BRIEFING
EU Legislation in Progress

European Parliament

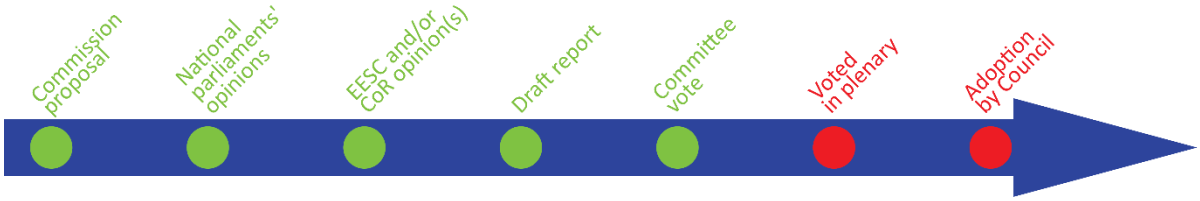
'Unshell' – Rules to prevent the misuse of shell entities for tax purposes

OVERVIEW

While shell companies – company entities that have no or minimal economic activity – can serve useful commercial and business functions, they are sometimes abused by companies or individuals for aggressive tax planning or tax evasion. To ensure sustainable public finances under the exceptional circumstances imposed by the COVID-19 pandemic, in December 2021 the European Commission presented a directive on preventing shell companies from misusing their structure for tax purposes ('Unshell').

The proposal introduces a 'filtering' system for EU company entities, which will have to pass a series of gateways, relating to income, staff and premises, to ensure there is sufficient 'substance' to the entity. Those entities that are deemed to be lacking in substance are presumed to be 'shell companies' and, if they are unable to rebut this presumption through additional evidence regarding the commercial, non-tax rationale of the entity, they will lose any tax advantages granted through bilateral tax treaties or EU directives, thereby discouraging their use. The directive requires unanimity in the Council for its adoption, following consultation of the European Parliament. While negotiations in the Council are ongoing, the Parliament will vote on its report in January 2023.

Proposal for laying down rules to prevent the misuse of shell entities for tax purposes and amending Directive 2011/16/EU		
Committee responsible:	Economic and Monetary Affairs (ECON)	COM(2021) 565 22.12.2021
Rapporteur:	Lidia Pereira (EPP, Portugal)	2021/0434(CNS)
Shadow rapporteurs:	Paul Tang (S&D, the Netherlands) Gilles Boyer (Renew, France) Ernest Urtasun (Greens/EFA, Spain) Gunnar Beck (ID, Germany) Michiel Hoogeveen (ECR, the Netherlands) Mick Wallace (The Left, Ireland)	Consultation procedure (CNS) – Parliament adopts a non-binding opinion
Next steps expected:	Vote in plenary	



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Introduction

The Commission's initiatives concerning the taxation of corporate entities are part of its broader taxation agenda, which aims for a tax system guided by the principles of fairness, efficiency and simplicity in order to strengthen the single market, alongside a balanced tax revenue mix.

The Commission has highlighted two priorities in the area of business taxation.

Enabling fair and sustainable growth

The Commission underlined the importance of adapting the tax framework to be in line with the EU Green Deal (e.g. through the revision of the Energy Taxation Directive), but also the need for simplicity for taxpayers. In July 2020, the Commission adopted a Package for Fair and Simple Taxation ('Tax Action Plan'), listing a number of measures, particularly in the area of VAT, which aim to lower the compliance cost for businesses when accounting for VAT.

Ensuring effective taxation

In terms of the second priority, the effective taxation of taxpayers, it was noted that the collection of tax revenue – including through the fight against aggressive tax planning, tax evasion and tax fraud – is vital to fund quality public services, and is a precondition for the fair sharing of the tax burden between taxpayers. According to the Commission, it is estimated that €35-70 billion is lost each year in corporate tax avoidance in the EU[1] and €46 billion is lost each year due to personal international tax evasion.[2] With the impact of the COVID-19 pandemic in mind, the sustainability of public finances is particularly relevant, and also because of other major trends such as the energy transition, the digitalisation of the economy and changing population demographics. Such trends pose challenges to (international) tax policy and require action to achieve an efficient, sustainable and fair tax framework.

