October 2023

Tax authorities to get tools to identify shell entities

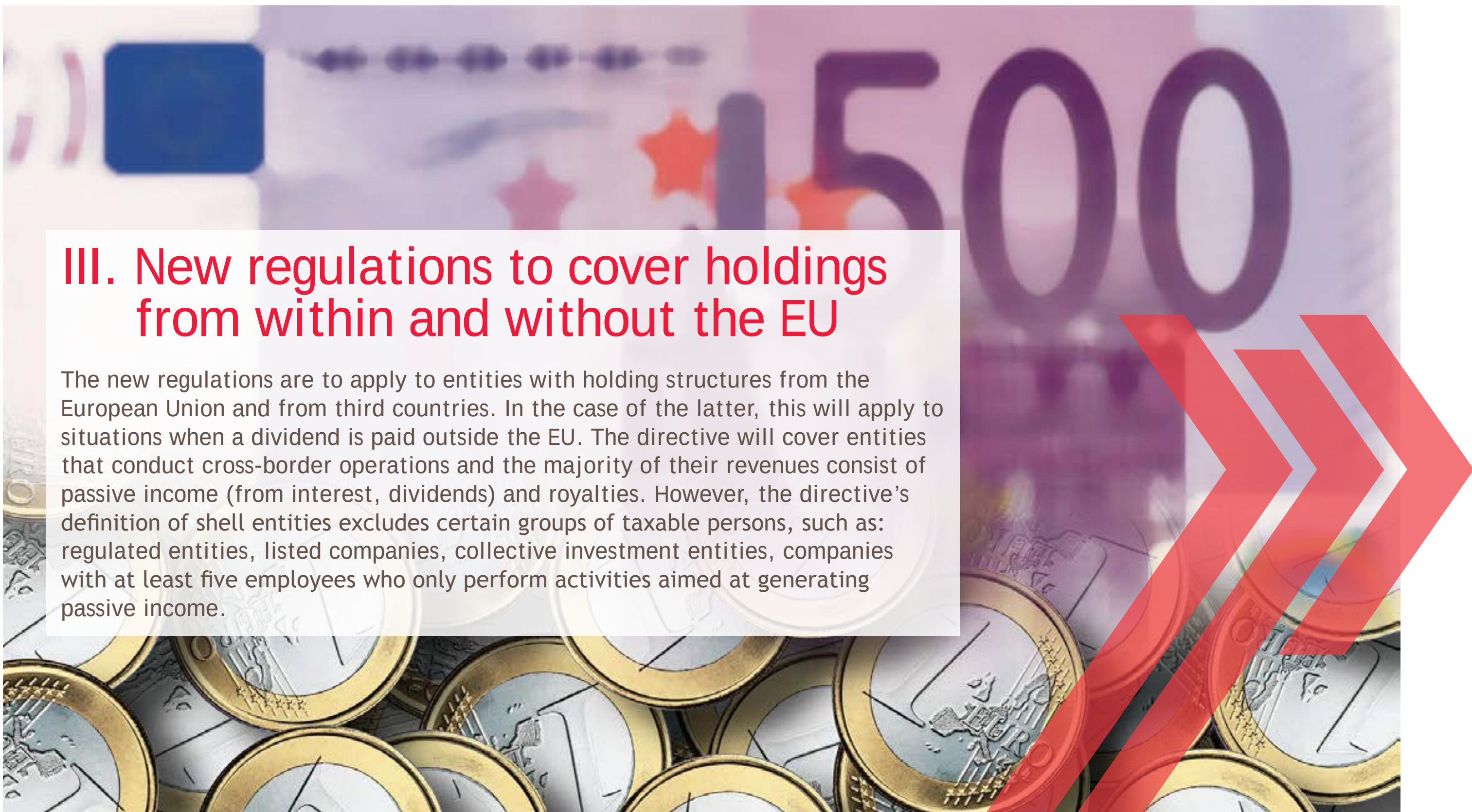
I. New regulations on so-called shell entities to go into effect as of 2024

The European Commission's proposal for a directive on preventing the misuse of shell entities for tax purposes changes Directive 2011/16/EU (so-called ATAD 3 Directive). It is to solve the problem of so-called shell companies, i.e. entities formed to take advantage of tax preferences. The provisions of the directive are to go into effect as soon as in 2024. More importantly, the provisions of the directive will be used to analyze data from two years prior, i.e. from 2022 and 2023. It is therefore clear that the companies covered by the directive should prepare to apply the new regulations now. Especially because penalties for violating the new rules are to reach as much as 5% of revenues.

