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NOTE

From:	General Secretariat of the Council
To:	Working Party on Tax Questions (Direct Taxation)
Subject:	Proposal for a COUNCIL DIRECTIVE laying down rules to prevent the misuse of shell entities for tax purposes and amending Directive 2011/16/EU - Presidency note on tax consequences (Chapter III)

In view of the meeting of the Working Party on Tax Questions on 27 September 2022, delegations will find attached the Presidency note on tax consequences (Chapter III).

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Presidency note

Working Party on Tax Questions (Direct Taxation)
27 September 2022

Overview

Since the initial presentation of the proposal for a Council Directive laying down rules to prevent the misuse of shell entities for tax purposes and amending Directive 2011/16/EU, the FR and CZ Presidencies have already dedicated six WPTQ meetings to the technical review of all articles of the proposal and related issues. In addition, the proposal has been discussed at the WPTQ (High Level) on two occasions. The CZ Presidency (hereinafter the "Presidency") has already expressed the intention to continue the debates with the aim of searching for the compromise solutions.

In the light of the previous debates, the Presidency decided to focus inter alia on the key part of the proposal, which is at the same time the most controversial part of the proposal, i.e. the **tax consequences** (Chapter III). Indeed, all the other parts of the proposal depend on Chapter III. It is therefore crucial to decide on how to proceed with the tax consequences, namely to have a discussion whether there is a possible way forward that would be acceptable to all Member States. Such an agreement would facilitate the discussion and it would allow for significant progress in other parts of the directive.

Based on the previous discussions at the WPTQ meetings, the Presidency believes that the best way to find a compromise that will have the chance to be unanimously agreed lies in a significant simplification of the proposal.

This Presidency note contains a summary of the issues identified so far in the area of tax consequences and suggests several ways on how to proceed. **The Presidency would like to know the positions of the Member States in order to see whether there is a chance to unanimously agree on any of the options identified below.**

The initiative is part of a broader fight against tax avoidance and evasion in the European Union. The Commission declares that the directive is intended to "fight against the misuse of shell entities for improper tax purposes" and "to help national tax authorities detect firms that exist merely on paper: when that is the case, the company will be subject to new tax reporting obligations and will lose access to tax benefits".[1] There is a clear goal to stop the use of shell (artificial, conduit etc.) entities that do not serve a genuine business purpose, but are being established with the aim of obtaining an unintended tax advantage which can be classified as tax avoidance or tax evasion. Even the title of the proposed directive stresses the element of prevention, namely "to prevent the misuse of shell entities".

The main importance of the directive lies in its deterrent effect (similar to other rules such as CFC or DAC6) because if establishing and using shell entities is not beneficial and the threat of possible additional taxation and related sanctions is strong enough, the motivation for such a behaviour will cease to exist.

The directive has the ambition to help identifying shell entities. Once a shell entity is identified, the information is exchanged. If the identified entity lacks substance, i.e. the arrangement is artificial (conduit entity etc.), tax consequences should follow in any case simply because many national and international anti-avoidance rules and principles (beneficial ownership concept, substance over form, PPT, LOB, general anti-abuse principle enshrined in EU law, anti-conduit rules etc.) already exist and are applicable. This is confirmed by Art. 31 of the Vienna Convention on the Law of Treaties.

Chapter III of the directive, especially Art. 11, represents the most problematic part of the Commission proposal. Chapter III has been heavily discussed among the Member States and they expressed very clearly that any consequences must be clear and fit together with the rest of national and international laws.

The discussions on Chapter III highlighted a number of issues. On the one hand, some of them could be solved by different wording or by adding an explanation or elaborating the provision concerned. On the other hand, many relevant problems

[1] https://ec.europa.eu/commission/presscorner/detail/en/ip_21_7027

remain unresolved. The selected significant issues identified in relation to the current wording of Art. 11 are the following:

- Conflict with the existing anti-avoidance/anti-abuse rules (especially if Member States are allowed to keep and apply all the already existing rules). It seems impossible to have completely new rules while keeping the existing rules. In such a situation the directive will not always lead to "common consequences" across the single market because other rules may lead to different results. Imagine a situation that a Member State already applies certain substance based rules.
- The relation between double taxation treaties and domestic (EU) law (not only the supremacy of EU law within the EU).
- The artificial look-through approach towards a shell entity.
- Taxation of dividends paid subsequently by a shell entity.
- Situation of more than one shareholder.
- Taxation by the state where a shell is located.
- Relationship with the CFC rules.
- Elimination of double taxation (risk of double/multiple taxation) - calculation of tax, credits/deductions for tax paid at the level of the payer and the shell entity (if a shell entity is not a beneficial owner, which is very likely, its state of residence should have no jurisdiction to tax).

The Presidency has identified three possible ways on how to proceed with the tax consequences, namely no tax consequences in the directive, limiting tax consequences only to benefits stemming from the corporate tax directives and a solution based on the initial Commission proposal with further modifications (mostly of a clarifying nature). Delegations will find a more detailed description of these options below with a focus on options that would offer an alternative approach compared to the Commission proposal.

