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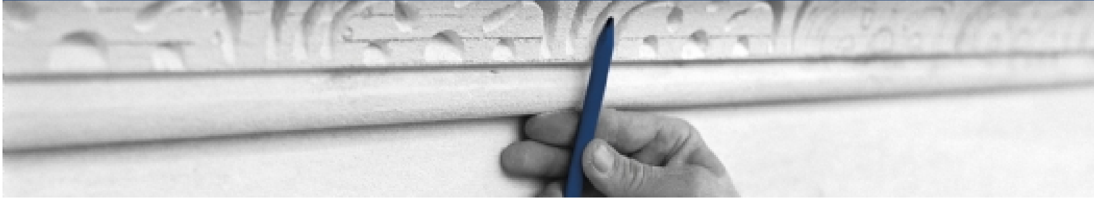

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EU Commission issues draft directives on substance requirements and minimum taxation

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On 22 December 2021, the EU Commission issued two major draft directives that are expected to have a significant impact on EU corporate taxpayers:

- a 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 "**Unshell Proposal**"); and
- a proposal for a Council Directive on ensuring a global minimum level of taxation for multinational groups in the Union (the "**Pillar II Proposal**").

The Unshell Proposal would have to be implemented and applied by Member States from 1 January 2024. The Pillar II Proposal would have to be implemented and largely applied by Member States from 1 January 2023.

Unshell Proposal

Following the adoption on 18 May 2021 of a Communication on Business Taxation for the 21st century, the EU Commission issued a draft directive on 22 December 2021 to tackle the misuse of shell entities for tax purposes within the EU.

The EU Commission considers that, despite all of the tax initiatives taken in recent years (such as the anti-tax avoidance directives (ATAD) or the amendments to the directive on administrative cooperation (DAC)), legal entities still remain that have no or only minimal substance, and that perform no actual economic activity. These entities continue to pose a risk of being used for improper tax purposes, such as tax evasion and avoidance.

The Unshell Proposal introduces measures to prevent the misuse of shell entities, and provides a multi-step test to facilitate their identification. It also introduces an automatic exchange of information on all in-scope entities by amending Directive 2011/16/EU (DAC). The proposed measures can be summarised as follows:

1. Reporting obligations

On the basis of a self-assessment, if an entity considered tax resident in a Member State passes the following three gateways but does not qualify for a derogation (**step 1**), it must report whether it meets indicators of minimum substance (and show supporting evidence) (**step 2**) on its annual tax returns filed with the competent authorities of the relevant Member State(s).

Step 1: the three gateways, which can be summarised as follows:

1. More than 75% of the entity's revenues in the previous two tax years is "relevant income", i.e.:
   a) interest or any other income generated from financial assets, including certain crypto assets;
   b) royalties;
   c) dividends and income from the 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;
   g) income from insurance, banking and other financial activities;
   h) income from services which the entity has outsourced to other associated enterprises;

or

more than 75% of the total book value of the entity's assets are (i) real estate assets and movable property (other than cash, shares or securities, held for private purposes and with a book value of more than €1 million) or (ii) shares.

2. The entity is engaged in cross-border activity on any of the following grounds:

(i) more than 60% of the book value of the entity's assets that fall within the scope of points (e) and (f) above was located outside the entity's Member State in the preceding two tax years;
(ii) at least 60% of the entity's relevant income is earned or paid out via cross-border transactions.

3. In the preceding two tax years, the entity has outsourced the administration of day-to-day operations and decision-making on significant functions.

Certain entities qualify for a **derogation** and are not subject to reporting requirements. These entities include i.a. listed companies, regulated financial undertakings (including, i.a., alternative investment funds (AIFs) and their managers (AIFMs), UCITS and their management companies, insurance/reinsurance undertakings and authorised insurance or reinsurance special purpose vehicles, securitisation special purpose entities as defined in Regulation (EU) No 2017/2402, and certain crypto-asset service providers), certain groups of companies where all entities and shareholders are located in the same Member State, and entities with at least five own full-time equivalent employees exclusively carrying out the activities which generate the relevant income.