Context

While the fight against tax evasion, tax fraud, aggressive tax planning and money laundering has been a long-standing commitment of governments and the EU, the last decade has seen a considerable focus by policymakers and civil society on strengthening this fight. In particular, in the wake of the 2008 financial crisis, there were a series of highly-publicised media revelations (Lux Leaks, Panama Papers, etc.) on alleged tax avoidance schemes by high net worth individuals or companies, often through the use of offshore companies set up as 'shells'. This prompted governments to take a series of actions to counter these practices. In particular, the OECD set up the base erosion and profit shifting (BEPS) project in 2013, finalised in 2015, which aimed 'to end the use of shell companies used to stash profits offshore or unduly claim tax treaty protection and neutralise all schemes that artificially shift profits offshore'.

However, the debate on shell entities, or shells, is not straightforward as there is, at the moment, no common global or EU-wide legally binding definition of what 'a shell' is. This also makes it difficult to provide estimates regarding their overall presence, impact on tax revenue and their different uses across the EU. Moreover, the word 'shell' is also often used interchangeably with terms such as 'letterbox companies', 'special purpose vehicles' or 'special purpose entities', although different actors (policymakers, academics, or tax lawyers) can hold different views on whether these terms are entirely synonymous with 'shells'.

A 2018 study by the European Parliamentary Research Service, at the request of the European Parliament's Special Committee on Financial Crimes, Tax Evasion and Tax Avoidance (TAX3), identifies three broad categories of shell companies:

- Anonymous shell companies
  This type of shell is characterised by a lack of information regarding its ultimate beneficial owner. Through a shell or a string of shells, the ultimate owner can stay

hidden from (tax) authorities. Such entities can sometimes be linked to high net worth individuals to avoid tax, but can also be used by criminals for money laundering.

- Letterbox companies
  A typical activity of a letterbox company is to register the corporate entity itself in one Member State, while the economic activity (e.g. where the employees are active, where the board of directors meets, etc.) takes place in another Member State. Companies may set up such structures to sidestep certain labour regulations or avoid social security contributions.
- Special purpose entities
  Special purpose entities (SPEs) are entities whose main activity is group financing or acting as holding companies. Their assets and liabilities mostly represent investments in or from other countries, with very few or no employees or physical presence (tangible assets) of their own. Such entities may sometimes be linked to aggressive tax avoidance practices.

The study concludes that, while there can be different types of shell entities, most of them can be broadly characterised by 'the absence of real economic activity in the Member State of registration. This generally means that these companies have no (or few) employees, and/or no (or little) production, and/or no (or little) physical presence in the Member State of registration.'

Existing situation

With pressure on public finances and widely discussed media revelations in the wake of the last financial crisis, several actions were undertaken to address base erosion and profit shifting by companies. In particular, the OECD set up the BEPS project mentioned above, which set out 15 action plans to address profit-shifting by companies, with more than 140 countries participating. While all of the measures can be linked to some extent to the issue of shell companies, some BEPS actions take targeted action towards corporate entities with little economic activity or without a substantial presence.

BEPS Action 5 strengthened significant activity requirements, ensuring that taxpayers who benefit from a preferential tax regime in a jurisdiction are actively undertaking their core income-generating activities within that jurisdiction.

BEPS Action 6 looked at the issue of 'treaty shopping' (whereby taxpayers are looking to get the most favourable tax treatment through bilateral tax treaties without necessarily being a resident in both jurisdictions, usually through the use of a shell company in a third country). To prevent this, Action 6 agreed on a limitation-on-benefits rule (which would ensure that tax treaty benefits are not available to all anymore, with a series of conditions put in place to make certain that there is 'a sufficient link between the entity and its state of residence' and a 'principle purposes test' (PPT), whereby an entity would be disallowed tax benefits in bilateral tax treaties if it is judged that obtaining that benefit was the sole purpose of a company's transactions or arrangements.

