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In this article, the authors examine the EU's proposed directive on the misuse of shell entities for tax purposes, which would introduce reporting obligations, and antiabuse rules similar to those already in place.

On December 22, 2021, the European Commission released a proposal for a council directive laying down rules to prevent the misuse of shell entities for tax purposes (the draft directive, also known as the Unshell proposal (COM(2021) 565 final)). The initiative was triggered by the commission's perception that legal entities with no or minimal substance performing no or very little economic activity continue to risk being used for aggressive tax planning structures.

This article considers the necessity and legal basis of the commission's actions and analyzes the proposed regime, which would establish new reporting obligations and antiabuse rules targeting shell entities.

I. Introduction

The international tax landscape has undergone a dramatic transformation over the last few years. Following the OECD's base erosion and profit-shifting project, many jurisdictions changed their tax laws and treaties, the OECD drastically revised its transfer pricing guidelines, and the EU adopted several directives that resulted in the implementation of strict antiabuse legislation and additional reporting obligations for some cross-border arrangements.

The draft directive[1] follows the commission's communication on EU business taxation in the 21st century (COM(2021) 251 final) to involve several other short- and long-term commission policy initiatives: The directive is a short-term, targeted initiative. At the latest, member states must adopt the draft directive by June 30, 2023, and the regime should apply from January 1, 2024.

Another initiative that will be presented by the commission as soon as 2023 is the "Business in Europe: Framework for Income Taxation" (also referred to as BEFIT), which is meant to provide a single EU corporate tax rulebook, replacing the

[1] European Commission, Proposal for a Council Directive laying down rules to prevent the misuse of shell entities for tax purposes and amending Directive 2011/16/EU, COM(2021) 565 final (Dec. 22, 2021).

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common consolidated corporate tax base proposal. Here, the objective is to harmonize rules on determining the tax base across the EU.

The commission has also released a proposal to implement the global tax reform agreed to by the OECD to ensure a global minimum level of taxation for multinational groups in the EU (also referred to as pillar 2). That proposal might apply to both multinational and large-scale domestic groups with combined revenues over €750 million. The EU Council intends to adopt that measure soon so it can apply as from 2023.

In light of the above, it is questionable whether there is a real need for the proposed reporting regime. It is unclear how it would interact with all the other upcoming tax law changes and whether there are entities lacking substance that are not captured by existing antiabuse legislation.

II. The Proposal's Necessity and Legal Basis

Substance has always been an important topic in international taxation when entities perform cross-border investment and business activities, and the OECD BEPS project heightened awareness by focusing on substance and transparency.

The BEPS project had a major impact on the international tax landscape. The EU adopted two anti-tax-avoidance directives (ATAD 1 and ATAD 2) that required member states to implement several antiabuse provisions.[2] Moreover, bilateral tax treaties have been modified through the multilateral instrument, developed as part of BEPS action 15, with a view to implement various antiabuse provisions, such as the principal purpose test (PPT). To increase transparency, the EU put in place a series of directives on administrative cooperation (the "DAC" series). One of the latest, DAC 6 (Council Directive (EU) 2018/822), requires reporting of potentially aggressive transactions in corporate tax matters.

Hence, EU tax authorities have a comprehensive arsenal of antiabuse rules that allow them to tackle any kind of abusive situation, as well as reporting requirements that should allow them to be aware of any residual abuse. Thus, it is unclear if the proposed directive can elevate existing substance requirements for EU entities or serves a real need.

A. Substance in International Taxation

Substance is a key element in international taxation and relevant for the application of domestic tax law, tax treaties, and the arm's-length principle. While it is crucial that companies are effectively managed in their states of residence, antiabuse provisions under foreign tax law or applicable tax treaties could impose more extensive substance requirements.

1. The Notion of Substance

The notion of substance is not a one-dimensional concept, instead involving many elements that may be interrelated (see Figure 1). One element is infrastructure, which includes employees, office premises, and other facilities such as meeting rooms and equipment (office furniture, IT equipment, and so forth). A website, specific email addresses, and business cards may also be evidence of substance. Companies might rely on their own staff and directors or outsource some functions to qualified Luxembourg service providers (for example, accounting, tax compliance, and legal services).

Another element of substance is corporate governance, which concerns the composition of the board of directors, the organization of board meetings in the company's state of residence, the involvement of qualified local directors in the decision-making process, and the proper documentation thereof (that is, in the minutes of the board of directors, email correspondence, internal memos, and so forth). Further, good corporate governance requires contractual aspects to be defined in clear and thorough legal documentation.

Companies' functional and risk profiles may vary, with companies performing different functions and bearing different kinds of risk in relation to their investment and business activities. Typical functions performed by companies involved in, for example, investment activities include monitoring and managing investments, cash flows, and risks; analyzing

[2] Council Directive (EU) 2016/1164 of July 12, 2016, laying down rules against tax avoidance practices that directly affect the functioning of the internal market (ATAD 1); and Council Directive (EU) 2017/952 of May 29, 2017, amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries (ATAD 2).

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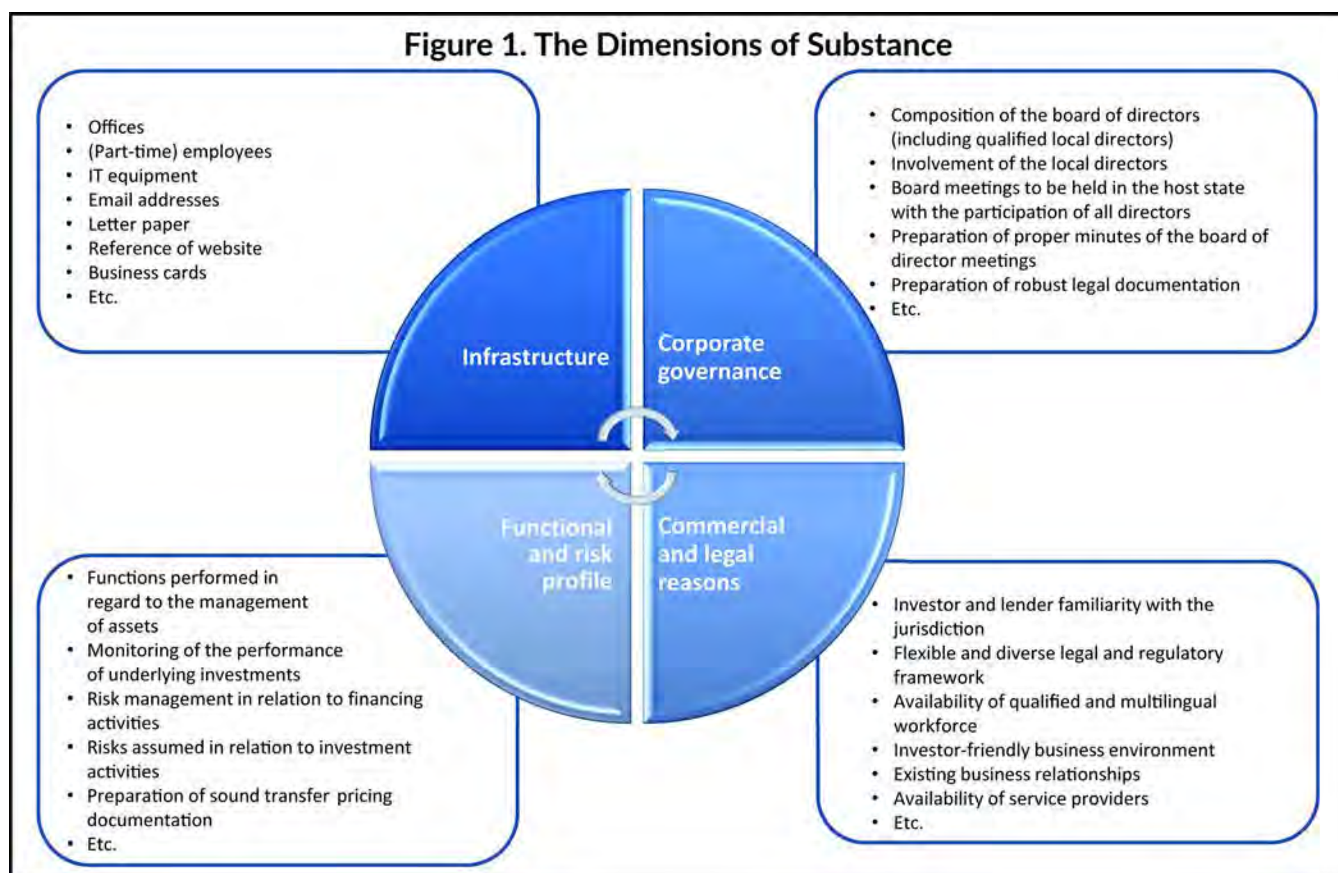
Figure 1. The Dimensions of Substance



investment opportunities; drafting or reviewing legal documentation; maintaining books and records; and preparing financial reporting and tax returns.

