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INFORMATIVE NOTE

TAX

The Unshell Directive – Shell companies

In line with the actions planned in the European Union's tax policy agenda to reform the corporate tax system, the Proposal for a Council Directive 2021/0434 (the "Unshell Directive") was published on 22 December 2021. This proposal introduces a set of rules to prevent the improper use of shell companies (companies without economic substance) exclusively intended to obtain tax advantages.

The Unshell Directive proposes a specific arrangements to combat the use of companies for tax avoidance or tax evasion purposes

If adopted, as we expect it will be, the Unshell Directive will have to be incorporated into national law by Member States by 30 June 2023 and will enter into force on 1 January 2024.

The following are the five key questions to understand what shell companies are and what the consequences of being considered a shell company are.

What are companies without economic substance?

What should I know? *Undertakings are considered to lack economic substance if, on the one hand, they do not fulfil a minimum set of substance indicators and, on the other hand, they do not demonstrate that they are not used for the main purpose of obtaining a tax advantage.*

The Unshell Directive proposes a specific arrangements to combat the use of companies for tax avoidance or tax evasion purposes. A company is considered to be any entity engaged in an economic activity, regardless of its legal form, provided that it is resident for tax purposes in a Member State of the European Union.

The assessment of the level of economic substance of a company involves the preliminary verification of a set of criteria (known as "gateways") that make it possible to identify companies that present a risk of tax abuse or tax avoidance. Notwithstanding this preliminary analysis, other relevant criteria are defined for a company to be considered a shell company. However, companies are allowed to demonstrate the existence of valid economic reasons for their incorporation.

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Three criteria (the "gateways") are established to identify companies that present a risk of not complying with minimum levels of economic substance.

What are the gateway (lack of substance) criteria?

What should I know? *Companies that cross the gateways are required to include a set of additional information in their annual income tax returns. This makes it possible for Member State's tax authorities to more easily identify entities that appear to lack sufficient economic substance.*

The three criteria (the "gateways") below are established to identify companies that present a risk of not complying with minimum levels of economic substance. To qualify as a shell company, it is necessary to fulfil all three of these criteria:

i) Gateway 1: companies where more than 75% of their revenues from the previous two financial years is passive income[1];

ii) Gateway 2: companies that mainly engage in cross-border activities[2]; and

iii) Gateway 3: companies do not have their own resources to engage in their activity and resort to the outsourcing of management functions, whether this is day-to-day management or at the level of strategic decision-making, in the previous two financial years.

If these three criteria are met, the company becomes subject to reporting obligations in its annual income tax return ('**reporting company**'). This will provide Member States' tax authorities with all the information they need to identify more easily any companies that appear not to meet the minimum levels of economic substance.

What information has to be reported?

What should I know? *When qualifying as a reporting company, the company must include in its annual tax return a set of particulars (the minimum substance indicators) which, if they do not meet the criteria set out in the Unshell Directive, lead to the application of a presumption that the company does not have a minimum level of economic substance.*

1 Under the terms of the Proposal for a Directive, this criteria is also deemed to be met when: (i) more than 75% of the company's assets consist of movable property for private purposes with a value exceeding €1,000,000 (excluding cash, shares or other securities) or immovable property; or (ii) more than 75% of the company's assets consist of assets from which dividends or income from the disposal of shares may be earned.

2 Companies that mainly engage in cross-border activities are considered to be those where: (i) more than 60% of the book value of certain types of assets (movable property above a certain value and immovable property) are located in another Member State of the European Union; or (ii) at least 60% of passive income earned originates from cross-border transactions.

When companies do not meet the "substance test" and thus qualify as reporting companies, they are subject to the obligation to report, in their annual income tax return, certain details and information – the minimum substance indicators.

These substance indicators are essentially intended to verify whether: (i) the company has its own premises in the Member State of incorporation, or whether the premises are for its exclusive use; (ii) the company has, at least, one own and active bank account in the European Union; (iii) the directors and/or employees are tax resident in the Member State of incorporation (or in another Member State that allows the performance of the functions in the country of incorporation) and have the qualifications required for the activity carried out.

If all three substance indicators are fulfilled, the company is presumed to have economic substance. If not, the company is presumed not to have economic substance and is thus subject to the consequences set out in the Directive.

Regardless of this presumption, companies can always submit additional information and documentation to demonstrate the commercial motives behind their incorporation, and relating to decision-making for their management. Accordingly, the presumption can be rebutted if the company demonstrates that: (i) its activity is effectively controlled in the Member State of its incorporation; and (ii) it bears the risks of that activity.

Moreover, where the existence of the company does not reduce the tax liability of its beneficial owner or of the group to which it belongs taken as a whole (a condition the entity will have to prove), Member States can exempt it from reporting obligations under the Unshell Directive - even if the minimum indicators of substance are not met.

What are the consequences of being a company without substance?

Companies without economic substance will no longer be able to benefit from the tax advantages arising from the application of Double Taxation Conventions and the European Directives.

What should I know? *Companies without economic substance will no longer be able to benefit from the tax advantages arising from the application of Double Taxation Conventions and the European Directives. Furthermore, certain income will be imputed and taxed at the level of the shareholder who is tax resident in a Member State of the European Union.*

Companies that do not comply with the minimum indicators of substance and simultaneously fail to demonstrate the economic rationality of their existence (i.e., companies without economic substance or shell companies) will be subject to the following consequences:

i) Non-applicability of Double Taxation Conventions concluded with the Member State of residence of the shell company;

ii) Non-applicability of the Parent-Subsidiary[3] and Interest and Royalties[4] Directives;

3 Council Directive 2011/96/EU of 30 November 2011

4 Council Directive 2003/49/EC, of 3 June.

iii) Impossibility of obtaining a tax residence certificate for presentation in other jurisdictions (or obtaining a residence certificate where the non-applicability of Conventions and Directives is expressly indicated)

iv) Certain income generated by the company without economic substance will be attributed to its shareholder, provided the shareholder is tax resident in a Member State of the European Union and taxed in that Member State.

Is there a carve-out for any type of company?

What should I know? *A certain number of entities do not qualify as reporting companies and, consequently, are not subject to the consequences set out in the Unshell Directive. This is either because they are subject to supervision, or because of the geographical scope of their activity, or because of the place of residence of their shareholders.*

A certain number of entities do not qualify as reporting companies and, consequently, are not subject to the consequences set out in the Unshell Directive. This is either because they are subject to supervision, or because of the geographical scope of their activity, or because of the place of residence of their shareholders. This list of entities includes:

A certain number of entities do not qualify as reporting companies and, consequently, are not subject to the consequences set out in the Unshell Directive.

i) Companies that have securities admitted to trading or listed on a stock exchange or multilateral trading facility;

ii) Regulated financial companies;

iii) Companies that are principally engaged in holding shares in operational entities that are established in the same Member State, provided that the beneficial owner is also resident in that Member State;

iv) Companies that manage other companies[5] which are established in the same Member State as their shareholder(s) or ultimate parent company; and

v) Companies employing at least five full-time employees or members of staff engaged exclusively in the activity that generates the relevant income of those companies. ■

5 As defined in point 7 of Section I of Annex III to Council Directive 2011/16/EU of 15 February 2011.