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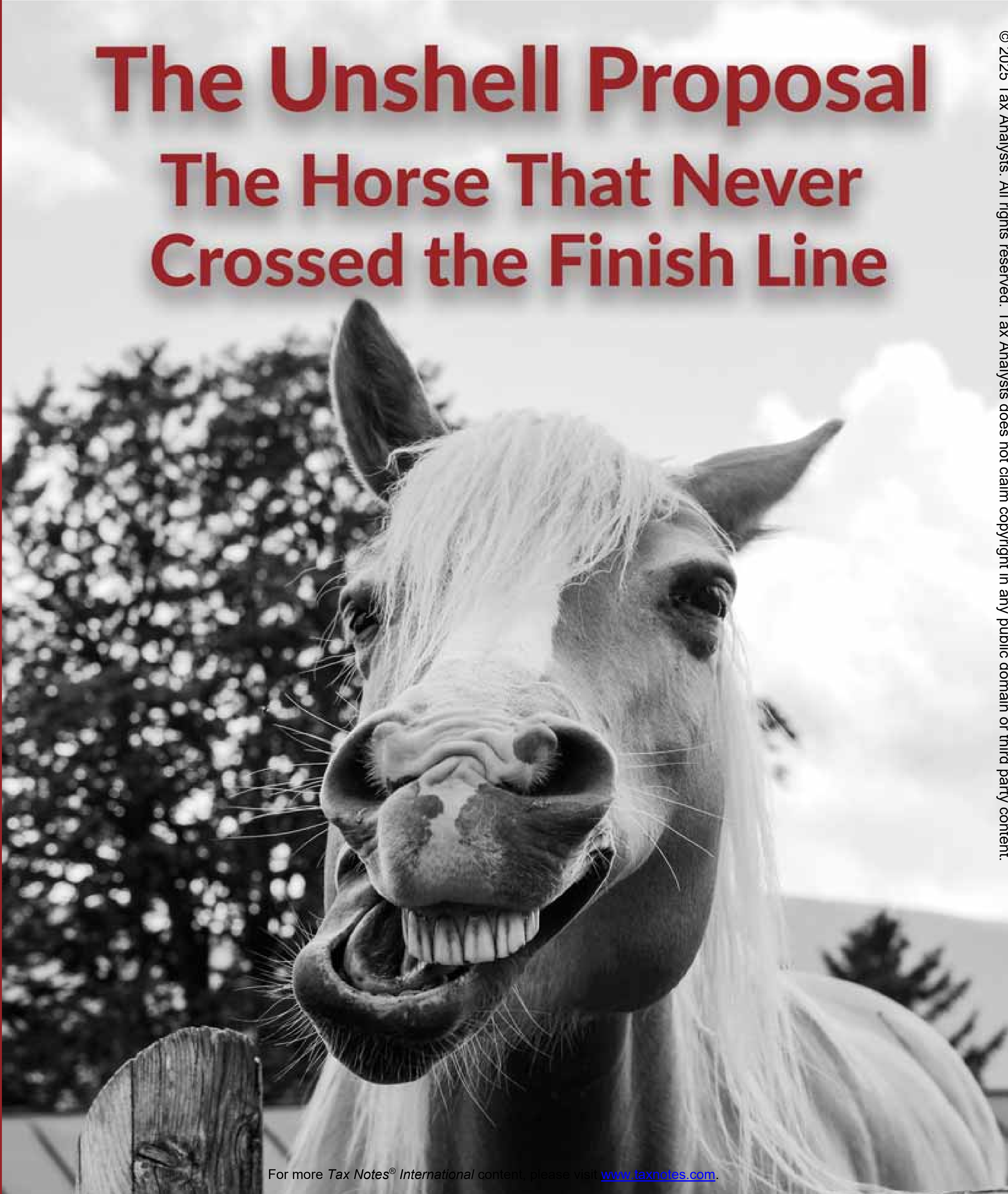
The Horse That Never Crossed the Finish Line



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In this article, Hoor explains why the abandonment of the European Commission's proposal targeting the misuse of shell entities is a welcome development.

The views expressed in this article are solely those of the author and do not necessarily reflect the official position of ATOZ Tax Advisers.

On December 22, 2021, the European Commission released a proposal for a council directive prescribing rules to prevent the misuse of shell entities for tax purposes (the draft directive or the Unshell proposal). The draft directive caused much legal uncertainty because of its imprecise concepts and substance requirements. After several years of discussions between the commission and EU member state delegations, the draft directive was finally abandoned on June 20.

Introduction

The concept of substance has always been important in international taxation, particularly in cross-border investment and business activities. However, awareness of it has increased significantly throughout the OECD's base erosion and profit-shifting project, which focused on substance and transparency as two central themes.