BEPS Actions 8-10 looked at the modernisation of current transfer pricing rules to ensure that value creation is linked to substance requirements.

While several anti-profit-shifting measures agreed under BEPS were introduced by countries through national legislation or by updating bilateral tax treaties, some of the measures were implemented through EU law through the EU's Anti-Tax-Avoidance Directive (ATAD), such as interest limitation rules, controlled foreign company rules, and rules on hybrid mismatches.[3] The ATAD also comprised additional measures including a general anti-abuse rule (GAAR), which, in the absence of specific anti-tax-avoidance legislation, allows Member States to deny tax advantages to taxpayers if these are obtained through abusive practices, including through shell companies.

Since its adoption in 2011, the EU's Directive on Administrative Cooperation in the field of taxation (DAC) has been revised several times to introduce requirements on additional types of income and

information. For example, under the DAC4, EU multinationals (companies with more than €750 million in annual turnover) also exchange with tax authorities 'country-by-country reports', which list, for each jurisdiction where the company is active, a number of indicators (e.g. nature of the activities, number of employees, and profit made before tax). Such information can also help tax authorities identify shell entities[4] used by multinational enterprises. These country-by-country reports, albeit with some changes, will also be made public in future, with the implementation of public country-by-country reporting.

In October 2021, the OECD's Inclusive Framework agreed on a global corporate tax reform, including a per country minimum corporate effective tax rate of 15 %. The EU launched a proposal for its implementation within the EU on 22 December 2021. If adopted, it can also ensure that the (passive) income of shell entities, owned by EU multinational companies, is taxed accordingly.

Parliament's starting position

The European Parliament has strongly urged the Commission to strengthen the fight against shell companies when they are used for tax-abusive practices. In light of media revelations such as Lux Leaks and Panama Papers, the Parliament set up the TAXE, TAXE2 and PANA committees, which repeatedly expressed concerns over shell companies. The PANA committee's final report of 16 November 2017 criticised, in particular, the role of intermediaries (banks, law firms, accountants) who help set up shell companies and open accounts, often resulting in anonymity for the ultimate beneficial owner.

More recently, in its resolution of 26 March 2019 on financial crimes, tax evasion and tax avoidance, the Parliament called on the Commission to design a common definition of what a shell company is, and noted that 'simple criteria such as actual business activity or the physical presence of staff working for a company' could be helpful in this area. In addition, it called for the identities of the actual owners of those shell companies to be disclosed to tax authorities.

The FISC committee organised two public hearings on the Pandora Papers.[5] It also prompted discussion of the OpenLux revelations in plenary in March 2021, during which many MEPs encouraged the Commission to take further action against tax avoidance.

Preparation of the proposal

The Commission adopted a communication on business taxation for the 21st century on 18 May 2021, in which it committed to strengthening the fight against shell entities when they are used for tax-abusive purposes. The Commission, while acknowledging that several actions already exist at EU and international level, noted that shell companies continued to pose a risk of being used for aggressive tax planning, tax evasion or money laundering. The proposal would require companies 'to report to the tax administration the necessary information to assess whether they have substantial presence and real economic activity, denying tax benefits linked to the existence or the use of abusive shell companies, and creating new tax information, monitoring and tax transparency requirements'. This proposal was expected to be adopted by the fourth quarter of 2021. In her September 2021 State of the Union speech, Commission President Ursula von der Leyen vowed to 'continue to crack down on tax avoidance and evasion' and announced 'a new initiative to address those hiding profits behind shell entities'.

During a European Parliament debate on the OpenLux leaks in March 2021, Commissioner Paolo Gentiloni stated that shell companies 'can pose a real threat within the internal market in terms of tax base erosion and profit shifting', and added that the Commission services were reflecting on a future initiative 'in order to tackle the challenges linked to the use of shell companies in relation to tax avoidance'.