II. Companies that do not conduct genuine business activities will be scrutinized

Shell entities are entities that do not conduct genuine business activities or conduct minimal business activities. They may sometimes be used for the performance of useful trade functions but may also be misused for the purposes of aggressive tax planning or tax avoidance. As explained by ACAMS (the largest association of anti-money laundering specialists), a shell company (also referred to as a front company) is any company set up and controlled by another organization. It is not always an illegal activity, but criminals use front companies to launder money by creating the appearance of a legal source. Front companies can offer products and services below market prices, or even below production cost.

The ATAD 3 Directive makes changes in the tax obligations of entities, making it easier for the tax administration to identify some of them as shell entities. To avoid the consequences, companies will have to report additional information in their tax returns, also for the years 2022-2023, even though the regulations will not go into effect until 2024.



III. New regulations to cover holdings from within and without the EU

The new regulations are to apply to entities with holding structures from the European Union and from third countries. In the case of the latter, this will apply to situations when a dividend is paid outside the EU. The directive will cover entities that conduct cross-border operations and the majority of their revenues consist of passive income (from interest, dividends) and royalties. However, the directive's definition of shell entities excludes certain groups of taxable persons, such as: regulated entities, listed companies, collective investment entities, companies with at least five employees who only perform activities aimed at generating passive income.

IV. There will be a baseline conditions test to verify company status

The directive will allow member states to identify shell entities – registered in the EU and used only for tax purposes – using a baseline conditions test. It will check the share of passive income and cross-border transactions, as well as determine whether management is outsourced. Suspicious entities will be required to present documentation to confirm their registered office, active bank account and the tax residence of its directors and most employees. If an entity lacks substance in (at least) one of these elements, it will be presumed to be a shell entity that is misused for tax purposes. Shell entities will be able to rebut that presumption by presenting more evidence that the entity is in fact used for purposes other than tax purposes. In consequence, if an entity has not been excluded from the scope of the directive, the tests specified therein will need to be performed.

V. Reduced application thresholds

The directive provides for lowering the currently specified thresholds, which will broaden the range of entities covered by the directive. Under the new regulations, higher risk entities will include those that meet the following criteria: more than 65 percent (currently 75 percent) of revenues consist of so-called passive income (such as interest, dividends, royalties, real estate income); conduct cross-border activities, i.e. more than 55 percent (currently 60 percent) of passive income comes from cross-border transactions or is paid abroad or more than 60 percent of the value of the real properties or intangibles that are the source of passive income is located outside the entity's country of tax residence; have outsourced the administration of day-to-day operations and the decision-making on significant functions – this criterion is met when outsourced to unrelated parties.

VI. Company to prove having appropriate assets and personnel

In order to avoid being identified as shell entities, companies will have to prove that they have the required substance, i.e. meet a set of indicators showing that they do in fact conduct business activities. These factors include: having own premises or premises for their exclusive use; having at least one active bank account in the European Union; having at least one "local" director who has the required qualifications and authorizations or employees the majority of whom are residents in the member state of the company (or reside at a distance that allows them to perform their duties properly), who have the qualifications to perform the activities that generate relevant income for the company.

VII. Annual returns must be filed under financial penalties

Evidence of having met the minimum substance requirements should be submitted in annual tax returns. The returns should also be accompanied by appropriate evidence of the following: the address and type of premises; the amount and type of gross revenues; the amount and type of business expenses; the type of business activities performed to generate the relevant income; the number of directors, their qualifications, authorizations and place of residence for tax purposes or the number of employees performing the business activities that generate the relevant income, as well as their qualifications and place of residence for tax purposes; information about outsourced business activities; bank account number, any authorizations granted to access the bank account and to use or issue payment instructions and evidence of the account's activity. The directive provides for cash penalties to be imposed on entities that fail to comply with the reporting obligations arising out of the ATAD 3 Directive at an amount equal to at least 5 percent of the company's turnover in the given tax year.

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VIII. No tax residence certificate for company identified as shell entity

Where a company is identified as a shell company, it will not be able to receive a certificate of tax residence. This will prevent it from applying preferential withholding tax rules. In consequence, if for example a Polish company pays a dividend to a company identified as a shell entity, the Polish company will be required to collect withholding tax at the rate of 19%, as it will not be able to apply the preferences arising out of double taxation treaties or exemptions under EU directives. When paying interest, instead of the advantages arising out of such treaties, a tax of 20% will have to be collected. Aside from refusing to issue a tax residence certificate, it will also be possible to issue a certificate with a warning statement that the company is not eligible for the advantages arising out of double taxation treaties or exemptions under EU directives. Such a warning statement will therefore have the same tax consequences as a refusal to issue the certificate.

The information presented herein does not constitute comprehensive information or opinion. Consult your adviser before making any decisions.

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