IBA London 2022

Capital Markets & Tax Conference
Updates on EU measures and developments

11th Annual IBA Finance & Capital Markets Tax Conference - 4 March 2022 - London

Agenda

1. Introduction
2. UK tax arena post Brexit
3. EU shell entities
4. Case studies withholding tax challenges

1 Introduction

Introduction

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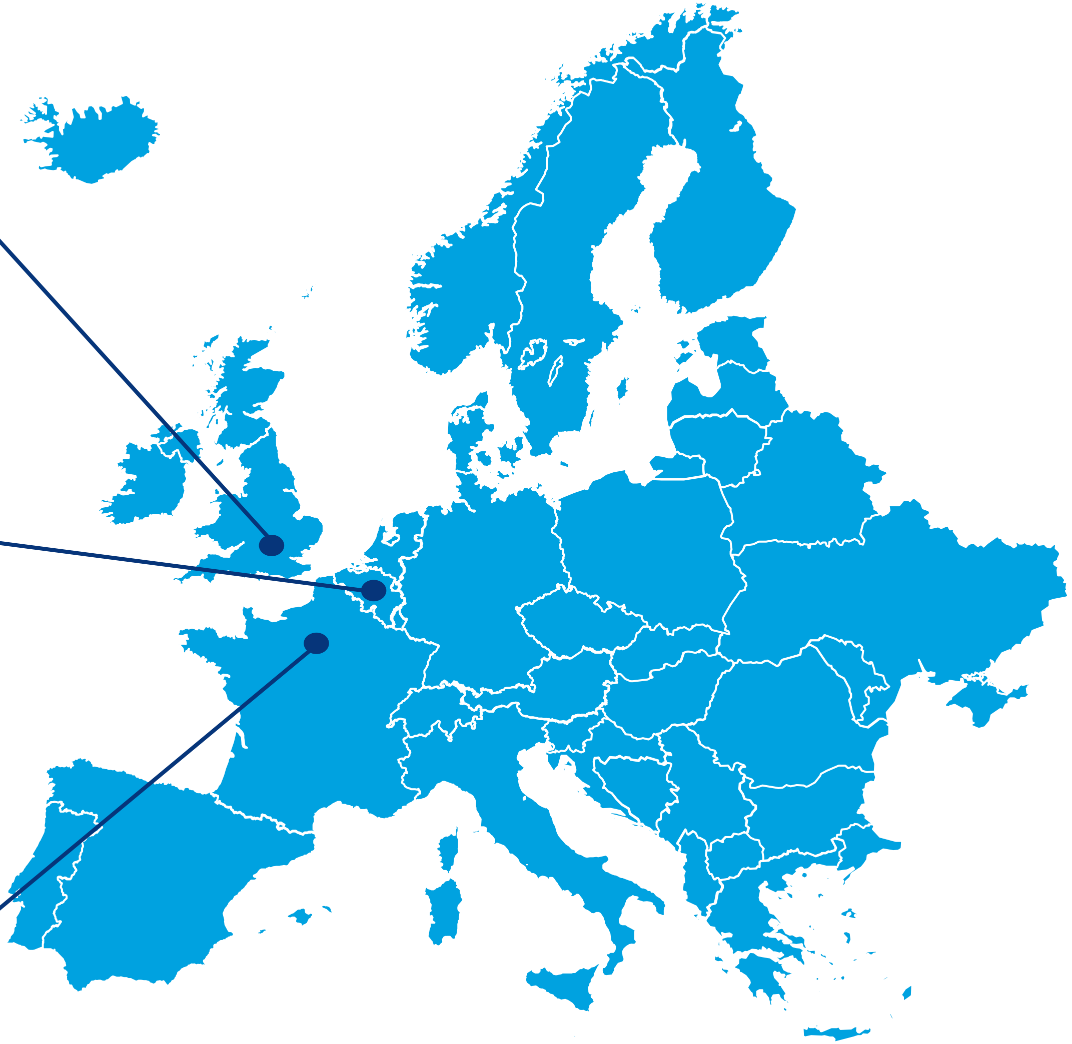

