



**UNIVERSITY OF
BELGRADE FACULTY OF
ECONOMICS**



MASTER THESIS

**COMPREHENSIVE ANALYSIS OF THE
PROPOSED UNSHELL DIRECTIVE AND ITS
ANTICIPATED APPLICATION AND IMPACT
ON THE NETHERLANDS**

Candidate:
Nevena Sićević (2866/2021)

Mentor:
Prof. Dr Svetislav Kostić

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Prof. Dr Svetislav Kostić

Committee Members:

Prof. Dr Savka Vučković Milutinović

Prof. Dr Mateja Đurović

BELGRADE

November

2023

Declaration of Authorship

Student: Nevena Sićević

Student ID number: 2866/2021

The author of the work entitled:

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COMPREHENSIVE ANALYSIS OF THE PROPOSED UNSHELL DIRECTIVE AND ITS ANTICIPATED APPLICATION AND IMPACT ON THE NETHERLANDS

REZIME I KLJUČNE REČI

Kako bi obeshrabrila zloupotrebu fiktivnih kompanija za potrebe agresivnog poreskog planiranja i izbegavanja poreza, Evropska Komisija je 22. decembra 2021 objavila predlog nove EU direktive protiv fiktivnih kompanija.

Tema ovog rada je sveobuhvatna analiza relevantnih odredbi predložene direktive u kontekstu EU prava, njene neophodnosti, prednosti i mana kao i potencijalni uticaj na ekonomsko okruženje EU i Holandije kao jedne od zemlja pod najvećim uticajem.

U zaključku ćemo pokušati da damo odgovor na pitanje da li postoji potreba za donošenjem direktive protiv fiktivnih kompanija u ovom trenutku, razmotriti nedostatke direktive kao što je pravni osnov poništavanja međunarodnih sporazuma i predložiti najprikladnije rešenje po mišljenju autora.

Za potrebe ovog rada, korišćene su metode kvalitativne i kvantitativne analize novijih publikacija i statističkih podataka vezanih za upotrebu fiktivnih kompanija i uticaja primene direktive, kao i uvid u kritike od strane PWC, KPMG i drugih relevantnih stručnjaka iz oblasti oporezivanja.

Ključne reči koje se mogu naći u ovom radu su:

- Fiktivna kompanija – pravno lice bez ili sa samo minimalnom ekonomskom osnovom i aktivnošću;
- Izbegavanje poreza – legalno iskorišćavanje poreskog sistema kroz strukturiranje poslova na način da se umanju poresko opterećenje i plati najmanji iznos poreza;
- Utaja poreza – upotreba nelegalnih metoda u kojima se poreska obaveza skriva ili ignoriše, odnosno poreski obveznik plaća manje poreza nego što je zakonski obavezan da plati prikrivanjem prihoda ili informacija od poreskih organa.

ABSTRACT AND KEY WORDS

In order to discourage misusing shell entities for the purposes of tax evasion and aggressive tax planning, the European Commission published on 22 December 2021 a proposal for a new EU directive known as “Unshell Directive”.

The subject of this paper is an analysis of the relevant features of the proposed directive in the context of the EU law, its necessity, its pros and cons, as well as its potential impact on the economic environment in the EU and the Netherlands as one of the most impacted countries.

In the conclusion we will try to provide an answer to the question if there is a necessity for implementing Unshell Directive at the moment, discuss other downsides, such as legal basis to overrule the tax treaties of it, and propose the most appropriate solution based on author’s view.

For the purposes of this paper, the methods used were both qualitative and quantitative analysis of recent publications and statistical data with relevance to the shell entities use and impact of the application of the directive, as well as insights into the criticisms issued by PwC, KPMG and other relevant professionals in the field of taxation.

Key words found in this work are:

- Shell company – legal entity with no, or only minimal, substance and economic activity (Clifford Chance - EU Proposal Directive on Transparency Standards for the use of shell entities in Europe– January 2022);
- Tax avoidance – legally exploits the tax system by structuring affairs to reduce tax burden and pay the least amount of tax due (Nerudova D. and Pavel J., “Profit Shifting and Tax Base Erosion: Case Studies of Post-Communist Countries”, June 2021);
- Tax evasion – illegal arrangements where liability to tax is hidden or ignored, i.e. the taxpayer pays less tax than he is legally obligated to pay by hiding income or information from the tax authorities (COM (2012) 351 final Communication from the Commission to the European Parliament and the Council on concrete ways to reinforce the fight against tax fraud and tax evasion including in relation to third countries, Brussels 27 June 2012).

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INTRODUCTION

In order to discourage the use of the shell companies in EU, on 22 December 2022 the European Commission introduced a proposal for a new EU directive ATAD3¹, the Unshell Directive (Proposal for a Council Directive laying down rules to prevent the misuse of shell entities for tax purposes and amending Directive 2011/16/EU, COM(2021) 565 final, 22 Dec. 2021). The new directive is aiming to diminish the benefits of using the companies with no or minimal economic substance (shell companies) within EU through introduction of the additional mandatory reporting requirements and possible reduction of the tax advantages previously provided by double tax treaties and EU directives, especially Parent- Subsidiary Directive and Royalties Directives with respect to withholding tax exemptions. Initially, it was anticipated that once adopted, the Unshell Directive would have to be transported into domestic laws of the member states by 30 June 2023, and would have taken effect from 1 January 2024. Despite the fact that on 17 January 2023, the (slightly amended) Unshell Directive was adopted by the European Commission, it turned out to be quite ambitious timeline. The implementation of the Directive is still pending possibly postponing the effective date to 1 January 2025.

The need for introduction of the measures that restrict the access to various tax benefits to companies with tax residences of EU lies in extensive use of (intermediate) holding companies by international groups to hold shareholdings in subsidiaries on divisional or regional basis or as a vehicle for portfolio investments as private equity where these holding companies were often utilizing benefits of tax treaties and directives in their country of residence with no negative perception of their entitlement to them. However, the position of these companies and perception of their beneficial tax positions has changed.

In 1977 the term “beneficial ownership” was introduced with the OECD’s Model Tax Convention with main aim to require the answer to the question who benefits from certain payment. Recently, the tax landscape was significantly changed by the G20/OECD Base Erosion and Profit Shifting (BEPS) initiative and many EU measures trying to address issues of aggressive tax planning and tax avoidance. There are multiple developments to note which can be summarized as follows:

¹ Third anti-tax-avoidance directive (ATAD 3)

1. The general anti-avoidance rule (GAAR) as a result of implementation of the EU Anti-Tax Avoidance Directive (ATAD 1) and the Court of Justice of the European Union (CJEU) decisions regarding the EU concept of abuse of law².
2. The concept developed with ATAD 1 of controlled foreign company (CFC), and introduction of the non-cooperative countries list defined on EU level and the implementation of measures to defend against these regimes by EU Member States.
3. The introduction by ATAD 1 and ATAD 2 of anti-hybrid and reverse anti-hybrid rules, which are applicable to companies, partnerships and trusts..
4. The obligatory disclosures introduced by the fifth amendment of the Directive on Administrative Cooperation (DAC6) .
5. The principal purpose test (PPT) implementation in EU countries tax treaties resulting from the OECD Multilateral Instrument (MLI).
6. Making an alignment in the concept of the income generating activities defined within BEPS Action 5 and economic substance, and further with the actions relating to Transfer Pricing (BEPS Actions 8-10).
7. Requirement for issuing publicly available report on country by country basis for international organisations operating in the EU (from 1 January 2024).
8. Fifth Anti-Money Laundering Directive and further proposals for strengthening rules regarding the financing of terrorism and the anti-money laundering.
9. The upcoming implementation of the OECD's Two-Pillar solution that will further decrease space for aggressive tax planning by introducing a minimum level of corporate tax within the EU.

As it can be concluded from above, the criteria for holding companies to have benefits from withholding tax reliefs and non-resident capital gains tax exemptions is being more and more strict. Newly published proposal for ATAD 3 to end the misuse of shell entities is so far the most precise and strict of rules when it comes to companies without the economic substance. There is even widely spread opinion that it should never be appropriate for a shell entity to obtain benefits from withholding tax reduction under the EU directives and tax treaties.

² Please refer to the example case of the EU Court of Justice decisions in the “Danish beneficial ownership cases”

The proposed directive states that it does not replace national and international measures to fight against tax abuse by the shell entity within the EU, but intends to reinforce and work complementary with them by setting objective substance criteria and a uniform set of rules.

The directive is expected to have more than significant impact on holding structures within EU. The scope of Unshell directive is not restricted to international organisations with global income above EUR 750 million as the scope of pillar 2³ is, and therefore will affect small and medium size companies as well. To assess if a company is within the scope of this directive, specific 'gateways' and 'substance indicators' should be assessed which we will elaborate further.

This paper analyses the most important features of the application of the Unshell directive and provides the comprehensive analysis of the:

- Requirements of the proposed Unshell Directive of the EU;
- Practical implications in different case scenarios;
- Criticism from the stakeholders point of view;
- Anticipated application impact on the Netherlands;
- Provide authors view of the application of the Directive.

The questions that we will try to provide answers to are mainly related to the legal and substance basis for the introduction of the Directive, requirements of the directive and practical application to companies, consequences and potential impact on the economy of EU and the Netherlands in particular having in mind the volume of business conducted through shell entities as well as the costs and benefits, and the provide critical view of the Directive in terms of its subsidiarity.

For the purposes of this paper, the following methods were used:

- Qualitative analysis of the official publications issued by European Commission,
- Insights into the criticisms issued by PwC, KPMG and other relevant professionals in the field of taxation,
- Qualitative and quantitative analysis of recent publications and statistical data relevant for the use of shell entities and impact of the application of the directive.

³ The OECD/G20 Inclusive Framework agreement on corporate taxation reform by which EU intends to implement the global 15% minimum tax rate for the large companies

BACKGROUND OF THE PROPOSED UNSHELL DIRECTIVE

Reasoning behind the proposal

EU tax policy led by the principles of fairness and efficiency has a goal to enable fair and sustainable growth. On 18 May 2021, the European Commission adopted a Communication on Business Taxation for the 21st century (COM(2021) 251 final). It sets out program to ensure the adequate public revenues in the future which will be supported by a sound, efficient and fair tax system. The Unshell Directive proposal, presented on 22 December 2021 is one of the short-term measures announced in the Communication to improve the current tax system by ensuring fair and effective taxation.

The proposal targets companies in the EU that have limited economic activity with the aim to enable them to make use of available tax benefits. The proposed Directive also alters the Directive on Administrative Cooperation (2011/16) (Council Directive 2011/16/EU of 15 February 2011 on administrative cooperation in the field of taxation and repealing Directive 77/799/EEC (OJ L 64, 11.3.2011, p. 1), DAC), by expanding the scope of information exchange for information with relevance to this proposal.

In the last years, important progress was made in the topic of preventing the tax avoidance especially with the anti-tax avoidance directive (Council Directive 2016/1164 of 12 July 2016 which sets the rules against tax avoidance that have direct effect on internal EU market (OJ L 193, 19.7.2016, p. 1), ATAD) and the increased scope of the directive on administrative cooperation (DAC), however, companies with limited economic substance continued to provide an option to corporates to utilize them for tax evasion and avoidance. While on one hand, there can be a valid rationale for the establishment of these entities, there is on another hand a situation where taxpayers evade their liabilities under tax rules having in mind their purpose by using enterprises that do not have real economic activity. The result of the latter is to reduce the tax expense. This causes shifting of the taxes to the fair taxpayers and interrupts decision-making in the market. If not successfully dealt with, this would further create an unfair allocation of tax expenses and consequently unfair tax competition.

Compared to the Directive requiring minimum corporate taxation which uses threshold based on revenues for its scope⁴, the Unshell Directive, that was proposed the same day, scopes in all entities that are tax residents in the EU, without any threshold meaning that it has significantly broader scope. The directive on the minimum tax applies only to large multinational groups or large groups on the national level with combined income of over EUR 750 million. As per the Explanatory Memorandum to the Unshell Directive, the two proposals, although complementary, have different purposes.

The Unshell Directive specifically targets entities within the EU that do not have any actual economic activities but make tax advantages available to their group or the owner.

Defining a shell

In the last couple of years, the term 'shell company' has been broadly used in various contexts. In most of the cases it is related to the terms such as 'special purpose vehicle', 'special purpose entity', 'letterbox company', 'mailbox company' and similar. These terms, however, are not per se the same type of entity. Shell companies are differently defined in the literature and practice in different contexts.

Broadly, shell companies can be split into three categories:

- special purpose entities,
- letterbox companies, and
- anonymous shell companies.

Term special purpose entities (SPEs) is used for the entities whose main purpose is holding or group financing activities, which have small number of personnel, is limitedly present in the jurisdiction where it is registered, and whose main balance sheet elements are investments from and/or investments in other jurisdictions. SPEs are known for being utilizing by international groups in aggressive tax structures.

Companies that are referred to as letterbox companies are established in one EU Member State but their economic substance can be located in a different Member State. These companies are

⁴ For more information about the proposed directive see European Commission Launches Directive Proposal Ensuring Minimum Corporate Taxation (22 Dec. 2021), News IBFD.

usually used to avoid less beneficial labour related laws in Member State where their actual business is located.

Anonymous shell companies provide anonymity as their most important feature. At the same time, they provide control over the business and companies resources. Using usually the network of connected (shell) companies, often in multiple jurisdictions, the ultimate beneficial owner (UBO) stays unknown for public. In recent years, anonymous shell companies became subject to many reports of International Consortium of Investigative Journalists (ICIJ), among the others, those concerning data from the Panama Papers leaks⁵. Due to their nature and purpose to hide UBO, anonymous shell companies are often connected to money laundering, tax evasion, corruption and financing of terrorism.

Although in general the term shell entities is associated with tax avoidance or evasion or illegal purposes like money laundering, their purpose can actually be absolutely valid from tax and business aspects. Their purpose can be: securing limited liability, protection of the investors and maintaining the portfolio value, meeting the third party lenders requirements to guarantee allocation of resources and financing, to be a vehicle for joint ventures, effective and efficient decision-making by authorizing the directors, to facilitate (partial) sale (DG TAXUD (2021) – Public Consultation "Tax avoidance - Fighting the use of shell entities and arrangements for tax purposes", input by the European Fund and Asset Management Association (EFAMA)). When it comes to SPE's, their legitimate purpose can be managing financial risk by spreading it over multiple economies and being facilitating vehicle for complex financing operations like international acquisitions, for example. On the other hand, examples of misuse of shell companies were publicized by OpenLux investigation where it was discovered that foreign non-resident investors used holding companies in Luxembourg to significantly lower their tax liability which could be an indication of tax evasion or avoidance, where these holding companies never had premises in Luxembourg, nor employees, nor did business in Luxembourg⁶. Further, the Pandora Papers proved that shell entities are continually utilized in complex offshore structures with the goal of tax avoidance or even tax evasion.

⁵ More information can be found at: <https://www.icij.org/investigations/pandora-papers/>

⁶ For more details see White, J. (February 2021). OpenLux shows failures of beneficial ownership registers. International Tax Review.

Despite the usual expectation that shell companies are associated only with large, international organisations, smaller entities and even (rich) individuals, also take advantages from them.

Shell entities can be found in various legal forms where different legal forms usually drive different tax treatments. Both legal entities like private limited liability companies and foundations can be used as shell entities for tax avoidance or tax evasion, as can legal arrangements like express trusts or partnerships and similar arrangements (COM (2020) 560 Report from the Commission to the European Parliament and the Council assessing whether Member States have duly identified and made subject to the obligations of Directive (EU) 2015/849 all trusts and similar legal arrangements governed under their laws). The difference is that usually the entity that is legally registered as a company for example, when registered in one jurisdiction will automatically get tax residency and be obliged to pay CIT but on the other hand will be able to benefit from tax treaties, while legal arrangements like a partnership, might not get a tax residency status as it might have transparency status regarding taxes and ultimate beneficiary would be subject to taxation at their residence jurisdiction.

What remains as a goal of the regulators expressed in multiple directives and similar is that, no matter which tax is involved, CIT, personal or any other, if a shell entity is used for avoiding or evading tax, it needs to be classified as such and measures are to be taken.

Magnitude of the effect of aggressive tax planning practice

Despite efforts to limit room for avoiding and evading taxes within the EU legislation and more broadly, the estimates regarding the lost tax revenues remain significantly high. Estimated effect of CIT that has been avoided is in a range from USD 90 billion to USD 240 billion yearly. Estimates with regards to the yearly effect on EU tax revenues is from EUR 35 billion to EUR 70 billion (Dover, R., Ferrett, B., Gravino, D., Jones, E., & Merler, S. (2015) Bringing transparency, coordination and convergence to corporate tax policies in the European Union, European Parliamentary Research Service, PE 558.773).

In order to address this abusive usage of shells for avoiding and evading taxes, as per request of the European Parliament driven by the effects of tax evasion and avoidance as explained above which ultimately affects operationally the internal EU market, the Unshell Directive provides rules against tax evasion and tax avoidance in a specific area of shell companies as we will elaborate further.

Geographical scope of expected impact of the Unshell Directive

Issue of using shell entities for avoiding and evading taxes is not immanent only for EU. All over the world, and especially in countries that can be considered tax havens with no or very low taxes, shell entities are widely used. Both data leaks⁷ by the International Consortium of Investigative Journalism (ICIJ) and Pandora Papers leaks suggest wide geographical scope and magnitude of the issue.

While it can be concluded that shell entities are present more often in third countries like for example British Virgin Islands, Panama, the Bahamas, Hong Kong, Seychelles or UAE, a significant number of these entities is still present in the EU Member States, such as Ireland, Luxembourg, Malta and Cyprus.