Moreover, companies may render administrative and other services to group companies, carry on treasury functions, or manage intangible property rights. When some functions are outsourced to qualified service providers or other group companies, the company directors or staff must carefully monitor the proper execution of those functions. The functions performed and risks assumed by companies in material intragroup transactions should be analyzed in sound transfer pricing documentation when the arm's-length pricing is determined.

A last element of substance involves commercial and legal reasons for establishing business activities in a jurisdiction. That encompasses location features, such as a flexible and diverse legal and regulatory environment, the availability of a qualified and multilingual workforce, an investor-friendly business environment, and political and financial stability. It also involves individual aspects, such as business relationships, the familiarity of investors and lenders with the entity's residence state, experience with the jurisdiction's legal and regulatory system, and possibly any existing substance.

2. Defining an Appropriate Level of Substance

When companies perform cross-border investment and business activities, they need to have an appropriate level of substance to mitigate tax risks — but there is no "one size fits all" approach. Instead, the right level of substance must be tailored to each case.

Many factors should be considered when determining an appropriate level of substance, including:

- *The type of investment or business activities*. While some activities require significant substance, others can be managed with limited substance.
- *The magnitude of the activities*. The need for substance also depends on the number of transactions and the related risks.

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- *The items of income that will be realized*. In a cross-border context, foreign jurisdictions generally adopt antiabuse legislation to address situations in which a nonresident company benefits from a tax advantage (for example, a reduced or zero withholding tax rate). In the absence of an advantage, there should be no excessive substance requirements from a foreign tax perspective.
- *The jurisdictions involved*. While the tax authorities of some jurisdictions are more demanding when it comes to substance, others have more reasonable expectations.
- *The investment strategy pursued*. When the investment strategy relies on the realization of items of income that are not subject to foreign taxation (for example, interest income and capital gains), there should be no excessive substance requirements from a foreign tax perspective.

As a rule of thumb, a company's substance should be appropriate for managing the activities the company performs. Thus, the more activities a company performs and the higher the amounts at stake, the more substance a company should generally have. However, some activities, such as holding and financing activities, might not need a high level of substance.

B. Existing Antiabuse and Reporting Rules

Substance requirements may be based on several antiabuse provisions implemented into the domestic tax laws of and bilateral tax treaties concluded by EU states. Also, substance may be relevant when it comes to determining potential reporting obligations under DAC 6, the mandatory disclosure regime.

1. Domestic Antiabuse Provisions

Many countries have adopted antiabuse legislation in their domestic tax laws, ranging from general antiabuse rules to provisions that target specific situations of abuse. Those rules generally subject the recognition of foreign companies or the granting of tax benefits to the condition that substance requirements are fulfilled.

a. General Antiabuse Rules

The involvement of foreign companies may be challenged under general antiabuse rules if the tax authorities can show that an investment is merely tax-driven or the choice of legal instruments represents an abuse of law.[3]

ATAD 1 required EU states to implement or modify a GAAR by January 1, 2019. The rules disregard nongenuine arrangements or a series thereof put into place with a main purpose of obtaining a tax advantage that defeats the object or purpose of the applicable tax law. Arrangements are considered nongenuine if they are not put into place for valid commercial reasons that reflect economic reality.

b. Anti-Shopping Rules

Anti-directive and anti-treaty-shopping rules let tax authorities challenge tax benefits such as reduced or zero withholding tax rates on dividends, interest, and royalty payments in accordance with EU directives (that is, the EU parent/subsidiary directive (2011/96/EU) and the EU interest and royalty directive (2003/49/EC)) or tax treaties if the recipient of the income does not fulfill specific substance requirements.[4]

In many cases, those rules also use the concept of beneficial ownership, under which reduced or zero withholding tax rates apply only if the income recipient is the beneficial owner thereof.

c. CFC Rules

Controlled foreign company rules meant to limit the use of subsidiaries established in low-tax territories (so-called base companies) to reduce (or at least defer) taxation in the parent's state of residence through a shifting of income to a base company might also include substance requirements.[5]

EU states have implemented CFC rules in accordance with ATAD 1 to attribute, under specified conditions, income realized by low-taxed foreign subsidiaries to their parent companies, irrespective of whether the subsidiaries distribute those profits.

2. Treaty Antiabuse Provisions

Tax treaties can include various antiabuse provisions, with substance requirements

[3] *See* Oliver R. Hoor, "Transformation of the Luxembourg Tax Environment: Towards the Post-BEPS Era," *Legitech* 185 (2021).

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

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

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including, in particular, the PPT and beneficial ownership.

a. PPT

Under the PPT, treaty benefits[6] are denied if it is reasonable to conclude that obtaining them was one of the principal purposes of any arrangement or transaction, unless the taxpayer can establish that granting the benefits would be in accordance with the object and purpose of the relevant treaty provisions.[7]

The PPT was developed as part of action 6 of the OECD's BEPS project, which targeted perceived abuses of tax treaties. It was added to the 2017 version of the OECD model convention as article 29(9) and is a minimum standard under the MLI.

According to OECD guidance, the PPT requires an in-depth analysis of all facts and circumstances to determine whether obtaining the benefit was a principal consideration and would have justified entering into the arrangement or transaction that resulted in the benefit. Thus, tax authorities should not casually 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.

b. Beneficial Ownership

The notion of beneficial ownership plays a prominent role in a tax treaty context. In essence, the beneficial owner concept is designed to prevent agents, nominees, or conduit companies from treaty shopping for benefits of a resident of a third state for income received from dividends, interest, and royalties.[8] More precisely, if dividends, interest, or royalties derived from a contracting state are paid to a resident of the other contracting state, the source state's taxing right is generally restricted to a set percentage of the gross amount[9] (or even excluded — for example, in the case of royalties[10]).

However, tax treaties typically stipulate that the person claiming the treaty benefits — that is, reduced or zero withholding tax rates in the source state — must be the beneficial owner of the dividends, interest, or royalties. Thus, the source state is not bound to grant the benefits of the relevant OECD model articles 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.[11]

According to the commentaries to the OECD model tax convention, the term "beneficial owner" should not be used in a narrow, technical sense, but rather understood in its context and in light of the treaty's object and purpose, including the avoidance of double taxation and the prevention of fiscal evasion and avoidance.

Consequently, one must verify whether the income recipient is liable to tax on the income; whether the income is actually taxed should be irrelevant. That test should be satisfied if the taxpayer is liable to tax on the income, irrespective of any applicable exemptions (for example, the participation exemption regime in the case of dividends) or available tax loss carryforwards.[12]

3. The Mandatory Disclosure Regime

Under the mandatory disclosure regime of DAC 6, tax intermediaries such as tax advisers, accountants, and lawyers who design, promote, or provide assistance with specific cross-border arrangements have to report that to the tax authorities. Since the regime's implementation, the analysis of potential reporting obligations has become an integral part of every tax analysis.

DAC 6 operates through a system of hallmarks that describe features of cross-border arrangements that might indicate a potential risk

[6]The term "benefits" includes all limitations (for example, a tax reduction, exemption, deferral or refund) on taxation imposed on the state of source under article 6 through 22 of the convention, 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 limitations; see para. 175 of the commentary on article 29 of the OECD model.

[7]*See* Hoor, *supra* note 3, at 245, 273; and Hoor and Keith O'Donnell, "Luxembourg: Impact of the PPT on Alternative Investments," *Tax Planning Int'l* 2 (Jan. 2018).

[8]*See* Hoor, *supra* note 3, at 246; and Hoor, "The OECD Model Tax Convention — A Comprehensive Technical Analysis," *Legitech* 73 (2015).

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

[10]OECD model article 12(1) allocates exclusive taxing rights to the recipient's residence state.

[11]*See* Hoor, "The OECD Model Tax Convention," *supra* note 8; and Philip Baker, *Double Taxation Conventions and International Tax Law — A Manual on the OECD Model Tax Convention on Income and on Capital of 1992* 91 (1994).

[12]When an agent, nominee, or conduit company is not treated as the owner of the income for tax purposes in its residence state, no double taxation should arise for that item of income.

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of tax avoidance and may trigger reporting obligations. The main benefit test (MBT) functions as a threshold requirement for many of those hallmarks and should filter out irrelevant reporting. It enhances the usefulness of the information collected by focusing on arrangements that have a higher probability of truly presenting a risk of tax avoidance.

When determining whether advice on a particular arrangement is reportable under DAC 6, one must first analyze whether the arrangement has a cross-border dimension. This would be the case when an arrangement concerns either more than one EU member state or an EU member state and a third country. Cross-border arrangements may be reportable if they contain at least one of the hallmarks listed in the appendix to DAC 6. If a hallmark is met, one must verify whether it is subject to the MBT. If not, there is an automatic reporting obligation under DAC 6. If it is, one must analyze all relevant facts and circumstances to determine whether obtaining a tax advantage was a main benefit.