Possible options

1) The directive will not include any tax consequences (identification of shell entities and exchange of information only)

The identification of any entities posing high risk of being used for fraudulent purposes is crucial. This option would mean that once an entity is labelled as shell and the information is exchanged, it is up to each Member State whether to use this information or not.

What can be expected to follow in such a situation? For tax purposes, it is always necessary to identify the beneficial owner of the respective payment (the beneficial owner should declare this to the withholding agent before the payment is made in countries applying the WHT relief at source automatically). It is hard to imagine a situation when an entity is identified as shell (and does not rebut this presumption), and at the same time it is the beneficial owner and the arrangement has not been artificial (if an undertaking has a genuine business purpose, it is never a shell). Once it is clear that the payee is not the beneficial owner, the relation to the payee becomes irrelevant and the only relevant ties for tax purposes are between the payer and the beneficial owner of the respective income.

It can be argued that special tax consequences (consisting in denial of benefits) could help to easily deny certain benefits, but it is always necessary to know the information who is the beneficial owner of the respective payment for the right tax assessment. The above mentioned principles (beneficial owner, conduit entity, abuse of law etc.) should be always taken into account and it follows from the essence of the matter that no special benefit should be granted if the beneficial owner is unknown.

Another significant argument for the key importance of the already existing principles is the fact that any findings may lead to changes in tax liability of taxpayers throughout many taxation periods (statute of limitations is the only limit). In other words, these consequences can have heavier impact on taxpayers trying to use shell entities for tax purposes. One can assume that countries will be willing to use this way if the tax consequences defined in the directive are more limited (especially in time).

2) Tax consequences will be limited to the benefits of the corporate tax directives (2011/96/EU and 2003/49/EC)

The Presidency suggests considering an option that keeps certain level of tax consequences but it does not create many of the issues connected with the original proposal due to the nature of the limited consequences. The tax consequences in this particular scenario will be limited to disregarding benefits based on Directive 2011/96/EU and Directive 2003/49/EC, i.e. no payment to or from a shell entity will be eligible to benefit from a special regime provided by these directives without any other conditions.

The group of entities covered by these two corporate tax directives is clear and even if another entity (which is not covered by the corporate tax directives) is identified as shell, the information will still be exchanged and may be used as described above.

Moreover, both corporate tax directives deal with passive income (dividends, interest, royalties) taxation only, i.e. there is no need to deal with the taxation of capital gains or property taxation. This fact would help to significantly simplify the rest of the Unshell directive. The compromise text proposal on Chapter II presented by the Presidency shows that this approach would allow for a considerable simplification.

An exclusive focus on benefits gained from the two corporate tax directives means that tax treaties are completely left out which means that a lot of problems discussed in connection with the initial proposal will never arise. The Presidency understands double taxation treaties as mainly bilateral treaties that have been concluded and may be changed on a purely bilateral basis (even the modifications via multilateral instruments must be agreed by both parties in order to be effective). It is therefore questionable (having in mind the principles of subsidiarity and proportionality) whether it is necessary to solve problems potentially arising from the application of bilateral treaties using the directive that covers all Member States and even deals with issues concerning third states. There is no doubt that certain double taxation treaties provide (in combination with domestic law) for a favourable treatment that attracts activities/transactions with the aim to obtain

tax benefits. In such situations it should primarily be the issue of the contracting states that signed the double taxation treaty since at least one of them is losing revenues.

Disregarding of benefits of the two corporate tax directives could limit the "directive shopping" activities within the EU. For the "treaty shopping" it is necessary to evaluate every single treaty and a specific bilateral relationship. It may be that a treaty provides (in relation to certain groups of taxpayers or types of income) for the same or very similar favourable treatment as either of the two corporate tax directives. Once again, if such a treaty is being misused, it is up to the contracting states to deal with this issue. Additionally, the willingness to change any treaties that cause problems will be a good sign to the public.

The proposed alternative additionally means that there is no need to address the interaction with CFC rules or any other existing domestic anti-abuse measures (both tax treaty based or purely domestic ones).

To summarize, the indisputable advantage of this alternative is that it allows for a simplification, i.e. easier administration. Having in mind how the shell entities are used, if the benefits of corporate tax directives will be denied (and the same benefit will not be allowed under double taxation treaty), the whole arrangement will lose its advantage. This is true for both, the payments from EU to a third country as well as the payments from a third country to the EU.

3) The tax consequences will be based on the initial proposal by the Commission with further modifications

Third option which is worth considering is to keep the tax consequences with adjustments based on the discussions during the previous WPTQ meetings. Based on the past meetings, certain clarifications will probably help to achieve the intended result. On the other hand, Member States were continuously stressing several serious issues which will remain unaddressed, and have potential to cause problems with the practical application of the proposed rules.

Way forward

In order to structure the discussion on the three options outlined above, the Presidency invites the delegations to reply to the following questions during the WPTQ on 27 September 2022:

1) **What would be your analysis on the three options above?**

2) **Which of the three options would you prefer?**

3) **Do you see other options which could lead to a compromise?**