Feedback on the European Commission proposal for a directive laying down rules to prevent the misuse of shell entities for tax purposes

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The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on the European Commission's proposal laying down rules to prevent the misuse of shell entities for tax purposes (ATAD 3) released for comment on 23 December 2021.

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors, and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

AFME is registered on the EU Transparency Register, registration number 65110063986-76.

Executive Summary

- AFME welcomes the Commission's plans to crackdown on tax avoidance and evasion to ensure fair and effective taxation and preserve the integrity of the internal market. AFME recognises that the Commission has taken several steps in recent years to combat tax avoidance and aggressive tax planning more effectively by equipping tax administrations with new targeted instruments to prevent, identify and penalise abusive practices, including those potentially involving the use of shell entities.

- AFME strongly agrees with the Commission's intended objectives on the Council Directive laying down rules to prevent the misuse of shell entities for tax purposes and amending Directive 2011/16/EU (the "Shell Directive") and agrees that the rules should be properly targeted and proportionate so as not to deter genuine commercial arrangements. AFME recommends that these rules are introduced in tandem with rules targeting non-EU entities to ensure a level playing field, in addition appropriate safeguards should be incorporated toprotect non-abusive and commercial arrangements and any legislation should be forward looking and non- retrospective. There is also a concern amongst members that the rules are currently drafted as a minimum standard, so EU Member States may implement additional domestic requirements which could lead to different rules across the EU bloc and create uncertainty and undue administrative burdens. Given the adverse consequences that can arise if an entity is classified as a shell entity, AFME would welcome clear and precise definitions on certain aspects as set out below.

- Our feedback is presented in greater detail throughout the remainder of the paper. We are grateful for the opportunity to comment on the ATAD 3 proposal, and we remain available to discuss further any of the points raised.

Observations

- **Requirement for harmonisation with other recently implemented and proposed anti- avoidance measures to ensure rules are properly targeted:** The preamble of the proposed Directive refers to recent Directives and other initiatives which aim to tackle tax avoidance within the Single Market. AFME members would agree that there have been a number of new measures implemented or proposed in recent years as a result of both OECD global initiatives (e.g., the MLI principal purpose test in double tax treaties, ATAD interest limitation rules, ATAD GAAR, ATAD CFC rules, anti-hybrid rules and more recently Pillar 1 and Pillar 2) and EU initiatives (e.g., DAC6 reporting obligations). We would recommend that it would be appropriate to monitor the efficacy of such recently introduced anti-avoidance initiatives and their interaction before determining whether further rules are required and their scope. Introducing such a review period could avoid unintended consequences that might otherwise arise, such as double taxation of returns on genuine investments which would deter inward investment.

  The EU Commission has recognised that double taxation can discourage cross border investment and articulated this point in their Inception Impact Assessment published in September 2021 "**EU system for the avoidance of double taxation and prevention of tax abuse in the field of withholding taxes"**. Specifically, the Commission observed in that assessment that: "*In addition, such withholding tax relief mechanisms for cross-border payments have proved to be lengthy, resource-intensive, and costly for both investors and tax administrations due to the lack of digitalized procedures and the existence of complex and divergent forms across Member States. In some cases, these high costs drive non-resident taxpayers to forego their right to apply for the tax treaty benefits that they are entitled to, thereby leading to double taxation and as a consequence to less attractive net returns than for domestic investments. The existence of inefficient, burdensome and costly procedures for the recovery of excess tax paid in a cross-border context discourages cross-border investment in the Union."*

- **Alignment between EU entities and non-EU entities and concerns regarding double taxation in the absence of such alignment:** The current proposal only applies to entities which are tax resident in a Member State. While the Commission has noted that it would envisage introducing an additional proposal to address non-EU entities in 2024, we would suggest that the proposals should be introduced in tandem so that they can be assessed and implemented together. Having different rules applying to entities in the EU to those outside the EU, particularly when their scope is unclear, could lead to legitimate business and investment moving away from the EU in order to avoid burdensome administrative reporting requirements as well as some anomalous and undesirable results such as double taxation.

  The Directive states that "*the allocation of taxing rights necessarily affects only Member States, which are bound by this Directive, i.e. it does not and cannot affect third countries",* although it is recognised *"that it should serve to communicate to Member States and third countries that no relief or refund would be granted with regard to transactions involving the undertaking based on any treaty with the Member State of the undertaking or Union directive if applicable"* and that *"whilst third party countries in which shareholders are based may apply treaties between the shareholder jurisdiction and the source jurisdiction they cannot be compelled to."*

  We would also note that in the absence of an alignment of rules between EU and third countries, there could be double taxation due to clashes with anti- abuse CFC rules in those third countries such as US sub- part F and Canadian FAPI.