It is also necessary to analyze the substance of the entities involved. When an entity would be classified as a wholly artificial arrangement, the MBT would likely be met. In that case, the tax authorities of the entity's state of residence will put the information into a database shared with the tax authorities of all EU states.

C. The Directive's Legal Basis

While member states' domestic laws and tax treaties have antiabuse provisions to challenge entities that do not have appropriate substance, the European Commission states in the explanatory memorandum to the Unshell directive that EU tax instruments do not contain "explicit provisions targeting shell entities." Because that is clearly incorrect, does the commission even have a legal basis for its initiative?

1. Tax Avoidance and Evasion

The commission's explanatory memorandum states that "legal entities with no minimal substance and economic activity continue to pose a risk of being used for improper tax purposes, such as tax evasion and avoidance." But is that really true?

Tax evasion involves intentional, fraudulent conduct to evade taxes by illegal means. Taxpayers deliberately misrepresent or conceal the true state of their affairs from tax authorities to reduce their tax liabilities. Examples of tax evasion include dishonest tax reporting,[13] faked transactions to reduce tax payments, and transfer pricing manipulations. As a legal violation, tax evasion can therefore be tackled by enforcing the law (once discovered by the competent tax authorities).

Commission Recommendation of December 6, 2012, on Aggressive Tax Planning (2012/772/EU) said aggressive tax planning (which should correspond to the term "tax avoidance" as used in the draft directive) involves taking advantage of the technicalities of a tax system or of mismatches among tax systems to reduce tax liability. According to the recommendation, the consequences of aggressive tax planning "include double deductions (for example, the same loss is deducted both in the State of source and residence) and double nontaxation (for example, income which is not taxed in the source State is exempt in the State of residence)."

When taxpayers take advantage of the technicalities of a tax system or of mismatches in tax systems, the tax treatment of their arrangements is inconsistent with the intention of the legislature. In contrast, an arrangement's tax treatment is consistent with legislative intent if it relies on the application of explicit tax law (which is the expression of the intent of the legislator) or, in a cross-border context, does not take advantage of tax system mismatches.

The transposition of ATAD 1 and 2 resulted in EU states adopting antiabuse legislation in the form of interest limitation rules, CFC rules, exit tax rules, the GAAR, and hybrid mismatch rules. The first three are specific antiabuse rules that target perceived vulnerabilities of domestic tax laws. They resulted in a substantial harmonization of EU members' tax laws. The GAAR allows tax authorities to tackle nongenuine arrangements that take advantage of technicalities of the applicable tax law, and hybrid mismatch rules eliminate tax system mismatch

[13] For instance, underreporting income or overstating expenses.

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outcomes (such as double deductions and deductions without inclusion).

Thus, the transposition of ATAD 1 and 2 eliminated the ability to use aggressive tax planning strategies and provided tax administrations with far-reaching powers to challenge taxpayers. However, tax authorities can challenge a foreign entity on grounds of substance only if it can be established that the entity is a wholly artificial arrangement.[14]

Tax evasion and avoidance can already be addressed under existing rules that also address substance concerns. The proposed regime adds virtually nothing to those safeguards, given that the resulting tax consequences following a shell entity classification would be conditional on that entity being a wholly artificial arrangement.

2. Public Consultation

From June to August 2021 the European Commission launched a public consultation on a potential initiative to fight the use of shell entities and arrangements for tax purposes. It invited interested parties to share their views in a (mostly multiple-choice) questionnaire and received almost 50 replies.

According to the explanatory memorandum to the draft directive, all consultation respondents noted that despite the EU's anti-tax-avoidance measures, "tax avoidance and evasion persists, including through the misuse of shell entities." We were involved in several responses from professional associations and must clarify that the memorandum's statement is, to say the least, a misrepresentation.

Thirty-three respondents (in particular, business and professional associations) provided extensive input beyond the consultation questions: Indeed, given the limited value of scripted multiple-choice questions, it was necessary to provide meaningful comments in the annex to the questionnaire.

One of the questions suggested the commission did not even know whether there was an issue with so-called shell entities. The questionnaire said the EU toolbox to fight tax avoidance had been enhanced recently, with new tools coming into effect from 2019 and 2020. Interested parties had to choose one of two statements about those measures:

- The impact of the new measures is not quantifiable yet. The EU should wait before taking new measures to fight tax avoidance until the impact of the existing measures is measurable.
- While the impact of the new measures is not quantifiable yet, there is margin for improvement. The EU should take action to complement the existing framework as soon as possible.

Given that the European Commission understands that the impact of the new measures is not yet quantifiable, it is difficult to understand how it could reach the conclusion that further action is needed.

Even the definition of shell or letterbox entities as "entities with little or no substance in their place of establishment or elsewhere" seems to be unclear to the European Commission, which gave participants the choice to agree or disagree with that definition. However, in an EU context, a definition of minimum substance must consider the wholly artificial arrangement doctrine developed by the Court of Justice of the European Union, which requires companies to have appropriate substance.

3. Legal Basis for the Commission's Initiative

Direct tax legislation falls within the ambit of article 115 of the Treaty on the Functioning of the European Union, which stipulates that legal measures must be presented as directives. However, the EU's competences are governed and limited by the principles of subsidiarity and proportionality.

The general goal of the principle of subsidiarity is to guarantee lower authorities a degree of independence in relation to a higher body or for a local authority in relation to central government. It therefore involves the sharing of powers between several levels of authority, a principle that forms the institutional basis for federal states.

The principle of subsidiarity serves to regulate the exercise of the EU's nonexclusive powers. It rules out EU intervention when an issue can be addressed effectively by the member states at

[14] *See* Section III.A.4.a.

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central, regional, or local levels. The EU is justified in exercising its powers only when member states cannot satisfactorily achieve the objectives of a proposed action and added value can be provided if the action is carried out at the EU level.

The explanatory memorandum says the Unshell directive is meant to tackle cross-border tax avoidance and evasion and provide a common framework for member states to implement into their national laws in a coordinated manner. It claims that those goals "cannot be achieved in a satisfactory manner through action undertaken by each Member State while acting on its own."

Envisaged legal measures must also comply with the principle of proportionality, under which a measure must not go beyond what is required to ensure the minimum necessary level of protection for the internal market.

The European Commission only has a legal basis in article 115 of the TFEU to the extent the draft directive adheres to the principles of subsidiarity and proportionality.

The draft directive does not comply with the principle of subsidiarity because member states already have the means to challenge entities that lack substance under the antiabuse legislation in their tax treaties and domestic tax laws. That is even more evident when considering that the tax consequences of a classification as a shell entity under the proposal would be broadly similar to those under existing antiabuse rules. As noted, the commission acknowledged in the questionnaire that the impact of the measures adopted in 2019 and 2020 cannot yet be quantified. It thus seems quite a stretch to conclude that there is a need for action at the EU level.

That directly leads to whether the draft directive adheres to the principle of proportionality. It seems at least questionable that the proposed regime, which would apply to all entities considered tax resident and eligible to receive a tax residency certificate in a member state, is proportionate to the potential problem.

Because the commission cannot establish that entities lacking appropriate substance are still a major problem, and because the Unshell initiative does not seem to comply with the principles of subsidiarity and proportionality, the commission should have no authority to intervene.

III. Analysis of the Proposed Reporting Regime

The draft directive applies to any undertaking considered tax resident and eligible to receive a tax residence certificate in a member state, regardless of its legal form. Determining whether an entity is a shell involves a series of tests and may sometimes require a comprehensive analysis.

However, only entities that meet specific gateway criteria must report indicators of minimum substance. When an entity satisfies all those indicators, there would be a presumption that the entity has minimum substance. Otherwise, there would be a rebuttable presumption that the entity does not have minimum substance.

The proposed regime also requires member states to timely exchange comprehensive information on entities subject to reporting and on entities that rebut the presumption of a lack of substance or are exempt from obligations under the Unshell directive.

The classification as a shell entity would have far-reaching tax consequences in the entity's residence state and in the other member states involved.

A. Classifying Shell Entities

When analyzing whether an entity is a shell, one must first analyze whether the entity is excluded from reporting requirements (carveouts).

Second, only if an entity cumulatively meets three gateway criteria will it have to report on its corporate tax returns specific indicators of minimum substance. When all those indicators are met, the entity is deemed not to be a shell. When they are not, there is a rebuttable presumption that the entity is a shell, and it will have the opportunity to show that it is not a wholly artificial arrangement.

Alternatively, an entity may request an exemption from reporting obligations if it can show that it does not reduce the tax liability of its beneficial owners or of the group as a whole.

1. Undertakings Excluded From Reporting

The proposed reporting regime provides numerous carveouts for some entities, saying the activities of those undertakings are subject to an

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adequate level of transparency and therefore do not risk lacking substance for tax purposes.

