



EU STRIKE AGAINST “SHELL ENTITIES”

I. Background

With the aim of combating tax avoidance and evasion, which have a direct impact on the functioning of the internal market, the European Commission adopted on 22 December 2021 a Proposal for a Directive laying down rules to prevent the abusive use of “shell entities” for tax purposes. This responds to a request from the European Parliament for measures to combat the abusive use of “shell entities” for tax purposes, and more generally to a demand of several Member States for a stronger and more coherent approach by the Union against tax avoidance and evasion.

II. The Proposal in brief

Entities that have insufficient substance and could be abused for tax purposes will in the future be required to report on their actual substance in their annual tax return. If no adequate substance can be proven to the tax authority of the country of domicile, the entity will be qualified as a “shell entity” and it will be presumed that it is being abused for tax purposes. If this presumption cannot be rebutted, the entity will be deprived of all tax benefits it has obtained or could obtain under the agreements, conventions or relevant EU Directives in force in its Member State.

1) Who is affected?

The Proposal refers to “undertakings” which are understood as any legal entity (regardless of its legal form) that carries out an economic activity and has its tax residence in a Member State of the European Union. Entities that cumulatively fulfill the following criteria (so-called “gateway criteria”) are subject to the reporting obligation:

1. More than 75 percent of the income derives from so-called “relevant income” (in particular, income from interest, crypto-assets, royalties, rentals and leases, insurance income, dividends and capital gains).
2. The entity carries on a cross-border activity, whereby either more than 60 percent of the book value of the assets is located outside the Member State or at least 60 percent of the relevant income is generated or paid through cross-border transactions.
3. The management of the day-to-day business and decision-making on significant issues are outsourced to third parties.

2) What is the content of the required reporting?

If the aforementioned “gateway criteria” are met, the entity is considered “being at risk to be misused for tax purposes” and must report annually on the existing substance at its tax domicile as part of its tax return. In doing so, the entity must cumulatively demonstrate the following three substance criteria:

1. That it has its own offices or has premises for exclusive use in the Member State.
2. That it has at least one own and active bank account in the European Union.



3. That it has at least one qualified director or the majority of the qualified full-time employees of the entity are resident for tax purposes in the Member State of the entity or are no further away from that Member State than is compatible with the proper performance of their duties.

3) Presumption of being a “shell entity” and rebuttal

Should an entity meet all the “Gateway Criteria” and should it also become apparent from its subsequent reporting that at least one substance criterion is missing, the presumption is raised that the entity in question is a “shell entity” that is being misused for tax purposes.

At this stage, the entity that is classified as a “shell entity” has the possibility to provide counterevidence and basically proof that its purpose is economic and that it was not built and maintained purely for tax reasons. This possibility serves the justice of the individual case, since the substance test is based on indicators and does not do justice to the circumstances in every case.

III. Consequences of a classification as a “shell entity”?

If an entity is classified as a “shell entity” - and the evidence to the contrary cannot be provided - the country of domicile is required either not to issue a residence certificate or to attach a warning to the certificate. This has the consequence of preventing the claiming of relief/exemptions under the respective DTA or other EU agreements. In particular, relief from withholding tax on dividend, interest or royalty payments to the “shell entity” could be eliminated. And in addition to that, the income of the “shell entity” will be taxed at the level of the EU resident owners of the entity as if the income had accrued directly to them (look-through approach).

IV. Implementation period?

Once adopted as a Directive, the Proposal should be transposed into the national law of the Member States by June 30, 2023, and enter into force on January 1, 2024. Nonetheless, it is important to note that the “gateway criteria” in 2024 will have to be determined from data from the two previous years. The bottom line is that this results in a de facto retroactive effect, as the years 2022 and 2023 will already be relevant.

V. Impact on entities outside the European Union?

Entities domiciled outside the European Union are not directly affected by the proposal. However, it can be assumed that the European Union will work towards including “shell entities” in third countries, which will also affect entities in Switzerland.

VI. What needs to be done now?

Even though the Directive is not yet in force, due to the expected de facto retroactive effect back to the year 2022, it is advisable for entities to enter into the analysis timely and to ask themselves the following questions in particular:

1. Are we considered to be “at risk” in the sense of the Proposal, respectively do we meet the “gateway criteria”?
2. Do we have sufficient substance at our tax domicile?
3. Are we able to provide evidence to the contrary, respectively are we pursuing economic motives and not purely tax motives?



If your answer to the last two questions must be “no”, the first step is to consider whether you would be willing - or even would be able - to endow the entity with additional substance or, alternatively, could transfer its function to other entities with sufficient substance.

Should you have further questions on the topic or do you wish a personal consultation? Do not hesitate to contact us!



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