **3 gateways (art. 6.1) leading to having reporting obligations** if all 3 are fulfilled are:

1. A **relevant income (or assets) test**:

    a. More than 75% of revenues of the previous 2 years is "relevant income" (essentially, passive income) or
    b. More than 75% of assets are valuable movable private property (other than cash, shares or securities) with a book value of EUR 1 million or real estate or shares;

2. A **cross-border activity test**:

    a. At least 60% of the undertaking's relevant income is earned or paid out via cross-border transactions or

[1] The proposed directive provides an exhaustive list, including (but not limited to) credit institutions, investment firms, AIFMs and UCITS ManCos, AIFs and UCITS, insurance undertakings and reinsurance undertakings, IORPS and pension institutions, CCPs, CSDs, PIs, EMIs, CFSPs and CASPs

   b. More than 60% of assets that are movable private property (other than cash, shares or securities) with a book value of EUR 1 million or real estate or shares were located outside the entity's MS in the previous 2 years;

3. **An outsourcing test**: in the previous 2 years, the entity outsourced the administration of day-to-day operations and the decision-making on significant functions.

If an entity (that has passed the gateways) provides sufficient evidence that the existence of the undertaking does not reduce the tax liability of its beneficial owner(s) or of its group as a whole, the entity may **request an exemption** (art.10) from its (reporting) obligations.

Otherwise, such an entity is a reporting entity, meaning it must provide specified documentary evidence concerning its activities and **declare** in its annual income tax return whether it meets all of the following **indicators of minimum (i.e. sufficient) substance** (art.7.1):

1. It has own premises or **premises for its own exclusive use**, in its MS;
2. It has at least one **active bank account** in the EU;
3.
   a. One or more of its **directors**
      i. are tax resident of the entity's MS or at no greater distance than is compatible with their duties and
      ii. are qualified and authorized to take decisions in relation to assets or activities that generate relevant income, and actively, independently and regularly use such authority and
      iii. are not employees or directors of enterprises that are not associated enterprises;

   b. **or** the majority of the undertaking's **full-time equivalent employees**
      i. are tax resident of the entity's MS or at no greater distance than is compatible with their duties and
      ii. are qualified to carry out the activities that generate relevant income.

If the entity does not meet one or more of these 3 substance indicators, or provides insufficient requisite evidence, it is **presumed to be a "shell entity"**.

It may rebut this presumption by providing sufficient additional supporting evidence of its business activities (art.9).

Consequences of the shell rules

The **tax consequences** for a shell entity are summarized in the Summary above.

Penalties: in addition to requiring that MS introduce proportionate, effective and dissuasive penalties, the proposed directive sets an administrative fine of at least 5% of the entity's annual turnover, if an entity required to report fails to do so on time or makes a false declaration.

Tax audit requests: the proposed directive would oblige MS to initiate a tax audit within a month if another MS requests an audit based on the requestor's claim to have reason to believe that an entity has not complied with its obligations under these rules.

Exchange of information: the MS of residence of the shell entity must exchange with all other MS within 30 days the information declared by the shell entity, a summary of the documentary evidence it provided, certifications of rebuttal and of exemption and tax audit reports.