The carveout applies to the following entities:

(a) companies which have a transferable security admitted to trading or listed on a regulated market or multilateral trading facility (as defined under Directive 2014/65/EU of the European Parliament and of the Council);

(b) regulated financial undertakings, including:

- a credit institution (as defined in Article 4(1), point (1), of Regulation (EU) No 575/2013 of the European Parliament and of the Council);
- an investment firm (as defined in Article 4(1), point (1), of Directive 2014/65/EU of the European Parliament and of the Council);
- an alternative investment fund manager (AIFM) (as defined in Article 4(1), point (b), of Directive 2011/61/EU of the European Parliament and of the Council, including a manager of Euveca under Regulation (EU) No 345/2013 of the European Parliament and of the Council, a manager of Eusef under Regulation (EU) No 346/2013 of the European Parliament and of the Council and a manager of Eltif under Regulation (EU) 2015/760 of the European Parliament and of the Council);
- an undertaking for collective investment in transferable securities (UCITS) management company (as defined Article 2(1), point (b), of Directive 2009/65/EC of the European Parliament and of the Council);
- an insurance undertaking (as defined in Article 13, point (1), of Directive 2009/138/EC of the European Parliament and of the Council);
- a reinsurance undertaking (as defined in Article 13, point (4), of Directive 2009/138/EC);
- an institution for occupational retirement provision (as defined in Article 1, point (6) of Directive 2016/2341 of the European Parliament and of the Council);
- pension institutions operating pension schemes which are considered to be social security schemes (covered by Regulation (EC) No 883/2004 of the European Parliament and of the Council and Regulation (EC) No 987/2009 of the European Parliament and of the Council as well as any legal entity set up for the purpose of investment of such schemes);
- an alternative investment fund (AIF) managed by an AIFM (as defined in Article 4(1), point (b), of Directive 2011/61/EU or an AIF supervised under the applicable national law);
- UCITS in the meaning of Article 1(2) of Directive 2009/65/EC;
- a central counterparty (as defined in Article 2, point (1), of Regulation (EU) No 648/2012 of the European Parliament and of the Council);
- a central securities depository (as defined in Article 2(1), point (1), of Regulation (EU) No 909/2014 of the European Parliament and of the Council);
- an insurance or reinsurance special purpose vehicle authorized in accordance with Article 211 of Directive 2009/138/EC;
- a securitization special purpose entity (as defined in Article 2, point (2), of Regulation (EU) No 2017/2402 of the European Parliament and of the Council);
- an insurance holding company (as defined in Article 212(1), point (f), of Directive 2009/138/EC) or a mixed financial holding company (as defined in Article 212(1), point (h), of Directive 2009/138/EC, which is part of an insurance group that is subject to supervision at the level of the group pursuant to Article 213 of that Directive and which is not exempted from group supervision pursuant to Article 214(2) of Directive 2009/138/EC);
- a payment institution (as defined in point (d) of Article 1(1) of Directive (EU) 2015/2366 of the European Parliament and of the Council);
- an electronic money institution (as defined in point (1) of Article 2 of Directive 2009/110/EC of the European Parliament and of the Council);

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- a crowdfunding service provider (as defined in point (e) Article 2(1) of Regulation (EU) 2020/1503 of the European Parliament and of the Council);
- a crypto-asset service provider (as defined in Article 3(1), point (8), of [the proposal for a Regulation of the European Parliament and of the Council on Markets in Crypto-assets, and amending Directive (EU) 2019/193731] where performing one or more crypto-asset services as defined in Article 3(1), point (9), of [the proposal for a Regulation of the European Parliament and of the Council on Markets in Crypto-assets, and amending Directive (EU) 2019/1937]).

However, most of the undertakings in this category are likely to have significant resources that would place them far from what might be considered a shell entity.

(c) undertakings that have the main activity of holding shares in operational businesses in the same Member State while their beneficial owners are also resident for tax purposes in the same Member State;

Generally, those kinds of holding companies cannot obtain any benefits the beneficial owners can obtain in their own capacities, so they should not pose any risk to the tax base of the member state that is the resident state of the operational businesses, the holding company, and the beneficial owners. Moreover, such holding company should never meet the second gateway criterion (that is, cross-border activity).

(d) undertakings with holding activities that are resident for tax purposes in the same Member State as the undertaking's shareholder(s) or the ultimate parent entity (as defined in Section I, point 7, of Annex III to Directive 2011/16/EU);

Again, because the entities performing holding activities should generally not be able to obtain any benefits that the shareholders or ultimate parent could not obtain in their own capacities, they should not pose any risks.

(e) undertakings with at least five full-time equivalent (FTE) employees or members of staff exclusively carrying out the activities generating the relevant income.

That employee test seems to apply at the entity level rather than the group level. However, given that in the EU an entity often relies on the infrastructure of other group entities resident in the same member state, it would be reasonable to extend the test to the group level using employees in the same member state. For alternative investments, it would also be reasonable to apply the employee test at the level of the asset manager. However, one may wonder if a minimum of five FTE employees is excessive, representing an artificially high level of substance.

2. The Gateway Criteria

The gateway criteria are tests regarding relevant income, cross-border activities, and the management of day-to-day operations and the decision-making on important functions. Only when all three criteria are met will the entity have to comply with reporting obligations in its corporate tax returns.

a. Realization of Relevant Income

The first test concerns the income realized by an entity. It is met when more than 75 percent of the revenue accruing to the entity in the preceding two tax years is relevant income, defined as:

(a) interest or any other income generated from financial assets, including crypto assets (as defined in article 3(1), point 2 of the proposal for a Regulation of the European Parliament and of the Council on Markets in Crypto-assets, and amending Directive (EU) 2019/193713);

(b) royalties or any other income generated from intellectual or intangible property or tradable permits;

(c) dividends and capital gains realized on disposal of shares;

(d) income from financial leasing;

(e) income from immovable property;

(f) income from movable property (other than cash, shares, or securities) held for private purposes and with a book value of more than €1 million;

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(g) income from insurance, banking, and other financial activities; and

(h) income from services that the undertaking has outsourced to other associated enterprises.

For income from movable (as defined under (f)) and immovable property (as defined under (e)), the test would be met if the assets' book value represents more than 75 percent of the total book value of the entity's assets, regardless of whether income from those assets has actually accrued. Likewise, when an entity owns participations, the test would be met if the assets' book value is more than 75 percent of the total book value of the entity's assets, regardless of whether income from those assets has accrued.

b. Cross-Border Activity

The second test is met if at least 60 percent of an entity's relevant income is earned or paid out via cross-border transactions.

This test should focus exclusively on the entity's assets and related income and business activities. Cross-border transactions should include all income-generating arrangements, investments, and business activities that involve foreign counterparts, including the ownership of assets located in a foreign jurisdiction.

Also, for assets that may generate income from immovable property and specific movable property (as defined under (f)), the test would be met if more than 60 percent of the book value of the entity's assets were located outside its residence state in the preceding two tax years.

c. Outsourcing Functions

The third test is met if, during the preceding two years, the entity outsourced both the administration of day-to-day operations and the decision-making on significant functions. Outsourcing parts of those functions should not suffice for meeting this test.

The draft directive notes that undertakings without adequate resources tend to engage third-party service providers or enter into agreements with associated enterprises to supply some administrative, management, correspondence, and legal compliance services. But it acknowledges that outsourcing only some ancillary services, such as bookkeeping, while retaining core activities, would not itself suffice to meet this condition.

However, outsourcing day-to-day operations to an associated enterprise (resident in the same jurisdictions) or professional service providers is legitimate and should not lead to the conclusion that an entity does not have appropriate substance. Moreover, even when some operations are outsourced, the entity's employees or directors have to monitor and review the services rendered. To be compliant with CJEU case law on substance requirements in the context of antiabuse rules, outsourcing to an associated enterprise resident in the same jurisdiction as the entity should not be considered outsourcing under this test.

The decision-making on significant functions is rarely outsourced and instead handled internally by the entity's directors (during board meetings that should be held in the entity's residence state). Directors are an entity's own resources, and the board is the competent body for making all important decisions regarding the entity's business activities, investments, compliance obligations, and so forth.

Even so, it is unclear whether appointing independent directors, considered best practice in many circumstances, would constitute outsourcing. Moreover, when an independent director offers services through a company established for that purpose (such as for risk management), the agreement for directorship would be entered into between the director's company and the entity. However, because individuals appointed to an entity's board of directors have a duty to fill their roles in an independent fashion and are subject to significant personal liability for wrongdoing or negligence (irrespective of contractual aspects), it seems logical that they should be considered the entity's own resources.

Likewise, nonresident individuals who are employees of the group or an asset manager and appointed to the board of directors of a company should not amount to outsourcing of decision-making on significant functions as these people, in their capacity as director, are the entity's own resources.