- **Disproportionate consequences of denial of certificates of residence (Article 12):** The effects of Article 12 as currently drafted are wider than the loss of treaty relief, Parent and Subsidiary and Interest and Royalties Directives ("the Directives") in EU jurisdictions prescribed by Article 11(1) and could lead to double taxation as referred to above.

- Potential loss of ability to obtain third country treaty relief or domestic exemptions from withholding tax. In the absence of receiving a valid certificate of residence from an entity, a third-party payor based outside the EU, would likely deduct the maximum amount of withholding tax without reference to the tax treaty applicable to the ultimate shareholder(s) even though they have not signed up to a regime equivalent to the Directive. The absence of a valid certificate of residence could also impact the ability to obtain domestic withholding tax exemptions unrelated to the Directives in certain EU jurisdictions where documentary evidence is required to support residency conditions, even if all the conditions are in reality, met. We are not sure what the benefit for the jurisdiction of residence would be. It would be more appropriate to dispense with Article 12(a) altogether and leave the qualified certificate proposed in what is now Article 12(b), valid only for reliefs outside the scope of Article 11(1). Suggested wording would be:

  "*Where an undertaking does not have minimum substance for tax purposes in the Member State where it is resident for tax purposes, that Member State shall grant a certificate of tax residence to the undertaking for use outside the jurisdiction of this Member State which prescribes that the undertaking is not entitled to the benefits of agreements and conventions between EU Member States that provide for the elimination of double taxation of income, and where applicable, capital, and of Articles 4, 5 and 6 of Directive 2011/96/EU and Article 1 of Directive 2003/49/EC*".

- Uncertainty relating to the amount of source country tax creditable in jurisdiction of the shell company: The proposed Directive states that the EU Member State is free to continue to regard the shell as tax resident in its territory and apply tax according to its national laws (it is not clear if it can credit tax levied in the source State and whether credit would be limited in any way e.g. by reference to the withholding tax that would be due under the treaty between the source jurisdiction and the shareholder jurisdiction especially if there is uncertainty about whether the substance requirement is met).

- Uncertainty relating to the amount of source country tax creditable in jurisdiction of the shareholders of the shell entity: The proposal is that that any taxes imposed by the source country and the shell company's Member State of tax residence should be deducted from the tax payable in the shareholder's Member State. However presumably in practice it would only be possible for a taxpayer in the shareholder Member State to credit tax if the payor is an EU resident and not if the payor is outside the EU (it is also not clear if the maximum amount of tax that could be credited is limited to the treaty rate even if more has been withheld by the payor). In addition if investors are based outside the EU, it is unclear how the rules would be applied outside the EU or in conjunction with the provisions of applicable double tax treaties as the Directive on its own cannot oblige non-EU shareholders to follow the same look through approach to the assets, so in fact such shareholders may not be granted double tax relief for withholding tax levied by the source country.

- **Concerns with the rebuttal presumption:** The Directive permits a taxpayer to rebut the presumption that it is a shell entity by proving that it has been set up for genuine business activities. This puts the burden of proof on taxpayers, which does not seem to be in line with CJEU jurisprudence, and there are genuine concerns that there could be significant time lags between the presumption of being a shell and the conclusion of any successful rebuttal (in this respect we welcome the recognition by the Commission of the administrative burdens inherent in rebutting the presumption and the provisions which permit the extension of a finding that the presumption has been rebutted for five years).

  We believe that a more proportionate approach would be for taxpayers to report the status as an entity that required further consideration but to be permitted in the interim to self-assess its tax position, subject to

future audit by tax authorities (such as the approach implemented for DAC 6 and CFC reporting). If this is not acceptable we believe the Directive should contain procedural protections, for example (i) an exhaustive list of documents which a taxpayer should provide in order to rebut the presumption that it is a shell company being used for abusive arrangements (the current requirement is that there should be "*satisfactory supporting documentary evidence*" but that could be interpreted in different ways by different tax authorities) and (iii) maximum timelines in which tax authorities are required to provide responses to confirm that the documentation provided is sufficient and to respond with a determination. Without such safeguards, there is the potential for double taxation. For example, a taxpayer could successfully rebut a presumption that it was not a shell company but by that time the income could have been subjected to tax in the source jurisdiction, given the inability to provide certificates of tax residence, as well as in the shareholder jurisdiction but, given the effluxion of time, may not be recoverable.

- **Requirement for consistency between EU states to avoid fragmentation of rules**: The proposed Directive introduces a "minimum substance test" which allows taxpayers to disclose specific information and provide documentary evidence along with its tax return. However, the proposed legislation allows Member State's tax administrations to classify an entity as shell or "low substance undertaking" under the Member State's own domestic legislation which could be more onerous than the EU Shell Directive (Member States are also entitled to apply their interpretations of beneficial ownership to deny treaty relief).