The topic of the geographical scope of the shell companies issue was attention point of some civil society organisations, and as most important the NGO Tax Justice Network which has developed a combined index that ranks countries base on their ability to facilitate tax avoidance by multinationals. The index is referred to as Corporate Tax Haven Index (CTHI)⁸. Based on the last research, the top 10 jurisdictions with highest CTHI are primarily third countries, but also Luxembourg and the Netherlands and are in the top⁹.

From the observable empirical facts, it is obvious that the Member States are strategically losing up the tax law requirements and adjusting their ETR (effective tax rates) for the purposes of competing between themselves. The reason behind it is that by reducing the effective tax rates, countries become more attractive for foreign direct investment (FDI).

However, as reliable data on shell companies are not available, researches are using proxies based on macroeconomic indicators for determining the latitude and magnitude of use of the shell entities within the EU. In summary, these are: the quantity of companies owned by foreign investors; the foreign direct investment (FDI) to gross domestic product (GDP) ratio; and the difference in profitability when comparing domestic and foreign companies (Kiendl Krišto, I., and Elodie Thirion, E., "An Overview of Shell Companies in the European Union," European Parliamentary Research Service Study PE 627.129 (Oct. 2018)).

⁷For more see <https://offshoreleaks.icij.org/>

⁸ For more data please refer to <https://cthi.taxjustice.net/en/cthi/data-downloads>

⁹ For more data please refer to <https://cthi.taxjustice.net/en/cthi/cthi-2021-results>

The first measurement of shell entities presence in the EU is focusing at quantification of companies with foreign capital, however, it is common sense that not all of them are shell entities.

The Figure 1 presented below ranks EU countries per number of legal entities that have their base in foreign businesses but are registered in chambers of commerce of the EU Member States using the definition of foreign company as "companies with all managers being from one of the other member states and the majority of those managers being shareholders". The overview rely primarily on the 2016 study for the European Commission on the Law Applicable to Companies (LSE, 2016)¹⁰.

The research suggests that there are about 420,000 foreign-owned companies, with the UK (being a member state at the time) leading with more than half of this number (227,000), followed by Estonia and Romania (approximately 30 thousand each), France and Slovakia (approximately 27 thousand each), while the rest of the EU (23 states) account for 18% of it (75,000), as presented in Figure 1 below.

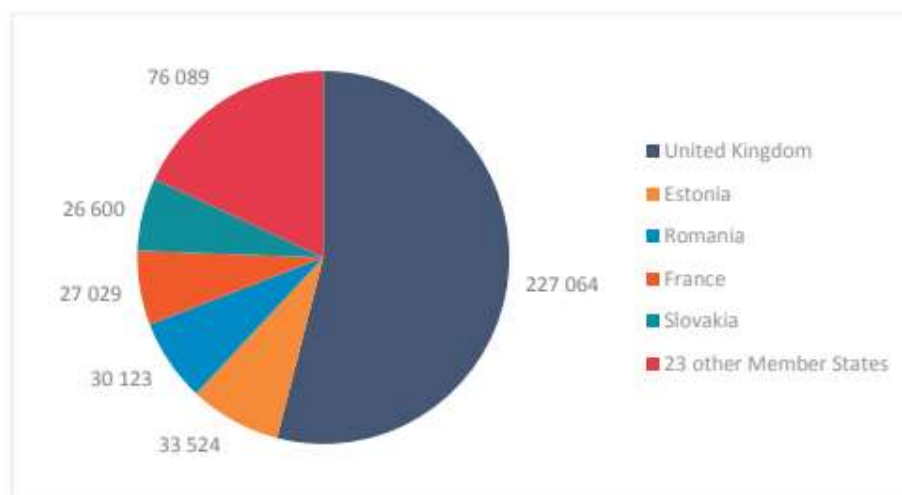


Figure 1 – Estimated number of foreign companies. Source: European Parliamentary Research Service (EPRS), 2018. An overview of shell companies in the European Union.

Possible explanation for UK being the most attractive country for foreign-owned companies, with four top rated countries following (three central and eastern European countries and France) lies in favourable tax and labour laws as well as supporting company law.

¹⁰ This work contains data from 2015.

The second indicator is the FDI to GDP ratio per state.

The definition of FDI for the purpose of this indicator is that it relates to the cross-border direct investment made by a non-resident. The objective is to establish interest in a company with the motive of obtaining a significant influence (control) for a long term. The 'lasting interest' is considered to exist when the investor owns 10% or more of the voting rights of the company. Secondary motive can be that direct investment also allows the direct investor an access to the (more developed) economy in which the investment is being made.

In the Figure 2 below, graph represent the total inward and outward FDI per EU Member State. It shows the investment value (in millions USD) and the proportion of the GDP. The figures given are based primarily on the European Commission data, in particular on the 2017 IHS Report on Aggressive Tax Planning Indicators (IHS, Aggressive tax planning indicators, prepared for the European Commission, DG TAXUD Taxation papers, Working paper No 71, October 2017) and on the 2018 European Semester Country Reports (European Commission, 2018 European Semester assessment, general document COM(2018)120 and Country Reports SWD(2018)200-226, 7 March 2018).

As it is visible from the Figure 2, quite a few Member States have high inward FDI in absolute values. In addition, as visible from Figure 3 and Figure 4, quite some countries have a high proportion of FDI in the GDP, taking into consideration effect of the size of the country.

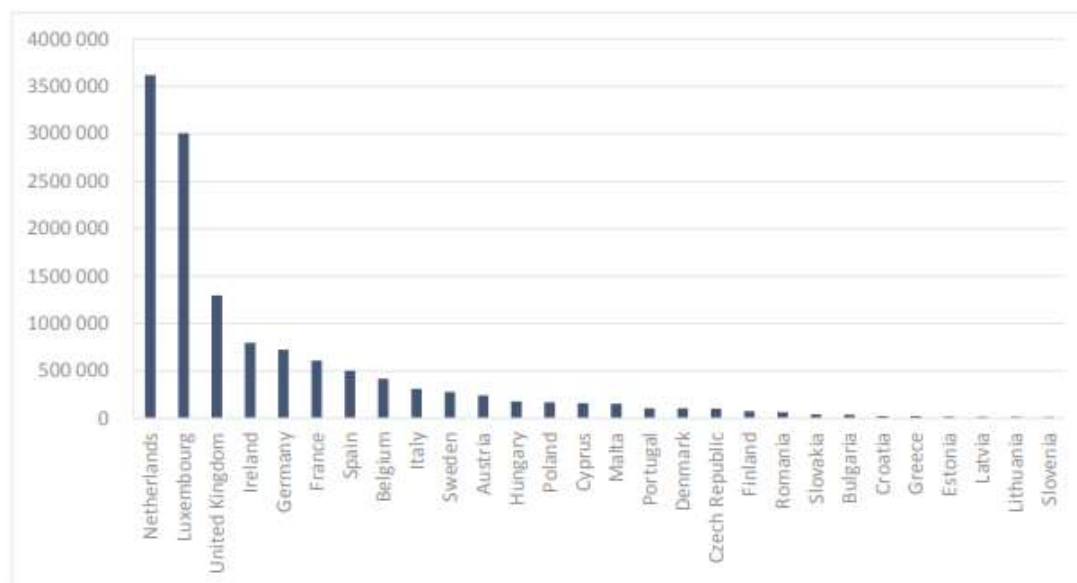


Figure 2 – Inward FDI in USD million in 2015. Source: European Parliamentary Research Service (EPRS), 2018. An overview of shell companies in the European Union.

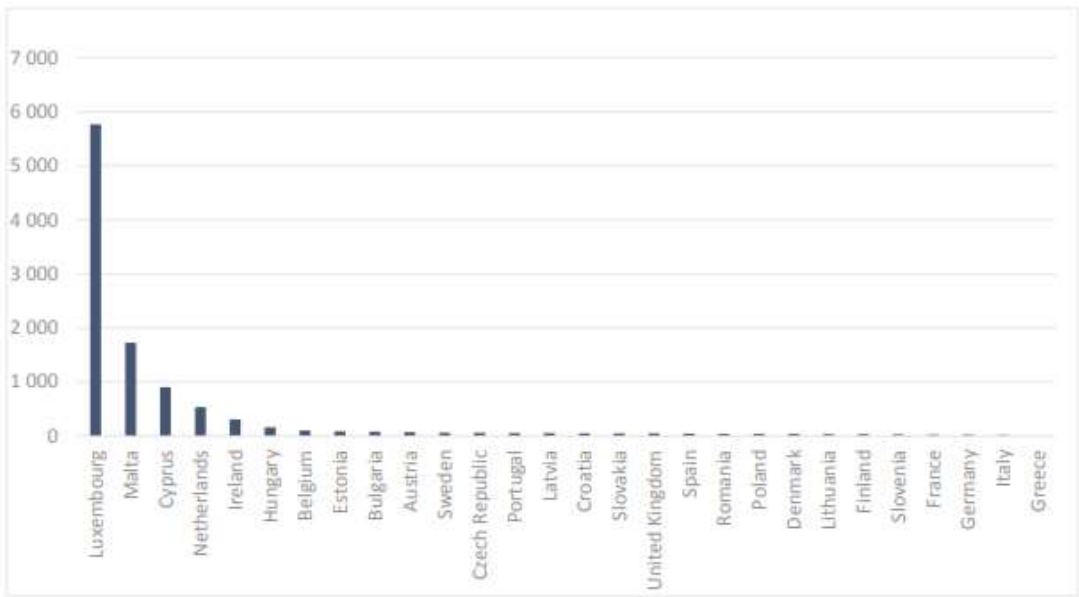


Figure 3 – Inward FDI as a percentage of GDP (2015). Source: European Parliamentary Research Service (EPRS), 2018. An overview of shell companies in the European Union.

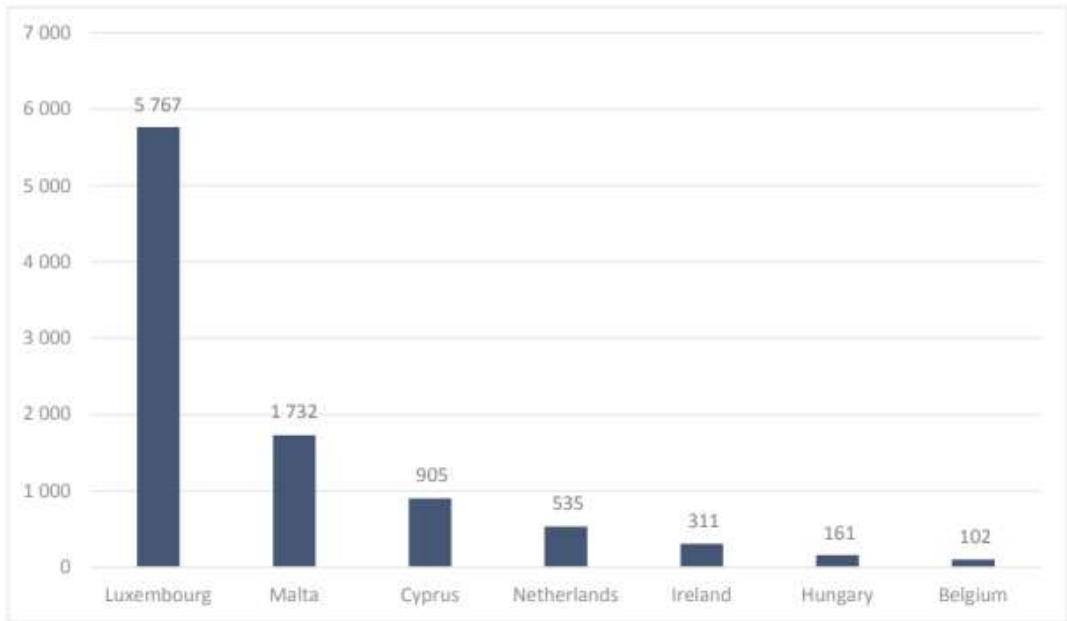


Figure 4 – Inward FDI as a proportion to GDP (2015) for Member States with inward FDI exceeding GDP. Source: European Parliamentary Research Service (EPRS), 2018. An overview of shell companies in the European Union.

From the graph above, it is visible that Luxembourg has inward FDI of even more than 57 times of GDP. It is followed by Malta where inward FDI is 17 times higher than its GDP, in Cyprus 9 times, in the Netherlands 5 times, in Ireland 3 times of its GDP, etc.

From the perspective of outward FDI, similar countries have high amounts of outward FDI (Figure 5) as a proportion to GDP (Figures 6 and Figure 7).

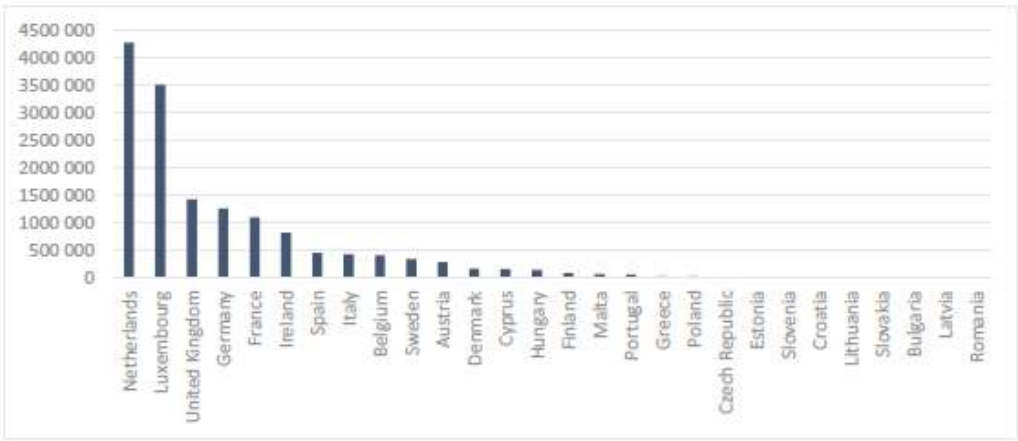


Figure 5 – Outward FDI in USD million (2015). Source: European Parliamentary Research Service (EPRS), 2018. An overview of shell companies in the European Union.

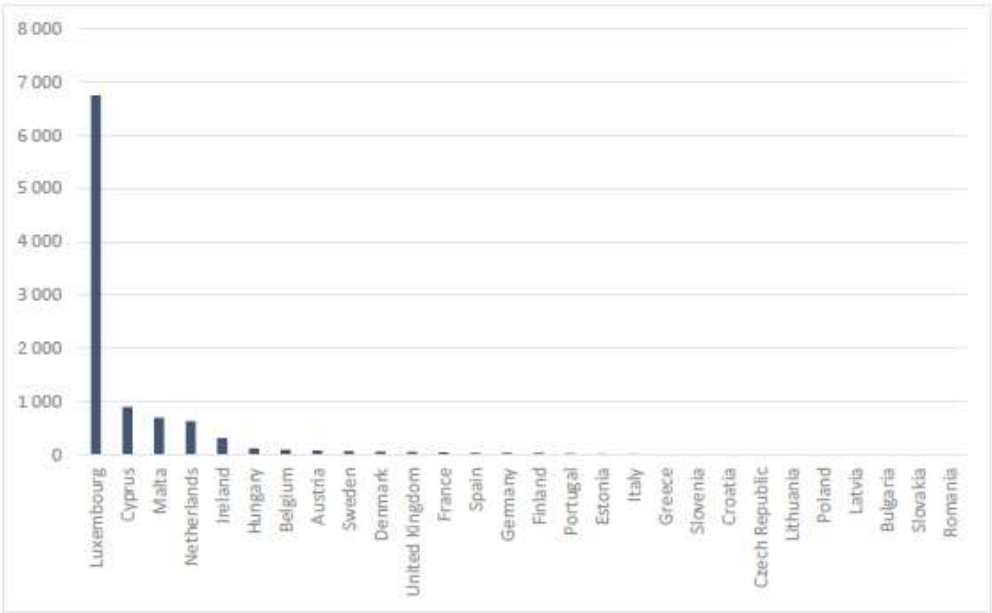


Figure 6 – Outward FDI as a proportion to GDP (2015) . Source: European Parliamentary Research Service (EPRS), 2018. An overview of shell companies in the European Union.

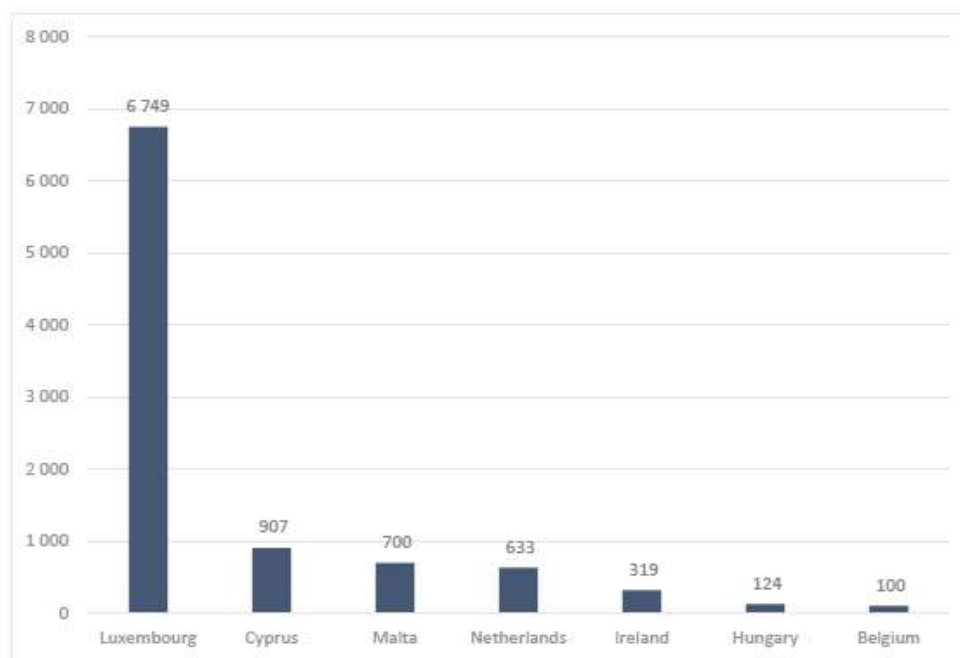


Figure 7 – Outward FDI as a proportion to GDP (2015) for Member States with outward FDI exceeding GDP. Source: European Parliamentary Research Service (EPRS), 2018. An overview of shell companies in the European Union.