The Commission launched a public consultation in June 2021 targeting businesses, business associations, academics, non-governmental organisations and citizens. Information was requested

on, for example, the key features commonly observed in tax-abusive schemes of shell companies, the business sectors and legal forms most prone to abuse, the preferred form and scope of an EU action, and mechanisms to monitor implementation by Member States. A summary report was published in November 2021, noting that 50 responses had been received (10 % of respondents were citizens, 70 % were from the corporate sector and 20 % were from non-corporate organisations). Most of the respondents argued that there were many legal and commercial, non-tax reasons for setting up a shell entity. Moreover, given that several anti-tax-avoidance legislation initiatives had only recently been implemented in the EU – such as the BEPS measures, the ATAD and the revisions to the DAC – the Commission should not undertake a new initiative but rather wait until the economic impact of previous measures has been evaluated.

The impact assessment acknowledged that the use of shell entities was not, per se, an indication of tax avoidance or evasion, and that they can serve useful commercial and business purposes, such as protecting companies against double taxation, protecting investors and maintaining the value of a portfolio, facilitating joint ventures between funds and other investors, and limiting liability. The Unshell initiative aims not to curtail such activities but rather to prevent the misuse of such entities for tax abuse purposes only.

The impact assessment also addressed concerns, frequently highlighted in the public consultation, about the supposed need for additional tools in anti-tax avoidance legislation. On recent legislation such as ATAD, the Commission considered the GAAR to be only a residual rule, and did not tackle shell entities specifically. On the DAC, the exchange of tax information was difficult in the case of shell entities, as there is no common legal definition of what a shell entity is. Regarding international legislation, taken forward by the OECD's BEPS project, it was acknowledged by the Commission that these rules were essential to combat tax abuse. However, the Commission argued that BEPS lacked specific criteria to determine whether an entity is lacking substance.

The changes the proposal would bring

The proposal introduces a multiple-step filtering procedure to help Member States identify undertakings located in the EU that are engaged in an economic activity, but which do not have minimal substance and are misused for the purpose of obtaining tax advantages. To ensure equal treatment, the directive does not introduce a threshold based on company turnover and applies to all shell entities, regardless of whether they are owned by an SME or a multinational.

At first, a 'gateway test' (Article 6) is set up: EU entities would need to check via three gateways whether they are 'at risk' of lacking substance and being misused for tax purposes. Some types of shell entities (Article 6(2)), particularly in the area of financial services, would be exempted from the proposal and would thus not need to apply the gateway test, as the Commission argues they are 'commonly used for good commercial reasons'. The three gateways are:

- more than 75 % of an entity's income is 'relevant income' (as defined in Article 4), which broadly covers passive income (interest, dividends, royalties);
- more than 60 % of the book value of the entity's assets has been located outside the undertaking's Member State for at least two years, or more than 60 % of the entity's relevant income is earned through cross-border transactions;
- the entity has outsourced the administration of its day-to-day operations and decision-making.

If the entity passes all three gateways, it will be obliged to report, through its annual tax return to its tax authority, information regarding the entity's level of substance (Article 7) concerning:

- the premises of the company;
- whether it has its own, active bank account in the EU;
- the tax residency of its director(s) and the majority of its full-time employees.

All declarations will need to be accompanied by supporting evidence.

If an entity lacks substance in one of these indicators, it is presumed to be 'a shell' for the purposes of the directive. A company has the right to rebut this presumption (Article 9), and it can do so by providing at least additional evidence on the commercial rationale of the undertaking, information about their employees (such as their level of experience, their decision-making power and role in the overall organisation, or their employment contract), and evidence showing that decision-making on the activity generating the relevant income takes place in the Member State where the undertaking is located. Additional information which the entity believes to be crucial can be provided. If the tax authority accepts the taxpayer's rebuttal, the rebuttal is valid for the tax year and may remain valid for an additional five years, if the factual and legal circumstances of the company do not change.

