Proposed EU Directive on Shell companies issued on December 22, 2021

Introduction

This memorandum services the purpose to provide a summary of the Proposed Directive on Shell companies issued on December 22, 2021 (further referred to as "the Directive") by the EU Commission, and to provide a review of the SABIC legal Entity structure in the context of the new requirements imposed by the Directive on EU based SABIC entities. To provide the reader with a comprehensive overview this memorandum is structured as follows:

- In part 1, the background, mechanics, and consequences pertaining to the Directive will be discussed.
- In part 2, the impact of the Directive will be assessed considering the relevant Entity structures in relation to EU Member States being operated by the SABIC Group.

Background

The proposed Directive consists of rules to prevent the misuse of shell entities for tax purposes ("ATAD 3"). If adopted, the Directive should be transposed into national law by June 30, 2023 and come into effect as from 1 January 2024.

The proposed Directive aims at introducing a European Union (EU)-wide "substance test," including a reporting obligation for taxpayers, to assist Member States in identifying undertakings that are engaged in an economic activity, but which do not have minimal substance and, in the view of the Commission, are misused for the purpose of obtaining tax advantages (shell companies). In addition, the Commission proposes to attach consequences to the qualification of a company as a shell company for tax purposes. It also envisages automatic exchange of information by amending the Directive on administrative cooperation in the field of taxation (Directive 2011/16/EU or DAC) as well as a potential request by one Member State to another for tax audits.

The proposed Directive will now move to the negotiation phase among Member States. The Directive constitutes tax legislation. The adoption of tax legislation generally requires unanimity between all 27 Member States to become effective.

Structure of the Directive

The proposed Directive comprises a **seven-step** approach which is summarized below. This step plan should be followed for each Undertaking which is resident for corporate income tax purpose in a Member State.

An Undertaking

An undertaking is an Entity engaged in an economic activity, regardless of its legal form, that is a tax resident in a Member States (hereafter referred to as "Entity"). The Commission proposes that the tax authorities in the Member State in which the Entity is resident shall make an assessment of the information provided by the Entity. For each Entity it will need to be assessed whether the Entity is at risk of falling in scope of the aim of the proposed Directive.

A Seven-Step Approach

Step 1: Gateway

The first step entails three cumulative "gateway" criteria. An Entity passes the gateway and will be regarded a shell company if:

a. More than 75% of the revenues accruing to the Entity in the preceding two tax years is relevant income (interest, royalties, dividends, income from the disposal of shares, income from financial leasing, income from immovable property, income from insurance/banking/other financial activities and income from services which the undertaking has outsourced to other associated enterprises.

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

    i) More than 60% of the book value of the undertakings' assets producing income from immovable property or certain income from movable property held for private purposes and with a book value of more than € 1 million, was located outside the Member State of the undertaking in the preceding two years.

    ii) At least 60% of the Entity's relevant income is earned or paid out via cross- border transactions.

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

However, specific Entities qualifying as Shell entties are excluded – i.e., these entities do not pass the gateway to step 2 – as they are commonly used for good commercial reasons. These Entities can be grouped as follows:

a. Companies with listed securities.

b. Regulated financial Entities included in the list of Article 6 paragraph 2.

c. Holding companies holding shares in operational businesses in the same Member State (OpCo's), while their beneficial owners are also resident for tax purposes in the same Member State.

d. Holding companies that are resident for tax purposes in the same Member State as their shareholder(s) or ultimate parent Entity.

e. Entities with at least five own full-time equivalent employees or members of staff, exclusively carrying out the activities generating the relevant income.

Step 2: Indicators of minimum substance and reporting

An Entity considered at risk under Step 1 need to report on its substance in its tax return to rebut the presumption of being a Shell company.

Summarizing, the Entity is obliged to confirm whether the following cumulative criteria are met and to provide the relevant documentation when filing its tax return declaration in support of its position:

- The Entity has premises available for its exclusive use.
- The Entity has at least one bank account in the EU.
- Has at least one director resident in the Member State of the Entity or in a country close to that Member State and the distance is compatible with the proper performance of the Director's duties, and:
    - The director has the proper qualifications to take decisions in relation to the activities of the Entity.
    - The director has the proper authorizations to take the decisions in relation to the income generating activities of the Entity and its assets.
    - The director has the authorization allowing him to take an active role in the decision-making process.
    - The director habitually makes use and excises the authorizations independently.
    - The director does not fulfill a similar employment function out outside the group of associated enterprises to whom the Entity belongs.
- Alternatively: The Entity has full-time equivalent properly qualified employees of which the majority is resident in a Member State on a distance compatible with the proper performance of their duties, and these employees are engaged in its core income generating activities.