Some of the Member States show high, both, inward as well as outward FDI. Those standing out in terms of values of both are the Netherlands, Luxembourg, Cyprus, Ireland and Malta. Data show large portion of this FDI are held in SPEs. It is a clear sign that these countries are highly attractive for holding companies owned by foreign investors.

Number of shell companies

Precise number of the shell entities in the EU is hard to determine primarily as there is no universal definition of it in the EU and consequently no available statistics about them.

Relying on the proxies based on number of foreign-owned companies, researches from 2016 that we analyzed previously, roughly estimate the quantity of shell entities in EU to approximately 200,000. A low-bound estimate based on the impact assessment prepared by the European Commission (Commission staff working document impact assessment report, 2021) arrives to a number of about 29,000 entities. Less conservative one, based on the insights from Ireland, comes to a number of not more than 75,000 shell entities in the EU (Annex 4(B), Impact assessment “Methods for estimates - Estimation of companies in scope of the initiative”). The latter can be considered to be the closest estimate to the total number of (shell) entities (companies and other forms) that would be a target of the directives and similar regulatory initiatives taken into account in the impact assessment. The optimistic outcome of the estimates

is that the number of shell entities is relatively limited. When comparing the more aggressive estimate of maximum number of shell entities (75,000) to the number of corporate income taxpayers (OECD Tax Administrations 2021 report, table A.20) it represents only 0.5 per cent of the total and approximately 0.3 per cent of the total number of active companies in the EU (according to 2018 data, 25,3 million). Despite the impression that these low percentages leave, it is important to emphasize that EUROSTAT database estimates that the total collected tax revenues in the EU was EUR 5.74 trillion in 2020 leaving us to a conclusion that even 0.3 per cent is material in monetary terms.

Usage of shell entities in tax avoidance and evasion

Intervention via the Unshell directive aims to address both tax evasion and tax avoidance as shell entities can be used for both purposes. There are multiple examples of tax evasion using shell entities. One can be the scenario where individual evades wealth taxes by covering up ownership over its assets by transferring them to shell entity. Another example is using shell entities registered in jurisdiction with low direct tax rates to evade direct taxes on employees. Representative case of tax avoidance using shell entities could be when multinational company, in order to make payments that are not aligned with economic reality, establishes a holding company for the purposes of transferring money within its group. Outcome of it is lower tax liability then if payments were taxed against their economic reality in respective jurisdictions.

While distinction between (legal) tax avoidance, or in other words tax planning, and (illegal) tax evasion is clear and robust both in legal and administrative terms, the concept of tax avoidance itself appears to be hard to be split into what is considered as unacceptable aggressive tax avoidance and what is being seen as acceptable tax planning. Recent legal cases between governments and taxpayers are the best representative of the challenges of separating legal from illegal tax avoidance within different forms of it. For example, the General Court of the European Union made a conclusion that no selective advantage was awarded in favour of the Amazon group's subsidiary in Luxembourg (General Court of the European Union PRESS RELEASE No 79/21 Luxembourg, 12 May 2021). On the other hand, the European Commission is of a different view and the case is not closed yet (Statement by Executive Vice-President Margrethe Vestager following today's Court judgments on the Amazon and Engie tax State aid cases in Luxembourg, 12 May 2021).

Tax avoidance by shell companies

As there is lack of reliability of quantifications of tax avoidance via shell entities due to the nature of the issue, only the rough estimates may be given to indicate the magnitude of the problem. In the US, for instance, there is an estimate that tax avoidance managed through companies registered in Delaware, cause loss of revenues for the rest of the US of USD 9.5 billion yearly¹¹. Some other studies estimate tax losses of developed economies such as the EU or the US to tens of billions of dollars annually (Commission staff working document impact assessment report, 2021).

Multinational corporations can set-up (artificial) corporate (tax) structures by taking advantage of tax rules that differ from one state to another in a way to minimise overall taxation. Current European legal framework is primarily focused on avoiding double taxation through arranging rules for dividend, interest and royalty within the EU. Local jurisdictions keep the responsibility for tax laws, tax rates and the measures for fighting tax structures without economic reality.

More precisely, the directive preventing double taxation on dividends between group companies in EU is so called Parent Subsidiary Directive (PSD), the Directive applicable in cases where subsidiary and the parent are not in the same Member States. The Interest and Royalty Directive (IRD) is in charge for abolishing royalties and interests withholding tax for international transactions with related parties in EU. Downside effect of these directives is that it makes room for cross-border tax avoidance.

Similarly to the above, we can often see that group companies engage in, what is called, 'treaty shopping'. In case that the intercompany payment is to be made between two countries with no tax treaty signed with each other, the group is due to pay domestic taxes in both of them. However, if there is a third country, with better tax treaties (i.e. double tax avoidance treaties with both countries involved), in order for the group can take advantage of its treaties, including even potentially lower withholding taxes, payment can be routed through this country through a shell entity, despite the fact it has nothing to do with the transaction.

Another example where shell entities are often use to avoid taxation is by establishing them as interposed intermediary for the payments to third countries in the EU Member States with a domestic law with no (or more favourable) withholding taxation regime for payments of interest,

¹¹ State of Delaware imposes no tax on income from intangibles from other US States

royalties and dividends out of the EU. As put by IBFD (DG TAXUD (2021) – Public Consultation "Tax avoidance - Fighting the use of shell entities and arrangements for tax purposes", input by IBFD, quote from p. 37) in their submission for the public consultation for this initiative: "(...) third-country based MNEs take advantage of the interplay between the Parent-Subsidiary and Interest-Royalty directives (PSD and IRD) and the domestic laws of several EU Member States. By utilizing withholding tax exemption for payments between EU countries (between original Member State and Member State where shell entity is founded) and no withholding tax regime of the Member State of the shell entity, the group can easily repatriate profits without any withholding tax due.

Additionally, domestic tax regulations can also offer tax exemptions for income received from another country, for example dividend in case of the Netherlands, regardless if withholding taxes are imposed on that payment or whether the country from which it is paid has a tax treaty with the country of the shell entity.

So far, there were numerous international initiatives to address tax avoidance, including by shell entities. Some of those are the OECD BEPS project and ATAD on EU level. However, these initiatives do not tackle use of shell entities in specific. Most importantly, none of these initiatives provides objective criteria to identify shell entity through identifying the lack of substance of the entity in the country at the moment of obtaining the tax benefits.

Tax evasion by shell companies

Unlike tax avoidance which is considered to be legal, tax evasion can be defined as intentional illegal act to avoid tax payments involving a direct violation of tax law (IBFD glossary). It goes without saying that shell entities have been widely used for this illegal activity. Their use for tax evasion has been the subject of many researches recently. As noted in responses to the public consultations for the initiative: "There is indeed evidence that shell companies might be used in the context of criminal activity to conceal funds, and move assets without authorities being able to identify those asset movements." (DG TAXUD (2021) – Public Consultation "Tax avoidance - Fighting the use of shell entities and arrangements for tax purposes", input by Confédération Fiscale Européenne / Tax Advisers Europe (CFE), referring to a World Bank study: "Stolen Asset Recovery (StAR) Initiative: Challenges, Opportunities and Action Plan.")

In cases where shell entities are used for tax evasion, they are often founded in jurisdictions (i) with zero (or close to zero) corporate tax systems; (ii) that offer tax exemption for income from abroad; and/or (iii) have no dividend withholding tax.

It is a challenging exercise to make an estimate of the impact of tax evasion via shell entities due to its concealed criminal nature. Recent investigations and leaked data, however, made general public more aware of the gravity of the problem. Based on the insights brought up in 2016 by the Panama Papers leak, it is estimated that tax authorities managed to recover above USD 1.3 billion of lost tax revenues. The leak revealed more than 214 thousand shell entities established for tax evasion purposes created by law firms, for example.

Tax evasion is sometimes connected to money laundering. Legal framework in the EU is now focusing on fight against money laundering and terrorism financing through multiple measures, including the establishing of EU register of beneficial owners (UBO) to increase transparency of information on UBOs of the companies in the EU. Per requirements of the 5th AML Directive, beneficial ownership registration is mandatory for trusts and similar legal arrangements as well, not only to companies. It also provides public access to some information regarding UBOs of companies. In addition to that, in 2021, the European Commission issued a new AML/CFT set of legislation in order to make EU's AML/CFT regulation more firm as the Commission has commitment for protecting EU financial system and citizens from terrorist financing and money laundering. It is consisting of 4 initiatives: 1) rules for establishment a new EU AML/CFT authoritative body; 2) directly applicable rules on AML/CFT; 3) sixth AML/CFT Directive that replaces the Directive 2015/849/EU; and 4) update of the 2015 Regulation on Transfers of Funds.

Nevertheless, regardless of enforcing the robust AML framework within EU, which in essence would prevent the establishment of anonymous shell entities and consequently reduce the tax evasion via it, the tax non-compliance issue is not addressed solely by AML legislation.

Problem drivers

As presented in Figure 8, when it comes to using the shell entities for tax avoidance and tax evasion both by individuals and legal entities, there are three key drivers behind the problem (Commission Staff Working Document Impact Assessment Report, 2021). The first driver can be defined as the absence of a universal definition of substantial economic activity to be imposed in order to define tax residency. The second driver is that there is no sufficient information available

to tax authorities to prevent or detect tax avoidance or tax evasion via shell entities. Finally, the third driver is advertisement and promotion of the shell entities for tax evasion and tax avoidance purposes.

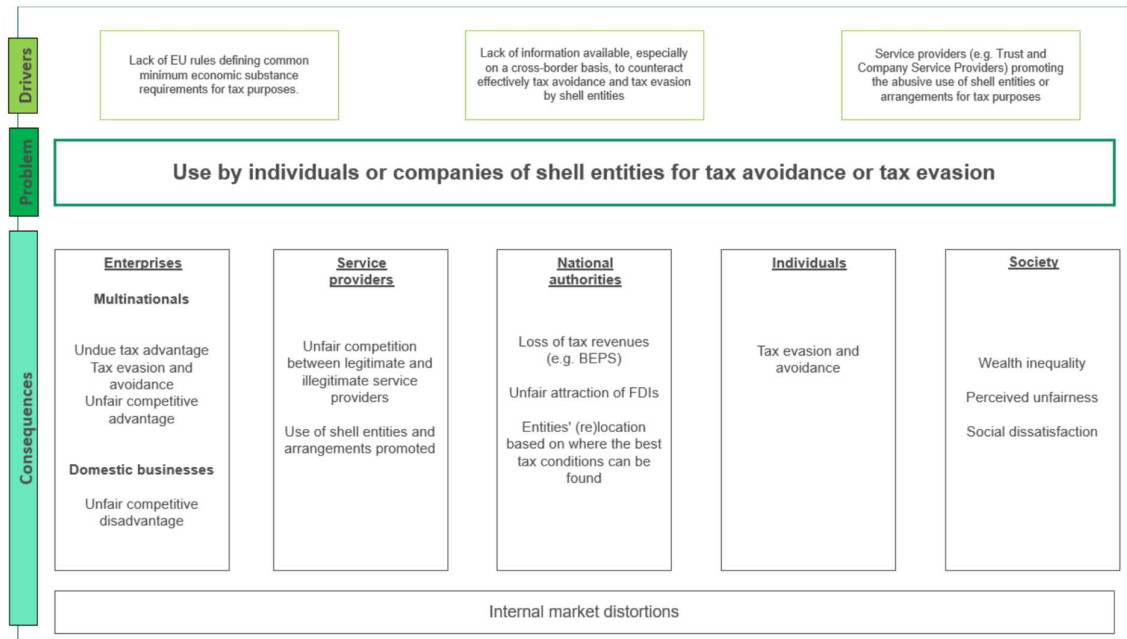


Figure 8: Problem tree. Source: Commission Staff Working Document Impact Assessment Report, 2021.

Lack of universal minimum substance criteria for tax residency determination purposes in the EU

Although the statement above could indicate that there is no common criteria on EU level regarding the minimal substance for company residency, there are actually various criteria on the level of EU in different contexts. Code of Conduct of EU has defined non-legally binding substance requirements limited to certain tax regimes for the purposes of assessment of preferential tax regimes in the EU. Substance criteria according to BEPS have to be fulfilled regarding the preferential tax regimes accepted by third countries. These apply also for the domestic tax laws of low-tax jurisdictions.

Current legal system of EU does not, however, define common minimum substance requirements for tax purposes. Further, apart from a few, most of the Member States do not have national laws defining minimal substance criteria to prevent tax abuse. Although some of the tax treaties include features as substance criteria or UBOs concept in order to get in the way of their abuse, these criteria are different in different Member States and sometimes are differently defined in the double taxation treaties between one Member State and third jurisdictions.

Regarding the rules against tax avoidance, as ATAD for example, their implementation into the national laws from the common EU rules can significantly differ. Different implementation of the anti-tax abuse rules could also apply to shell entities definition as well as measures and sanctions against their use for tax avoidance and tax evasion. These differences provide space for organizations to explore them, which results in shell entities still being used for the purposes of tax evasion or avoidance by establishing them in states with more beneficial tax regime. More globally, this weakness may also result in lack of coordination in measures to fight against tax evasion or tax avoidance via shell entities in the EU, making them fragmented and consequently weaker.

Deficit of information for effective application of the existing rules

There is evidently a shortage of readily available information to correctly apply taxes to cross-border transactions and fairly distribute them between jurisdictions.

Having anti-abuse rules in place in Member State does not guarantee that tax authorities can effectively use them for international transactions due to the lack of necessary information to apply them. An example of this can be found in the widely used scenario where entity in one Member State pays dividend to a shell entity in another Member State. This dividend is not subject to taxes based on the EU Parent-Subsidiary directive tax exemption for intra-group dividends. The general anti-tax avoidance rule brought by the directive states: "(...) Member State shall ignore an arrangement or a series of arrangements which, having been put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the applicable tax law, are not genuine having regard to all relevant facts and circumstances." The problem arises as the Member State from which the dividend is paid from does not have sufficient information to verify genuinity of the shell entity. As put by IBFD, the main problem is the discrepancy between availability of the information (in the residence country where shell entity is in our example) and the need for it (in the source country from which the dividend is paid), are two different countries (DG TAXUD (2021) – Public Consultation "Tax avoidance - Fighting the use of shell entities and arrangements for tax purposes", input by IBFD, p. 48).

Due to the complexity of the nature of international transactions combined with the lack of information available to the tax authorities to assess the substance of it, the tax avoidance and tax evasion cannot be prevented timely but merely can subsequently an attempt be made to

recover part of the tax losses as a result of an tax audit, however, this exercise as well can be expensive .

Deficit of readily available information to implement already existing anti-abuse rules puts an additional challenge to address the problem of tax avoidance and tax evasion via shell entities. As additionally put by IBFD: “(...) both the incentive for treaty and jurisdiction shopping and the consequences, should an abusive structure be discovered, suggest that traditional anti-avoidance measures do not suffice.” (DG TAXUD (2021) – Public Consultation "Tax avoidance - Fighting the use of shell entities and arrangements for tax purposes", input by IBFD, p. 38).

Nevertheless, it is also important to emphasize that, even where information is available, current anti-abuse measures act as corrective, rather than preventive. In other words, tax avoidance and tax evasion is mainly to be discovered by tax audits and tax authorities can react subsequently to address it.

Endorsement of shell companies by intermediaries

When it comes to establishing and operating the shell entity in foreign country, it is a practice that we see in many cases that the group engages various intermediaries like trusts and company service providers for corporate administration and management services. Shell entities can rely on support from these intermediaries, including registering their postal address as its own which was deemed sufficient to prove minimum physical presence in the Member State in question. Recent leaks like the Panama Papers have also pointed out the extensive use of intermediaries to set up organizational schemes with shell entities involved in order to avoid or evade taxes. Internationally, this was also noted through the FATF and the OECD65. At EU level, Directive 2018/822/EU (DAC6) addresses the issue by requesting intermediaries to report international tax set-ups to their domestic tax administration.

Objectives of the directive

The Directive aims to achieve the following three objectives:

The first objective is the identification of the shell entities. The goal is to introduce common rules within EU to have the basis for identifying shell entities that represent risk for tax abuse. These rules need to define objective criteria for identification and allow prompt results of the investigation. Nevertheless, in order to prevent tax abuse, substance requirements are not

enough on its own. In order for the Directive to be effective and prevent tax losses awhile avoiding tax and regulatory arbitrage, a clear, universal, pre-determined set of tax consequences throughout the EU need to be established.

Secondly, to enable the Member States to take effective and swift measures to prevent or penalize cross-border tax abuse it needs to have information about the presence of identified shell entities in its national level as well as in another Member State's jurisdiction. For example, based on proper and timely information, Member State can decline tax treaty benefits and charge withholding taxes for payments to the shell entity in another Member State by a company in its own jurisdiction. Timely availability of information is predisposition for an effective mechanism to fight against tax abuse via shell entities in the EU.

Thirdly, the Directive also aims to address usage of intermediate companies like trusts and company service providers from establishing shell entities in the EU. In essence, if the substance requirement strikes services provided by intermediaries, postal address set up for example, the requirement for their services would decrease which would have a critical negative impact on their business model.

More broadly, if the initiative set by the Directive turns to be successful, the ultimate result could be higher tax revenues for EU countries in total.

Legal Basis, Subsidiarity and Proportionality

Legal basis

Article 115 of the Treaty on the Functioning of the EU (TFEU) regulates direct taxes legislation within EU. This article states that legal measures of unification under that article shall be defined through a legal form of a Directive.