Moreover, even when the board of directors receives recommendations (for example, recommendations by the portfolio manager in the

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context of alternative investments) or certain board decisions are prepared outside the residence state of the entity, decision-making on significant functions should not be outsourced as the directors have to analyze independently whether a decision is beneficial for the company and take the decision during board meetings organized in the residence state of the entity. At the very least, directors have a veto right that they would have to exercise if a specific decision would not be in the best interest of the company. Also adding uncertainty is the term "during" — should it be understood as meaning, at one end of a continuum, any outsourcing that took place at any moment during the two previous years or, at the other end of a continuum, outsourcing lasting the entire two-year period? Common sense suggests the answer is somewhere along the continuum, but the draft is unclear.

3. Indicators of Minimum Substance

a. Declarations to Be Made on a Tax Return

When an entity meets all the gateway criteria, it would have to declare in its annual corporate tax return whether it meets several indicators of minimum substance:

> (a) the entity has own premises in its residence state or premises for its exclusive use;

At first sight, that indicator seems too narrow because the availability of premises requires neither ownership nor exclusive use. Rather, depending on the requirements of the specific case, an entity may rent premises for its exclusive use, on an ad hoc basis (such as when office spaces or meeting rooms are needed), or use the premises of other group companies resident in the same jurisdiction.

For alternative investments, a company could also rely on the asset manager's premises. That broad interpretation would be consistent with relevant CJEU case law that an entity may legitimately rely on the resources and infrastructure of another group entity that is resident in the same jurisdiction.[15]

> (b) the entity has at least one own and active bank account in the Union;

While it might be expected that all entities have their own accounts with banks in a member state, it is unclear what "active" means in this context. In our view, a bank account should be considered active when it is operational and used by the entity when needed.

> (c) one of the following indicators:
>
> (i) One or more directors of the undertaking:
>
> - are resident for tax purposes in the residence state of the entity, or at no greater distance from that Member State insofar as such distance is compatible with the proper performance of their duties (for example, frontier commuters);
> - are qualified and authorized to take decisions in relation to the activities that generate relevant income for the undertaking or in relation to the entity's assets;
> - actively and independently use the authorization to take decisions on a regular basis;
> - are not employees of an enterprise that is not an associated enterprise and do not perform the function of director or equivalent of other enterprises that are not associated enterprises;

The first three aspects of that indicator should generally not be problematic because it is fairly common for entities to have local directors that must be sufficiently experienced and qualified for the position. Further, all directors must be actively involved in the decision-making process, which should be properly documented (for example, in the minutes of the board of director meeting, internal memos, email correspondence).

However, the last aspect is problematic because qualified directors could legitimately be appointed to the boards of several companies that may or may not be part of the same group. Further, it is inconsistent with CJEU case law on wholly artificial arrangements.

> (ii) the majority of the FTE employees of the undertaking are resident for tax

[15] Some important examples include *Cadbury Schweppes*, C-196/04 (CJEU 2006); *Eqium SAS, previously Holcim France SAS, and Enka SA v. France*, C-6/16 (CJEU 2017); *Deister Holding and Juhler Holding*, joined cases C-504/16 and C-613/16 (CJEU 2017); and *GS*, C-440/17 (CJEU 2018).

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purposes in the Member State of the entity, or at no greater distance from that Member State insofar as such distance is compatible with the proper performance of their duties (for example, frontier commuters), and such employees are qualified to carry out the activities that generate relevant income for the undertaking.

While this indicator seems to consider exclusively FTE employees of the entity itself, it would make sense to amend the wording to explicitly include employees of other group entities that are resident in the entity's residence state or are frontier commuters. For alternative investments, it would also be reasonable to include employees of the asset manager in the analysis.

Overall, the proposed indicators of minimum substance are not suitable to detect a wholly artificial arrangement. Moreover, the CJEU has held that antiabuse legislation cannot rely on formatted criteria; instead, whether an entity's substance is inappropriate for the activities performed must be established case by case.

b. Documentary Evidence

Entities that meet the gateway criteria must also provide the following documentary evidence in their tax returns:

- premises address and type;
- amount and type of gross revenue;
- amount and type of business expenses;
- type of business activities performed to generate the relevant income;
- the number of directors, as well as their qualifications, authorizations, and place of tax residence, or the number of FTE employees performing the business activities that generate the relevant income, as well as their qualifications and place of tax residence;
- outsourced business activities; and
- bank account number, any mandates granted to access the bank account and to use or issue payment instructions, and evidence of the account's activity.

c. Presumption of Minimum Substance

Entities that satisfy all the indicators of minimum substance and provide appropriate documentary evidence as defined in the draft directive are deemed to have minimum substance for that tax year.

As mentioned, the indicators of minimum substance should be interpreted broadly to be consistent with relevant CJEU case law. It would be helpful if the commission provided clarification on that point.

In contrast, when an entity does not meet all the indicators of minimum substance or does not provide appropriate documentary evidence, there is a rebuttable presumption that it is a shell that lacks minimum substance.

4. Rebutting the Presumption

Entities presumed to lack minimum substance can rebut that presumption by providing additional supporting evidence of the business activities they perform to generate relevant income.

According to the draft directive, entities presumed to be shells should provide the following additional evidence:

- a document that would help tax authorities ascertain the commercial rationale behind the establishment of the undertaking;
- employee profiles, including their qualifications and experience, decision-making powers in the overall organization, roles and positions in the organization chart, and employment duration, as well as the type of their employment contracts; and
- concrete proof that decision-making regarding the activity generating the relevant income occurs in the entity's member state.

An entity is deemed to have rebutted the presumption if it can show that it has performed, continuously had control over, and borne the risks of the business activities that generated the relevant income (or, in the absence of income, the entity's assets).

When an entity successfully rebuts the presumption of being a shell entity, a member state can accept that for five years as long as the entity's factual and legal circumstances remain unchanged during that period.

While it is positive that the draft directive offers entities to rebut the presumption, in practice there might still be devastating consequences for taxpayers. The draft directive

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neither requires member states to review the evidence in a specific time nor provides taxpayer protection while the competent authorities review the evidence. Thus, entities could face adverse tax consequences for an extended period.

a. Limits of EU Antiabuse Legislation

An entity rebutting the presumption that it lacks minimum substance should rely on the criteria from CJEU decisions involving wholly artificial arrangements because antiabuse legislation in domestic law or bilateral treaties must comply with EU law as interpreted by the CJEU.[16] Given the far-reaching tax consequences of being classified as a shell entity under the directive, the proposed regime clearly must adhere to that standard.

According to the CJEU, the objective of combating tax evasion and avoidance — whether that relies on article 1(2) of the parent-subsidiary directive or is a justification for an exception to primary law (freedom of establishment) — has the same scope. Therefore, antiabuse provisions must specifically target wholly artificial arrangements that do not reflect economic reality and whose purpose is to unduly obtain a tax advantage.

Consequently, tax authorities should not easily find fraud or abuse. Moreover, taxpayers can rely on their EU freedoms when structuring investments, and jurisdiction shopping is a legitimate activity in an internal market, even if the choice of jurisdiction was principally based on tax considerations.

However, it is undisputed that member states can protect their tax bases through antiabuse rules directed exclusively at wholly artificial arrangements. Even so, when assessing the existence of fraud and abuse, tax authorities may not rely on predetermined general criteria. Instead, they must carry out an individual examination of the entire operation at issue. Thus, indicators of minimum substance that are unsuitable to detect a wholly artificial arrangement should be inconsistent with CJEU case law.

An abusive situation does not depend only on the taxpayer's intent to obtain tax benefits — that is, a motive test. It also requires the existence (or absence) of some objective factors, including an actual establishment in the host state (for example, premises, staff, facilities, and equipment) and the performance of a genuine economic activity.

The CJEU does not seem to require an extensive level of substance for there to be an actual establishment. As a rule of thumb, the substance should be appropriate for the activities performed by the company. In that regard, the directive's indicators of minimum substance go beyond the wholly artificial arrangement standard.

The notion of genuine economic activity should be understood broadly and may include the mere exploitation of assets such as shareholdings, receivables, and intangibles to derive passive income. The nature of the activity should not be compromised if that income is principally sourced outside the entity's host state. Thus, it is unclear why two gateway criteria focus on relevant income and cross-border activity, which are not indicators of a wholly artificial arrangement.

Further, domestic antiabuse rules cannot require any specific ties or connections between the economic activity assigned to the foreign entity and that entity's host state. Therefore, for the EU internal market, the mere fact that an intermediary company is active in conducting the functions and assets allocated to it (rather than being a mere letterbox company) should suffice to remove it from the scope of domestic antiabuse legislation. Hence, even if an entity merely realizes income from foreign sources, there should be no indication of a wholly artificial arrangement if the entity properly manages its activities.

When analyzing a company's substance, it is necessary to analyze not only the situation of the entity but also that of the group as a whole: A company relying on the staff and premises of another group company in the same jurisdiction might suffice. Thus, why does one of the proposed carveouts require at least five own FTE employees at the entity level? Why does one of the indicators of minimum substance require the entity to have its own premises?

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[16] *See id. See also* Hoor, *supra* note 3, at 243.

