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Re: Fighting the use of shell entities and arrangements for tax purposes – 17 June 2021

1. Introduction

We welcome the opportunity to respond to the European Commission's inception impact assessment on 'Fighting the use of shell entities and arrangements for tax purposes' (the "**Impact Assessment**") in respect of the issue of tackling the use of abusive and aggressive tax structures by taxpayers operating cross-border to reduce their tax liability, in particular the use of shell entities (the "**Proposed Measures**"). We have set out our comments on the Impact Assessment below.

2. Definition of Shell Entity and the meaning of Substance

There is no uniform definition of a shell entity and so, this term can often be used by different people to describe different things. The term 'shell company' is often associated with a letterbox company (i.e. a company incorporated in a jurisdiction primarily but whose activities are carried out elsewhere), as well as a special purpose entities that have no employees and no real economic activity in any jurisdiction.[1] As well, "shell entities" is sometimes used to describe entities that have large inward and outward foreign direct investment stocks but have no genuine investment in a particular country and have been established there for tax reasons.[2]

Possibly due to the lack of common understanding on the meaning of a shell entity, there is (as described in the Study) a lack of data available on shell companies in the EU so the scale of the purported problem of shell entities is unknown. Indeed, whether there is any problem at all is also unclear due to this lack of data. Until the parameters are defined, objective and reliable data are gathered and issues are identified, it would not seem possible to develop legislative policy. Thus, any action is premature.

It is asserted that central to the question of shell entities is the question of 'substance'. We note that there are separate proposals for adoption of a definition of minimum level of economic substance.[3] No proposals for legislation should be made until the lack of clarity on the following matters has been resolved: (i) what constitutes a shell company, (ii) valid, statistically significant and objective data on shell companies has been gathered, (iii) whether there is a problem to be addressed (i.e. many "shell" companies have valid business purposes), and (iv) whether existing legal principles have addressed

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[1] Study on '*An overview of shell companies in the European Union*' prepared by Ivana Kiendl Kristo and Elodie Thirion, October 2018 (https://www.europarl.europa.eu/cmsdata/155724/EPRS_STUD_627129_Shell%20companies%20in%20the%20EU.pdf) (the "**Study**").

[2] Ibid.

[3] https://www.europarl.europa.eu/news/en/press-room/20210525IPR04711/getting-tougher-on-harmful-tax-competition-between-member-states

these issues. None of these actions have been undertaken so it is, therefore, premature to impose any obligations on entities operating within the EU on this rationale.

Separately, we note that the questionnaire provided as part of the feedback process on the Proposed Measures is quite broad and provides a set of answers rather than being open-ended to allow for expression of views. It would have been preferable that the questions did not guide the respondents to specific answers as we are at the early stages of the data gathering process.

3. Impact on business

Full and proper consideration is needed of the impacts of the Proposed Measures on corporate activity generally and, in particular, on banking, investment funds, capital markets, financing and securitisation transactions.

In general, there is a well-documented positive correlation between the ease of doing business in an economy and increased economic activity and wealth generation. The Proposed Measures would make doing business in the EU more expensive and therefore depress wealth of the EU citizenry. Thus, the burden of showing the utility of the Proposed Measures falls on those proposing them. This has not been shown.

4. Examples of "good" Shell companies

The use of "shell entities" should not be conflated with tax evasion or tax avoidance as there are good commercial reasons for the use of special purpose vehicles, in particular in secured lending, securitisation and similar transactions.

Suppose a corporate group wishes to issue a bond or a bank wants to securitise some assets, both of which are legitimate economic activities and are essential to the function of the corporate group and the bank. Typically, a special purpose vehicle is established which will not have any employees. This is largely because employees are unnecessary as the operating functions of such companies are small and the activities are outsourced. Also rating agencies will require that unnecessary contingent liabilities are quantified and minimised (employees create such contingent liabilities in a company) so that the credit quality of the bond issuer and/or the securitisation company can be assessed with a greater level of certainty. The purpose of these arrangements is to segregate the specific asset pool so that it can be used to collateralise bonds or other financing; there is usually no tax avoidance motive. This approach to credit enhancement is common across many forms of financing including trade receivables financing, CLOs, asset repackaging, CMBS, RMBS, secured financing, equipment and real estate leasing. The common feature is that none of these have a tax avoidance motive so they should fall outside the scope of the policy of any "shell" company proposal. The Anti-Tax Avoidance Directive (Council Directive (EU) 2016/1164), as amended, ("**ATAD**") has addressed any concerns in relation to tax avoidance in this (as well as other areas) so it seems that there is no further need for action.

It should be borne in mind that the European Central Bank will only accept collateral corporate bonds with specified ratings and these can only be issued by SPVs with no employees holding the relevant collateral. If EU companies cannot carry out these transactions, they will cease to have access to capital markets financing and will be at a competitive disadvantage compared with their non-EU competitors. In addition, the EU capital markets will be fundamentally undermined. Separately, a policy objective of the EU is to promote the EU Capital Markets Union.[4] While introducing measures to tackle abusive tax practices are essential, any Proposed Measures have to be proportionate to the goal of preserving existing structures that are used by businesses to access finance across the EU and are not contrary to the proposals for an EU capital markets union policy.