  The lack of consistent general standards or fragmentation has been noted as undesirable by the FISC Subcommittee on DAC 6 (Assess*ment of recent anti-tax avoidance and evasion measures (ATAD & DAC6))* which noted as follows "*the uncertainties and ambiguities of law can be the source of discrepancies that can also cause over reporting and an overflow of information that some Member States' tax authorities are not prepared to handle. Both of these factors may compromise the goals of the Directive*". And further on "*the impact of the ATAD on Member State laws differs widely between different rules of the Directive and among Member States. Overall, the* ***existing options granted in the ATAD give rise to a certain fragmentation****. While this is lower than it would be in the absence of the Directive's minimum harmonisation effect,* ***a reduction of the number of options should be considered for a more homogenous anti-avoidance landscape*** *across all Member States."*

  As we have noted above the EU Commission has also recognised that fragmentation of tax rules and processes can discourage cross border investment (see the Inception Impact Assessment published in September 2021 "***EU system for the avoidance of double taxation and prevention of tax abuse in the field of withholding taxes***"). We would note that AFME provided feedback on this initiative in late 2021 which agreed with the Commission's assessment, highlighted the importance of having a common understanding of the term "beneficial owner" and asked that any solutions adopted by the proposed Directive should take into consideration the desire to simplify the withholding tax refund procedure. In this respect we would note that giving Member States the possibility to either deny a certificate of tax residency to the shell company or to issue a certificate of tax residency with a warning statement will make the process of withholding tax reconciliation even more complex and will create the potential for more discrepancies between the practices of Member States.

- **Concerns with retroactive period:** The proposed Directive does not apply a transitional period. For example, the gateway criteria examine the "preceding two tax years" which could result in a taxpayer being considered to be a shell entity, despite the fact a number of definitions in the Directive remain unclear and, as a draft Directive, is subject to amendment. A transitional period should be included to allow taxpayers to adapt to any new substance criteria introduced.

  We have noted in preceding paragraphs that there is a significant overlap between existing anti-avoidance legislation and this Directive and so retrospection is of particular concern. Many EU Member States already

have CFC legislation in place with existing substance-type as well as motive test type exemptions and CFCs may well represent a large part of the population of undertakings targeted by this Directive. Retrospective application would result in further taxing the income of the CFCs in EU Member States that has already been taxed under existing CFC rules. Where these CFCs are exempt because of a substance based or motive test exemption, comparing the conditions that they meet with those of Articles 7 (minimum substance test) and 10 (exemption where there is no overall groupwide tax reduction) to ensure that they also meet the new conditions appears to be somewhat counterproductive and unnecessary. It would be reasonable to grandfather existing CFCs meeting those exemptions and assume that they meet the substance-based conditions until there is a change in circumstances, in which case they would be brought within the new regime. Subject to the above, once the new regime comes into force, it would be appropriate to abolish existing domestic CFC and similar regimes which would only add an additional unnecessary burden. Equally, many potentially in-scope entities may sit within corporate groups that are subject to non-EU CFC regimes with the result that they do not represent an opportunity for avoidance or evasion. We therefore think an exclusion from the regime for companies that are captured by these regimes would be appropriate.

- **Concerns with definitions of income classified as relevant income (often referred to as "passive income"):** income from "insurance, financial and banking activity is classified as passive income. Income generated from many types of insurance and banking activities is generally trading income. We note that regulated financial undertakings (e.g., credit institutions, investment firms, insurance undertakings) themselves are not subject to the requirements of Article 7, but certain activities which banking groups conduct (e.g., provision of advisory services) may not be regulated. Entities carrying out such activities may generate cross border revenues and may undertake some outsourcing, so absent any exemption could potentially have extensive reporting requirements. If the concern is with a particular type of financial income e.g. interest generated on loans, then this is covered by the definition of income in Article 4(a). We would welcome more clarity on this point.

- **Concerns with lack of de minimis exemptions:** as the rules are currently drafted there is no *de minimis* test for minority shareholdings. We believe it would be within the spirit of the rules to allow a de minimis exemption for minority shareholders who are not able to influence the activities of the enterprise, so that they are not treated as owning the assets of the underlying entity and taxed on the income generated from the assets of that entity. There are precedents for this approach e.g., this in accordance with the principles of existing CFC legislation. For example this exemption could be aligned with the existing IFRS standard on "significant influence" which in IAS 28 is defined as the "***power to participate in the financial and operating policy decisions of the investee"*** and is presumed to exist where the investor holds at least 20% of the investee's voting power; it is presumed not to exist where less than 20% is held. This would also have the added advantage of reducing the administrative burden for tax authorities that could otherwise arise e.g., in respect of determining the amount of tax that would need to be credited for small percentages of shareholdings.