Introduction

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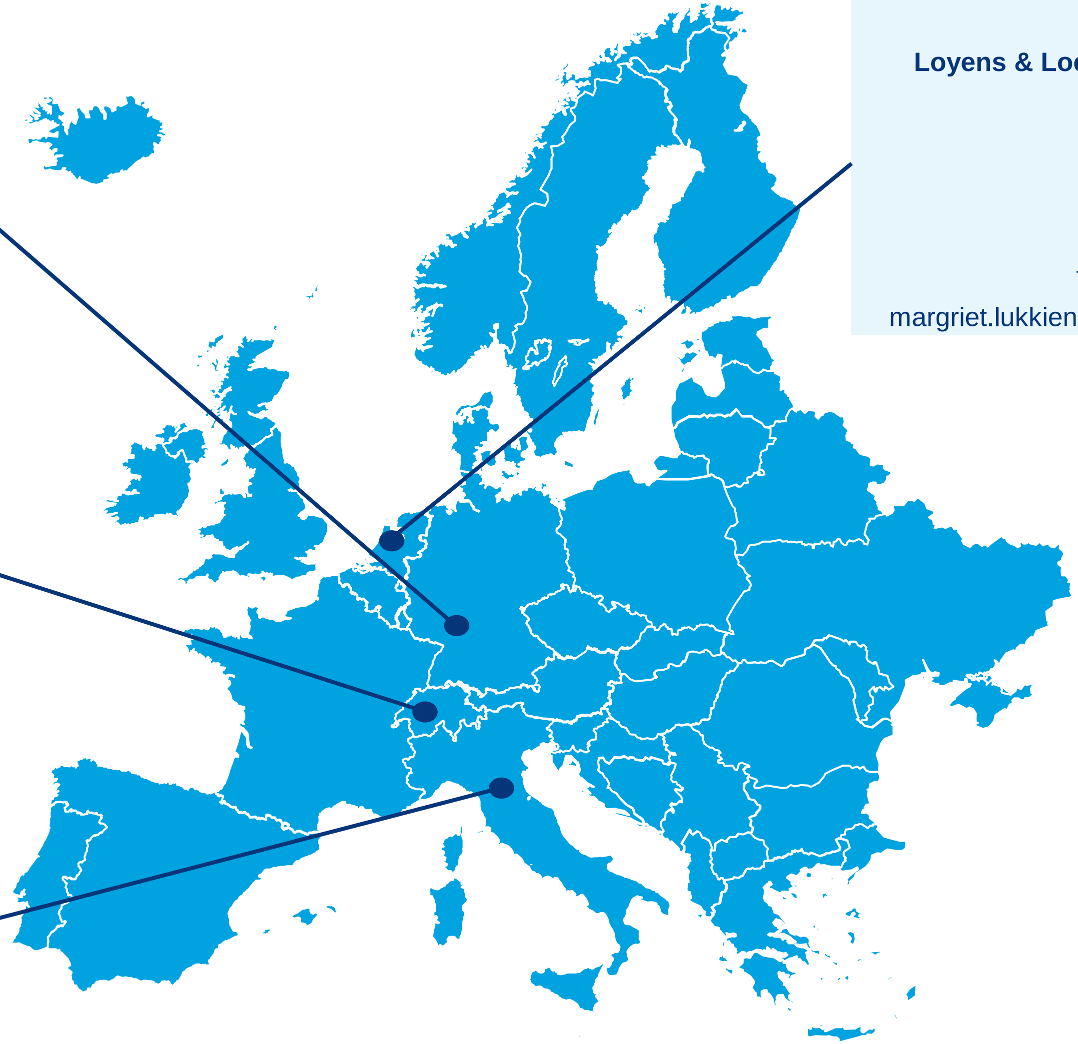


2 UK tax arena post Brexit

UK tax arena post Brexit

Timing

- Brexit on 31 January 2020, but transition period (TP) until 11pm 31 December 2020
- New relationship after that date governed by the Trade and Cooperation Agreement (TCA)

What has changed in UK tax terms since then?

- VAT – UK rules largely unchanged, but:
  - UK now third country in relation to EU/EU member states third countries in relation to the UK – change to place of supply rules for services and input VAT recovery rules for supplies of "specified services"
  - Import VAT (rather than acquisition VAT) on imports of goods into the UK
  - No access to EU-only VAT systems/simplifications
- EU tax directives no longer apply to the UK
  - IRD and PSD – UK recipients now reliant on DTTs to eliminate/mitigate WHT
  - IRD – UK's domestic WHT exemption repealed
  - DAC 6 – UK has disapplied obligations that go beyond OECD's MDR
- Fundamental freedoms no longer apply to the UK – UK's group relief rules amended to align for all non-UK companies
- CJEU jurisdiction – pre-TP referrals still binding, but post-TP decisions are not
- Other - customs duties/Northern Ireland Protocol/state aid

UK tax arena post Brexit

What might (or might not) be changed post-Transition Period?

- UK has freedom to amend tax rules where previously it was constrained by EU law
  - VAT – new categories of exemption/zero-rating unlikely?
  - VAT - consulting on changing UK’s land exemption
  - Stamp duty/SDRT - re-instate the 1.5% charge on issue/transfer of shares to depositaries and clearance systems? Unlikely
- Limited room for manoeuvre in light of need to maintain/increase tax revenues

What else is changing (even if not direct consequence of Brexit)?

- Freeports
- UK funds review – UK open for business
- Asset holding company regime – attempt to compete with typical holding company jurisdictions in the EU?

3 EU shell entities

EU shell entities

- Proposal for a directive published on 22 December 2021 (COM(2021) 565 final to:
  - define minimum substance criteria for certain companies;
  - create reporting obligations for in-scope companies; and
  - deny the benefits of EU directives and double tax treaties if the substance criteria are not met
- In order to recover part of annual estimated tax loss of 20 bln euros in the EU
- May be adopted as such. To be transposed by 30 June 2023 to come into effect on 1 January 2024
- Entities out of scope (**carve outs**): listed companies, regulated financial companies and companies whose main activity is to hold shares in operating companies located in the same State and having beneficial owners also located in the same State

EU shell entities

The Proposal contains a series of steps

These steps should result in a determination of whether a certain entity qualifies as a shell and what the consequences are.