Once an undertaking is presumed to be a shell for the purposes of the directive (Article 7), and the undertaking does not rebut such a presumption (Article 9), or when the Member State's tax authority does not accept the rebuttal, the directive will aim to disallow any tax advantage for the entity, in particular any tax advantage gained through bilateral tax treaties of the undertaking's resident jurisdiction or through EU directives such as the EU Parent/Subsidiary Directive[6] (90/435/EEC) and the EU Interest/Royalty Directive[7] (2003/49/EC). As a tax consequence, the Member State of the tax residence of the shell company will not issue a tax residence certificate at all, or will issue a certificate with a warning statement, to inform the source country that it should not grant the benefits of its tax treaty with the Member State of the shell (or applicable EU directives) for payments towards the shell (Article 12), making them subject to higher withholding taxes. Moreover, the relevant income of the shell company will be taxed in the Member State where the shareholders of the shell entity are residing, as if that income had directly accrued to them (Article 11).

Information on EU shells will be exchanged automatically through an EU-wide central directory (Article 13). The directory will also include information on when a tax authority has accepted an entity's rebuttal or exempted a company from the scope of the directive. Member States will also be able to request another Member State to launch a tax audit if they have reason to believe that an entity might be lacking minimal substance (Article 15).

The directive would apply from 1 January 2024.

Shell undertakings which are not located within the EU fall outside the scope of the directive.

Advisory committees

The European Economic and Social Committee (EESC) adopted its opinion on 23 March 2022 (rapporteur: Benjamin Rizzo, Diversity Europe – Group III, Malta). The EESC expressed its full support for the Commission proposal, highlighting that fair taxation is vital for the effective recovery of the EU economy after the COVID-19 pandemic. The impact of the proposal was considered to be proportionate, providing a fair balance between the tax revenue gains, indirect effects on the single market, effectiveness of the proposal in reducing the misuse of shell entities, and competition among firms and compliance costs for businesses and tax administrations. However, the opinion did express its concerns about some of the terminology used in the directive regarding 'residence', 'resident director' and 'premises', and about potential divergent interpretations between Member States, which could be harmful for the internal market. In this light, the EESC would welcome appropriate guidelines from the Commission on the particular meaning of these terms.

Stakeholder views

The European Fund and Asset Management Association (EFAMA) welcomed the proposal's carve-out rules to protect investment structures and end-investors, but was concerned that not all entities commonly used by investment funds would be covered by the carve-out, and that, as a result, some investment structures could relocate outside the EU.

The Association for Financial Markets in Europe (AFME) recommends that the Unshell rules be introduced in tandem with (upcoming) rules targeting non-EU entities to ensure a level playing-field. Furthermore, it expressed its concern regarding the rebuttal of presumption (Article 9), which 'puts the burden of proof on taxpayers, which does not seem to be in line with CJEU jurisprudence', adding that there could be 'significant time lags' between the presumption of being a shell and a successful rebuttal.

The European Trade Union Confederation (ETUC) regretted the directive's exclusive focus on tax practices, and argued that effective legislation against shell companies should also look at their social impact (e.g. the possible circumvention of labour laws and social security contributions). They were also concerned that it would be possible for companies to pass a substance test, even in the absence of a workforce. The ETUC also underlined that tax authorities must be much better resourced and equipped in order for the directive to be implemented and enforced effectively.

Legislative process

The legislative proposal (COM(2021) 565) was presented on 22 December 2021. It falls under the consultation procedure (2021/0434(CNS)).

In the European Parliament, the proposal was assigned to the Economic and Monetary Affairs Committee (ECON – rapporteur: Lídia Pereira, EPP, Portugal). The rapporteur issued her draft report on 12 May 2022. After discussions and amendments, the ECON committee adopted its report on 30 November 2022.