The requirement to deny benefits of member state treaties and benefits of other directives to a shell company, as elaborated further, might conflict member state's commitments under tax treaties entered into with other member states. Despite the fact that secondary EU law such as directives have precedence over treaties concluded between member states¹², directives cannot

¹² There is an abundance of case law to that effect; see, e.g., *Costa v. E.N.E.L.*, C-6/64 (CJEU 1964). For further discussion, see F.A. Engelen, J. Vleggeert, and T.M. Vergouwen, "Belastingverdragen en voorrang van richtlijnen op het gebied van directe Belastingen," 257(7314) *Weekblad voor fiscaal recht* (2019) (in Dutch); and Ilaria Panzeri, "Tax Treaties Versus EU Law: Which Should Prevail?" *Eur. Tax'n* 147 (Apr. 2021).

directly impose duties on persons or organisations. This has to be introduced in the applicable national legislation¹³ first. Further, some of member's constitutional system priorities tax treaties over national laws (which reflect EU directive requirements) In addition, it also depends if a relevant treaty already has a principal purpose test incorporated that applies in the particular case or not. On the other hand, tax authorities might be of the opinion that the test is applicable to companies that are in scope of the Unshell directive and that the treaty is there for not relevant, resulting in no discrepancy between the domestic laws and the treaty.

In general, the Unshell directive is based on OECD base erosion and profit-shifting initiative. It is also a response to s request to add economic substance criteria requirements for low-tax jurisdictions. From this reason, in order to keep them off the blacklist, EU is now requesting low-tax jurisdictions outside of EU (tax havens like Cayman Islands for example) to introduce economic substance requirements for industries specific for their economy. However, surprisingly, the substance requirements that those jurisdictions have implemented are usually more comprehensive and demanding than those initiated in the Unshell directive.

When it comes to the case law of EU, the supporting case at the Court of Justice of the European Union, dealing with the similar topics addressed in the directive is the so-called Danish cases of 2019¹⁴. These provide a very good basis for establishing substance requirements in case of treaty shopping. However, looking at the proposal, it appears like that the requirements of the proposal are setting the bar bit lower then verdicts of the Court of Justice.

Subsidiarity

Goals of the proposed Directive cannot be adequately achieved by separate actions undertaken by each Member state on its own. That is why the requirements of this Directive pursue common framework that is to be coordinately implemented by each Member state into their domestic laws in order to intercept cross-border tax avoidance and evasion practices.

Key feature of the business of all the shell entities without minimal substance used for tax avoidance or tax evasion is that they involve multiple jurisdictions. Usually, multiple tax systems

¹³ The so-called reverse direct effect; see *N Luxembourg 1 v. Denmark*, joined cases C-115/16, C-118/16, C-119/16, and C-299/16 (CJEU 2019), para. 42.

¹⁴ *Denmark v. T Danmark*, joined cases C-116/16 and C-117/16 (CJEU 2019); and *N Luxembourg 1 v. Denmark*, joined cases C-115/16, C-118/16, C-119/16, and C-299/16 (CJEU 2019). For related analysis, see Roland Meuwissen, "The Dutch Take on Antiabuse Rules and Conduit Companies in the Context of the CJEU's Danish Cases," *Tax Notes Int'l*, Oct. 25, 2021, p. 405.

are involved in these schemes at the same time. Consequently, several Member State can be impacted by the shell entity in one of the Member State.

When looking into the current anti-tax avoidance and evasion measures taken by separate Member States, it is evident that although some of them have developed rules in their tax systems to address this issue, mostly these are created with national priorities and current tax system in mind and not the common internal market of the EU. In addition, as these rules significantly differ from each other, there is visible fragmentation with the market of EU.

If the Member States are to take measures individually, this existing fragmentation could continue and possibly become worse. In that way current inefficiencies and ineffectiveness in the separate measures taken would only be proceeded with. The aim needs to be mutual solution, coordinated initiative, that would function on the EU market as a whole and improve its overall resilience against tax evasion and tax avoidance.

In addition to all from above, initiative on EU level would add value compared to national initiatives having in mind that these initiatives need to have cross-border impact as shell entities in one state are used to avoid tax rules of another one and decrease its tax liability in it. Overall EU initiative would be aligned with common goals of the union and provide balanced solution to divergent interests of the members. This centrally designed legislation would also provide legal certainty and decrease compliance costs for businesses.

To conclude, based on all the considerations above, approach taken by the Directive is in accordance with the subsidiarity principle, as noted in Article 5 of the Treaty on the European Union.

Proportionality

Proposed measures by the Directive have to respect the principal of proportionality meaning that they cannot go beyond warranting only the minimum necessary level of protection against tax avoidance and evasion within the market of EU. From this reason, the Directive does not aim for full harmonization of Member States' tax systems.

More precisely, the Directive provides unified rules for Member States to help them identify shell entities misused for tax purposes in coordinated way, while national legislation is to add criteria to address shell entities not captured by the Directive if needed. National rules should also reflect

the new information brought into light by the measures of the Directive. Additionally, the Directive defines penalties for shell entities taking into account international agreements and conventions between Member States and third countries related to double taxation.

Therefore, the focus of the Directive is coordination within the Union in order to realize its purpose. As such, the proposal does not breach the principle of necessity having in mind its objectives and is therefore can be considered compliant with the proportionality principle.

Policy options

In addition to the 'no action' scenario as a starting point scenario, the impact assessment (IA) issued by Regulatory Scrutiny Board (RSB) on 22 October 2021 explores four possible policy options for the Directive. Option 1 was in favor of a soft law measure to increase the ruling of an existing peer review mechanism, the Code of Conduct (Business Taxation). Another proposal explored was for the Commission to issue a recommendation to Member States. Nevertheless, soft law instruments would have limited effect in solving the issue of the tax misconduct via the shell entities as it represents a cross-border problem and needs to be addressed by a persistent approach that needs to be ensured through more robust measures than soft law.

Remaining three options are regulatory in kind with the set of rules that should be implemented by all Member States. They vary on the level of coordination that they require. Option 2 requires unification of the criteria for identification, process to perform the identification and subsequent treatment of the shell entities. In addition to Option 2, option 3 implies an automatic exchange of information as well. Compared to Option 3, option 4 additionally prescribes unified sanctions for non-compliance.

All four Options have been analysed and rated based the following criteria: a) effectiveness in fighting the issue of tax avoidance and tax evasion via shell entities, b) public tax revenues expected to be realized, c) business compliance costs, d) tax administration compliance costs, e) indirect effects on the single market, f) firms competition, g) competitiveness of EU, h) social impacts and i) coherence. According to the analysis, despite higher costs, options 2, 3 and 4 were anticipated to be effective in accomplishing the goals of the Directive, with option 4 appearing to have the best effects. More precisely, option 4 is the one expected to provide the highest compliance level by the scoped entities, while it is aligned with the current EU efforts against tax avoidance and tax evasion and additionally contributes to already existing information exchange

systems.(Proposal for a Council Directive laying down rules to prevent the misuse of shell entities for tax purposes and amending Directive 2011/16/EU, COM(2021) 565 final (22 Dec. 2021)).

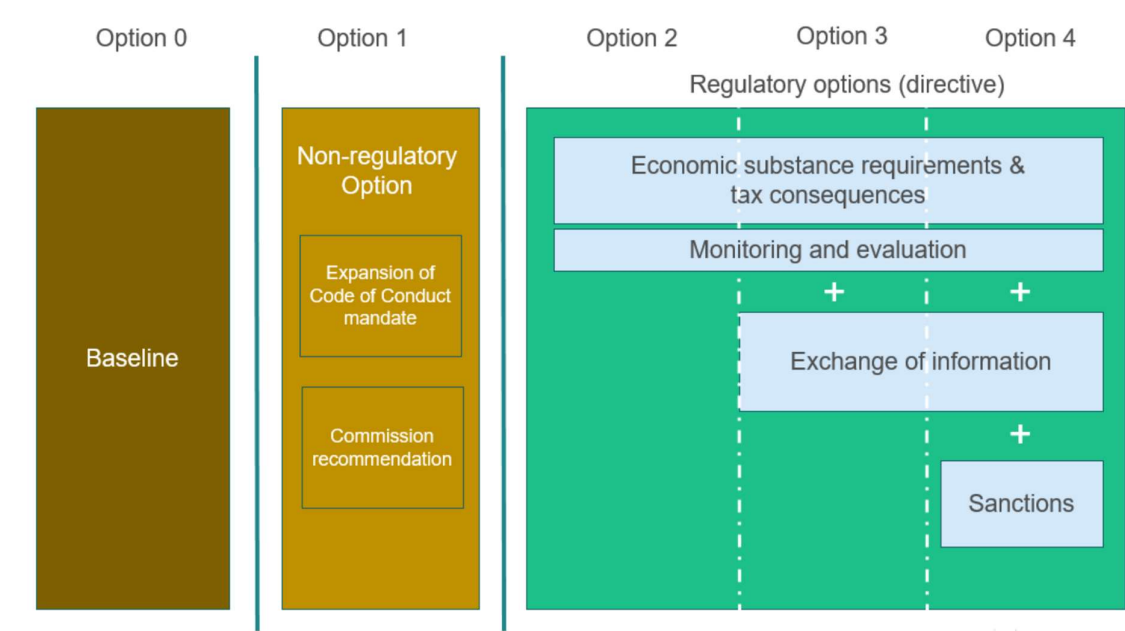


Figure 9: Policy options. Source: Commission Staff Working Document Impact Assessment Report, 2021

THE SEVEN STEPS

The Unshell Directive provides a set of criteria for identification of minimum substance (so-called substance test) for organisations (companies and similar as trusts for example) within EU and prescribes a tax treatment for those that do not pass the substance test. Furthermore, it provides tax measures for organisations that cannot prove to have satisfied a minimal substance requirements and are consequently considered a shell entity. It also supports the automatic exchange of information and possible support for the one-off requests from one country to another relating to the tax audits which have in scope number of organisations that are considered to be risky as they meet prescribed conditions but are not automatically falling the criteria of lack of minimum substance.

The Unshell Directive sets out a logical sequence of steps in respect of the substance test. The Explanatory Memorandum identifies the following seven steps, corresponding to consecutive articles in the proposal of the Directive: (i) which organisations should report (those found to be risky) (article 6); (ii) reporting requirements (article 7); (iii) presumption of (lack of) minimal substance and tax abuse (article 8); (iv) possible rebuttal of the presumption (article 9); (v) reporting exemption due to a lack of tax motives (article 10); (vi) tax consequences (articles 11 and 12); and (vii) automatic exchange of data through Central Directory, as well as a possible request for the tax audit (article 13). These steps are described in detail in the following sections.

Undertakings that should report (chapter II, article 6)- Gateways

The result of the first step is dividing organisations into those at risk due to a lack of substance that are being used for tax abuse and those that are rather not risky. Instead of defining shell companies, the proposal casts the net wide with a series of tests, or so-called gateways. The gateways target all companies, partnerships, and other entities tax resident in the EU that realize (mobile) income abroad, then shrink the net to catch only targeted low-substance companies. Risky organisations to be used for tax abuse purposes present, simultaneously, a number of features generally related to a lack of substance and are referred to as gateways (article 6(1)). The proposal outlines three gateways (as explained below). When an organisation passes all three gateways, there is a requirement that it reports more information to their annual tax return (i.e. the second step below). Undertakings that present none or only some of the gateways are considered at low risk and are not subject to further steps.

The first gateway represents the passive element and takes into account the activities of the enterprises looking into the nature of the income they make. It is passed if 65% or more (75% initially, however amended with the final proposal) of a total revenues of the entity in the previous two consecutive (tax) years consist of relevant income per definition given article 4 of the Unshell Directive. This essentially covers income that is not derived from the entity's substantial business activity and consists of passive income defined as: interest or other income from financial assets as crypto assets for example¹⁵, dividends, royalties and capital gain from disposal of shares, as well as financial lease income, income from immovable and some movable property with the book value of EUR 1 million or more (except for cash, shares and securities), income from insurance, banking and other financial services, and income from associated companies for outsourced services. This gateway is also deemed to be met if real estate assets or other private assets of high value such as shares, immovable property, and valuable movable property represent more than 75% of the total assets book value.

The second gateway reflects a cross-border nature of the tax abuse activities that the Directive aims to prevent. It defines the requirement that if the majority of companies relevant income (more than 55%, initial proposed 60%) is earned or paid out from transactions abroad or passes relevant income to other companies abroad, this gateway has been passed. Alternatively, if more than 55% (initially proposed 60%) of the book value of the undertaking's real estate (immovable property or high value movable property) in the preceding two years was located outside of the original jurisdiction of the company, again, this gateway has been passed.

The third gateway is probably most vague one as it concerns the third-party outsourcing element. It looks at the administration of day-to-day administration and the decision-making on significant functions. In instances when these are outsourced in the preceding two years, this gateway has been crossed. While the definition of day-to-day administration activities or decision-making on significant functions is not precisely defined, certain organisations are scoped out as they are considered to be of low risk based on their specific activities (article 6(2)). In the initial proposal of the Directive it was unclear if the outsourcing also includes the outsourcing within the group. Amended directive reflects the consideration for the groups with certain functions centralized so the outsourcing refers only to the third-party one.

¹⁵ As defined in the European Commission's September 2020 proposal (COM/2020/593 final) for crypto regulation and to amend Directive (EU) 2019/1937.

Those gateways raise many questions. The proposal is meant to target companies that engage in geographically mobile cross-border activities, which is at odds with the inclusion of immovable property, which by definition is not mobile. Further, the tax income and capital gains tax from the immovable property sale is rapidly being reallocated to the countries where the property is situated¹⁶. This seems to be one of the items supporting the notion that there might be another purpose to the directive: preventing the concealment of ownership of specific types of assets. The same applies to high-value property, which is in general subject to taxation in the country where the company is a tax residence and therefore has no cross-border element.

Second is how to interpret the definition of income that is earned or paid out through cross-border transactions. There are two possible interpretations: (1) The words “earned or paid out” refer to how the relevant income is realized — that is, whether it is paid or accrued; or (2) relevant income is realised or subsequently paid-out through cross-border transactions. Under the second interpretation, a company that has, say, EUR 100 of rental income from real estate in its country of residence and pays EUR 60 in dividends to its foreign shareholder meets the second gateway because either it pays the relevant income (rental income) via a cross-border transaction or the dividend distribution itself is the payment of relevant income in a cross-border transaction. It is unclear which interpretation the European Commission has in mind, because neither the preamble nor the supporting documentation clarifies that.

The main guidance that can be found in the proposal is that the proposal speaks of income, not expenses or outgoing payments, in multiple places and does not explicitly speak of companies that directly pass on income, which supports the first interpretation. On the other hand, the first gateway refers to revenue, which unmistakably means incoming or accrued payments, which diminishes that argument.

The second interpretation would mean that a local holding company of an operational company would be caught by the first two gateways: dividend income received and later paid out in cross-border transactions. Then it is still not clear if the holding company was interposed to avoid tax.

¹⁶ See, e.g., OECD, Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, article 9 (2016).

Exemptions from gateways

Companies that pass the three gateways might still fall under one of five exemptions. However, it is unclear when those exemptions apply because there seem to be conflicting instructions when comparing articles 6(2) and 7(1) of the Unshell directive. Either companies falling under the exemptions are not obliged to report anything in their corporate income returns, that is, they are fully exempt from the proposal, or they must still comply with the reporting obligations and disclose that they fall under an exemption.

A company is exempt if:

- it has a transferable security listed or traded on a regulated market or multilateral trading platform as per definition in the Directive 2014/65/EU (for example, shares (or depository receipts thereof) or bonds);
- it is considered regulated financial organisation as further defined in the directive (including, notably, alternative investment fund managers, pension funds, and securitization special purpose entities);
- it, its active subsidiaries, and its beneficial owners are all residents for tax purposes in the same Member State;
- its holding companies are tax resident in the same Member State as the ultimate parent entity (as defined in Directive 2011/16/EU on administrative cooperation in taxation) or shareholders; or
- it has minimum of five full-time employees or staff members exclusively engaged in relevant income generating activities.

The rationale for the exemptions varies. The first two are because being subject to financial regulatory provisions means there is sufficient transparency in the eyes of the European Commission. The shell companies in the third and fourth scenarios are likely not established to cause tax avoidance, and the company in the fifth scenario is expected to prima facie have sufficient substance to forestall further evaluation (preamble 6 of the Unshell directive).

The first two exemptions versus the next two again show the Unshell directive's mixed purposes and why it is confusing to combine those purposes in one legislative instrument. For example, a group with a holding company that has difficulty meeting the substance requirements might have the holding company, rather than a special purpose vehicle, issue a bond because it wants to

ensure the proposal does not apply, even though that might not be preferable from a commercial perspective.

Reporting (chapter II, article 7)

After going through the first step determining if the organisation is considered at risk as it crosses the three gateways, the second step follows. It represents the key of the substance test itself. Organisations that are found to be at risk are then required to report additional information on their substance in their annual tax return. This information, or so-called substance indicators, is related to its bank accounts, premises and even tax residency of its directors and its employees. The Directive requests that all tax returns need to be supported by proper documentation (article 7(2)).

Presumption of (lack of) minimal substance and tax abuse (chapter II, article 8)

In the next step, the information about the substance submitted in the second step is assessed, at least at first glance. If in its declaration entity states that it meets all the criteria for a minimum substance and presents sufficient supporting documentation to prove it, it will be considered to have a minimum substance level for the current tax year. However, if an entity doesn't meet criteria for substance indicators or it fails to support them by sufficient documentation, it will be considered a shell (i.e. it is presumed not to have a minimum substance level for the tax year).

Companies that meet the substance requirements face no consequences under the proposal. However, the directive states that under domestic rules, those companies might still be considered to lack sufficient substance or considered not to be the beneficial owner of income streams, with all the attendant tax consequences. Thus, the directive is a minimum standard.