Step 2: the minimum substance indicators that entities must meet can be summarised as follows:

1. The entity has own premises, or premises for its exclusive use, in the relevant Member State;
2. the entity has at least one own and active bank account in the EU;
3. one of the following indicators applies:
   a) either one or more of the entity's directors meet certain conditions (i.a. they are resident for tax purposes in the entity's Member State (or cross-border workers), they are qualified and authorised to take decisions in relation to the entity's activities and use this authorisation actively and independently, they 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); or
   b) the majority of the entity's full time-equivalent employees are resident for tax purposes in the entity's Member State (or cross-border workers), and such employees are qualified to carry out the activities that generate relevant income for the entity.

2. Tax consequences

If an entity meets all the substance indicators and provides the requisite documentary evidence, it will be presumed to have minimum substance for the tax year.

By contrast, if an entity does not meet one or more of the substance indicators, it will be presumed not to have minimum substance, and the following tax consequences will apply, unless the entity rebuts the presumption created:

- benefits under tax treaties and the Parent-Subsidiary and Interest and Royalties Directives will be denied;
- tax residence certificates will be denied, or will be granted but with the indication that the entity is a "shell";
- the presumed "shell" entity will be treated as a "flow-through entity". As a consequence:

    (i) if the "shell" entity has shareholders in third countries, payments by EU entities to the "shell" entity will incur withholding tax, subject to domestic law / any applicable tax treaty being applicable;
    (ii) if the "shell" entity has EU shareholders and receives payments from EU entities, the EU shareholders must tax the relevant income received by the "shell" entity as if it had accrued to them directly, and deduct any tax paid on such income in the "shell" entity's Member State(s);
    (iii) if the "shell" entity has EU shareholders and receives payments from third-country entities, the EU shareholders must tax the relevant income of the "shell" entity as if it had accrued to them directly, without prejudice to any applicable tax treaty.

- if the "shell" entity owns real estate assets that are for the private use of individuals and that have no income flows, these assets will be taxed by the state where they are located as if they were owned by the relevant individual directly.

A presumed "shell" entity can **rebut the presumption** not to have minimum substance by providing evidence of the business activities it performs to generate relevant income, such as detailed information about the commercial rationale of its establishment, the profiles of its employees and proof that decision-making takes place in its Member State of tax residence. If the presumption is successfully rebutted, this may remain valid for five years, under certain circumstances.

In addition, an entity may qualify for an **exemption** if it provides sufficient objective evidence that its existence does not create a tax benefit for its beneficial owner(s) or the group as a whole. Such exemption is valid for one year, and can be extended for five years under certain circumstances.

3. Automatic exchange of information

Information on all entities in scope of the Unshell Proposal will be automatically exchanged, regardless of whether they are "shell" entities.

Member States' certifications that an entity qualifies for an exemption or has successfully rebutted the "shell" presumption will also be exchanged automatically.

The Unshell Proposal will also enable Member States to request that another Member State conduct a tax audit of any entity that reports in the latter State, and that it communicate the outcome to the former State within a reasonable timeframe.

4. Penalties

Penalties are to be set by Member States, but must include an administrative pecuniary sanction of at least 5% of the entity's turnover in the relevant tax year for non-compliance with the reporting obligations or a false declaration on the tax return.

5. Timeline

Once adopted as a directive, the Unshell Proposal is expected to be adopted and published into Member States' national law by 30 June 2023, and to come into effect as of 1 January 2024.

Pillar II Proposal

On 20 December 2022, following an agreement known as Pillar II signed by more than 130 countries in October 2021 on a global minimum tax, the OECD published final model rules for a global minimum tax (the Global Anti-Base Erosion Rules or "GloBE rules").

