Taxation: rules to prevent the misuse of shell entities for tax purposes

2021/0434(CNS) - 22/12/2021 - Legislative proposal

PURPOSE: to reduce tax revenue loss related to tax avoidance and tax evasion due to the use of shell entities in the EU.

PROPOSED ACT: Council Directive.

ROLE OF THE EUROPEAN PARLIAMENT: the Council adopts the act after consulting the European Parliament but without being obliged to follow its opinion.

BACKGROUND: on 18 May 2021, the European Commission adopted a Communication on Business Taxation for the 21st century to promote a robust, efficient and fair business tax system in the European Union. It sets out both a long-term and short-term vision to support Europe's recovery from the COVID-19 pandemic and to ensure adequate public revenues over the coming years. It aims to create an equitable and stable business environment, which can boost sustainable and job-rich growth in the Union.

The Commission proposal responds to a request from the European Parliament for EU action to counter the misuse of shell entities for tax purposes and, more generally, to the demand of several Member States, businesses and civil society for a stronger and more coherent EU approach against tax avoidance and evasion.

This proposal is one of the short-term, targeted initiatives which were announced in the Communication as a means to improve the current tax system with a focus on ensuring fair and effective taxation. It complements a number of other policy initiatives promoted by the Commission in parallel, in the short- and long-term. These include a proposal for a Directive on ensuring a global minimum level of taxation for multinational groups in the Union.

As a reminder, shell entities are legal entities and arrangements with no – or only minimal – business presence and economic activity. Shell companies are often used for aggressive tax planning or tax evasion purposes. Businesses can direct financial flows through shell entities towards jurisdictions that have no or very low taxes, or where taxes can easily be circumvented. Similarly, some individuals can use shells to shield assets – particularly real estate – from taxes, either in their country of residence or in the country where the property is located.

The number of shell entities within the EU is unknown. This is in particular because within the EU, there is no common definition of what shell entities are and consequently nor statistics about them.

CONTENT: this Commission proposal aims to **counter the misuse of shell entities for tax purposes only** , and in so doing contribute to fair and effective taxation. It lays down indicators of minimum substance for undertakings in Member States and rules regarding the treatment for tax purposes of those undertakings that do not meet the indicators. It will apply to all undertakings that are considered tax resident and are eligible to receive a tax residency certificate in a Member State.

Transparency

The proposal aims to introduce, within the EU, common rules to be able to identify shell entities at high risk of tax abuse. Such rules would define objective **substance requirements** and would ensure that shell

entities used for tax abuse can be identified promptly. However, substance requirements alone are not enough to prevent tax abuse. To be effective, the initiative will set clear, pre-determined, common tax consequences throughout the EU to prevent tax losses and also to prevent tax and regulatory arbitrage in the EU.

Substance test

The proposal lays down a test that will help Member States to identify undertakings that are engaged in an economic activity, but which do not have minimal substance and are misused for the purpose of obtaining tax advantages. This test can be commonly referred to as a 'substance test'. Using a number of objective indicators related to income, staff and premises, the proposal will help national tax authorities detect entities that exist merely on paper.

Gateways

The proposal introduces a **filtering system** for the entities in scope, which have to comply with a number of indicators. These levels of indicators constitute a type of 'gateway'. The Commission sets out three gateways. If a company crosses all three gateways, it will be required to annually report more information to the tax authorities through its tax return.

1. The first level of indicators looks at the activities of the entities based on the **income they receive**. The gateway is met if **more than 75% of an entity's overall revenue** in the previous two tax years does not derive from the entity's business activity or if more than 75% of its assets are real estate property or other private property of particularly high value.

2. The second gateway requires a **cross-border element**. If the company receives the majority of its relevant income through transactions linked to another jurisdiction or passes this relevant income on to other companies situated abroad, the company crosses to the next gateway.

3. The third gateway focuses on whether corporate management and administration services are performed **in-house or are outsourced**.

Exchange of information

In addition, Member States need to know about the existence of shell entities being identified as such in another Member State. This would allow other Member States to take effective and prompt actions to address cross-border tax abuse by, for example, denying tax treaty benefits on withholding taxes paid to the shell entity by a company in their own jurisdiction. Timely availability of information on the existence of identified shell entities, both at national level and in other Member States, will provide Member States with an effective mechanism to prevent shell entity tax abuse in the EU. Member States will exchange the information within 30 days from the time the administration has such information.

Penalties

The proposal leaves it to Member States to lay down penalties applicable against the violation of the reporting obligations provided by the draft directive as transposed into the national legal order. The penalties shall be effective, proportionate and dissuasive. A minimum level of coordination should be achieved amongst Member States through the set of a minimum monetary penalty as per existing provisions in the financial sector. Penalties should include an administrative pecuniary sanction of at least 5% of the undertaking's turnover.

Deter trust or company service providers from creating shell entities in the EU

Lastly, the proposal aims to discourage the use of trust or company service providers from creating shell entities in the EU in the first place. The substance requirements include criteria which aim to combat the very services that trust or company service providers offer such as setting up postal addresses.