1 Scope and carve-out

2 Gateways

3 Exemption upon request

4 Substance indicators

5 Rebuttal

6 Tax consequences

1 **Do I have a reporting undertaking?**

2 **If so, does it pass the minimum substance requirements?**

3 **If not, what are the consequences?**

EU shell entities

- Entities in-scope: EU resident undertakings that meet the following three cumulative conditions (“gateways”), assessed over the two previous years :

1. More than **75%** of the income over the two preceding years constitutes **Relevant Income** (i.e. passive income).

2. **Engages** mainly **in cross-border activities.**

3. **Outsourced** its day-to-day **administration** and **decision making** relating to significant functions in the two preceding years.

- => In practice, therefore, holding companies, financial companies, companies holding intellectual property rights and real estate companies with cross-border activities are covered.

EU shell entities

International Bar Association

Substance indicators

- Reporting obligations for in-scope entities to allow tax authorities to more easily detect misuse of shell entities: entities must provide information on “substance indicators” in their annual tax return + supportive evidence
  - Availability of own premises or premises for the exclusive use of the undertaking?
  - Holding of at least one own active bank account in the EU?
  - Concerning the directors:
    - at least 1 of the directors is resident in the country of the entity or a cross-border commuter, is qualified and regularly takes decisions on the activities generating the entity's income and is not an employee or director of other unrelated companies? OR
    - the majority of full-time employees reside in the same State as the entity?
- If one of the indicators is not met, the entity is presumed to be a shell company for the year covered by the annual tax return.
- In practice, it is the indicator for managers that is most often missing.

EU shell entities

Exemption upon request

- Exemption from reporting obligations: if the in-scope entity demonstrates to the administration of its State of residence that its interposition does not provide a tax advantage (does not reduce the tax burden) to its beneficial owners or to the beneficial owners of the group to which it belongs
  - comparison of the overall tax burden of the beneficial owners or the group with and without the interposition of the entity.

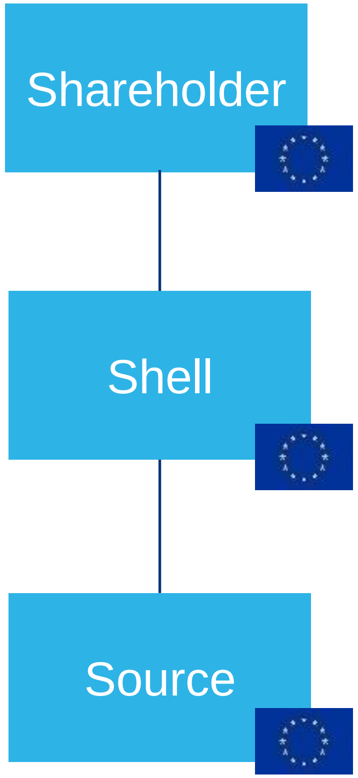
Rebuttal rule

- Possibility of rebutting the shell presumption when the entity provides the following elements to its tax administration:
  - Justification of the economic reasons that led to the creation of the entity
  - Information on employees (qualifications, decision-making powers, working hours and nature of their contract)
  - Concrete evidence that the key decisions are taken locally

- The tax administration of the State of residence of the entity has the possibility to validate for a maximum of 6 years the exemption or the rebuttal.

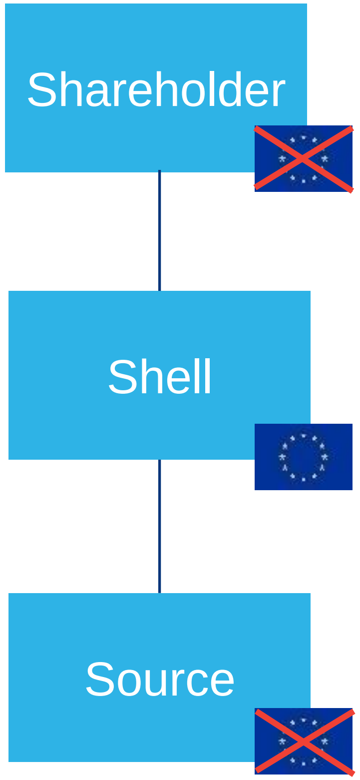
EU shell entities

- Consequences if the entity is considered a shell company:
  - In situations involving only EU states: (source-shell-shareholder):
    - Member State of residence refuses to issue a certificate of residence or issues a certificate with a warning statement;
    - Transparency of the shell entity and immediate taxation of the EU shareholder on the income received by the shell company;
    - In other Member States, refusal to apply the Directives and tax treaties to the shell entity.
      - The source state may apply its domestic rate.
    - =>The shareholder's Member State taxes the income as if the payment were made directly to him after deduction of the tax borne in the state of the shell entity and potentially of the withholding tax levied in the source state.
    - In practice: the question of the imputation of the withholding tax remains uncertain if the shareholder is resident in France, as the principle of transparency consisting in disregarding the existence of an interposed company in order to grant the tax credit corresponding to the withholding tax is far from being established in French law and practice.