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[4] European Commission on '*What is the Capital Markets Union (CMU) and why is it important?'* https://ec.europa.eu/commission/presscorner/detail/es/qanda_20_1676

Other types of entities that do not have employees are investment vehicles such as Alternative Investment Funds ("**AIFs**") and Undertakings for the Collective Investment in Transferable Securities ("**UCITS**") which operate throughout the EU. Based on the current lack of definition of "shell" entities and the lack of data, these vehicles may be viewed as shell entities. However, they nevertheless provide an essential platform for EU investors to provide capital to EU companies. This is done in a safe and well-regulated manner with rigorous investor protection rules governed by EU directives. They should not be designated as shell entities under the Proposed Measures.

Outside of financial and investment transactions, many corporate groups use holding companies to hold different entities in their groups. These do not normally have employees but cause no tax avoidance concerns. Another example is setting up of "Project Companies" specifically established for the purpose of managing a project and for entering into contracts with various parties. Such Project Companies do not have employees but perform an essential function in the area of infrastructure projects across the EU.

Conclusion

The above demonstrates that there are a number of bona fide commercial uses "shell entities". The conclusion could be reached that any measures targeting shell entities should include an exemption for such activities, however, in our view that is the wrong conclusion to reach.

While we have identified above a number of "good" uses of shell entities, the proponents of the Proposed Measures have not identified any policy need for these measures. Rather than introduce rules with exemptions for the "good" uses, the "bad" uses should first be identified so that any measures specifically target only those bad uses.

Further, even if it was possible to draft any such rules with wide enough exemptions to permit all of the identified "good" uses of shell entities, those exemptions would have a chilling effect on economic activity by preventing innovation due to restrictions on the use of entities without employees. Economic activity, financing structures and corporate needs change constantly; the structures that facilitate that in the most economically efficient manner today, may not be the best structures to use tomorrow. Over time, this chilling effect will hamper EU business activity and disadvantage EU companies.

5. **FDI Hubs**

Another issue raised by the Study is the ratio of foreign direct investment (FDI) to a Member State's gross domestic product (GDP) and the profitability gap between foreign and domestic companies in a Member State.[5] The Study highlights that several Member States stand out with high values of both inward and outward FDI stocks and very large parts of these FDI stocks are held in special purpose entities.

Where a country provides for easy and efficient process of setting up new companies, it tends to attract FDI. However, this is not necessarily a bad thing nor is it an indication of tax avoidance. By way of example, there are many entities formed in the US state of Delaware because it provides up to date and modern corporate law statutes and has a very good quality of courts and judges. If a similar analysis was undertaken on the FDI into the US, Delaware would be identified as containing a high proposition of US FDI. There is no tax motivation to this outcome. This proves that in an integrated market, like the US or the EU, hubs will develop for particular activities and an "eco system" develops around this activity.

6. **Existing measures**

[5] https://www.europarl.europa.eu/cmsdata/155724/EPRS_STUD_627129_Shell%20companies%20in%20the%20EU.pdf

If it is considered that shell entities cause a risk of Base Erosion and Profit Shifting ("**BEPS**") or tax avoidance, those concerns have already been addressed.

From 1 January 2022, the ATAD, mentioned above, will be fully implemented across the Member States. All Member States will have a general anti-avoidance rule, anti-hybrid rules, interest limitation rules and CFC rules, in addition to their existing suite of anti-avoidance measures. It is premature to introduce additional legislation allegedly to tackle tax avoidance in the EU as it should be first assessed how effective the existing measures actually are.

Further, the majority of double tax treaties now contain the "principal purpose test" ("**PPT**"). Under the PPT, no treaty benefits are available if one of the principal purposes of an arrangement is to obtain treaty benefits, unless it is established that granting these benefits will be in accordance with the object and purpose of the provisions of the relevant treaty.

Changes to transfer pricing rules have now been implemented and these further prevent profits being allocated without substance.

In addition, the recent decisions of the CJEU in the "Danish cases" [6] have confirmed that EU tax directives cannot be used to avoid withholding tax where payments are made to conduit structures that were not beneficially entitled to the payment. Thus, the CJEU has effectively already put a stop to the practice of using conduit companies to abuse EU law.

Accordingly, the Proposed Measures can only affect genuine commercial arrangements since tax avoidance situations have been comprehensively addressed by ATAD, the CJEU, tax treaty changes and transfer pricing rules changes. Accordingly, the Proposed Measures can have no practical impact other than to hamper EU business activity and to disadvantage EU companies compared to their non-EU competitors.

7. Summary

The Proposed Measures are not based on sound data and clear definitions. Their alleged benefits have not been identified and there are already existing measures that address any alleged concerns. It is reasonable to conclude, therefore, that their only impact will be on genuine commercial situations and will only disadvantage EU companies compared with their global competition. The Proposed Measures will breach EU policy in a number of areas. The most intellectually honest action that could be taken at this stage would to drop the proposals.

Yours faithfully,

ARTHUR COX LLP

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[6] Joined cases of N Luxembourg 1 (C-115/16), X Denmark (C-118/16), C Danmark 1 (C-119/16), and Z Denmark case (C-299/16).