The BEPS project has significantly affected international tax. In the EU, two anti-tax-avoidance directives (ATAD and ATAD 2) have been adopted, requiring EU member states to implement various antiabuse provisions, like interest limitation rules, hybrid mismatch rules, and controlled foreign corporation rules.

The multilateral instrument has also been used to modify bilateral tax treaties and implement antiabuse provisions, including the principal purpose test. To increase transparency, a series of administrative cooperation directives, or the DAC series, have also been introduced. DAC6 requires reporting potentially aggressive transactions in corporate tax matters.

Hence, EU member states already have a comprehensive arsenal of antiabuse rules and reporting requirements that should enable the tax authorities to detect any remaining instances of abuse. Given that, it was questionable from the outset whether the Unshell proposal served a real need.

The initiative was prompted by the commission's view that legal entities with little or no economic activity or substance posed a continued risk of being exploited for aggressive tax planning purposes. I previously analyzed the initiative and the draft directive in two articles published in *Tax Notes*.[1] This article provides a brief overview of the draft directive and the antiabuse legislation that EU member states can

[1] *See* Oliver R. Hoor and Keith O'Donnell, "The New EU Initiative on Fighting Shell Entities: Tackling a Nonissue?" *Tax Notes Int'l*, July 26, 2021, p. 459; Hoor, O'Donnell, and Samantha Schmitz, "Using a Sledgehammer to Crack a Nut: The European Commission's Draft Directive to Tackle Shell Entities," *Tax Notes Int'l*, Apr. 11, 2022, p. 225.

apply to tackle shell entities (i.e., letterbox companies).

Scope of the Unshell Proposal

The draft directive was intended to apply to all entities that were considered tax residents and eligible for a tax residence certificate in a member state, regardless of their legal form. Under the proposed reporting regime, determining what would qualify as shell entities would have involved a series of tests and, in some cases, comprehensive analysis.

Entities at Risk

When deciding whether an entity is a shell entity under the proposed reporting regime, the first step would be to establish whether the entity is exempt from reporting requirements (in other words, there have been several carveouts).

Second, an entity would have reporting obligations only if it meets all three of the following criteria:

(1) relevant income (75 percent threshold);

(2) cross-border activities (60 percent threshold); and

(3) management of day-to-day operations and decision-making on significant functions.

Reporting Obligations

After meeting those criteria, the entity would have to report specific minimum substance details in its corporate tax returns. Those include owning premises in its residence state, having premises for its exclusive use, owning an active bank account in the EU, and meeting requirements regarding company directors. The EU Court of Justice has held in various decisions that these criteria were inconsistent with EU law.

Once all these criteria were met, the entity would not be considered a shell entity. Otherwise, there was a rebuttable presumption that it was a shell entity. In that case, the entity could provide evidence on a case-by-case basis to demonstrate that it was not a wholly artificial arrangement.

Entities could request an exemption from reporting obligations if they could demonstrate that they do not reduce the tax liability of their beneficial owners or the group as a whole.

Member states would have been obligated to promptly exchange comprehensive information on entities subject to reporting, as well as on entities that rebut the presumption of a lack of substance or are exempt from obligations under the draft directive.

Tax Consequences for Shell Entities

Overview

Classifying an entity as a shell entity would have far-reaching tax consequences both in its residence state and other EU member states.

Notably, all the tax consequences outlined in the draft directive already existed under the laws of EU member states.

Tax Consequences in the Residence State

If an entity were classified as a shell entity under the draft directive, the tax authorities of the member state in which the entity is tax resident would either not issue a tax residence certificate or issue one with a warning statement.

Tax Consequences in Other EU Member States

The draft directive also proposed tax consequences that should have been applied in other member states.

Anti-Directive/Anti-Treaty Shopping Rules

Member states in which the shell entity invests or conducts business activities (other than the member state where the entity is resident) would disregard (the domestic implementation of) the parent-subsidiary directive (Directive 2011/96/EU) and the interest and royalty directive (Directive 2003/49/EC) as well as any tax treaty concluded with the entity's residence state.

Accordingly, the shell entity would not be able to claim reduced or zero withholding tax rates on dividends, interest, or royalty payments based on those EU directives' domestic implementation or an applicable tax treaty with the payer's residence state, nor could it claim other tax benefits provided under those tax treaties.[2]

[2]For example, a capital gains exemption realized upon disposal of a participation in a company that is resident in the other member state.

Disregarding Shell Entities

Classifying the entity as a shell entity would also affect its shareholders in their member states. They would report the entity's income according to the shareholder's domestic tax rules, as if the income had accrued directly to the shareholder.

This provision is broadly similar in effect to the CFC rule implemented by member states in accordance with the ATAD.