EU shell entities

- Consequences if the entity is considered a shell company:
  - In situations involving third countries :
    - Non-EU source state – EU resident shareholder :
      - Non EU source state may apply its domestic law or the tax treaty with the EU shareholder state (but this is not governed by the Directive),
      - The EU shareholder's Member State taxes the income as if it had been received directly by the shareholder, without prejudice of the application of the treaty between the source state and the state of the shell entity. The tax borne by the shell entity and potentially the withholding tax levied in the third state in accordance with the treaty can be deducted.
      - In practice, when the shareholder is resident in France, the question of the imputation of the withholding tax levied in the third State remains unclear.
    - EU source state – non-EU resident shareholder (e.g. Switzerland),
      - The source Member State applies the withholding tax provided for under its treaty with the third state or, if there is no treaty, applies the withholding tax under domestic law => will the country of residence of the shareholder take into account this withholding tax?



EU shell entities

- As the text stands, certain risks of double taxation have already been identified, relating to the possibility of imputing withholding taxes in the shareholder's state. Moreover, it is not certain that third countries, whether of the source or of the shareholder, will recognise the tax transparency of the shell entity and agree to disregard it for the application of their treaties with EU Member States.

- Automatic exchange of information between Member States for all entities in scope (whether shell entities or not)

- Possibility for Member States to request another Member State to conduct a tax audit of any entity in its jurisdiction and communicate the outcome to the requesting state in a reasonable time frame

- Common sanctions regime at EU level: penalty of minimum 5% of turnover plus penalties at the discretion of the Member States

EU shell entities – Belgium

- Certain considerations from a Belgian perspective:
  - Too early to tell how this will be implemented on a Belgian level (although no surprises are expected as Belgium showed the last years to take an extensive approach in implementing EU tax/ATAD directives).
  - In the Belgian tax community, the added value of this tax development is discussed:
    - In substance, ATAD3 probably does not add much in addition to the current state of law
    - The proposal would however enhance visibility and traceability, which undoubtedly is an additional tool for tax authorities to identify new cases and support ongoing case files
  - In Belgium, we expect the effect of this rule to be in particular important in the framework of the increasing WHT tax claims on outbound passive income.
  - Groups are generally advised to review and rationalize their group charts – the potential tax impact of reorganizations should be carefully considered (e.g., TP adjustments, WHT claims, neutrality of mergers)

EU shell entities – Italy

- Substance of foreign intermediate holding companies from an Italian perspective
  - Position of the Italian tax authorities (circular letter No. 6/2016 regarding LBO transactions). No economic substance in case of:
    - light organizational structure (“conduit company”), or
    - back-to-back financial structure (“conduit transaction”).
  - Case law of the Italian Supreme Court

- Preliminary comments on the Directive Proposal
  - The presumption of minimum substance does not exclude that the Italian tax authorities
    - may still view the entity as a shell under the Italian domestic GAAR (see explanatory report)
    - may challenge the structure under the beneficial ownership requirement

- Exemption under Art. 10 of the Directive Proposal
  - Should prevent challenges based on abuse of law?
  - Does it prevent beneficial ownership challenges?

EU shell entities – Germany

- German Tax Haven Defense Act (*Steueroasen-Abwehrgesetz*) in response to Code of Conduct Group (Business Taxation) Report to the Council of 25 November 2019 – 1411/19, 45
- Applicable from 2022
- Extensive defense measures for dealings with non-cooperative countries:
  - Suspension of tax treaties
  - Extension of extraterritorial taxation and withholding taxes
  - Aggravation of CFC taxation
  - Suspension of tax exemptions
  - Denial of deduction of business expenses
  - Severe extension of cooperation obligations of taxpayers
- <u>Currently very limited relevance</u> as non-cooperative countries are limited to those on the EU blacklist (American Samoa, Samoa, Fiji, Guam, Palau, Panama, Trinidad Tobago, US Virgin Islands, Vanatu and from 2023 likely Dominica)
- Extension of application might be considered in response to the EU shell entities initiative

EU shell entities – UK

- Two schools of thought from a UK perspective:
  - Might make the UK more attractive as a holding company jurisdiction (including for qualifying asset holding companies) – potentially an advantage over EU-based companies; OR
  - Might incentivise those with existing EU structures to move more substance there (and potentially away from the UK)
- Will EU look to extend to non-EU entities (including UK entities)? Mentioned in the original press release so seems likely
  - Query how that would work from a technical perspective? But would seem likely to remove or at least reduce any advantage enjoyed by UK-based structures

EU shell entities – Switzerland

- Switzerland has a long-standing practice established by the tax authorities with respect to the acceptance of offshore companies, e.g. as beneficiaries of services, for tax purposes (including VAT purposes). Despite the lack of CFC rules, offshore subsidiaries (in non DTA-countries) can be scrutinized in converter structures, e.g. by streaming financing income to such subsidiaries.

- With respect to shell entities in DTA / EU countries as shareholder, the Swiss dividend withholding tax of 35% will only be refunded if certain substance requirements are met and the shareholder is the beneficial owner.
- Different substance requirements generally apply in case of
  - corporate (listed group) structures,
  - personal holding structures (of individual shareholders) and, e.g.
  - fund structures.

EU shell entities – The Netherlands

- 21 February 2022: Dutch government published its appraisal on the EU shell Directive
- Refers to measures already taken (e.g. conditional withholding tax on interest, royalties and dividends, ruling requirements, PPT) and the commitment of the Netherlands to prevent tax avoidance involving shells
- Support for the EU shell Directive, however with a few observations:
  - EU Member States continue to have obligations under existing bilateral tax treaties; not issuing a tax residence certificate to a shell would not per se change that
  - Definitions are sometimes ambiguous (e.g. ‘outsourcing’, qualified employees, rebuttal and exemption)
  - Implementation and compliance costs are a struggle: wide scope, complex subject matter
  - The implementation timeline is ambitious, with the envisaged effective date of 1 January 2024. In particular in combination with the ambitious timing for implementation of the proposed EU directive on Pillar Two rules.