The full list of documentary evidence to be included in the tax return declaration is reflected under Article 7 paragraph 2.

Step 3: Shell company

An Entity considered at risk under Step 1 which does not meet the three criteria under Step 2 is considered a “shell company” which is in principle in scope of the proposed Directive.

Steps 4 and 5: Rebuttal of presumption

Step 4 provides an Entity considered as a “shell company” under Step 3 with two opportunities to rebut this presumption. The first opportunity is that the Entity substantiates that it conducts a genuine economic activity and is therefore not a shell company (in spite of it not meeting the criteria under Step 2). The second opportunity is that the Entity substantiates that it does not create a tax benefit. In such case, despite the Entity having low substance, it is considered out of scope of the proposed Directive as the proposed Directive is aimed at preventing the granting of tax benefits using low-substance companies.

Step 6: tax consequences

The Commission proposes a number of tax consequences for a shell company which fails to rebut the presumption under Steps 4 and 5. Firstly, the Member State of residence of the shell company should either deny the granting of a tax residency certificate to the shell company or only provide a tax residency certificate with a warning statement.

Secondly, other Member States should effectively disregard such a shell company for the granting of benefits under the relevant tax treaties between Member States and tax Directives (for example the Interest and Royalty Directive). This means that no benefits should be provided due to the interposition of such a shell company and that a **“look through”** approach is provided, taxing the beneficial owner(s) of the shell company directly, which can result in a (partial) reduction of the tax benefit obtained through the shell company.

This “look through” approach should also be applied where a Member State is the state of the beneficial owner. In the above context, the Explanatory Memorandum provides for four possible scenarios:

1° Scenario, source state A is a third state, while the shell and its shareholder(s) are resident within EU Member States B and C, summarizing:

- A, source state (non-EU): can decide to apply the tax treaty or national tax law
- B, EU shell: no significant changes, may be able to provide evidence of tax applied on the payment
- C, EU shareholder(s): shall include the payment received by the shell in their income, claiming relief for the tax paid at source, in accordance with the tax A-C tax treaty. It will also consider and deduct any tax paid by the shell.

2° Scenario, source state A is an EU Member State, while the shell and its shareholder(s) are resident within EU Member States B and C, summarizing:

- A, source, payer (EU): it will not have a right to tax the payment, but may apply domestic tax on the outbound payment to the extent that it cannot identify whether the shell's shareholders are in the EU
- B, shell (EU): no significant changes, may be able to provide evidence of tax applied on the payment
- C, EU shareholder: will include the payment received by the shell in its taxable income, as per national law and may be able to claim relief for the tax paid at source, including by virtue of EU directives. It will also consider and deduct any tax paid by the shell.

3° Scenario, the source state and the state of residence of the shell are EU Member States, while the shareholders are resident in a third state, summarizing:

- A, source, payer (EU): will tax the outbound payment in accordance with the tax treaty A-C
- B, shell (EU): no significant changes, may be able to provide evidence of tax applied on the payment
- C, third state of residence shareholders: state C is not compelled to apply any consequences; it may be requested to apply the A-C tax treaty to provide relief.

4° Scenario, source state A is a third state, the shell is resident in an EU Member State, while the shareholders are in a third state C, summarizing:

- A, source, payer (non-EU): may apply domestic tax on the outbound payment or may decide to apply the A-C tax treaty if it wishes to look through the EU shell Entity as well;
- B, shell (EU): no significant changes, may be able to provide evidence of tax applied on the payment
- C, shareholders (non-EU): state C is not compelled to apply any consequences; it may be requested to apply the A-C tax treaty to provide relief.

Step 7: Information exchange

As a final step, the Commission proposes that all Member States shall have access to information on any entities considered at risk under Step 1 even if such entities meet any of the exceptions of the other steps. This information will be exchanged automatically. Furthermore, a Member State would be able to request the Member State of the Entity to conduct an audit to a tax resident Entity if it suspects that this Entity lacks the minimal substance.

Penalties

Although the proposed Directive leaves it to Member States to establish penalties, a minimum penalty for non-compliance is provided consisting of at least 5% of the Entity’s turnover.