The GloBE rules aim to ensure that large multinational enterprises (MNEs) groups pay a minimum level of tax on the income arising in each of the jurisdictions where they operate, by imposing a top-up tax whenever the effective tax rate, determined on a jurisdictional basis, is below the minimum rate of 15%.

The Pillar II Proposal issued on 22 December 2021 by the EU Commission builds on the OECD GloBE rules and expands their scope to domestic groups. The following is an overview of the EU Pillar II rules.

The proposed rules will apply to any large group, domestic or international, including in the financial sector, with combined financial revenues of more than €750 million a year, and with either a parent company or a subsidiary located in an EU Member State.

In line with the OECD model rules, the Pillar II rules provide for the exclusion of certain entities from the scope of the Pillar II Proposal, including:

- pension funds, investment entities and real estate investment vehicles that are ultimate parent entities;
- governmental entities, international organisations, non-profit organisations; and
- certain entities owned by these excluded entities that hold assets or invest funds and only carry out ancillary activities, or that mostly derive excluded income.

- In order to compute the potential Pillar II tax liability of a group in scope of these rules, one of the first steps is to compute the effective tax rate ("**ETR**") per jurisdiction where the group operates. Broadly speaking, the ETR is calculated by dividing the taxes paid by the entities in the jurisdiction by their income. If the ETR for the entities in a particular jurisdiction is below the 15% minimum, then the Pillar II rules are triggered and the group must pay a top-up tax to bring its rate up to 15%. This top-up tax is known as the "income inclusion rule". The calculations are to be made by the group's ultimate parent entity, unless the group assigns another entity.

If a group is based in a non-EU country which does not apply the GloBE rules or equivalent measures, Member States will apply the "undertaxed payments rule" ("**UTPR**"). This is a backup mechanism. It means that a Member State will effectively collect part of the top-up tax due at the level of the entire group if some jurisdictions where group entities are based tax below the 15% minimum and do not impose a top-up tax themselves. The amount of top-up tax that a Member State will collect from the entities of the group on its territory is determined using a formula based on employees and assets.

The proposed rules provide for exceptions, including i.a.:

- A *de minimis* exclusion: no top-up tax will be charged on the group's profits earned in a jurisdiction in which both the revenues and the profits in that jurisdiction are under a certain minimum amount, even when the effective tax rate is below 15%.

- A "substance carve-out": an amount of income that is at least 5% of the value of tangible assets and 5% of payroll will be excluded from the top-up tax. For the first 10 years, the substance carve-out starts off at 8% of the carrying value of tangible assets and 10% of payroll costs. For tangible assets, the rate declines annually by 0.2% for the first five years and by 0.4% for the remaining period. In the case of payroll, the rate declines annually by 0.2% for the first five years and 0.8% for the remaining period.

- Income earned in international shipping.

Once adopted as a directive, the Pillar II Proposal is expected to be implemented into Member States' national law by 31 December 2022, and come into effect as of 1 January 2023. Provisions necessary to comply with the UTPR rules would apply from 1 January 2024.

Next steps

The Unshell Proposal and the Pillar II Proposal must now be unanimously agreed by Member States in Council.

As the Unshell rules would apply from 1 January 2024, and the Pillar II rules mainly from 1 January 2023, corporate taxpayers operating in the EU have a relatively short time to assess the impact of the proposed rules on their operations.
Such taxpayers should also bear in mind other initiatives that the EU Commission intends to issue in the coming months and years, including i.a. the presentation from 2022 of a new initiative to respond to the challenges linked to non-EU shell entities, another proposal requiring large groups to publish their effective tax rates, the 8th directive on administrative cooperation covering crypto assets, or the new framework for business taxation in the EU (BEFIT).

How can we help?

The Tax Law partners and your usual contacts at Arendt & Medernach are at your disposal to further assess and advise on the impact of the EU Commission proposals on your operations.

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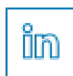
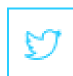

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