4

Case studies withholding tax challenges

Case studies withholding tax challenges

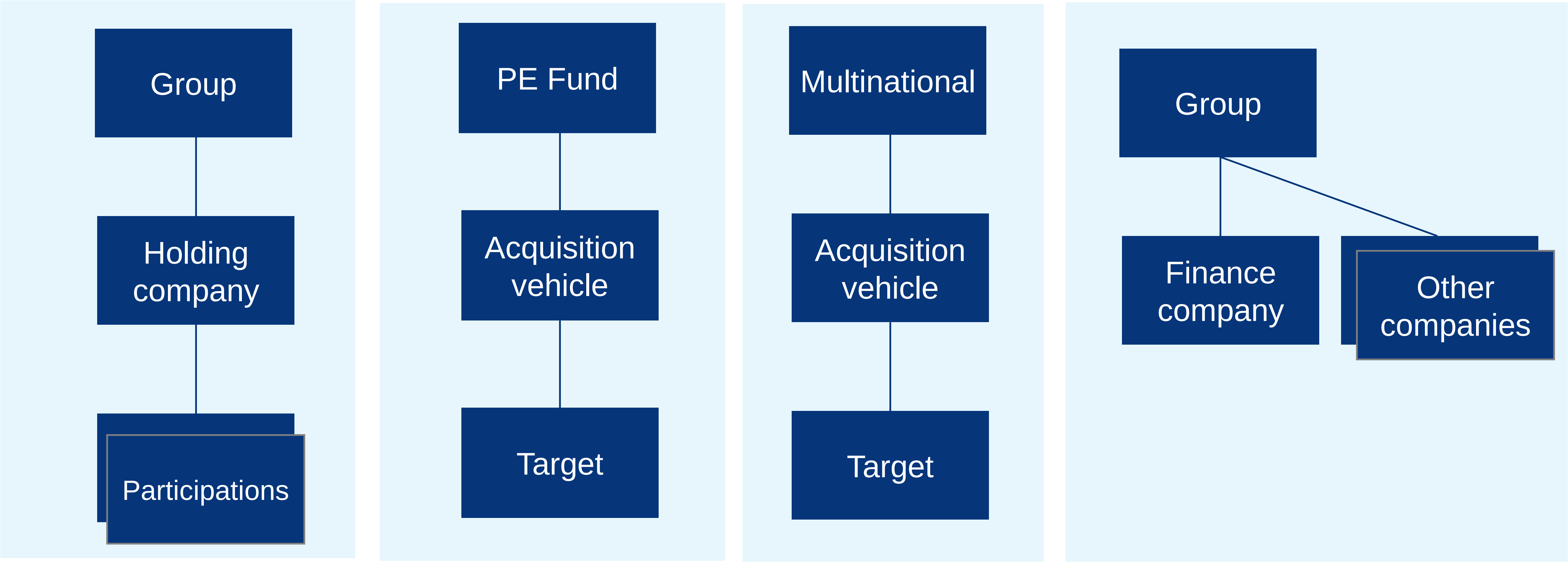
The Danish cases of the European Court of Justice of 26 February 2019 - key points to remember:

Additional indications to assess the existence of **abuse** have been provided

Economic Interpretation of the concept of **beneficial ownership** under EU law

Case studies withholding tax challenges

- Base cases - Holding companies versus acquisition structures versus separate financing companies



Case studies withholding tax challenges – Belgium

- Withholding tax challenges regarding outbound passive income appear to be one of the priorities of the Belgian tax authorities since the Danish cases
  - Increased datamining / expertise (and hirings)

- Most cases are still in the administrative level (other are pending for the court of first instance) – too early for general conclusions

- The tax authorities do not distinguish the different base case set out above, but focus on the question whether the recipient in turn pays the passive income to another group entity
  - Generally refuse to consider substance (and margin) at the recipient level
  - Also target structures that make use of a foreign tax unity
  - Apply domestic and EU anti-abuse rules in cases where the taxpayer relies on an exemption provided for in the applicable double taxation convention
  - Priority for cases (as we understand) where the ‘ultimate beneficial owner’ would not have been entitled to a WHT exemption

Case studies withholding tax challenges – Belgium

- Tax challenges lead to very significant tax assessments
  - Cumulative challenge at different levels in the distribution chain of the same dividend
  - Cumulative challenge at the level of the Belgian distributing entity and the Belgian recipient (manager in a private equity context)
  - Application of gross-up

- Revival of challenges of deductibility of interest expense
  - Obligation to notify interest paid directly or indirectly to tax havens
  - The ‘purpose’ of intercompany loans
    - Considered in the light of recent Supreme Court case law regarding the deductibility of interest expenses in the framework of leveraged dividends (Cass. 19 March 2020)

Case studies withholding tax challenges – France

- DWT exemption denial (case law dealing with (lack of) economic rationale)

- No significant impact of Danish cases;
- Cases of challenge of dividend WHT exemption under EU parent subsidiary directive :
  - The EU holding company does not have its effective place of management in the EU
  - The company receiving the dividends is not the beneficial owner
    - even in the absence of redistribution
  - The interposition of an EU holding company is artificial (re: business rationale, substance) and entails a tax benefit (anti-abuse provision) ; difficult to have the tax authorities distinguish between acquisition structures.

