LOYENS & LOEFF

4 APRIL 2022

Q&A regarding the EU Proposal for a Directive laying down rules to prevent the misuse of shell entities for tax purposes (also referred to as Unshell Proposal or ATAD 3)

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Introduction

During the L&L webinars on the Unshell Proposal as hosted in February 2022 various questions were raised by the audience. While we provided our answers to the attendees asking the questions, we thought it would be valuable for all attendees to read through the top 10 questions and answers.

These questions address various items, such as:

- the application of ATAD3 in case of a tax consolidation regime;
- the application of the carve outs and the gateways;
- the two-year reference period in the Unshell Proposal that has already started as of 1 January 2022;
- the application of withholding tax exemptions and participation exemptions by a shell entity;
- the risk of double taxation; and
- the interaction with Pillar Two.

These items might also be relevant for you and could help you with assessing the potential impact of the Unshell Proposal on your structure. So we are pleased to share this Q&A with you.

Question 1: Would a fiscal unity be recognized for the application of the Unshell Proposal?

The Unshell Proposal applies to 'undertakings' which are entities that, regardless of their legal form, are (i) engaged in an economic activity, (ii) considered to be tax resident and (iii) eligible to receive a tax residency certificate in a Member State (the gateway criterion). The Unshell Proposal does not give any guidance on how the gateway criterion and substance indicators should be applied to entities that are included in a tax consolidation. Hence, it is currently unclear whether the Unshell Proposal is to be applied on a fiscal unity / group consolidation level or whether, for example, crossing the gateways is to be tested on a stand-alone entity level. So it remains to be seen what further guidance will be provided. It could for example depend on the type of tax consolidation regime in a Member State as to how the Unshell Proposal would be applied.

Question 2: Certain regulated financial undertakings are carved out. Does the carve-out also include the subsidiaries of these undertakings?

Based on the current wording of the Unshell Proposal, regulated financial companies are considered low-risk (and thus carved out), because their activities are subject to an adequate level of transparency. In our view, this does not imply that the subsidiaries of those regulated financial companies would also fall within the scope of a carve-out. Based on the current wording, whether a carve-out applies should be assessed for each individual undertaking.

Question 3: Does the carve-out relating to undertakings with at least five full-time equivalent employees have to be met in the two years preceding 1 January 2024? Is there a requirement for these employees to be a resident in the same Member State as the undertaking?

According to the Unshell Proposal, undertakings with at least five own full-time equivalent employees exclusively carrying out the activities generating the relevant income are carved out. The current wording of the Unshell Proposal does not refer to the two preceding years for this carve out. For this reason, it is in our view reasonable to expect that such carve-out should be met on a yearly basis.

In relation to this carve-out, there is no explicit requirement for the employees to be (tax) resident in the same Member State as the undertaking. However, in relation to the substance indicators, the tax residency of the employees is relevant.

Question 4: What is exactly meant with the following carve-out: “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”?

The current wording of this carve-out in the Unshell Proposal relates to holding entities held (directly - or indirectly, under certain conditions) by (a) shareholder(s) or an ultimate parent company that is a tax resident in the same Member State. For example: if a Dutch company (DutchCo 1) holds all the shares in another Dutch company (DutchCo 2) which is engaged in holding activities, DutchCo 2 would fall within the scope of this carve-out. There is currently not much guidance on what these holding activities should entail. Since the definition of ‘undertaking’s shareholder’ leaves room for different interpretations, it also remains unclear whether DutchCo 2 would still fall within the scope of the carve-out if DutchCo 1 is a shell, lacking sufficient substance. We hope that more guidance will be available in this respect soon.

Question 5: Is the first gateway assessed at head office level (excluding the branches) or should branches also be included?

Based on the current wording in the Unshell Proposal, we expect that the financial statements are decisive when assessing whether the first gateway criterion (i.e. the 75% relevant income test) is met. When the income of a branch is included in the financial statements of the undertaking under review, we expect that this income has to be taken into account for the analysis in relation to the gateway criterion. However, there is currently not much guidance in the Unshell Proposal.