Rebuttal of the presumption (chapter II, article 9)

The fourth step provides an opportunity for the organisations that are, in terms of the Directive, considered a shell misused for tax purposes to prove differently. In other words, they are given a chance to prove having a substance or that they are not used for tax abuse.

In this case, such organisations are asked to provide additional information. As per article 9(2) of the Directive, such detailed information should include reasons for establishing the enterprise from the commercial, non-tax, perspective, the employee profiles and explanation that business decisions are being made in the jurisdiction where they are considered to be a tax resident.

According to the directive, that rebuttal should prove that the entity exercised control over the business from which it earns relevant income (or has ownership of assets) and it was bearing the risk from it. That broadly worded provision seems to allow an economic analysis of the company's role in the group. In practice, an important aspect that is difficult to show via substance requirements is that a company might bear the risks of the interest, interest, royalties and dividends it has received and decide on its own accord whether to further distribute the profit or reinvest it. The question remains whether tax authorities will accept that argument.

Successful rebuttal of the presumption is to be considered valid for a period of five years unless the factual and legal circumstances change in a meantime .

Exemption due to lack of tax motives (chapter II, article 10)

It is important to note that although some organization doesn't pass three gateways test or cannot claim to have minimum substance criteria fulfilled, it can still have genuine business purpose and activities without misusing its position for tax purposes both for itself or for the group it belongs to or for the ultimate beneficial owner(s). These organisations have the possibility to prove this by means of objective evidence, and hence might request a scope exemption from the Unshell Directive. That documentation must at least show the total tax burden both with and without the company's interposition.

Unless factual and legal circumstances or the ultimate beneficial owner change, the entity can ask for the extension of the approved exemption for another five years.

Tax consequences (chapter III, articles 11 and 12)

If the entity is defined as a shell under the Directive, and it doesn't succeed in using the possibility for rebutting this, or it doesn't obtain an exemption for the lack of tax motives, there are tax consequences prescribed by the Directive. In case that the entity is considered a shell, it will be denied from potential tax reliefs and tax benefits derived from the tax treaties of its residence Member State. It might also be not granted with benefits from the EU Parent-Subsidiary Directive (2011/96) (Council Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, OJ L 345/8 (2011), Primary Sources IBFD) or the EU Interest and Royalties Directive (2003/49) (Council Directive 2003/49/EC of 3 June 2003 on a Common System of Taxation Applicable to Interest and Royalty Payments Made Between Companies of Different Member States, OJ L157 (2003), Primary Sources IBFD).

The tax residence in the Member State would either be denied or a certificate of their tax residency would be stating that the entity is labeled as a shell and, consequently, is will not be entitled to tax treaties' benefits and, benefits under the Interest and Royalties Directive (2003/49) and the Parent-Subsidiary Directive's (2011/96).

Other Member States where the shell is not considered a tax resident would take no account of tax treaties and other directives (the parent-subsidiary directive and the interest and royalty directive) for that company. These countries are to tax the shell's profit as if it was directly the profit of the shareholders of the shell. That taxation must take into account a relief for any taxes paid by the shell company, but it is not clear if that relief will sufficiently neutralize the double taxation risk. In practice, deductions and credits may be difficult to fully realize, given their many limitations. The proposal applies only if the shell has residency in a Member State, so the shareholders' and subsidiaries' tax residency could impact tax consequences differently.

Withholding tax will be imposed to payments to third countries made by interposing the shell company in the jurisdiction of the entity that made the payment to the shell entity while inbound payments will be subject to tax in the jurisdiction of the shareholder of the shell. Under article 11(3) of the proposal, real estate registered on the shell entity used for the private purposes of wealthy individuals that make no income flow will be subject to tax at the jurisdiction of the its location.

Exchange of information (chapter IV, article 13)

Article 13 of the Unshell Directive provides an amendment of the DAC. Accordingly, authorities of Member States will be automatically exchanging information relating to all entities within the Directive's scope (as per company's annual tax return, but also information relating to the presumption rebutting and exemption for the lack of tax motive, and in the context of tax audits). Information regarding all EU shell entities will be always accessible by all Member States with no requirement to issue a request for particular information.

The information will be exchanged between Member States with no delay or the latest within 30 days from the moment when such information was made available to the administration.

Under article 15, in case Member State has basis to believe that certain entity is not complying with the requirements of the Directive, it is allowed to require from other Member State to perform a tax audit of any entity that reports in that other Member State. The result of the tax

audit must be made available right away and the latest within the one month period from the moment outcome of the tax audit becomes certain.

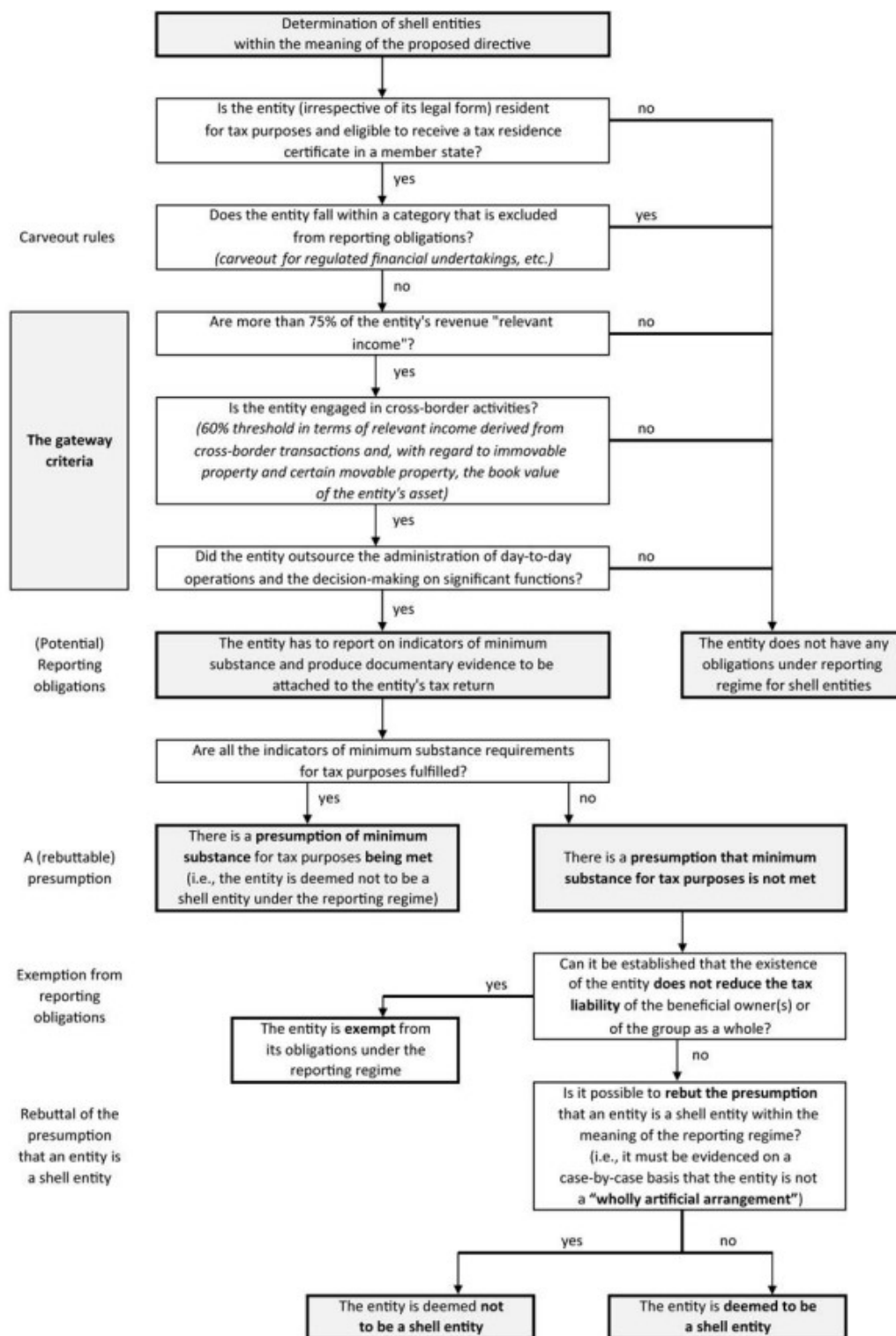


Figure 10: Shell entities checklist. Source: Tax Notes International, vol 106, 11 April 11 2022

Penalties

According to the Directive, it is left to the Member States to define in their own national legislation penalties that will apply for the violation of the reporting requirements of the Directive. These penalties need to be not only effective but also proportionate as well as dissuasive. Minimum monetary penalties as already defined in the existing provisions of the financial sector are supposed to achieve a minimum coordination level between Member States. Penalties are to include an administrative financial fine of at least 5% of the shell's turnover. However, this minimum amount need to take into consideration the specific circumstances of the reporting entity.

Entity vs group approach

As evident from the test above, the criteria are applied at the entity level. However, when applying the tax consequences in cases when an entity is considered a shell under the Directive, the approach is broader as it requires the tax administration to apply the prescribed consequences in the source jurisdiction, the jurisdiction of the shell as well as the shareholder's jurisdiction. The tax consequences impact the taxation of the group as a whole.

Effects of the directive application

Although the allocation of the tax residency (taxing rights) per Directive cannot impact third countries as they have mandatory effect only on Member States as they are bound by the Unshell Directive, there are cases that involve third countries. Examples of these are when the shell's shareholders are residents of a third country or when income of the shell comes from a third country or when the assets owned by the shell are located in a third country. In situations like these, double taxation avoidance agreements between a third country and a Member State have to be adhered regarding the allocation of taxing rights. If there are no such agreements in place, national laws of the Member State will be applied.

We can extract four basic scenarios:

1. Source, the payer: Third country jurisdiction; Shell: EU jurisdiction; Shareholders: EU jurisdiction

The first scenario deals with the situation where the jurisdiction of the payer (source) is not obliged by the Directive as it is out of its scope, while the shell's and shareholder's jurisdictions are bound by it.

- EU shell remains a tax resident in the respective Member State. It will be obliged to follow applicable national law, which means also to report the receipt of the payment. In addition, it might be able to prove applied tax on the payment.
- Third country source / payer has two choices. Outbound payment can be subject to national tax or the effective treaty between its jurisdiction and EU jurisdiction of the shareholder will be applied.
- EU shareholders' taxable income should incorporate also the payment that shell has received, applying the domestic law. There is also a possibility that, according to the applicable treaty with the jurisdiction of the third country source, the relief for tax paid at source can be claimed. Any tax declared by the shell already should also be taken into consideration and deducted.

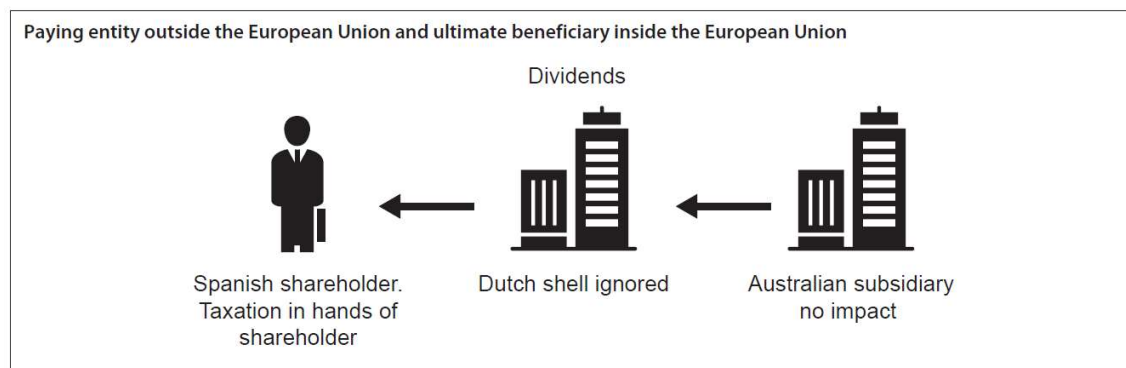


Figure 11: Illustration Source, the payer: Third country jurisdiction; Shell: EU jurisdiction; Shareholders: EU jurisdiction

Example 1:

In this scenario (see Figure 11), Australia's national tax might be applied on the outbound payment or it can be decided that benefits under the treaty with Spain will be granted if the shell entity is considered to be a look-through entity. The Netherlands shell company is a Netherlands resident. It reports the received payment and can document declared tax on it. The Netherlands may impose taxes on the received income of the shell company under its tax law, however, if certain criteria are fulfilled, the participation exemption could be applicable. In accordance with the article 11(2) of the Directive, the payment will be fall under the Spanish tax as Spain will regard this payment as if it was directly received by the shareholder. Relief under the Income Tax Treaty between Australia and Spain (1992) could be obtained. Finally, according to the article 11(2) of the Directive, the tax paid by the shell is eligible for a deduction.

2. Payer, source: EU jurisdiction; Shell: EU jurisdiction; Shareholders: EU jurisdiction

In the second scenario all the jurisdictions are in scope of the Directive meaning they are bound by it.

- EU source / payer may apply local taxes on the outgoing payments if it is not possible to determine if the shareholder is from the EU, otherwise it will not be entitled to tax the payment
- EU shell remains a tax resident in the respective Member State. It will be obliged to follow applicable national law, which means also to report the receipt of the payment. In addition, it might be able to prove applied tax on the payment.

- EU shareholder(s) taxable income should incorporate the payment that shell received, applying the domestic law. There is also a possibility that the relief for tax paid at source can be claimed, including those on account of EU directives. Any tax declared by the shell already should also be taken into consideration and deducted.

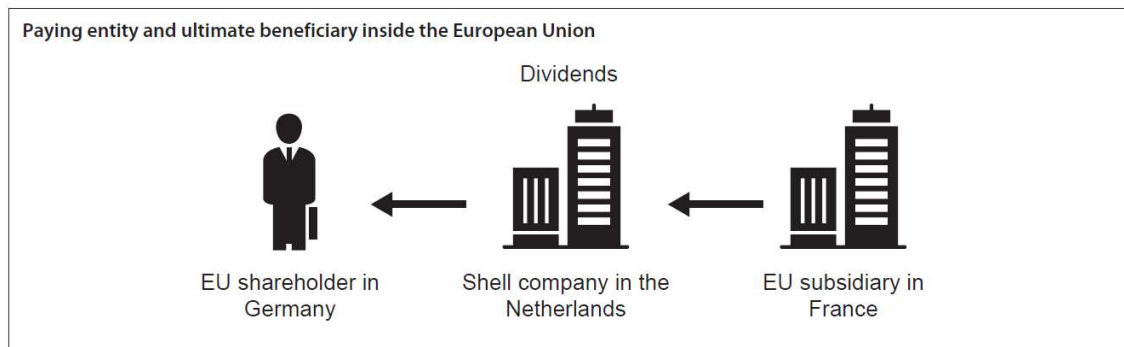


Figure 12: Illustration Payer, source: EU jurisdiction; Shell: EU jurisdiction; Shareholders: EU jurisdiction

Example 2:

In the second scenario (see Figure 12), France can impose its withholding tax if it is not possible to determine if the shareholder/s of the subsidiary are in the EU. The Netherlands shell entity which is a resident there, reports the incoming payment and may provide documentation on the tax already declared on the payment in question. The shell company may be in scope of domestic taxes for the payment, however, in case that certain criteria is fulfilled, the participation exemption might be applicable.

According to the article 11(2) of the Directive, the tax on dividends is the obligation of the German shareholder as if the payments were directly received by that shareholder. In addition, according to the article 11 of the Directive, other Member States (excluding the one where the shell company is established), cannot take into account tax treaties with the country of the shell company. Consequently, if the French company knows of the German residency of the shareholder, only the Income and Capital Tax Treaty (1959) between France and Germany can be applied. Treaty relief for the French withholding tax may be granted by Germany based on the treaty with France and a deduction will be granted for any tax the shell has paid based on article 11(2) of the Directive.

3. Payer, source: EU jurisdiction; Shell: EU jurisdiction; Shareholders: third country jurisdiction.

The third scenario deals with the situation where the jurisdiction of the shareholder is not obliged by the Directive as it is out of its scope, while the shell's and payer's jurisdictions are bound by it.

- EU source / payer should tax the outbound payment based on the effective treaty between the respective Member State and the shareholders' (third country) jurisdiction or in case there is no treaty in place, based on its domestic law.
- EU shell remains a tax resident in the respective Member State. It will be obliged to follow applicable national law, which means also to report the receipt of the payment. In addition, it might be able to prove applied tax on the payment.
- Third country shareholder(s) might be required to apply effective treaty between the respective third country and respective Member State of the source to be able to obtain the relief although the shareholders' (third country) jurisdiction is not to have any implications.

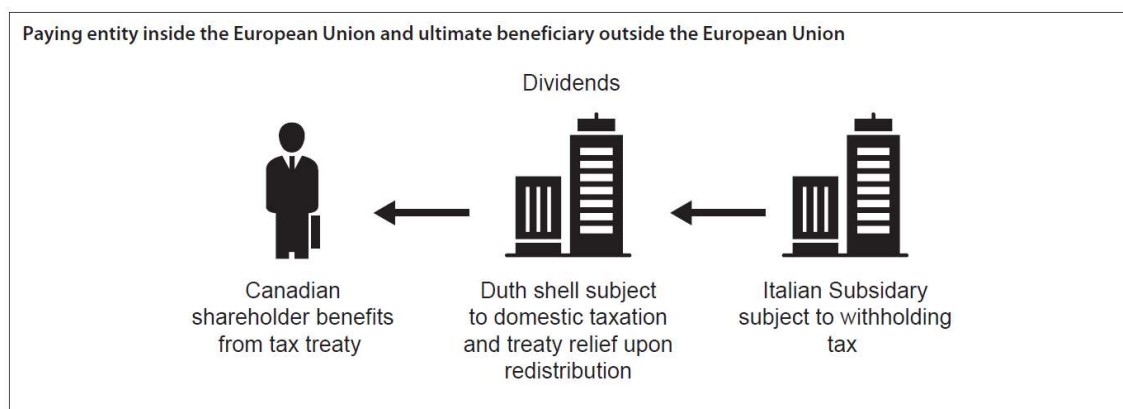


Figure 13: Illustration Payer, source: EU jurisdiction; Shell: EU jurisdiction; Shareholders: third country jurisdiction

Example 3

In this scenario (see Figure 13), the Italian subsidiary applies its withholding tax or apply the applicable withholding tax rates defined by the Income Tax Treaty between Canada and Italy (2002). The shell in the Netherlands will normally be tax resident in the Netherlands but the participation exemption might be applicable in certain cases. In addition, the shell company has to report the incoming payment and may provide documentation on the already declared tax on the payment. Upon redistribution to the shareholder from

Canada, treaty relief will be granted. The Canadian shareholder will bear the dividend tax and the benefits under the treaty between Canada and Italy might be used.