- => Application of domestic rate with a gross up (33.33%) plus potentially high penalties 80 p cent for fraudulent maneuvers

- However, based on recent case law, if the tax authorities consider that the recipient is not the beneficial owner but its shareholders are resident in the same country it seems that they could agree on not applying domestic law

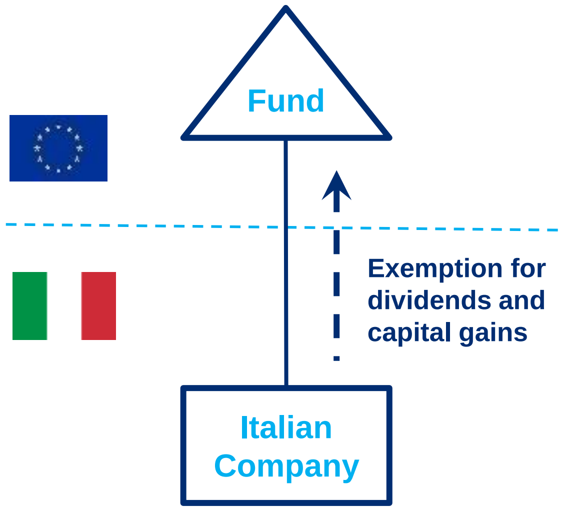
Case studies withholding tax challenges – France

- DWT exemption denial (case law dealing with (lack of) economic rationale)

- New provision : possibility to request a partial WHT refund to take into account actual expenses incurred for the acquisition and retention of the income (CGI, Art. 235 quinquies);
  - Applicable to :
    - EU / EEA legal entities
    - third country (other than blacklisted countries) entities not taking part to effective management or control of the French subsidiary
  - Provided that :
    - sums would have been deductible if the beneficiary were located in France;
    - the taxation rules in the State of residence do not allow the beneficiary to offset the WHT there.

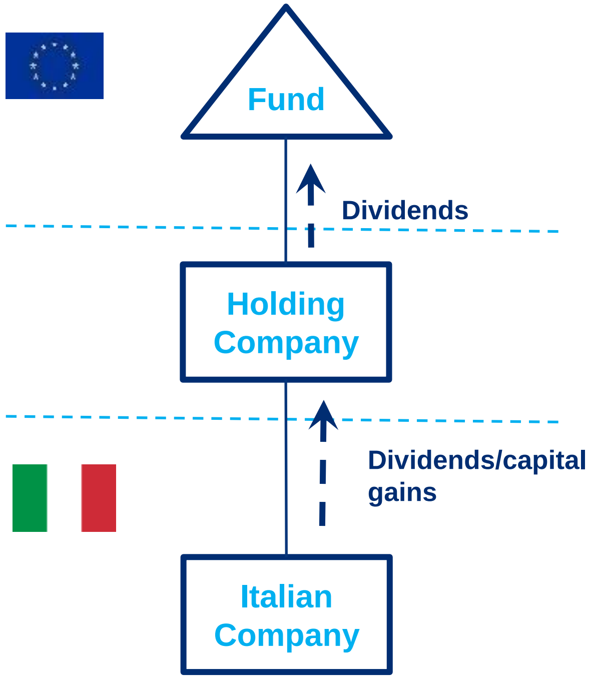
Case studies withholding tax challenges – Italy

- New regime for EU/EEA regulated funds
  - Effective from 1 January 2021
  - Dividends from Italian companies and capital gains from the sale of shares in Italian companies are fully exempt from Italian taxation
  - Eligible funds:
    - Non-Italian undertakings for collective investment compliant with the UCITS Directive established in EU or EEA member states that allow an effective exchange of information
    - Non-Italian undertakings for collective investment established in EU or EEA member states, managed by a regulated fund manager under the AIFM Directive



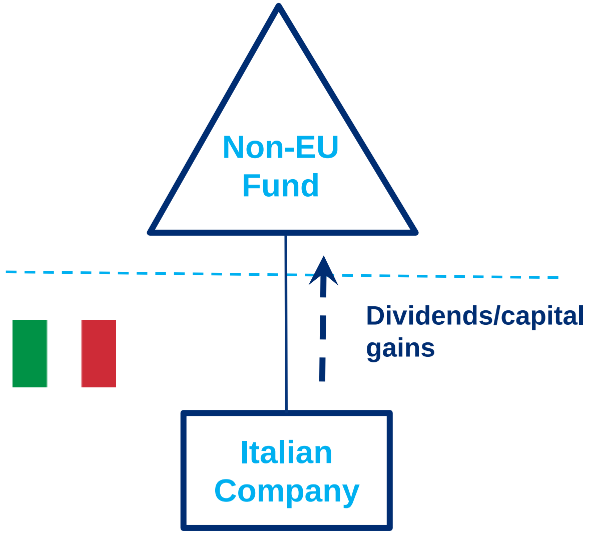
Case studies withholding tax challenges – Italy

- Investment through an intermediate holding company
  - Two lines of reasoning
    - The new exemption for EU/EEA regulated funds could be claimed on the basis of the interpretation of the Italian tax authorities regarding the exemption from Italian WHT on profits distributed by Italian real estate funds to corporate vehicles fully owned by foreign regulated funds; or
    - Dividend WHT exemption under the Parent Subsidiary Directive as there is no reduction of overall tax liability (see Art. 10 of Shell Companies Directive Proposal).