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Further, antiabuse legislation should not establish an irrebuttable presumption of fraud or abuse; instead, the taxpayer must have the chance to provide evidence of the appropriateness of the structure. While it seems obvious that the gateway criteria and indicators of minimum substance are unsuitable to detect a wholly artificial arrangement, the Unshell directive does provide taxpayers the opportunity to rebut the presumption that an entity lacks minimum substance (when the gateway criteria are met and the indicators of minimum substance are not satisfied).

A general tax measure that automatically excludes some categories of taxable persons from a tax advantage without requiring tax authorities to provide even prima facie evidence of fraud and abuse goes beyond what is necessary to prevent fraud and abuse. Accordingly, as long as the foreign company has appropriate substance, the nature (corporates versus individual), origin, or tax status of its shareholders should be irrelevant for the application of antiabuse legislation.

From a practical perspective, setting up holding and finance companies with an artificially high level of equipment, facilities, and employees would be somewhat contrary to their economic nature. The simple presence of a manager monitoring the holding and finance activities of a Luxembourg company may sometime be considered sufficient to bring substance to the structure and thus prevent it from being (partially) disregarded as a result of the application of antiabuse provisions. A low level of substance is the direct consequence of the specific purpose of a holding and finance vehicle and should be accepted for tax purposes, according to the CJEU.

Given that an entity's substance must be appropriate for the activities performed, there cannot be a "one size fits all" list of substance requirements that must be fulfilled to be out of reach of antiabuse legislation. National courts have not deviated from the CJEU's wholly artificial arrangement doctrine.

b. Performing a Case-by-Case Analysis

As noted, entities that do not satisfy the Unshell directive's indicators of minimum substance can still provide evidence that they are not wholly artificial arrangements. In our view, a case-by-case analysis should consider the following aspects:

- overview of the group or investment platform;
- purpose of and commercial rational behind the establishment of the entity;
- overview of the assets owned and income realized by the entity;
- information about the entity's corporate governance (such as the composition and meetings of the board of directors and the involvement of Luxembourg resident directors);
- information about the infrastructure of the entity (and the group, as the case may be) in the entity's member state;
- information about the entity's functional and risk profile;
- reasons for the choice of the entity's residence state;
- tax treatment of the entity in its residence state and abroad; and
- tax benefits obtained and potential antiabuse legislation that may apply.

That would provide the tax authorities with a comprehensive overview of the entity's purpose, substance, business rationale, and activities and should rebut the presumption that the entity is a wholly artificial arrangement.

5. Exemption in the Absence of Tax Benefits

According to the draft directive, an entity should be able to request an exemption from its reporting obligations if its existence does not reduce the tax liability of its beneficial owners or of the group as a whole.

The exemption would be subject to the entity's provision of sufficient and objective evidence that its interposition does not lead to a tax benefit for its group or beneficial owners. The evidence should include information about the group's structure and activities, as well as sufficient information to determine whether a more beneficial overall tax treatment is achieved through the implementation of the entity. However, proving that an entity's existence does not generate any benefit requires a costly comprehensive tax analysis that could span over several jurisdictions. Further, it is unclear whether tax attributes such as tax losses would be deemed a tax benefit under the exemption.

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Once granted, an exemption may be extended for five years after the end of the tax year for which it was granted, as long as the entity's factual and legal circumstances, including those of the beneficial owners and the group, remain unchanged during that time.

Even so, the draft directive again fails to require member states to review an exemption request within a specific time or to provide protection for any review period by the competent authorities. Thus, entities may face adverse tax consequences for an extended time.

6. Shell Entity Checklist

Figure 2 provides a checklist to follow in determining whether an entity is a shell under the proposed directive.

7. Case Study: The Real Estate Fund

On February 1, 2021, an asset manager established a Luxembourg reserved alternative investment fund as a special limited partnership for investing into Pan-European real estate assets. The fund is managed by a Luxembourg limited liability company that is its general partner (GP).

The investors in the fund are institutional investors such as pension funds and insurance companies resident in the EU and North America that invest the contributions of assured people to generate regular income and to benefit from the expertise of the asset manager. No investor owns more than 5 percent in the fund.

The fund's AIFM employs several qualified employees in Luxembourg that render fund management services (portfolio management, risk management, and so forth) and manage the activities of the fund's Luxembourg subsidiaries.

a. Investment Structure

Fund investments are made via a Luxembourg company (LuxMasterCo) and a Luxembourg or local property company per investment (Lux or Local PropCo). The investments in the foreign real properties are financed by a mix of equity and interest-bearing loans.

When determining the optimal ratio between equity and debt funding, the tax law of the situs state of the real property must be considered because income derived from immovable property is taxable in the situs state (and related expenses should be deductible there). If possible, debt funding is generally preferred because it is less formalistic to grant and repay a loan. Further, interest accrued under a loan facilitates the repatriation of cash.

LuxMasterCo finances the interest-bearing loans granted to the property companies largely by interest-bearing loans granted by the fund. In accordance with the Luxembourg transfer pricing regime, LuxMasterCo bears all the risks of its financing activities (in particular, the credit risk) and has the financial capacity to bear the risk should it materialize — that is, LuxCo is financed with sufficient equity to cover the risk if it materializes. LuxMasterCo realizes an arm's-length remuneration as determined in a transfer pricing study.

The participations LuxMasterCo holds in the property companies are financed by a mix of equity (share capital, share premium, and contributions to equity account 115) and convertible bonds that bear fixed interest at arm's length (as substantiated in the transfer pricing study).

Figure 3 shows the fund structure.

b. Tax Considerations

Lux or Local PropCo is subject to tax in the situs state of the real property. When determining the taxable income in the situs state, the rental income derived from the property is reduced by the building's depreciation, arm's-length interest charged under the interest-bearing loan (granted by LuxMasterCo and, when external funding is obtained, the bank), and other operational expenses. Dividend and interest payments made by Lux or Local PropCo should generally not be subject to foreign withholding tax or benefit from a zero withholding rate under EU directives or an applicable tax treaty.

LuxMasterCo is subject to corporate income tax and municipal business tax at an aggregate rate of 24.94 percent (in 2022) and realizes an arm's-length finance margin on its financing activities. Dividends LuxMasterCo receives benefit from the Luxembourg participation exemption regime (the implementation of the EU parent-subsidiary directive into Luxembourg tax law). Interest payments from LuxMasterCo to the fund are not subject to Luxembourg withholding tax. In contrast, dividends LuxMasterCo pays to the fund may be subject to Luxembourg

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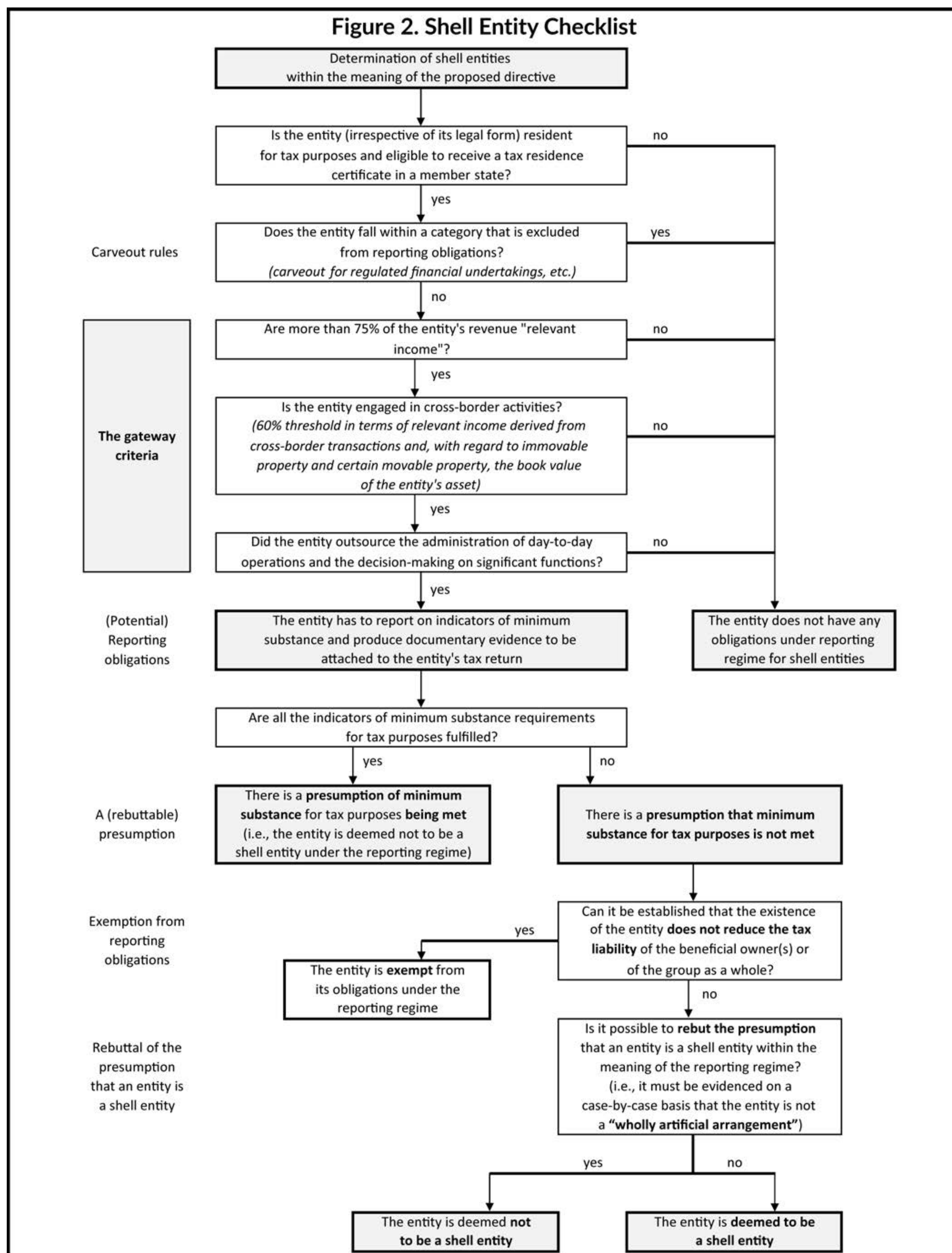