- **Administrative burden:** as currently drafted, an entity is required to provide documentary evidence with annual tax returns demonstrating that an entity meets each of three "minimum substance" requirements which will unnecessarily increase compliance costs. We would propose there be a requirement to notify the tax authorities only where one or more of the requirements is not met.

- **Concerns with proposed penalty regime:** the proposal is that penalties should include an administrative pecuniary sanction of at least 5% of the undertaking's turnover. We agree that these penalties are dissuasive, but they do not appear to be proportionate, particularly when the reporting includes an obligation to provide "satisfactory evidence" which is a highly subjective test. We would suggest that the penalty regime is tiered to reflect the seriousness of the non-reporting with only the most serious cases of non-reporting attracting penalties of this level.

- **Concerns with lack of clear definitions and/or guidance**: Given the adverse consequences such as onerous reporting and the potential for double taxation we think that the EU Directive should contain very precise definitions or guidance on how terms should be interpreted by tax authorities to provide taxpayers with maximum clarity. The following are examples of where such precise terms are required:

  (i) Article 6(1)(c) states that "*in the preceding two tax years, the undertaking outsourced the administration of day-to-day operations and the decision-making on significant functions."* This term "significant functions" is very vague and could be open to different interpretation in different Member States and by different taxpayers. In addition, no provision is made for entities which previously outsourced operations, but which no longer do so.

  (ii) The requirement to having one qualified director who is tax resident in that Member State or "within such reach of the company as should enable the proper performance of duties" requires clarification - e.g., is a one-hour flight fine?), in addition this requirement does not take account of Covid/post Covid hybrid working practices. Guidance would also be welcome on how a director could demonstrate he/she was suitably qualified and that he/she is "actively and independently" using his/her authorisation on a regular basis.

  (iii) There are also questions about when a bank account should be treated as "active". Some types of SPVS (e.g., securitisation vehicles or holding companies) may only enter into a few transactions each year given the nature of their business. Would this be sufficient to treat a bank account as active?

  (iv) An undertaking can rebut the presumption that it is a shell entity if it demonstrates that it has "performed and continuously had control over, and borne the risks of, the business activities that generated the relevant income or, in the absence of income, the undertaking's assets." Would an entity be treated as bearing risk if it insured or hedged its assets?

- **Concerns that certain commercial undertakings could be in scope**: there are concerns that normal commercial arrangements could be in scope of the new regulations and although entities may be able to rebut the presumption that they are in scope, as noted earlier this could take significant amounts of time given the presumption.

  (i) There is a requirement for each company to own or have exclusive use of premises: global businesses may have several companies or SPVs in one jurisdiction for non-tax reasons (e.g., legal segregation of liabilities required for bankruptcy remoteness, separation of borrowing, guarantee and collateral in leveraged buyouts). It would seem unnecessarily costly for each of these entities to have separate premises.

  (ii) Businesses may have several entities in one jurisdiction but for non-tax reasons may consider it impractical to split employees between these businesses from an administrative perspective (e.g., payroll). It can also be undesirable from an employee perspective to be employed by an entity (or several entities) with a smaller business (i.e., great redundancy potential) rather than a master entity that provides services to all entities in the same jurisdiction. In addition, regulators may require employees to be employed by a service entity to ensure continuity should the operating entity fail. It should be made clear that insourcing arrangements where employees servicing the entity are employed by the group are not viewed as outsourcing arrangements.

  (iii) The market practice regarding the listing of notes issued by securitisation/repackaging vehicles may vary depending on the jurisdiction in which the SPV has been established. Typically, an Irish

repackaging vehicle would have its notes listed but this may not be the case for a Luxembourg SPV. To the extent a Luxembourg repackaging SPV and an Irish repackaging SPV perform a similar function, the derogation set out in Article 6 (which would only cover SPVs as defined in Article 6(2)(n)) appears too narrow.

(iv) It is not clear why bank holding companies should be in scope, they are not regulated entities unlike banks but undeniably have important functions such as corporate governance, the facilitation of additional nonbanking activities (e.g., treasury functions, the employment of staff for deployment across the group) and greater corporate, financial, and operational flexibility. Requiring holding companies of unquoted banking groups to provide documentary evidence which would not be required from their quoted equivalents would subject them to an unnecessary administrative burden. There is no reason for the holding company of a privately owned bank having a less commercially useful function than for a publicly owned bank.

We would welcome the opportunity to discuss this proposal and our concerns with you.

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