Case studies withholding tax challenges – Italy

- Investment by non-EU funds
  - Not eligible under the new exemption on dividends and capital gains
  - But possible violation of the principle of the free movement of capital



Case studies withholding tax challenges – Germany

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Germany – Amendment of Anti Treaty Shopping Rules for WHT

- In Germany strict domestic anti treaty shopping provisions for income subject to WHT have been in place for many years (e.g. dividends, royalties, interest on certain debt instruments) – treaty override
- Applicable also to income protected under EU Parent Subsidiary Directive and Interest and Royalty Directive
- ECJ of December 20, 2017, C-505/16 and C-613/16 (Deister Holding) and of June 14, 2018, C-440/17 (GS) – rules violated EU law
- Recent revision and application of new rules to all open cases (but grandfathering if old rules allowed for relief)

Case studies withholding tax challenges – Germany

Germany – Amendment of Anti Treaty Shopping Rules for WHT (2)

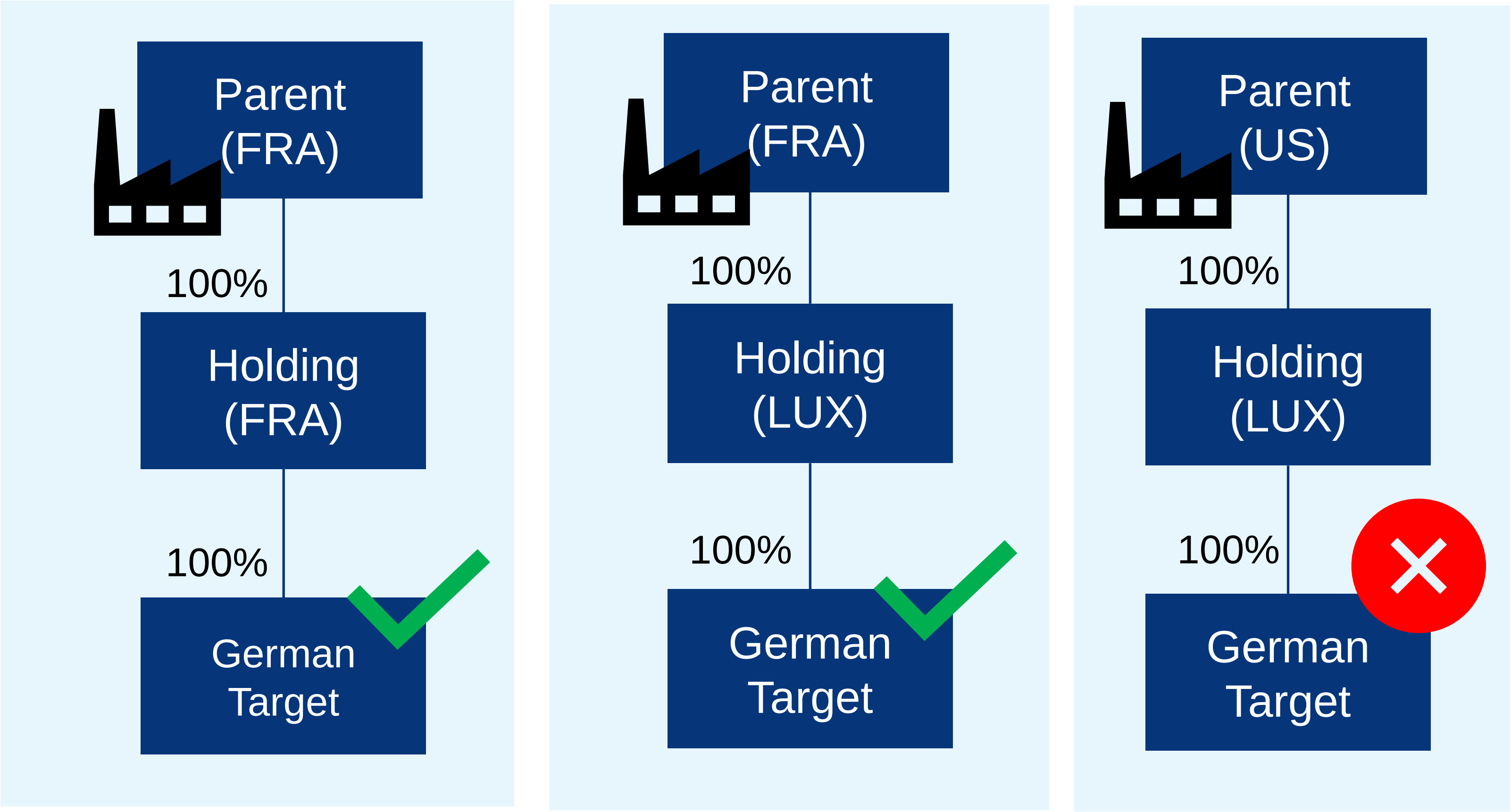
- New rules (Sec. 506 (3) Income Tax Act): No treaty/directive relieve from WHT for a company to the extent