Question 6: If an undertaking outsources activities to another group entity, does it matter where that group entity is located (i.e. in the same country or foreign country) for the application of the third gateway?

The third gateway reads as follows: “*in the preceding two tax years, the undertaking outsourced the administration of day-to-day operations and the decision-making on significant functions*”. The current wording of the Unshell Proposal may leave room for the interpretation that both third party outsourcing as well as intra-group outsourcing falls within the scope, but the exact meaning of ‘outsourcing’ for now remains unclear. In our view, intra-group services should conceptually not be considered outsourcing. Assuming for the time being that intra-group outsourcing is intended to fall within the scope of the third gateway, the Unshell Proposal does not differentiate according to the location of the other group entity involved.

Question 7: Considering the implementation per 2024, it is too late for insourcing the relevant functions in time considering the reference in among others the third gateway to the two preceding years?

Based on the current wording of the Unshell Proposal, the two-year reference period would indeed result in an undertaking meeting the third gateway in 2024 if it insources the relevant functions in 2022. However, the Unshell Proposal is not in final form and could be amended before being adopted by all Member States. We hope that there will be grandfathering rules for 2024 in the final text, but we do not have further information in that respect. We will closely monitor this.

Question 8: EU investors need to include the relevant income of a shell in their taxable income. If those EU investors receive actual income (e.g. a dividend) from the shell, would an exemption be available to avoid double taxation?

The Unshell Proposal does not address the tax treatment of relevant income distributed from a shell to its EU investors. Member States of the EU investors must tax the relevant income as if it accrued directly to the EU investors. If the shell were to make an actual distribution to its investors, it would be fair to expect that the actual distribution is not taxed if the EU investors are able to demonstrate that the distribution has previously been included in their taxable base. However, this expectation remains uncertain as it is not covered in the Unshell Proposal. We hope this will be clarified.

Question 9: If the shell receives a dividend, would the shell then still be able to apply a participation exemption on the dividend it receives and a withholding tax exemption on the dividend it redistributes, based on the Parent-Subsidiary Directive?

The Unshell Proposal indicates that the shell entity itself remains taxed as a resident in its Member State. As a result, the tax treatment of the dividend received by the shell entity should indeed be verified. Based on the current wording of the Unshell Proposal, it seems that only the EU source state and the EU residence state of the shareholder are obliged to deny the benefits of the double tax treaties and the relevant EU Directives (i.e. the Interest and Royalty Directive/Parent-Subsidiary Directive) to the shell entity. It could therefore be argued that the Unshell Proposal does not prevent the shell entity itself from applying the participation exemption and withholding tax exemption laid down in the Parent-Subsidiary Directive. However, it should also be verified in the Member State of the shell entity concerned whether other anti-abuse provisions could still prevent the application of the participation exemption and/or withholding tax exemption.

Question 10: Will any potential tax impact of the Unshell Proposal be included in Pillar II calculations?

There is no guidance yet on the interaction between the Unshell Proposal and Pillar II. Based on the current proposed rules we expect that the tax paid pursuant to the Unshell Proposal should be included in Pillar II calculations. As the Unshell Proposal would in principle not imply adjustments to the financial accounts, which are the starting point for Pillar II calculations, the potential impact on the jurisdictional effective tax rates should be closely monitored.

LOYENS & LOEFF

Contact us

Margriet Lukkien
Partner - Tax adviser
The Netherlands
T +31 20 578 54 18
E margriet.lukkien@loyensloeff.com

Linda Brosens
Of Counsel - Attorney at Law / Professor of Tax Law
Belgium
T +32 2 700 10 20
E linda.brosens@loyensloeff.com

Aline Nunes
Senior Associate - Tax adviser
Luxembourg
T +352 466 230 597
E aline.nunes@loyensloeff.com

Daniel Elling
Senior Associate - Tax adviser
The Netherlands
T +31 20 578 52 71
E daniel.elling@loyensloeff.com

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NL-22-04-QASE