Furthermore, it is up to Canada to decide if the relief for the tax that the shell company already paid will be granted.

4. Payer, source: third country jurisdiction; Shell: EU jurisdiction; Shareholders: third country jurisdiction.
 - Third country source / payer might apply national tax on the outbound payment or if it wishes to consider shell entity in EU as transparent and ignore its establishment, it may opt for application of the effective tax treaty with the shareholders' (third country) jurisdiction.
 - EU shell remains a tax resident in the respective Member State. It will be obliged to follow applicable national law, which means also to report the receipt of the payment. In addition, it might be able to prove applied tax on the payment.
 - Third country shareholder(s) might be required to apply effective treaty between the respective third country and the source country to be able to obtain the relief although the shareholders' (third country) jurisdiction is not to have any implications.

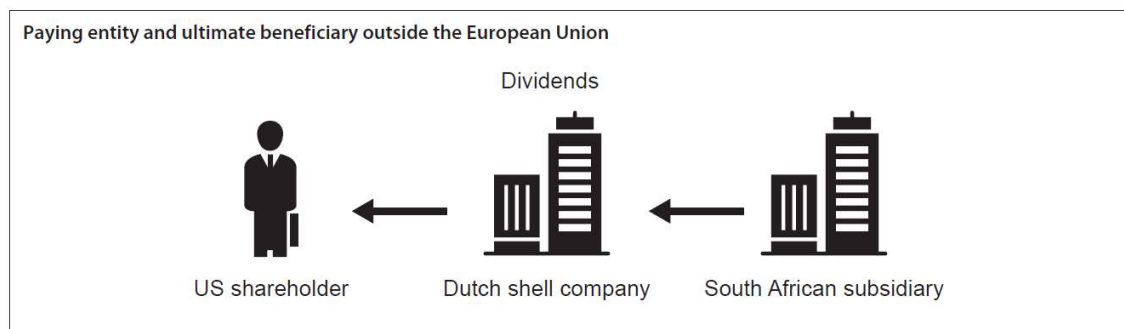


Figure 14: Illustration Payer, source: third country jurisdiction; Shell: EU jurisdiction; Shareholders: third country jurisdiction

Example 4

In this scenario (see Figure 14), the national withholding tax rate applies or the rates under the Income Tax Treaty (1997) between South Africa and the United States if South Africa decides to treat the shell company as a look-through entity. The participation exemption may apply. The third country might apply tax on the payment in accordance

with its national law. It is not obliged to apply any consequences from the Directive, but may decide to provide relief based on the treaty with the source jurisdiction and to provide relief for tax paid by the shell company.

All other scenarios in which the shell is not a resident of the EU are out of the scope of the Unshell Directive.

The examples above show that shell entities with a lack of substance can be ignored by the shareholder's EU jurisdiction. That jurisdiction has to provide a tax relief for the tax that the shell already paid. This, however, brings into question the double taxation risk due to unclarity if deduction will sufficiently neutralise the double taxation risk, since there might be applicable limitations. In case that the shareholder's jurisdiction is not in the EU, it is not clear if that jurisdiction will provide tax deduction for the tax that the shell entity has already paid.

Impact assessment

Economic impacts

Having in mind that the Directive deals with the type of entity for which there is not even a common definition and there is a quite limited data available relating to them, the economic impact assessment was exposed to many obstacles.

Benefits

Despite the lack of solid impact assessment, the preferred option, option 4, is anticipated to provide in general positive economic impact. An increased tax revenues resulting from reduced tax abuse by the shell companies is considered to be the main direct benefit of it. A small decrease even of the current tax loss that is estimated to be approximately EUR 20 billion in the EU (Explanatory memorandum EC Proposal for a Council Directive laying down rules to prevent the misuse of shell entities for tax purposes and amending Directive 2011/16/EU) is going to make a significant impact on public revenues. Identification of shell entities with Option 4 is reinforced by aligned penalties within EU and application of exchange of information which makes this option the most effective one. Further direct benefits are expected from income from monetary sanctions. In addition to the direct benefits, some indirect benefits are expected too. It will send a message of EU commitment to stand on the way of tax evasion and tax avoidance and encourage tax compliance. In addition, important information will be gathered enabling better understanding of the shell entities misuse in tax content.

Costs

Most significant costs of the preferred option 4 are the increased tax compliance costs. The increase will impact both tax administrations and businesses. Compliance costs for tax administrations are expected to show modest increase. They will need to expand their resources to be able to support the information exchange, process the information that they will be provided with and be able to implement and apply the sanctions. On the other hand, compliance costs incurred by business are expected to show more limited increase. In general, due to the limited number of companies in scope, costs should be relatively limited (not more than 0.3% of all companies within EU), and the additional reporting requirements include information that is expected to be easy to obtain. Overall, in the way it is designed, the Directive aims to find an optimal balance between positive impact and the negative one expressed through an additional burden. Nevertheless, the risks exists that capacities of Member States to deal with the new burden are not sufficient. One of the examples is the management of tax rulings.

CRITICISM OF THE PROPOSAL

The draft Directive adds to a growing legislative trend for taxpayers with cross-border operations and holding structures, in particular multinationals and private equity groups, to take account of the level of 'substance' in their holding companies with a view to benefiting from cross-border tax reliefs.

The Unshell proposal appears not to show understanding on activities of the business, stakeholders shared with the European Commission (E. Lamer European Union - EU Unshell Proposal Misses the Mark, Stakeholders Say – 7 April 2022 News, IBFD news). Companies and tax advisers' representatives believe the directive's criteria for identifying lack of economic substance and misuse for tax purposes are too robust, they shared with the commission in feedback on the Unshell proposal process that ended April 6.

According to the proposed directive, high-risk companies are those deriving 75 percent or more of their income from royalties, interest, financial income and dividends; make 60 percent or more of their book value or "relevant income" from international transactions; and have outsourced the decision-making on significant functions and administration of day-to-day operations. These entities need to add more information in their annual tax returns, like the ownership of premises and the use of a bank account in the same country where they are registered, and whether a director or most of the full-time employees live in the country. Listed companies, entities with five full-time employees or more, and entities with the same jurisdiction as their parent company would have the exemption from this requirement.

"In an ever-digitalized world and with a strong tendency towards home office, it is questionable if the requirement of having premises for its exclusive use is still up to date," the European Tax Adviser Federation (ETAF) said in its feedback. "We do not see a policy reason why multinational companies should not be permitted to centralize management functions for the benefit of multiple entities within a single entity," which is a common practice for nontax commercial purposes, the American Chamber of Commerce to the EU (AmCham) believes.

"We believe that the number of 'five' employees does not have any economic justification," the French business federation, Mouvement des entreprises de France (MEDEF), added. It suggested bringing that number down to one employee because some activities may not require more than that, and because a few employees may have split contracts.

While ETAF believes legislators should thoroughly rethink whether the same requirements should apply to small and medium-size enterprises, AmCham said big companies with a turnover of at least EUR 750 million will have to pay a minimum level of tax in each jurisdiction under pillar 2 of the OECD's global tax deal. It recommends that Unshell cover only the companies that are not in the scope of that minimum tax.

Many stakeholders question the interaction of the proposal with EU law. Court of Justice of the European Union case law provides that the application of antiabuse legislation "cannot rely on fixed criteria." Rather, it must be established on a case-by-case basis whether the substance of an undertaking is inappropriate for the activities performed, Taxand said. The Association of the Luxembourg Fund Industry also noted that a general presumption of abuse is forbidden.

According to UK tax review (Journal article, British tax review, B.T.R. 2022, 2, 127-134), there is no suggestion that the draft Directive would remove the need to consider other similar anti-avoidance provisions (such as the principal purpose test added to treaties in the wake of base erosion and profit shifting (BEPS) Action 6, or the general anti-avoidance rules already present in the ATAD and the Parent-Subsidiary Directive), or indeed the meaning of "beneficial ownership" in a treaty or EU law context which has been the subject of recent litigation. Rather, the draft Directive will layer another regime alongside these existing rules. Some may question whether the structure of the draft Directive, including its presumption of "shell" status if certain documentation cannot be produced is inconsistent with the EU fundamental freedoms and vulnerable to legal challenge on Cadbury Schweppes¹⁷ grounds. The purported override of double taxation treaties may also cause constitutional law difficulties in some Member States. To the extent that the application of the draft Directive gives rise to double taxation, these points may be a focus for future litigation.

ETAF said that assuming all the legal requirements (regarding taxation and money laundering, among others) are met, it is "fundamental . . . that the freedom of establishment (article 49 [of the Treaty on the Functioning of the European Union]) is . . . preserved." The International Bureau of Fiscal Documentation task force believes that the directive would make it difficult to draw a precise separation line between shell entities and the valid use of the right of establishment in the EU. That is because, the task force said, the proposed directive conflates several separate tax

¹⁷ For more details see Cadbury Schweppes Plc v Inland Revenue Commissioners (C-196/04) EU:C:2006:544; [2007] Ch. 30

issues: residence, attribution of income (transfer pricing) and abuse. AmCham also said it believes the directive is insufficiently tailored to target abusive structures.

MEDEF criticized a specific provision of the proposal: article 15 (request for tax audits). This article provides that when a member state believes that an entity that is tax resident in another member state has not fulfilled its liabilities under the proposed directive, it could ask that member state to conduct a tax audit.

"For legal certainty purposes, a 'reason to believe' should not be sufficient to automatically trigger a tax audit in another Member State, without prior investigation by the latter," MEDEF said.

PwC questioned the interaction of the Unshell proposal with double tax treaties (DTTs) and international investment treaties. "It is true that the CJEU on various occasions underscored the supremacy of EU law, including EU directives, over DTTs," it said. "It is also true that the CJEU set aside the rules of DTTs in favor of EU law for the benefit of taxpayers and the EU fundamental freedoms," meaning that situations in which tax treaties are applied rather than EU law will lead to discriminatory tax results, restricting freedom of establishment (PWC, Comments on the Proposal for a COUNCIL DIRECTIVE laying down rules to prevent the misuse of shell entities and arrangements for tax purposes and amending Directive 2011/16/EU ("ATAD3"), 6 April 2022).

Most stakeholders say the sanctions provided by the commission proposal, an administrative pecuniary sanction of at least 5 percent of the turnover, are not proportional.

Several respondents questioned the very need for new legislation against tax abuses. "There has been a deluge of anti-abuse legislation at EU level during the last decade," MEDEF said. Deloitte also pointed out an "overlap with existing other anti-abuse legislation at EU or domestic level targeting similar situations." The French banking Federation said existing measures are sufficient and make a new directive unnecessary.

ETAF said that "the multiplication of anti-abuse regulations at EU level in recent years," though justified, has resulted in "an increasingly confusing patchwork for taxpayers and tax advisers."

In its published version of the impact assessment, the commission underlines that the Regulatory Scrutiny Board issued a positive opinion on the upcoming proposal on 25 October 2021, while stating some reservations. One of these reservations was that the report "should better explain

why the existing EU legislation and the international tax frameworks are not sufficient to address the problem.”

For taxpayers and their advisers, states UK tax review, the element of retrospectivity in the gateways, the two year lookbacks, presents an opportunity to start reviewing their holding structures and operational protocols today, with a view to putting themselves in the best possible position when the draft Directive comes into force. This may include considering the removal of dormant or low activity EU entities from existing structures. For the same reason, the draft Directive will likely begin to feature in due diligence processes relating to the resilience of a target group’s cash repatriation strategy, and in the structuring and financing of acquisitions. This of course comes with the difficulty that the application of the lookbacks to business reorganisation and combination transactions (such as intra-group asset transfers, or mergers and demergers) is unclear. A further challenge for tax directors is that any such review will take place against a backdrop of potential significant amendments to the draft Directive which may be made during the negotiations.

The Swedish Riksdag says it “considers that the Commission does not provide sufficient justification to support the fact that the proposal does not go beyond what is necessary to achieve the set objectives.” The Czech Senate’s resolution, dated April 8, shows a similar position. It requests that the commission “prove that the adoption of this proposal is necessary and it is not possible to effectively combat the tax evasions related to the use of shell entities on the basis of current legislation.” Czech and Swedish lawmakers’ documents also show concern regarding the additional administrative burden for the taxpayers and the tax administrations of EU member states.

To better support its proposal, the commission explained in the report that the general antiabuse rule of the antiavoidance directive “in practice means that tax administrations address the use of shell entities in tax schemes on a case-by-case basis.” It also says tax administrations lack the information necessary to detect tax abuse via shell entities, as well as the time and resources needed to implement existing measures to counter that use.

IMPACT ON THE NETHERLANDS

Criticism of the Dutch tax system

Multiple reports from 2013 and back from 2006, show that there was a significant presence of shell companies in the Netherlands. Report made by the Centre for Research on Multinational Enterprises (Stichting Onderzoek Multinationale Ondernemingen, SOMO) in 2006 (Centre for Research on Multinational, SOMO, The Netherlands: A Tax Haven, 1 Nov. 2006), indicate that many shell entities have been founded in the Netherlands, which caused as a result a base erosion in other (developing) countries. Based on the report from 2013 issued by the SEO Economic Research, the estimated withholding tax lost in the developing countries as a result of the shell entities usage in the Netherlands is approximately EUR 145 million (SEO Economic Research, Out of the shadow of the banking system, 1 Jan. 2013). In the report of SOMO published in 2013, it is stated that the Netherlands is often utilized for treaty shopping. This results in developing countries' annual loss in terms of the withholding tax on dividends and interest of EUR 771 million in the (SOMO, Should the Netherlands sign tax treaties with developing countries, June 2013).

According to the March 2022 news publication of the European Commission, Members of the European Parliament (MEPs) criticised the Dutch tax regime. It indicates that MEPs find it not up to expectation when it comes to tax abuse addressing, especially as it is still found attractive for establishing the shell entities and it still contains loopholes when it comes to withholding tax (European Parliament Press Release, MEPs scrutinize Dutch tax system and tax information exchanges with Pandora Papers jurisdictions, 29 Mar. 2022).

The proposed Unshell Directive appears to be designed to address tax regimes of countries such as Luxembourg, the Netherlands and Ireland, which are known for attracting large sum of foreign direct investments, resulting from the tax avoidance possibilities provided by their tax regimes (Kiendl Krišto, I., and Elodie Thirion, E., "An Overview of Shell Companies in the European Union," European Parliamentary Research Service Study PE 627.129 (Oct. 2018); and Damgaard, J., Elkjaer, T., and Johannesen, N., "Phantom Investments," Fin. & Dev. 11 Sept. 2019).

Motives for establishing a shell company in the Netherlands

Withholding taxes

In general, the Dutch tax system does not prescribe a withholding tax on royalties and outbound interest. It does impose a withholding tax rate of 15% on dividends, however even this one is usually decreased for qualifying dividends due to tax treaties.

This attractive aspect of the Dutch tax regime is further supported by a very well established treaty network. At the moment, there are 95 tax treaties in the Netherlands. Further, except for a few cases, the withholding tax rates on royalties and interest are also in the range from 0% to 10%. This means that inbound royalties and interest in the Netherlands are taxed at a low tax rate and can be redistributed without tax. As a result, for example, many artists have founded shell entities in the Netherlands.

Policy in the Netherlands was always to keep low rates for withholding taxes under its treaties due to a risk of double taxation occurrence due to tax withholding after tax on profit is imposed (NL: Notitie Fiscaal Verdragsbeleid 2020 [Netherlands treaty policy Memorandum 2020], para. 4.5.). This results in the aim of the Netherlands to set tax rate to 0% on royalties, qualifying dividends and interest and to 15% on portfolio dividends.

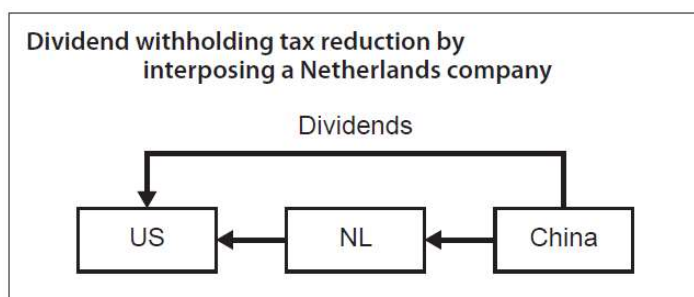
For company to be eligible to benefits of the reduced withholding tax rates under a tax treaty, it has to be a resident. Companies legally registered under the laws of the Netherlands are considered a resident, except in the case when it is already a resident in the other country party to a treaty covered by the treaty tiebreaker rule, example of which is when management is operating from that country (Corporate Income Tax Act 1969 [Wet op de vennootschapsbelasting 1969], art. 2(4)). If the management is settled in the Netherlands, a shell entity is, for treaty purposes, considered a resident in the Netherlands although it can have limited substance. In general, the requirement is that minimum 50% of the directors are Dutch residents and the board meetings are to be organized in the Netherlands. If this applies, the company will obtain a residence certificate from the tax authorities.