Income Derived From Immovable Property

When a shell entity owns real estate in a member state, that member state would tax the property as if it were owned directly by the entity's shareholders in accordance with its domestic tax law.

While a tax treaty between the residence state of the shareholders and the member state in which the immovable property is situated may apply, tax treaties frequently allocate an unlimited primary taxing right to the situs state of the property.

Developments With the Unshell Proposal

The draft directive created much legal uncertainty, prompting some investors and businesses to consider reorganizing their investments. That uncertainty persisted throughout 2022 and 2025 because the commission and EU member state delegations could not reach an agreement.

Amid the deadlock, the Spanish presidency, which supported the initiative, made two proposals in the second half of 2023 to address the concerns of some of the delegations.

First, because many delegations seemed particularly opposed to the tax results of shell entity classification under the proposed regime, the Spanish presidency suggested implementing the reporting regime first and addressing the tax consequences later. However, delegates appeared to see through this negotiation strategy and rejected the proposal.

Second, it was proposed that minimum substance requirements be introduced that were broadly in line with the minimum substance criteria included in the draft directive. Under this proposal, EU member states would be free to request additional substance requirements. However, given that the base substance requirements were already inconsistent with EU law as interpreted by the Court, allowing more substance requirements would technically have incited EU member states to disregard EU law.

After neither of these proposals met with agreement between all parties by the end of 2023, the initiative lost considerable momentum, despite pressure from the commission to achieve a resolution.

On June 20 the EU Economic and Financial Affairs Council announced that many delegations believed that the objectives of the Unshell proposal could be achieved through clarifications or amendments to DAC6, and the proposal was abandoned.

Existing Antiabuse Legislation and Reporting Obligations

Substance requirements may be based on several antiabuse provisions in the domestic tax laws and bilateral tax treaties of EU member states. Substance may also be relevant when determining potential reporting obligations under the mandatory disclosure regime (DAC6).

Under Domestic Law

Many countries in Europe (and worldwide) have adopted different types of antiabuse rules in their domestic tax law. The legislation ranges from general rules to provisions that target specific situations of abuse. They all generally base the recognition of foreign companies or the granting of tax benefits on the fulfillment of substance requirements.

Anti-Treaty-Shopping Rule

Anti-treaty-shopping rules allow tax authorities to challenge benefits such as reduced or zero withholding tax rates on dividends, interest and royalty payments in accordance with EU directives (also known as the EU parent/subsidiary directive[3] and the EU interest and royalty directive[4]), or tax treaties if the income

[3]Council Directive 2011/96/EU of November 30, 2011, on the common system of taxation applicable in the case of parent companies and subsidiaries of different member states.

[4]Council Directive 2003/49/EC of June 3, 2003, on a common system of taxation applicable to interest and royalty payments made between associated companies of different member states.

recipient does not fulfill specific substance requirements.[5]

In many cases, this legislation also uses the concept of beneficial ownership, under which reduced or zero withholding tax rates apply only if the recipient of the income is its beneficial owner.

CFC Rules

Another antiabuse provision that may be a source of substance requirements are CFC rules aimed at limiting the use of subsidiaries established in a low-tax territory (so-called base companies) to reduce or defer taxation in the residence state of the parent company by shifting income to a base company.[6]

CFC rules have been implemented by EU member states in accordance with the ATAD (if they didn't exist before) to attribute, under certain conditions, income realized by low-taxed foreign subsidiaries to their parent company, irrespective of whether the base company distributes these profits.

General Antiabuse Rule

The involvement of foreign companies may further be challenged under GAAR if the tax authorities can evidence that an investment is merely tax driven or the choice of legal instruments represents an abuse of law.[7]

The ATAD required EU member states to implement (or modify) a GAAR by January 1, 2019. Under this provision, "nongenuine" arrangements or a series of nongenuine arrangements put into place for the main purpose of obtaining a tax advantage in violation of the applicable tax law are disregarded. Arrangements are considered nongenuine if they are not established for valid commercial reasons that reflect economic reality.

Tax Treaty Law

General

Tax treaties may include a number of antiabuse provisions. However, substance requirements may in particular be based on the principal purpose test and the concept of beneficial ownership.

Principal Purpose Test

Under the principal purpose test (PPT), tax treaty benefits[8] are denied when it is reasonable to conclude that obtaining that benefit was "one of the principal purposes" of any arrangement or transaction, unless the taxpayer can establish that granting the benefit would be "in accordance with the object and purpose" of the relevant treaty provisions.[9]

The test was developed as part of the OECD's work on BEPS action 6, which targeted perceived abuse of tax treaties. The test is included in paragraph 9 of article 29 of the 2017 OECD model treaty and was part of the minimum standard of the multilateral instrument under BEPS action 15.