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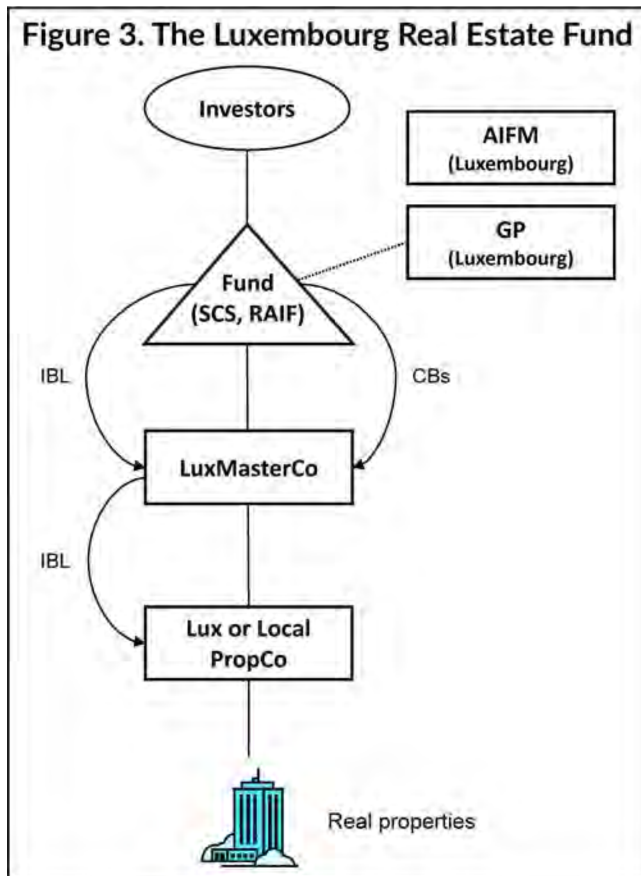

Figure 3. The Luxembourg Real Estate Fund

withholding tax at 15 percent, unless the domestic dividend withholding tax exemption[17] or a reduced treaty rate applies. Because the fund is viewed as transparent from a Luxembourg tax perspective, the potential application of the domestic withholding tax exemption or tax treaties depends on the fund's investors.

The fund is not subject to corporate income tax, municipal business tax, or net wealth tax, but it must pay an annual subscription tax of 0.01 percent (applicable on its net asset value). Payments it makes to its investors are not subject to Luxembourg withholding tax.

c. Commercial Rationale of the Investment

There are many commercial reasons for investing via separate Lux or Local PropCos into different real estate assets, such as segregating investments and related risks, facilitating external financing and arranging bank guarantees, the possibility of organizing co-investments, and providing flexibility for future disposal of the investment (while some investors prefer the acquisition of the real estate asset, others prefer the acquisition of the property company).

Likewise, LuxMasterCo is established for several commercial and legal reasons, such as protecting the fund from liabilities of and potential claims against its investments, facilitating debt funding (including debt obtained from third parties), managing investments (including the acquisition and disposal thereof), and administering claims for relief of withholding tax under any applicable tax treaty.

Further, LuxMasterCo performs numerous investment activity functions, including approving and monitoring investments; carrying on treasury functions; maintaining the books and records of the company and its Luxembourg subsidiaries; ensuring compliance with regulatory requirements in the investment jurisdictions; rendering administrative and other services to subsidiaries; monitoring dividend, interest, and other payments; monitoring and managing investment activity risks; managing and coordinating potential reporting obligations under DAC 6; and handling accounting and bookkeeping requirements.

d. Corporate Governance

The board of directors of LuxMasterCo and GP (as well as Lux PropCos) is composed of at least 50 percent Luxembourg resident directors that have extensive experience in managing real estate investments (portfolio management, legal, accounting, regulatory, tax, and so forth).

LuxMasterCo's functions are performed by the directors, who commonly use the company's rented office space in Luxembourg City. For some functions, such as monitoring investments, the directors rely on support from the AIFM.

The directors also supervise the drafting of legal documentation, the preparation of financial reporting and transfer pricing documentation, and direct and indirect tax compliance, all of which are outsourced to qualified Luxembourg service providers.

e. Why Luxembourg?

The asset manager had many reasons for choosing Luxembourg as a fund and holding location, such as having extensive experience with the Luxembourg regulatory environment

[17] Article 147 of the Luxembourg Income Tax Law.

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and available fund regimes; the flexible and diverse regulatory and legal environment; lender and investor familiarity with the location; access to qualified, multilingual personnel; existing business relationships with various Luxembourg services providers, depositary banks, and so forth; and the country's extensive tax treaty network and political stability.

f. Analyzing Potential Obligations

i. Fund

The fund is a tax-transparent partnership that is generally ineligible to receive a tax residence certificate and thus should not be considered tax resident anywhere under the Unshell directive. As such, the fund would not fall within the scope of the proposed reporting regime.

If established in corporate form, the fund should be considered tax resident in Luxembourg and may be eligible for a tax residence certificate. However, it would fall under the carveout rules as an AIF managed by an AIFM.

ii. LuxMasterCo

LuxMasterCo is tax resident in Luxembourg and thus eligible to receive a tax residence certificate. Accordingly, it falls under the proposed reporting regime. Even though it is owned by an AIF that is managed by an AIFM, LuxMasterCo itself should not benefit from the carveout.

Because LuxMasterCo will likely realize more than 75 percent of relevant income (interest income, dividends, and potentially income from the disposal of shares), the first gateway criterion can be assumed to be met. LuxMasterCo meets the second gateway criterion concerning cross-border activities if more than 60 percent of the relevant income is derived from cross-border transactions. However, because the decision-making on significant functions is performed by LuxMasterCo directors — who are the entity's own resources — the third gateway criterion should not be met.

Accordingly, LuxMasterCo would not meet all three gateway criteria and would not have to report on the indicators of minimum substance.

iii. LuxPropCo

LuxPropCo is tax resident in Luxembourg and eligible for a tax residence certificate, so it falls within the scope of the proposed reporting regime. Even though it is indirectly owned by an AIF that is managed by an AIFM, LuxPropCo itself should not benefit from the carveout.

Because LuxPropCo will likely realize more than 75 percent of relevant income (income from immovable property), it can be assumed that the first gateway criterion is met. It meets the second gateway criterion because it can be assumed that the book value of LuxPropCo's foreign real estate assets represents more than 60 percent of its total assets. However, the decision-making on significant functions is performed by the directors of LuxPropCo, so the third gateway criterion should not be met.

Consequently, LuxPropCo would not meet all three gateway criteria and would not have to report on the indicators of minimum substance.

iv. GP

GP is tax resident in Luxembourg and eligible for a tax residence certificate, so it falls within the scope of the proposed reporting regime.

Because GP will likely not realize more than 75 percent of relevant income (mostly, fund management fees), it can be assumed that the first gateway criterion is not met. It further does not meet the second gateway criterion because it can be assumed that most of the GP's income is derived from Luxembourg sources. Last but not least, the decision-making on significant functions is performed by the directors of GP, so the third gateway criterion should not be met either.

Consequently, GP would not meet all three gateway criteria and would not have to report on the indicators of minimum substance.

v. AIFM

The AIFM is tax resident in Luxembourg and eligible for a tax residence certificate, so it falls within the scope of the proposed reporting regime. However, it would fall under the carveout rules as an AIFM.

B. Tax Treatment of Shell Entities

The classification of an entity as a shell would have far-reaching tax consequences in any EU states involved.