On the other hand, countries that are on the other side of transactions usually do not provide residency to shell entities as the income from these entities is mostly limited while the foreign withholding tax credit has to be granted in any case. The only party that should be interested to dispute residency of the shell is the source country of the payments for interest, dividend and

royalty. The reason lies in potential application of the domestic rate for withholding tax that is higher than the one prescribed by the treaty. As long as the treaty doesn't have a provision related to tax abuse, it is quite challenging to fight against abuse of the treaty.

In general, companies are eligible to use benefits of the treaty in case they can prove to be the beneficial owner of the received payments for interest, dividends and royalties. This applies if they are not immediately obligated to distribute further the received payments and are able at their own discretion manage proceeds of those payments. The consequence of the above is that placing the intermediate shell entity in the Netherlands usually have effect in lower tax burden than in the case when interest, dividends or royalties are directly paid from one country to another.

Example 1:

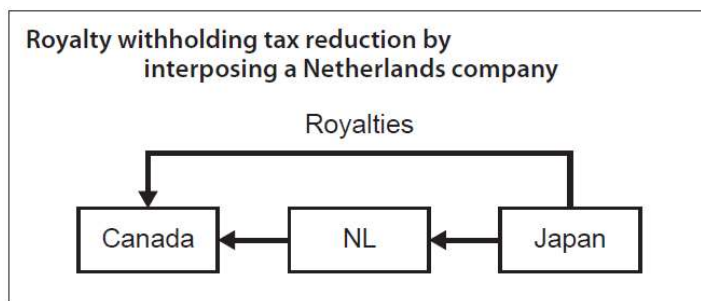


Per Income Tax Treaty between China and the Netherlands (2013) , qualifying dividends are subject to tax at 5% rate, while, according to the Income Tax Treaty between the Netherlands and the United States (1992), they are taxed at a 0% rate for an 80% shareholding. Further, the Netherlands tax system prescribes participation exemption for received dividends. Per Income Tax Treaty between China and the United States (2013), the uniform rate of 10% for dividend withholding taxes is applied. Therefore, establishing intermediate shell entity in the Netherlands, would decrease the withholding tax expense for 5%.

Furthermore, when combining the network of tax treaties of the Netherlands, the participation exemption available in EU and possible tax restructuring on international level, the withholding tax on dividend can be even decreased to 0%.

The same applies to royalties and interest.

Example 2:



The rate for royalties withholding tax per the Income Tax Treaty between Japan and the Netherlands (2010) is 0%. Paid out royalties are not subject to tax. Withholding tax is nil on outbound royalties to Canada. As payments from Japan directly to Canada are subject to 10% withholding tax, establishing the intermediate shell entity in the Netherlands, would save 10% of the withholding tax expense.

Participation exemption

Furthermore, the significant benefit of establishing the holding company in the Netherlands lies in the offered participation exemption rule. Based on it, outbound and inbound dividends are not taxed as long as certain criteria are met.

The participation exemption in the Netherlands is offered for received dividend and similar profit distribution, currency gain/ loss as well as capital gain/ loss related to the disposal of the whole or partial qualifying participation under the condition that the receiving (Netherlands) company keeps a shareholding of minimum 5% in a subsidiary (foreign or domestic). There is no period of holding applied. Further, there must be a business reason for participation and cannot be held only as an investment. In addition, the company that is receiving the payment or the permanent establishment (PE) in the Netherlands has to be subject to tax fully. In order to fulfill the requirement for business reasons for establishing the company, it has to have a purpose to realize profits that are not limited to only profit management. If there is a direct connection between the parent's activity and the subsidiary or in case that parent has a chain function or acts as a top holding a participation is not to be considered as only an investment. Significant actual presence in the Netherlands is not a requirement.

The exemption would still apply in case that participation is established as an investment, in case that maximum of 50% of the assets of the subsidiary are portfolio investments (investments with less than 5% of voting rights or capital) with no business function. Portfolio investments are participations of less than 5% in the voting or capital rights. In addition, the exemption is still

applicable if a subsidiary which has more than 50% of the assets in portfolio investments is subject to tax in its country where it belongs as a resident if that country's statutory tax rate is 10% or more. In case that tax base is minimal, or the participation already uses benefit of another regime that is considered preferential, this 'subject to tax' criteria is not considered to be met.

The goal of participation exemption rule is to make companies from the Netherlands competitive in other countries with the same tax treatment as companies that are residents in those other countries.

Paid dividends may be subject to exemption if they are paid to an EU resident company as specified in Parent-Subsidiary Directive, article 2 (2011/96), Switzerland, an EEA Member State or another jurisdiction which has a tax treaty in place with the Netherlands.

Ruling practice

For decades, the ruling practice in the Netherlands, had its basis in a General Decree and multiple other Decrees related to the particular rulings. However, in 2001, general rulings, were abolished. As a result, only tailored advance pricing agreements (APA) and advance tax rulings may be approved each particular case. Such general rulings used to address multiple matters such as moneylending consequences, which initially marked law and tax regime in the Netherlands attractive for shell companies.

The ruling practice in the Netherlands went through notable modifications in 2019. New requirement for economic nexus was the most significant change in the new Dutch ruling practice. For company to become eligible for ruling in the Netherlands, it had to exercise economic activities in the country in the same way as the resident company assuming the risks and being responsible with regards to its accounts. Critical factor is that the staff number and the operating costs level properly represent the activities of the company. When making a decision on a ruling request, tax authorities take into account activities that are based in the Netherlands as well as from which countries the funds are coming from and to which they go to. 'Pure' shell entities registered in the Netherlands primarily for the purposes of tax savings are not eligible to rulings any more. Further, tax authorities will deny a ruling to organisations involved with a country with substantially low taxes or with territories marked as non-cooperative. Usually, rulings are provided with the term of five years.

As a consequence of the requirement for economic nexus, only the shell companies that are part of the group commercially operating in the Netherlands can be granted with an advance tax ruling. Further, the risks and expenses of the operating activities have to be carried by the party requesting the ruling. In addition, the final condition is that there is in the Netherlands sufficient personnel with sufficient corporate grade to perform the operations as per registered business activity.

Failing to meet the requirement for economic nexus is not the only reason to deny an advance tax ruling. It will also not be granted if the establishment of the shell is clearly only for the purpose of saving in taxes both in the Netherlands or abroad. The same applies if the organizational structure involves a jurisdiction with notably low taxes.

Company Law

Apart from the fiscal factors, there are many others that make the Netherlands attractive for (shell) entity. Some of the main ones are highly educated work force, an infrastructure that is reliable and far in digitalisation, predictable and efficient legal and tax regime, secure political and legal systems that and a huge and reliable legal infrastructure.

From October 2012, the rules to incorporate a company with limited liability are made rather simpler. Establishing the company is faster and it can amend its corporate structure easier. The requirement for the minimum capital is abolished (contribution of EUR 18,000 needed to be invested and registered before this rule was changed). Further, contribution in kind does not require a statement from the auditor in order to be registered as capital contribution.

With regards to the share issuance, there is a possibility to issue shares with no voting or profit rights, or with multiple voting rights per share. Also, shares can have a lower nominal value. Further, the voting and profit rights can be split per share. If this is the case, trust office is taking over the voting rights (*stichting administratiekantoor*) while entitlement to profit and dividend is left with the owner.

There is also a possibility to issue various types of shares with divergent voting rights. Capital changes, as shares repurchase, share cancellation or payment of share premium for example, can be done with no difficulties. Distribution of interim dividends is possible. Management board can have authorization for share issuance over the longer period.

Investment protection agreement

The number of investment protection agreements (IPAs) that the Netherlands has signed goes above 90. Their main purpose is investments protection in foreign jurisdiction. These guarantee right to compensation in case of expropriation, reasonably fair treatment and no discrimination.

Tax measures in the Netherlands affecting shell entities

General

Being perceived as attractive for shell entities has impacted the Netherlands reputation negatively. Due to this and as a response to the measures on the international level, the Netherlands had to undertake multiple measures to decrease its shell attractiveness.

Substance requirements in the Netherlands

The Finance State Secretary indicated in June 2012 that when talking about the substance for companies it relates to its clarity in usage of tangible assets, its staff and ownership. This means application of approach comparable to substance over form principle where, when comparing facts with agreements, economic reality prevails over what is on the paper. In other words, it implies that the assessment of the company is made based on the control and usage of tangible assets as well as based on the services that personnel performs on the risk and for the benefits of the company. Per tax treaties, control or ownership is important as it is one of the parameters to determine the residency and a fair (arm's length) price, but also as it applies to the benefits limitation and provisions of the purpose test.

Comparing the Dutch and Proposed EU Substance Requirements

Category	EU Proposal Requirements	Dutch Requirements
Directors	Minimum one director: (1) has to be resident for tax purposes in the member state of the entity he/ she represents, or at least at reasonable distance from that state so it is possible to perform his/ her duty as a director;	(1) Minimum 50% of the decision-making members of the board are residents of the state that dividend receiver is (2) These members of the board are professionally capabilities to sufficiently perform their duties. Minimal duties of the board are

	(2) is capable based on his/ her qualifications and authorizations for decision making with respect to the relevant income generating activities or entity's assets; (3) is regularly using this authorization independently and actively ; and (4) is not employee of another entity that is not part of the group and is not performing the duty of a director or similar of another entity that is not part of the group.	decision making, within the normal business of the group and on basis of the responsibility of recipient of the dividend, with regards to transactions by the recipient of the dividend and their processing. (3) Executive decisions of the recipient of the dividend are made in the jurisdiction of the recipient.
Employees	Majority of the employees working on full time basis (or equivalent) are residents for tax purposes in the entity's jurisdiction (or close by so they can perform their duties still). They must have qualification for carrying out the relevant income generating activities.	There are employees with proper qualifications at the disposal of the recipient of the dividend capable of adequately implementation and recording of the recipient's transactions.
Directors/Employees	There is a choice between the requirement for directors and employees, so only one needs to be fulfilled. (The rules in the Netherlands have both as mandatory requirement.)	Additionally to the above, there is a requirement for minimum cost of salaries of EUR 100,000 for dividend recipient, for the economic activities related to its interest in the entity that is Dutch resident.

Bank account	The entity must have minimum one (active) bank account within the EU.	Principal bank account of the dividend recipient is in the entity's member state.
Premises	The entity has to have (own or exclusively used) business premises in the jurisdiction.	Recipient of the dividend must have available for minimum 24 months office facilities sufficient for the relevant activities in the jurisdiction of the entity. The recipient needs to perform activities from that office.
Bookkeeping	Not applicable.	The dividend recipient's bookkeeping must be performed in the member state of the entity.

Note: The Dutch substance requirements are used in several places in the country's tax legislation. For example, they apply to parents of Dutch companies when the Dutch companies distribute dividends and want to apply the withholding tax exemption (the regular rate for withholding tax is 15 percent).

Following questions on whether the CJEU rulings in the Danish cases will affect the Dutch participation exemption, the Dutch government stated it will investigate whether to require Dutch intermediate holding companies to adhere to the substance requirements or risk the exchange of information. The investigation was expected be completed this year, but the Unshell proposal effectively answers those questions because it requires holding companies to comply with the substance requirements.

The proposed EU and the Dutch substance requirements are quite similar. The biggest difference is in the lower requirements for employees and directors as per the directive. As can be seen in the above table, only one director must meet the requirements of qualification, authority, and actual usage of it, while per the requirements in the Netherlands, majority of directors must fulfill the conditions and it even adds additional requirement regarding the minimum salary.

It appears that the most important element of the Unshell directive is the fourth requirement from the table above, more precisely, that minimum one director must be an employee either of the entity in question or another entity from its group. This requirement comes from the goal to prevent outsourcing of the director's function and/ or administration to, for example, trust offices as then no decisions would be made locally by the directors from the company. It appears that, taking this substance requirement combined with the third gateway from the Directive, the companies that use outsourcing for decision-making functions, even with one factor, pass the gateway. Companies will have to report if their substance requirement is met in case the other gateways are met as well. In cases where all directors are outsourced, entities do not meet the substance requirement, and relevant consequences apply. This is aligned with the risk based approach of the Directive that can also be seen in the fact that even as long as only one director is outsourced it has to be reported so it is made clear if the company has outsourced maybe non-acceptably large percentage of directorship.

When applied, this will have significant impact on multinational holding companies in the Netherlands, Ireland and Luxembourg, for example. Trust offices in these countries are often hired to provide assistance to directors of multinationals' holdings that also act as employees or directors of other group companies.

Discussions might be further focusing to the definition of outsourcing significant functions in terms of the third gateway. The question is, for example, if outsourced functions are helping with preparing significant decisions but the directors of the company, although they are also employed in the other group company, actually keep the responsibility for them? It could be the case that understanding of outsourcing in terms of the third gateway need more broad interpretation as to include intergroup outsourcing as well.

In the Dutch substance requirements, the results of the outsourcing discussion can be seen in the rule regarding salary costs. The company's salary costs must exceed EUR 100,000. Further, outsourcing is possible with group companies or external parties, which may have to change.

While the Dutch requirements provide some good pointers on rules for directors, it is unclear what direction the European Commission will want member states to go when preparing implementation legislation. Further, the Unshell directive is a minimum standard and does not mean that member states cannot impose more stringent requirements.

Although the rules regarding premises differ, it is expected they will not vary greatly in practice. The Dutch requirement that the premises be available for 24 months must be examined in the context of the taxes to which the Dutch substance requirements apply. The withholding tax on dividends applies at the moment of a dividend distribution and is not tied to a period of time like an income tax is.

The Unshell proposal applies to all sorts of income taxes, which implies that its premises requirement must apply continuously. Its exclusivity wording seems more stringent because the Dutch substance requirements speak only of being available to the company, implying that an office space can still be shared but it has to be available to the entity. This requirement likely has to change.

ATAD 1

Per the requirements of ATAD 1, the Netherlands, has also implemented multiple measures against tax abuse, effective from 2019.

The Netherlands anti-abuse concept

Based on the Dutch provisions addressing tax abuse, transactions that are simulated or artificial are not taken into account on basis of the actual circumstances determined. Based on the previous approval of the Ministry of Finance, tax authorities are allowed not to adhere to legal acts for the purposes of tax assessment (so called, “just levy” principle from article 31 of the General Tax Act). However, this provision is not applicable at the moment and the law principle abuse (fraus legis) based on the case law is in use.

CFC legislation

In 2019, the Netherlands implemented controlled foreign company (CFC) regulation to address the tax abuse. This regulation is not targeting shell entities, however it reassigns the non-distributed profit coming from fictitious arrangements that had as a primer goal providing the tax advantage, from the entity that is classified as a CFC taxed at low rate to its parent company in the Netherlands. The CFC regulation applies to specific kinds of income, such as interest, dividend, royalty, lease payment, profit made from activities that add low or zero economic value and benefit from banks, insurances, or other some financial activities.

CFC regulation is applicable to direct or indirect subsidiaries of the Dutch parent company in which it has 50% or more of interest defined as equity or voting rights, or profit distribution rights. CFC qualifies as low-taxed if its corporate income tax (CIT) rate is below 9%¹⁸. CFC regulation is also applicable to non-cooperative countries from the list defined by EU¹⁹. This regulation is not applicable to (i) financial institutions generating income from third parties and companies generating unsuspicious income that is not from the list of CFC qualifying income; and (ii) where substance requirement is clearly fulfilled as the CFC performs an actual economic activity.

Anti-abuse provisions in tax treaties

In order to address shell entities, in 2013 the Netherlands started applying the policy that its tax treaties would incorporate anti-abuse provision as well. To adhere to this policy, the Netherlands went back to many counterparties, mostly developing countries, to add such a provisions to the tax treaty already in place. Add-ons are usually formulated as a principal purpose test (PPT), which was the option the Netherlands chose in the Multilateral Instrument (MLI). Based on PTP, no benefit under the treaty will be granted if primer goal of the arrangement is the benefit from the same treaty. When determining this, criteria such as the intention behind the transaction or group structure is looked into so it would be guaranteed that there is no impact on actual economic activities.

Additionally, party would be granted with benefit from the treaty if that benefit would be applicable even without the transaction or structure put in place. Also, the Netherlands would perform consultation with counterparty of the treaty before it would deny treaty benefits as per PPT.

¹⁸ Countries with lower CIT rate currently are the Bahamas, British Virgin Islands, Anguilla, Bermuda, Cayman Islands, Guernsey, Turkmenistan, Isle of Man, Jersey, Vanuatu Turks and Caicos Islands, and the United Arab Emirates

¹⁹ Current list includes Fiji, , Trinidad and Tobago, American Samoa, Palau, Guam, Samoa, Panama, Vanuatu and the US Virgin Islands. The list is applicable also to the conditional withholding tax. The current list was published by NL: Regulation of the State Secretary of Finance on 28 December 2021 [Regeling van de Staatssecretaris van Financiën van 28 december 2021 tot wijziging van onder meer enige uitvoeringsregelingen op het gebied van belastingen en toeslagen], no. 2021-0000025821 of 28 December 2021, Official Gazette no. 2021- 0000025821 (28 Dec. 2021)

Withholding tax measures

Withholding tax obligation for holding cooperatives

Up to 2018, cooperative as a legal form of an enterprise was frequently used as an intermediate company in the Netherlands as they had no liability to provide for withholding tax on dividend. Netherlands cooperatives were often owning shares of Netherlands holding companies. In such a case, cooperative would receive dividend tax free in the Netherlands and distribute it further to foreign owner without withholding tax on dividend.

From 2018, cooperatives that have as their primer activity acting as a holding company or financing of individuals or affiliates have liability to withhold tax.

Conditional withholding tax on interest and royalties

As of 2021, the conditional withholding tax on royalties and interests is applicable. Aim of this measure is to diminish benefits of using the Netherlands to move taxable profits to low-tax countries or as a payment channel to low-tax countries. In other words, the goal of introducing conditional withholding tax is reducing the Netherlands attractiveness for shell entities.