The report proposes to lower the income thresholds of the gateway test, whereby more companies, who may lack in economic activity, would be subject to the reporting requirements of the directive.

In terms of the documentary evidence that companies need to provide to prove their economic substance, the report proposes that companies within its scope should also provide information on the undertaking's number of full-time employees and the amount of profit before and after tax.

The report also introduces a deadline of nine months for Member States' tax authorities to assess a company's contestation of the shell company presumption. If a Member State fails to answer a company's rebuttal within that time period, it will be considered to be automatically accepted. Parliament also supports the proposal to produce a report on the directive five years after its entry into force, but specifies that such a review should look at the impact on tax revenues in Member States and whether there would be a need to amend the directive. The report will be discussed and voted on in the January plenary session (16-19 January 2023).

In the Council, the proposal is being examined within the 'Working party on tax questions (direct taxation)'. Negotiations in the Council are ongoing, and a first round of technical article-by-article analysis was completed in May 2022. In December 2022, the Council stated that, while 'most delegations supported the objectives of the proposal', further important technical work was necessary before an agreement could be reached.

EUROPEAN PARLIAMENT SUPPORTING ANALYSIS

Krišto I. and Thirion E., An overview of shell companies in the European Union, EPRS, European Parliament, October 2018.

Remeur C., Anti-Tax Avoidance Directive, EPRS, European Parliament, July 2016.

Remeur C., Understanding BEPS, EPRS, European Parliament, October 2019.

Karaboytcheva M., Advances in administrative cooperation in the field of taxation, EPRS, European Parliament, April 2021.

OTHER SOURCES

BEPS Frequently Asked Questions, OECD, October 2015.

BEPS Action 5: Countering Harmful Tax Practices, OECD, October 2015.

BEPS Action 6: Prevention of Tax Treaty Abuse, OECD, October 2015.

BEPS Action 8-10: Aligning Transfer Pricing Outcomes with Value Creation, OECD, October 2015.

Communication on Business Taxation for the 21st Century, European Commission, May 2021.

De Wispelaere F., Schuster E., Morel S. et al., Letterbox companies – overview of the phenomenon and existing measures: final report, European Commission, November 2021.

Taxation: rules to prevent the misuse of shell entities for tax purposes, Legislative Observatory (OEIL), European Parliament.

ENDNOTES

1 The Commission refers to R. Dover, B. Ferrett, D. Gravino, E. Jones and S. Merler, Bringing transparency, coordination and convergence to corporate tax policies in the European Union, European Parliamentary Research Service, PE 558.773, 2015; M. Álvarez-Martínez, S. Barrios, D. d'Andria, M. Gesualdo, G. Nicodème and J. Pycroft, How Large is the Corporate Tax Base Erosion and Profit Shifting? A General Equilibrium Approach, CEPR Discussion Papers 12637, 2018; and T. Tørsløv, L. Wier and G. Zucman, The Missing Profits of Nations, NBER Working Paper 24701, 2018.

2 The Commission refers to ECOPA and CASE (2019), Estimating International Tax Evasion by Individuals, Taxation Papers 76.

3 The interest limitation rule puts a limit on the tax deductibility of interest payments by companies. Controlled foreign company rules (CFC) allow the jurisdiction of the parent company under certain conditions to tax the income of low-taxed controlled subsidiaries located in a different jurisdiction to the parent company. Rules on hybrid mismatches aim to prevent companies from exploiting differences between the tax treatment of financial instruments, payments and entities in order to get double deductions.

4 It should be noted that the 'Unshell' proposal applies to all companies, regardless of turnover, unless they are listed as an exempted company according to Article 6(2).

5 These were held on 30 November 2021 and 28 March 2022.

6 The EU Parent/Subsidiary Directive abolishes withholding taxes on payments of dividends between associated companies of different Member States.

7 The EU Interest/Royalty Directive abolishes withholding taxes on royalty payment and interest payments within a group of companies between different Member States.

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