Questions and Answers on the Commission's proposal to end the misuse of shell entities

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What did the European Commission propose?

The European Commission has today presented an initiative to fight against the misuse of shell entities for improper tax purposes. Today's proposal will ensure that shell companies in the EU that have no or minimal economic activity are unable to benefit from any tax advantages, thereby discouraging their use.

Why are shell companies a problem?

Shell companies are often used for aggressive tax planning or tax evasion purposes. Businesses can direct financial flows through shell entities towards jurisdictions that have no or very low taxes, or where taxes can easily be circumvented. Similarly, some individuals can use shells to shield assets – particularly real estate – from taxes, either in their country of residence or in the country where the property is located.

What will the new rules do?

The proposed new measures will establish transparency standards around the use of shell entities, so that their abuse can more easily be detected by tax authorities. Using a number of objective indicators related to income, staff and premises, the proposal will help national tax authorities detect entities that exist merely on paper.

What are the standards and indicators used to determine if a company has real economic activity?

The proposal introduces a filtering system for the entities in scope, which have to comply with a number of indicators. These levels of indicators constitute a type of "gateway". Today's proposal sets out three gateways (explained below). If a company crosses all three gateways, it will be required to annually report more information to the tax authorities through its tax return.

How do these gateways work in practice?

The first level of indicators looks at the activities of the entities based on the income they receive. The gateway is met if more than 75% of an entity's overall revenue in the previous two tax years does not derive from the entity's business activity or if more than 75% of its assets are real estate property or other private property of particularly high value.

The second gateway requires a cross-border element. If the company receives the majority of its relevant income through transactions linked to another jurisdiction or passes this relevant income on to other companies situated abroad, the company crosses to the next gateway.

The third gateway focuses on whether corporate management and administration services are performed in-house or are outsourced.

What happens if an entity crosses all gateways?

An entity crossing all three gateways will be required to report information in its tax return related, for example, to the premises of the company, its bank accounts, the tax residency of its directors and that of its employees. These are known as "substance indicators". All declarations need to be accompanied by supporting evidence.

If an entity fails at least one of the substance indicators, it will be presumed to be a 'shell'.

What happens if a company is deemed to be a shell?

If a company is deemed a shell company, it will not be able to access tax relief and the benefits of the tax treaty network of its Member State and/or to qualify for the treatment under the Parent-Subsidiary and Interest and Royalties Directives. To facilitate the implementation of these

consequences, the Member State of residence of the company will either deny the shell company a tax residence certificate or the certificate will specify that the company is a shell.

Moreover, payments to third countries will not be treated as flowing through the shell entity and will be subject to withholding tax at the level of the entity that paid to the shell. Accordingly, inbound payments will be taxed in the state of the shell's shareholder. Relevant consequences will apply to shells owning real estate assets for the private use of wealthy individuals and which as a result have no income flows. Such assets will be taxed by the state where the asset is located as if it were owned by the individual directly.

Can a company deemed to be a shell contest this decision?

Entities that do not meet all substance indicators will still have the opportunity to rebut the presumption of being a shell. They will have to present additional evidence, such as detailed information about the commercial, non-tax reason of their establishment, the profiles of their employees and the fact that decision-making takes place in the Member State of their tax residence.

Will this pose a disproportionate burden on small and medium enterprises?

The Directive does not create a disproportionate burden for any taxpayer. Small and medium enterprises are within the scope of the measures, along with larger businesses. The Directive sets out objective and straightforward criteria, which rely on elements readily available to taxpayers. The process primarily consists of self-assessing whether a specific entity fulfils the substance indicators and is mostly limited to providing answers as part of filling in the tax return.

Will Member States exchange information on shell companies?

Given the cross-border nature of aggressive tax planning, tax avoidance and tax evasion, Member States' authorities will automatically exchange information on all entities in scope of the Directive, regardless of whether these are shell entities or not. The proposal will amend the Directive on administrative cooperation in the field of taxation (or DAC) to this effect.

Most importantly, the proposal will enable Member States to request another Member State to conduct a tax audit of any entity that reports in the latter State and communicate the outcome to the former Member State in a reasonable time frame.

When will the proposal come into force?

Once adopted by the Member States, the Directive should come into effect on 1 January 2024.

How does this fit in the wider Commission agenda on tax evasion and avoidance?

This is one initiative in the Commission's toolbox of measures aimed at fighting abusive tax practices. In December 2021, the Commission tabled a very swift transposition of the international agreement on a global minimum level of taxation for multinational enterprises. In 2022, the Commission will put forward another transparency proposal, requiring certain large groups to publish their effective tax rates, and the 8th Directive on Administrative Cooperation, equipping tax administrations with the necessary information to cover crypto assets. In addition, while this proposal addresses the issue inside the EU, the Commission will present in 2022 a new initiative to respond to the challenges linked to non-EU shell entities.

For more information

Press release

Factsheet

Link to legal texts

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