If the interests or royalties are paid to related parties registered in low-tax country with the CIT rate of less than 9% or in a non-cooperative country from the EU list, the withholding tax liability will be imposed at the highest statutory CIT rate.

So far, the conditional withholding tax is applicable only on interests and royalties to related parties but from 2024, it will be applicable, in a similar form, for dividends as well.

DAC6

DAC6 introduces a reporting liability for cross-border group structures that are found to be aggressive in terms of tax. It was legally introduced in the Netherlands in 2019 with an update in 2020.

The Explanatory Memorandum supporting the Law incorporates also clarifications that might also be applicable to shell entities. The Explanatory Memorandum states that deductions of cross-border payments between related parties are applicable with regards to:

- tax exemptions for some types of payments;
- preferential tax regimes; and

— payments to companies from countries with a statutory rate of less than 1%.

Report of the Ter Haar Expert Committee

The Ministry of Finance has founded the expertise committee (Ter Haar Committee) which has issued in October 2021 the report analysing potential changes in fiscal and civil law impacting the shell entities with respect to their tax treatment (Ter Haar report). Aim of the report is to respond to initiatives on the international level with regards to the anti-abuse having in mind that the Netherlands has negative image worldwide as it is perceived as being attractive destination for shell entities. It was acknowledged that there is significant flow of funds through the Netherlands via the entities that usually can't prove their substance as it is encouraged by the current tax regime in the Netherlands. These entities could also be vehicles for money laundering.

Conclusion of the experts was that there is a difficulty in defining a shell entity as the current definition in a law has scope limits. Experts had to come with the list of features that characterise the shell entity. Shell entities can be defined as those that are founded in the Netherlands, under the Dutch law but are utilized with in the international organisations for related party transactions. Additionally, the economic substance (actual presence) in the country is narrow as they have limited number of employees and office space is not available. Usually, there is financial, tax or legal purpose for their existence. There is a significant cash flow worldwide present with these entities. Usually it concerns payments of interest, dividends, royalties, leases and rent with other countries (both inbound and outbound). Further, there are also often involved assets like interest in subsidiaries located abroad, usually with material net book values.

While in practice it is easy and practical to refer to multinational organisations, in theory, there might be an issue as according to EU law, different treatment of international and domestic transactions and positions is not allowed if the circumstances are comparable. Multinational organisation that contains as well a company with actual activities, can have a holding entity that is not to be considered a shell if there is a connection between the business in the Netherlands of that company with the actual business and the income made by the holding from that company.

Additional problem that occurs is that experts' report does not make a clear distinction between acceptable and unwanted usage of a shell entity.

According to the report, there was a number of around 12,400 shell entities in 2019 in the Netherlands. Their total asset value was about EUR 4,500 billion, which makes 550% of the GDP of the Netherlands. Payments of dividend, interest and royalty made with those entities was in average EUR 170 million per year in a 4 years period before 2019, from which 32 billion went to low-tax jurisdictions (IMF, Capital Income Taxation in the Netherlands WP21/45 and a report of the central planning office CPB of 2019, entitled Doorsluisland Nederland Doorgelicht [cash flow country the Netherlands screened]). Experts' conclusion was that most of these payments were to tax havens, however, the ultimate beneficial was usually registered in US.

Despite the above figures, when looking at the employee number engaged and tax revenues made by the state from them, shell entities are actually not significant to the economy of the Netherlands. Tax revenue from shell entities only consisted around 0.2% of the total taxes in 2019. On the other hand, tax revenues of the developing countries could be significantly impacted. In addition, so called, treaty shopping using shell entities registered in the Netherlands could once again become popular.

Apart from the wide and strong treaty network and the good ruling practice, two reasons to register a shell entity in the Netherlands are the participation exemption and no interest and royalties withholding tax regime (with exception for non-cooperative countries and low-tax jurisdictions).

Apart from the tax related reasons to found a shell company in the Netherlands, there are also significant reasons not related to tax. These are, for example, secure legal (expert) infrastructure and good judicial practice, positive climate for investments and corporate law known for its flexibility. Additionally, risk for foreign investors is also mitigated by number of investment protection agreements which the Netherlands entered into.

Experts committee has issued number of recommendations with regards to tax regime that should have an impact on, still large, number of shell entities without economic substance registered in the Netherlands. Their first suggestion is to terminate the minimum risk requirement (safe harbor) as principle per CITA, article 8c. This would decrease the attractiveness of the Netherlands for establishing a shell entity for financial service sector as companies should then have proper risk management measures in place to mitigate these kind of risks.

In place of the safe harbor, experts suggest an open norm, according to which case by case determination if the company is sufficiently exposed to risks to be able to claim a foreign withholding tax credit and benefits from tax treaties should be done.

This recommendation is combined with the another one related to increased exchange of information on spontaneous basis for those companies that are not found to have taken the sufficient risks, especially for those shell entities that are linking pin for the activities of group entities in an multinational organisation.

Further step concerns sharing information with the source country in case of capital gain relating to share transfer. Unlike most of the tax treaties under which country of residence of the shareholder disposing the shares is entitled to tax the capital gain, unless source state has anti abuse measures in place, the Dutch tax regime provides a tax exemption in this respect. Proposal of the Committee is to inform the source country regarding the transfer that was scoped in this tax exemption in order for it to be able to put its anti-abuse measures in force if the intermediate shell entity without economic substance is registered in the Netherlands only for the purposes of this tax exemption.

In order to further diminish usage of shell entities with limited economic substance, the report further recommends restriction of other tax benefits. Important one is defining the ultimate beneficial owner more precisely so it wouldn't allow for senior management to be registered as such anymore. Additional important one is participation exemption. Overall, the report recommends enhanced reporting regarding, among the other things, the annual accounts, as currently shell entities can even publish concise reporting as they are classified as SME.

For those treaties where both parties apply principal purpose test (PPT) under the MLI, but also to treaties where MLI is not applicable, the Committee suggests an increased application of PPT to the entirety of the tax treaty.

Next recommendation is denying the tax benefits for intermediate holdings based on better definition of anti-abuse per EU law. Some of these benefits include participation exemption, those under the EU Interest and Royalties Directive (2003/49) and those under the EU Parent-Subsidiary Directive (2011/96).

Report also includes the proposal for excluding shell entities from IPA scope and finally a recommendation for the government to support the Proposed Unshell Directive.

Experts have also issued a few recommendations not related to tax. Starting from 2019, every company in the Netherlands has an obligation to register ultimate beneficial owner (UBO). In case it is not possible to identify UBO, one of the senior management personnel must be registered as one and the reason for not being able to identify UBO must be documented. According to the committee, this documentation should be recorded in UBO register and companies administration. Further to the above, there is also a note that UBO register should be improved with regards to its searching possibilities and connected to more countries where UBO registers should also be advanced.

When it comes to annual reports, the Committee recommends that all group companies would be obliged to publish their reports which would make money laundering and tax abuse using shell entities harder.

Finally, experts note that when determining if the company is large or SME, high importance is on available data regarding its assets, revenues and number of employees which is in particular sensitive for holding companies.

Position of the Netherlands Regarding the Ter Haar Report and Proposed Unshell Directive

Following up on the Ter Haar report, it was recognized by the Dutch government at the time that recently, various actions were undertaken to fight the tax abuse. These resulted in a wider base for taxation and improved and more fair taxation of multinationals. Some of the measures that have effect on shell entities are information exchange increase for entities with little or no substance, conditional royalty and interest (dividends as well from 2024) withholding tax to countries with low tax rates, using PPT for stopping the treaty abuse and reduced EBITDA from 2022 included in the criteria for to the excessive interest deduction (from 30% to 20%).

On top of addressing a base erosion, there was a lot of attention on implementing instruments fighting shifting of profits to countries known for their low taxes and to increased transparency and information exchange.

In accordance with the recommendations from the Committee, the government was also in favor of multilateral measures to fight against shifting of profits and tax abuse via shell entities. In line with that, the government supported the Proposed Unshell Directive, increased exchange of information and initiatives restricting the benefits from the Parent-Subsidiary Directive (2011/96) and EU Interest and Royalties Directive (2003/49).

Cash flows via Dutch shell entities should disappear as a result of the conditional royalties and interest withholding tax.

The government acknowledged also that, in line with the Proposed Unshell Directive, the Netherlands, from 2014, is already involved in information exchange regarding the companies from the financial sector with a little or no substance. From 2019, granting of the tax rulings are conditioned with the economic nexus. Companies that qualify for withholding tax on dividends exemption need to prove shareholders' actual presence in his residence country. Intention of the Netherlands is also to implement PPT for its treaties.

Due to the fact that multilateral solutions give best results in fighting against tax avoidance, the Proposed Unshell Directive is found as necessity for this purpose. It promotes the Netherlands as attractive destination for investments for companies with actual activity and it also creates a fair completion. From these reasons, the Netherlands is in favor of the Proposed Unshell Directive.

The government finds that when taking into account the limited revenues received from cash flows made through shell companies and the impact on developing countries, negative effects prevail. The Netherlands finds that most important measure is the transparency with countries with a tax interest in cash flows, so it would enable them to impose taxes to relevant payments. From these reasons, recommendations from the Ter Haar Committee that the benefits from treaties as well as those of the EU Interest and Royalties Directive (2003/49) and the EU Parent-Subsidiary Directive (2011/96) should not be provided to shell entities anymore is supported.

The government of the Netherlands finds that there is a need for investigation if currently present provisions on anti-abuse included in every treaty within EU are sufficient for the purpose or new provisions need to be implemented.

While right to tax with regards the flow of funds between the EU states is understandable the right to tax when it comes to transactions with group companies registered in third countries is not always clear.

Further, the government objects the complexity of the proposed way of determining if a shall entity is used for tax abuse. It also brings into question feasibility of information exchange within the provided deadline of 30 days. In summary, what needs to be reassessed is the efficiency and practicability of the information exchange as well as the proportionality. Anyhow, the measures

taken need to guarantee that states where related parties of a shell entity are registered need to be informed sufficiently so that tax is charged by the appropriate one.

The government stated that due to the fact that the proposed Unshell directive is too wide and includes multiple steps its implementation is going to be a challenge with many complexities (Tolman C. and Molenaars M., "The Unshell Directive and Its Impact On Dutch Holding Structures" (2 April 2022)). Having in mind all these issues, it is found that feasibility of the 1 January 2024 as a deadline to implement the Directive is doubtful.

From a technical side, the government doesn't question competence of the European Commission for issuing a proposed Directive. Treaty on the Functioning of the European Union, Article 115 (TFEU) (2007) does allow the Commission right to interfere administrative and legal provisions by proposing a Directive. Purpose is to allow it to impact foundation and operating of the internal EU market. Further, there are no issues with subsidiarity condition as tax abuse cases via shells have to be fought at the level of the union. The proportionality principal also appears to be met, as there is a clear definition of a shell and defines measures for the abuse if identified. The result of it should be a fair competitive market. On the other hand, government finds the implementation might become challenging as the scope of the Proposed Unshell Directive is too wide-ranging, especially with regards to the information exchange. Focus of the government was to propose more efficient system for exchange of information, increase of the 30-days deadline for the exchange of information and raising fines for cases of non-compliance.

Finally, more clarity is needed for some definitions, like for example the outsourcing of making the decisions and daily operations, who is considered a qualified employee, when is employee engaged in generating the revenues that are considered relevant and importantly, tax treaties application implications and audit requests regarding residence certificates by other tax authorities.

In general, the effect of the proposal implementation is expected to improve the reputation of the Netherlands internationally and promote it as a destination for investments with actual business activity. Overall, the Netherlands has an optimistic view on the Directive.

Does the Unshell Directive bring the Netherlands shell company practice to an end

Due to its attractiveness for shell entities with 0% royalties and interest withholding tax and participation exemption, developed ruling practice and excellent treaty network, it became quite

a popular practice to register intermediate holding, a shell entity, in the Netherlands. There were cases that dozen of them were even registered with the same office address. After a few reports from different NGOs, this was not seen as a positive image anymore. It was. The disproportionality of the benefits compared to the loss of tax revenues in the developing countries was notable. The government wanted to make a clear departure from the past practices and improve countries image.

As a response, with the aim of standing on the way of shell entities with limited or no substance, the Netherlands implemented unilateral policies to request more of a substance to issue the residence certificate so that the party involved can utilize benefits from its treaties and EU directives.

Next wave of measures was to tackle cash flows to non-cooperative and low-tax countries using CFC legislation, the obligatory reporting of aggressive cross-border structures (DAC6) and introducing the conditional royalties and interest withholding tax that also applies if real economic activities are carried out in the low-tax country.

The above is aligned with the report from Ter Haar Committee on shell entities, however, the government needs to make it more clear what is considered to be acceptable usage of a shell entity and what exactly are features of a shell. While using the criteria as per the proposal of the experts committee is practical, it might cause discrepancies in treatment for international and domestic cases. If the cases are similar, this would not be acceptable by the EU legislation, though.

As the economic substance requirement per the Proposed Unshell Directive is less demanding than national law, the Netherlands should not have an issues accepting the directive. Despite this, the Netherlands still requires above mentioned minor issues to be addressed before the proposal would be accepted.

Topics that have to be addressed still are the relevant income definition, the proposal's scope, carve-outs, the information exchange liability and evidence that proportionate risk is taken by the company.

The possibility of completely ignoring shell entities is quite incomprehensible and could lead to the treaty benefits denial and double taxation. It might also be hard for some countries to ignore

the tax treat because of the secondary EU law that prevails the treaty. All in all, all measures taken are bringing the usage of shell entities with little economic substance closer to end.

CONCLUSION

Although the European Parliament has approved the amended proposal for the Unshell Directive in early January 2023 and despite the widespread support for the initiative, there is still a lack of consensus regarding the final version of the text. There are still an ongoing disputes over the key technical provisions of the Directive such as appropriate indicators of substance, tax consequences for the entities that are considered a shell and what information is to be reported and exchanged by the Member States. The proposal, once adopted as a Directive, was supposed to be transposed into Member States' national law by 30 June 2023 and come into effect as of 1 January 2024. Although the deadline for introduction to national laws is already breached, there is still no official postponement of the effective date of 1 January 2024.

With the Unshell proposal, the European Commission has again tried to push the boundaries of its role in matters of direct taxation. For the first time, it plans to enact legislation that forces member states to clearly disregard shell companies, and as a result, disregard tax treaties they have concluded with other member states. Despite the primacy of EU law, the directive may require EU states to amend their tax treaties, especially those that do not contain a principal purpose test, before it can be invoked against shell companies.

The substance requirements are relatively light in that they target only true shell companies and can be met with careful planning. The effect is to strengthen the trend of reducing the number of group companies and centralizing functions (and substance). Further, the Unshell proposal stresses that the documentation regarding the business rationale for changes to a corporate structure is paramount for having a better starting position in discussions with tax authorities. The main two issue here are, what is the reason to address tax evasion and tax avoidance together and how to separate shell entities used for tax abuse purposes from legitimate ones.

The Unshell directive does seem to try to tackle tax evasion resulting from a lack of transparency in some situations (the high-value property scenario). However, in some situations, that casts the gateway net too wide and makes some of the exemptions seem out of place, given the directive's primary purpose.

Having in mind that there are already certain anti-abuse measures as well as disclosure requirements impacting misuse of shell entities, already in force or upcoming, a careful consideration is to be taken if additional rules tackling shell entities in specific are really required.

The consideration to be taken into account is also how Member States have technically and practically implemented new anti-avoidance rules.

Without any dispute, there are benefits from ensuring a harmonized substance requirements within the EU. Most importantly, it increases tax certainty for taxpayers, but also it increases tax efficiency and fairness. On the other hand, the current proposal is aiming to be assessed within the current tax system and the important changes in international and EU tax rules that are expected. It is also trying to make a balance with the implications for MNEs in EU in terms of complexity of new reporting requirements and rules to address tax abuse.

Another consideration to be taken into account is also how to make sure that introduced measures have equal effect on entities out of the EU in order to safeguard the fair play on a global level. Measures that are deemed to be needed are to be applied consistently to non-EU entities as well so the goal of the Directive would be achieved globally in line with OECD BEPS initiative.

Further to note is that if one of the measures, denial of issuing a tax residency certificate (or issuing a qualified certificate) will impact double tax treaties conclusion and application which is supposed to be at liberty of each Member State. From this reason, they are expected to question the legality of a measure.

In order for the Directive to be effective, it is requiring a common initiative within EU. Nevertheless, the national tax authorities are given the option to determine based on their national anti-abuse rules if the entity lacks substantial economic activity, or is considered a shell. This leads to a lack of legal certainty and harmonization.

From the technical side of the proposal, apart from missing a clear definition of some of the terms used in it which leaves room for different interpretations, main issues are identified in the lack of legal certainty, administrative burden and timing issues.

Having in mind all of the above, probably the most practical solution would be to introduce a monitoring and analysis period before a decision is made whether additional rules to address shell entities are needed. Most importantly, this would include analysis of implementation of new anti-avoidance and reporting requirements by Member States. In this way, better resource deployment would be ensured for the sake of effective implementation of “old” rules and introduction of the necessary new ones.

Finally, any new measures need to be aligned with the existing case law from the Court of Justice of the European Union. Based on that it should be targeting abusive scenarios in which way it would make sure that measures are actually relevant for tax administration and it would minimize the burden for businesses. It is also very important that any measure should not leave freedom for different interpretations or implementations in order to provide legal certainty first of all but also the harmonization.

The Unshell Directive clearly brings forward a coordinated effort against misuse of shells for tax purposes in the context of the continuous EU work towards fair taxation and in light of the recent scandals on the misuse of such entities. The rules, however, come at a moment when there is so much happening at the international level on this plane, so they must properly complement the international rules without being premature or overburdening. The moment of implementation is also important in this respect, as the measures add pressure to Member States' administrative capacity and intensify cooperation between Member States meaning that the current deadline appears to be unrealistic.

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