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Shell companies in the firing line: criteria and indicators of substance finally unveiled by the European Commission (ATAD III)

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On 22 December 2021, the European Commission published a directive proposal establishing transparency standards to facilitate the identification of shell companies used for tax purposes to ensure that they cannot benefit from tax benefits. This measure is part of the European Union's (EU) policy to combat harmful tax practices.

The draft directive introduces a mechanism for presuming the existence of shell companies, i.e., entities with no or very limited economic activity. All companies established in an EU Member State are concerned, with the exception of those already subject to a certain level of tax transparency or certain holding companies (Articles 2 and 6).

Step 1: Analysis of the economic substance of the entity (Article 6)

This analysis is carried out through three "**decisive criteria"** assessed over the last two financial years.

- **Activity**: +75% of total revenues **are not derived from a business activity** - e.g., passive income from outsourced services to related entities - or, +75% of its assets are real estate and/or high value private property.
- **Cross-border element**: at least 60% of non-derived revenues from a business activity are **received from or transferred to another jurisdiction or at least 60% of the assets** are located in another Member State.
- **Administration and decision-making**: the administration and decision-making processes related to the business activity are **outsourced**.

If **these three criteria** are met, the company will be subject **to an additional reporting** obligation.

Step 2: Reporting obligation (Article 7)

Entities meeting the relevant criteria will be required to report **"indicators of minimum substance"** each year when filing their tax returns.

This includes information on:

- The **premises of the entity**;
- **Active bank accounts**;
- **The tax residency** of managers or employees.

Each of the information communicated must be supported by **documentary evidence**.

Non-declaration will be sanctioned by a **penalty** of at least 5% of the entity's turnover (Article 14).

However, a company **may be exempted** from this obligation if it proves that its interposition does not have the effect of reducing the tax burden of its beneficial owner(s) or of the group to which it belongs, nor does it give them any tax advantage. This exemption will be valid for a period of one year, renewable for a period of five years (Article 10).

If the company does not comply with one of these minimum substance indicators and cannot benefit from the exemption, it will be **presumed to be a shell company** (Article 8).

Rebuttal of the presumption (Article 9)

The entity may rebut this presumption by **providing additional evidence relating to:**

- the **business motive** for its establishment in a Member State;
- the **employees** whom it employs, e.g., their level of experience, their involvement in the management of the company, their contract;
- the fact that **decisions relating to its business** are taken in the Member State in which it is located.

Tax consequences of qualifying as a shell company (articles 11 et 12).

- **Refusal to issue a residence certificate** or, alternatively, issuance of a certificate expressly mentioning the qualification of "shell company".
- **Non-eligibility for tax benefits granted by international tax treaties** and for exemption from withholding taxes under the Parent-Subsidiary (2011/96/EU) and Interest and Royalty (2003/49/EC) Directives.
- **Taxation of incoming flows from a third State or where the shareholder of the shell company is established in a third State:** these flows will be deemed to be made directly between the payer and the shareholder of the shell company and taxed according to the domestic law of the Member State of the shareholder or the Member State of the paying entity.

Exchange of information between Member States and control procedure (Articles 13 and 15)

The information obtained will be subject **to automatic exchange between the tax authorities of the EU Member States** (Directive 2011/16/EU).

In addition, **each Member State will have the possibility to request another Member State to carry out a tax audit** of an entity that has not complied with its obligations under this Directive. The results of this procedure must be communicated to the requesting State within a reasonable time.

Entry into force (article 18)

The proposal of directive to end the misuse of shell entities provides for **transposition** into national law by **30 June 2023** at the latest. **Implementation** should be effective **from 1 January 2024**.

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