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1. Tax Consequences in the Residence State

When an entity is classified as a shell under the draft directive, the tax authorities of the member state where the entity is tax resident should either not issue a tax residence certificate at all or issue a certificate with a warning. The warning should include a specific statement to prevent the certificate's use for obtaining advantages under a tax treaty, the parent-subsidiary directive, the interest and royalty directive, and other international agreements that provide for the elimination of double taxation.

2. Tax Consequences Abroad

a. Anti-Shopping Rules

Member states where the shell entity invests or performs business activities (other than the state where the shell is resident) should disregard the domestic implementation of the parent-subsidiary and interest and royalty directives, as well as the tax treaty concluded with the entity's residence state.

Accordingly, the shell entity would be unable to claim reduced or zero withholding tax rates on dividends, interest, and royalty payments based on the domestic implementation of those directives or under the applicable tax treaty, as well as other tax benefits provided under the treaty.[18]

Thus, this aspect of the directive is broadly similar to existing anti-directive and anti-treaty-shopping provisions under domestic tax law and PPT in tax treaties.

b. Disregarding the Shell Entity

Being classified as a shell entity would also result in tax consequences in the member state where the entity's shareholder is tax resident. More precisely, the entity's shareholder(s) should tax the relevant income of the entity in accordance with its domestic tax rules as if the income had directly accrued to the shareholder. The tax consequences in the member state where the entity's shareholder is tax resident are broadly similar to the CFC rules implemented by member states in accordance with ATAD 1.

In those circumstances, any applicable tax treaty between the member states of the shareholder and the entity is disregarded. However, tax paid on the relevant income in the entity's residence state would be deductible from the tax otherwise due in the shareholder's state.

Also, potential withholding tax levied in the payer's residence state should be deductible in the shareholder's member state to avoid economic double taxation — the draft directive should clarify that.

When the income payer is not tax resident in the EU, the tax treaty between the shareholder's member state and the payer's state may still apply.

When the entity's shareholder is not tax resident in the EU, the payer's member state should apply withholding tax in accordance with its domestic tax law. However, the tax treaty between the payer's state and the third state could result in a reduced or zero withholding tax rate.

c. Income From Immovable Property

When a shell entity owns a real property in the EU, the member state should tax that property in accordance with its domestic tax law as if the property were owned directly by the entity's shareholder. While a tax treaty between the shareholder's residence state and the member state where the property is situated may apply, tax treaties frequently allocate an unlimited primary taxing right to the property's situs state.

When the entity's shareholder is an EU resident, the member state should tax the income derived from the property in accordance with its domestic tax laws. However, the tax treaty between the shareholder's residence state and the situs state should provide a method for eliminating double taxation (either the exemption or credit method).

The tax consequences of this provision would be broadly similar to the application of a GAAR (which had to be implemented in accordance with ATAD 1) when a foreign entity owning domestic real estate assets is found to be a wholly artificial arrangement. Even so, because the situs state has an unlimited primary right to tax income derived from the immovable property, the application of the GAAR or this draft provision should generally not result in a higher tax liability.

[18] For example, exempting capital gains realized on disposal of a participation in a company that is resident in the other member state.

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3. Relationship to Other Antiabuse Legislation

As discussed, the tax consequences in the draft directive are broadly similar to those under antiabuse legislation under the domestic tax law of member states (anti-directive/anti-treaty shopping rules, CFC rules, GAAR) and bilateral tax treaties (PPT, concept of beneficial ownership). But which hierarchy of norms would apply when the draft directive is transposed into domestic law?

The directive suggests that its antiabuse legislation, as the more specific rule, should take precedence over other antiabuse legislation. However, that outcome would not make sense because the other antiabuse provisions are generally more comprehensive (including further tax consequences and substantial guidance) than the directive's rules.

Given the far-reaching tax consequences resulting from being classified as a shell entity, the proposed regime must adhere to the wholly artificial arrangement standard that applies to the other antiabuse provisions in an EU context. As a result, if adopted, the Unshell directive cannot impose higher substance requirements than those applicable under existing antiabuse legislation.

C. Exchange of Information

Article 13 of the directive outlines the comprehensive information to be exchanged regarding an entity, its shareholders (and beneficial owners), and any person or member state likely to be affected by the reporting.

The proposed reporting regime would require member states to automatically exchange information through a central directory. Exchange would need to occur when an entity meets the gateway criteria or when a member state, based on the facts and circumstances, decides to certify that an entity has rebutted the presumption of being a shell or should be exempt from the reporting obligations. Information exchange would need to occur within 30 days from the time the tax administration has the entity's tax return or issues a decision to certify that an entity rebutted a presumption of being a shell or should be exempt. The information exchanged on any certification should allow other member states to understand the reasons for the tax authorities' assessment.

Automatic exchange would also take place within 30 days of the conclusion of an audit for an at-risk entity if the outcome of the audit affects information already exchanged, or that should have been exchanged, for the entity.

D. Penalties

The Unshell directive proposal leaves it to the member states to establish the penalties for violating the reporting obligations. Penalties could apply, for instance, when an entity meeting the gateway criteria fails to timely report the indicators of minimum substance or makes a false declaration on its tax return regarding those indicators.

The penalties should be effective, proportionate, and dissuasive. According to the draft directive, penalties should include an administrative sanction of at least 5 percent of the entity's turnover in the relevant tax year.

E. Request for Tax Audits

Member states will also be able to ask the entity's resident state to perform tax audits if they have grounds to suspect that the entity might be lacking minimal substance.

The competent authority of the requestee state would have to initiate the audit within one month of receiving the request and conduct it in accordance with the requesting state's audit rules. The requestee state must provide to the requesting state information on the outcome of the audit as soon as possible but no later than one month after the audit's outcome is known.

F. Information Sharing With the Commission

Member states would have to biannually provide the European Commission with statistical data for each tax year, including:

- number of entities that meet the gateway criteria;
- number of entities that reported on indicators of minimum substance;
- penalties for noncompliance;
- number of entities presumed not to have minimum substance and number of entities that rebutted the presumption;
- number of entities exempt from the reporting requirements;

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- number of audits for entities meeting the gateway criteria;
- number of cases in which an entity presumed to have minimum substance was found not to have substantial activity (in particular, following an audit);
- number of requests for information exchange submitted and received; and
- number of requests for tax audits submitted and received.

G. Impact Assessment

Both the European and international tax environments are characterized by extreme legal uncertainty following a multitude of tax law changes in the aftermath of the BEPS project. The commission's proposed regime would only elevate that uncertainty.

The commission has acknowledged that the impact of the measures implemented over the last few years is not yet quantifiable, so it is impossible to establish that entities lacking substance are still a major problem for the internal market.

Given that the tax consequences under the proposed regime are broadly similar to those of antiabuse legislation under domestic tax laws and tax treaties, the expected additional scope of the directive's application is minimal if there is any scope at all.

Should the draft directive be adopted, all entities would have to analyze potential reporting obligations, regardless of whether they obtain tax benefits. That would mean a shift in paradigm from "innocent until proven guilty" to "guilty until proven innocent," and it inserts the suspicion that entities involved in cross-border investment and business activities are illegitimate. That clearly runs counter to the fundamental freedoms on which the European single market and European Union are based.

The directive would also increase compliance obligations on taxpayers that already must consider potential reporting obligations under DAC 6 whenever cross-border arrangements are involved. Likewise, the regime would be a heavy burden for tax administrations, which would have to monitor compliance, review tax analyses by taxpayers, report within short deadlines through a central directory, and perform audits on request from other member states.

Overall, implementing another comprehensive reporting regime that may be expected to have a very limited additional scope does not seem sensible, especially when considering the other tax measures on the short-term agenda (for example, global minimum taxation).

IV. Conclusion

The Unshell directive is meant to restrict abuse by entities that lack substance. However, a lack of substance may already be challenged by national tax authorities based on an all-encompassing web of antiabuse provisions that has been implemented EU-wide, so there should in principle be no residual category of entities that could be caught by the proposed reporting regime.

Thus, it is unclear whether the commission has a legal basis for its initiative. Because it cannot establish that shell entities are still a major problem, and because (we believe) its initiative does not comply with the principles of subsidiarity and proportionality, the commission should not have the authority to intervene, according to TFEU article 115.

Crucially, substance requirements under EU antiabuse legislation must be consistent with EU law as interpreted by the CJEU. Taxpayers are free to rely on their EU freedoms when organizing their investment and business activities as long as the underlying contractual arrangements are not wholly artificial. The proposed reporting regime would have to adhere to the same standard and could not add substance requirements.

Unfortunately, the directive would result in significant administrative burdens for both taxpayers and tax administration. It also risks creating chronic legal uncertainty for years to come, which will hardly contribute to the proclaimed objective to support Europe's recovery from the COVID-19 pandemic. Further, because it would hamper cross-border investment and business activities, the draft directive also fails to ensure the goal of raising adequate public revenue.

Ultimately, it remains to be seen whether the commission will amend the proposed regime for the better and provide useful clarifications. It seems rather unlikely that the commission would give up this initiative throughout the legislative process. ■

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