According to OECD guidance, the PPT requires an in-depth analysis of all facts and circumstances of each case to determine whether obtaining the benefit was a principal consideration and would have justified entering into the arrangement or a transaction that resulted in the benefit. Thus, tax authorities should not easily conclude that a principal purpose was to obtain benefits under a tax treaty. Substance is also an element to consider when analyzing whether the PPT is met.

Beneficial Ownership

The notion of beneficial owner plays a prominent role in tax treaties. In essence, the beneficial owner concept is an antiabuse rule designed to prevent treaty shopping by agents, nominees, or conduit companies for the benefit of

[5] *See* Hoor, "The Concept of Substance in a Post-BEPS World," *Tax Notes Int'l*, Aug. 12, 2019, p. 593.

[6] *See* Hoor, "Luxembourg's New CFC Rules," *Tax Notes Int'l*, Apr. 29, 2019, p. 419.

[7] *See* Hoor, *Transformation of the Luxembourg Tax Environment Towards the Post-BEPS Era*, p. 185 (2021).

[8] The term "benefits" includes all limitations (for example, a tax reduction, exemption, deferral, or refund) on taxation imposed on the state of source under articles 6-22 of the convention, and the relief from double taxation provided by article 23 and the protection afforded to residents and nationals of a contracting state under article 24 or any other similar limitation; see paragraph 175 of the OECD model commentary on article 29.

[9] *See* Hoor, *supra* note 7 at page 245 and 273.

a resident of a third state for income received from dividends, interest, and royalties.[10]

More precisely, if dividends, interest, or royalties derived from a contracting state are paid to a resident of the other contracting state, the taxing right of the source state is generally restricted to a certain percentage of the gross amount[11] or even excluded (for example, in the case of royalties[12]).

However, tax treaties typically require that the person claiming the treaty benefits (meaning reduced or zero withholding tax rates in the source state) be the beneficial owner of the dividends, interest, or royalties. Thus, the source state is not required to grant the benefits of articles 10 (2), 11 (2), and 12 (1) of the OECD model tax convention solely because the income is received by a resident of the other contracting state. Instead, the recipient must be the beneficial owner of that income.[13]

Mandatory Disclosure Regime (DAC6)

Under the mandatory disclosure regime, intermediaries such as tax advisers, accountants, and lawyers that design, promote, or assist in certain cross-border arrangements must report them to the tax authorities. Since the implementation of the regime, the analysis of potential reporting obligations has become critical.

The mandatory disclosure regime operates through a system of criteria that may trigger reporting obligations and the main benefit test that functions as a threshold requirement. Therefore, the main benefit test should filter out irrelevant reporting and enhance the usefulness of the information collected because the focus will be on arrangements that are more likely to present a risk of tax avoidance.

When at least one of these criteria is met, it must be determined whether it is subject to the main benefit test. If not, there is an automatic reporting obligation under the mandatory disclosure regime. If it is subject to the main benefit test, it is necessary to examine all relevant facts and circumstances to determine whether the main benefit (or one of the main benefits) was obtaining a tax advantage.

It is also necessary to analyze the substance of the entities involved. When an entity would be classified as a wholly artificial arrangement (like a letterbox company), the main benefit test would likely be met, and reporting must be made to the local tax authorities that share this information in a central database that is accessible to the tax authorities of all EU member states.

Conclusion

The draft directive was intended to restrict abuse by entities that lack substance. However, a lack of substance may already be challenged by tax authorities using an all-encompassing web of antiabuse provisions that have been implemented throughout the EU and beyond. There is no residual category of entities that could only have been addressed through the proposed reporting regime.

Substance requirements under antiabuse legislation must comport with EU law as interpreted by the Court. Thus, taxpayers may rely on their EU freedoms when organizing their investment and business activities as long as the underlying contractual arrangements are not wholly artificial arrangements (or letterbox companies).

If an entity does not have an appropriate level of substance for its activities, any tax benefits obtained may be challenged under existing antiabuse legislation. When that is a concern, tax authorities have the power to investigate the substance of foreign entities in detail.

Ultimately, the failure of the Unshell proposal is a positive outcome. It avoids added legal uncertainty and a new reporting regime that would incur high implementation and maintenance costs without offering much practical benefit — much like the mandatory reporting regime (DAC6). ■

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[10] *See* Hoor, *supra* note 7 at page 246; *see* Hoor, *The OECD Model Tax Convention — A Comprehensive Technical Analysis*, p. 73 (2015).

[11] OECD model convention, articles 10 (2) and 11 (2).

[12] OECD model convention, article 12 (1) (allocating an exclusive taxing right to the residence state of the recipient).

[13] *See* Hoor, *supra* note 10; also see Philip Baker, *Double Taxation Conventions and International Tax Law — A Manual on the OECD Model Tax Convention on Income and on Capital of 1992*, p. 91 (1994).