  (i) shareholders/beneficiaries would not be entitled to similar relief under <u>same</u> treaty/directive provisions; and

  (ii) the source of income has no material connection with an economic activity of this company.
- Applicable also to income protected under EU Parent Subsidiary Directive and Interest and Royalty Directive
- Pass through to shareholders/beneficiaries or activities without a business operation appropriately set up for the business purpose do not qualify as own economic activity
- Exemptions for listed companies and expection based on principal purpose test, but no longer for investment funds

Case studies withholding tax challenges – Germany

Big issue: requirement for relief under same provision



Case studies withholding tax challenges – Switzerland

- Different substance requirements for acquisition companies to qualify for a withholding tax refund
- General requirements:
  - Resident shareholder
  - Beneficial ownership (in particular: no legal duty to forward dividend)
  - No treaty abuse
    - Substance: personal (employees/infrastructure), functional (e.g. 2 subsidiaries) or balance sheet (e.g. minimum equity of 30% for a holding) substance

    → Depending on shareholder: one or two criteria relevant
    - Tax avoidance (unusual/inappropriate structure, intent to save taxes, actual tax saving if accepted)

Case studies withholding tax challenges – Switzerland

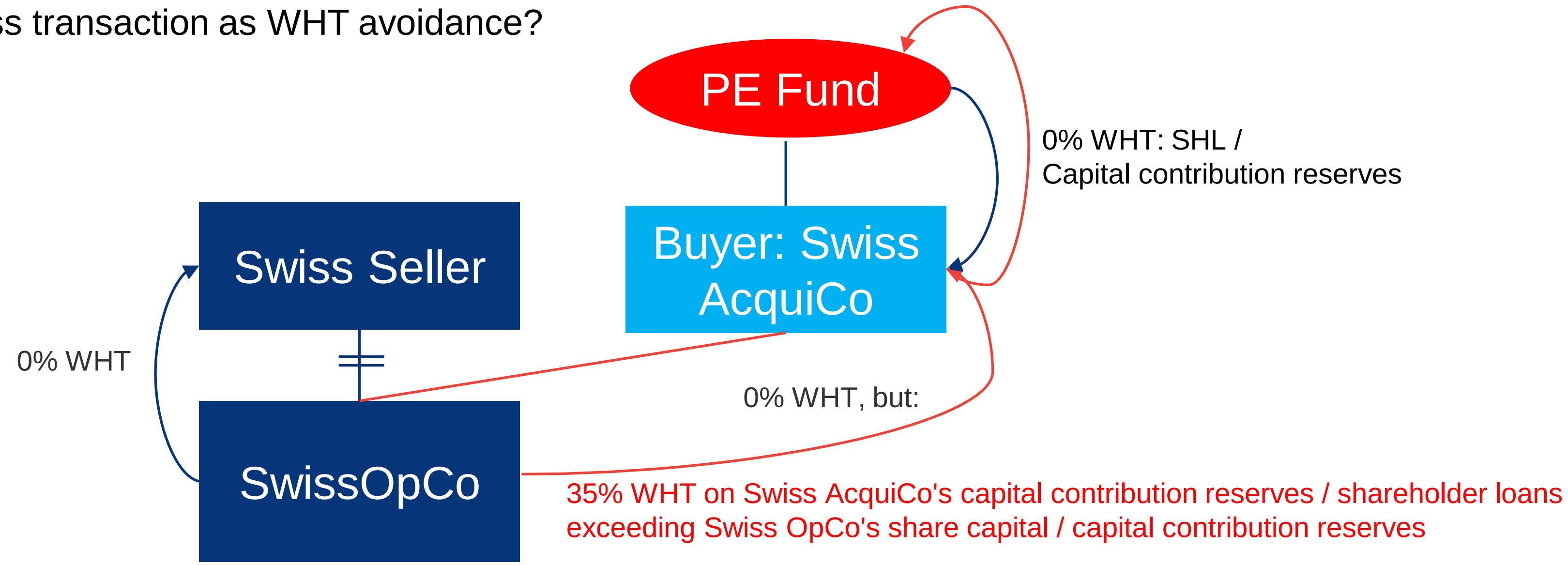
Tax avoidance practice in acquisition scenarios

- Old reserves
  - Shareholder without (full) withholding tax refund entitlement sells Swiss company with a) distributable reserves and b) non business required assets (group level) to a buyer with better withholding tax situation
  - Assumption: ordinary seller would have distributed such funds before the sale, ordinary buyer would not acquire excess cash → later distribution to buyer suffers the same dividend withholding tax as a distribution to seller (non refundable)
  - No limit in time!

Case studies withholding tax challenges – Switzerland

Tax avoidance practice in acquisition scenarios

- Extended international transposition
  - Swiss-Swiss transaction as WHT avoidance?



  - Interposition of Swiss acquisition company with capital contribution reserves/shareholder loans to offshore no substance shareholder! Comparison of direct acquisition by PE Fund and WHT repatriation via Swiss AcquiCo to PE Fund
  - Exception: Business reason for Swiss AcquiCo, e.g. substantial bank financing

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