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PROPOSAL

From:	Secretary-General of the European Commission, signed by Ms Martine DEPREZ, Director
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To:	Mr Jeppe TRANHOLM-MIKKELSEN, Secretary-General of the Council of the European Union
No. Cion doc.:	SWD(2021) 577 final
Subject:	COMMISSION STAFF WORKING DOCUMENT Subsidiarity Grid Accompanying the document Proposal for a COUNCIL DIRECTIVE laying down rules to prevent the misuse of shell entities for tax purposes and amending Directive 2011/16/EU

Delegations will find attached document SWD(2021) 577 final.

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COMMISSION STAFF WORKING DOCUMENT

Subsidiarity Grid

Accompanying the document

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} - {SEC(2021) 565 final} - {SWD(2021) 578 final} - {SWD(2021) 579 final}

Subsidiarity Grid

1. Can the Union act? What is the legal basis and competence of the Unions' intended action?
1.1 Which article(s) of the Treaty are used to support the legislative proposal or policy initiative?
The legal basis for this initiative is Article 115 of the Treaty on the Functioning of the European Union (TFEU), to ensure the proper functioning of the Internal Market.
1.2 Is the Union competence represented by this Treaty article exclusive, shared or supporting in nature?
The Union competence represented by this Treaty is shared between the Commission and Member States as provided under Article 4 (2) (a) Internal Market.
*Subsidiarity does not apply for policy areas where the Union has **exclusive** competence as defined in Article 3 TFEU[1]. It is the specific legal basis which determines whether the proposal falls under the subsidiarity control mechanism. Article 4 TFEU[2] sets out the areas where competence is shared between the Union and the Member States. Article 6 TFEU[3] sets out the areas for which the Unions has competence only to support the actions of the Member States.*
2. Subsidiarity Principle: Why should the EU act?
2.1 Does the proposal fulfil the procedural requirements of Protocol No. 2[4]: - Has there been a wide consultation before proposing the act? There has been extensive consultations with the following actions: • Targeted consultation with stakeholders on the inception impact assessment from 20 May until 17 June, 2021. Stakeholder groups included the following: Academic/research institutions, Business associations, Companies, EU citizens, Non-EU citizens, Trade Unions and NGOs; • Extensive targeted consultation with Member State national tax authorities in the form of: individual Member State consultations from June to September 2021 building and mapping information on existing rules and seeking their views and feedback on possible policy designs; and a meeting[5] seeking national tax authorities experts' views on the need for EU action and possible policy design on 22 June, 2021; • Meeting with the Commission expert group on Tax Good Governance to gather business and NGO's views on a possible initiative on 9 July, 2021; • Public consultation to gather public views on the added value of an EU action and the potential scope of such initiative from 4 June to 27 August, 2021. Overall respondents acknowledge the ongoing challenge of tax avoidance and evasion, including through the misuse of shell entities. However, they are divided when it comes to solutions. While some respondents support action to tackle tax avoidance and evasion via shell entities, others take the view that an EU legislative initiative in this direction may be premature. Generally, the business associations consulted argue that the current framework as well as the upcoming international framework would suffice to address the problem of tax avoidance and evasion and shell entities. On

[1] https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:12008E003&from=EN
[2] https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:12008E004&from=EN
[3] https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:12008E006:EN:HTML
[4] https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:12016E/PRO/02&from=EN
[5] Commission Expert Group WPIV in Direct Taxes

the other hand, Member States and civil society organisations are generally supportive of EU intervention. Several respondents point out the lack of capacity in Member States' tax administration and the insufficient administrative cooperation between Member States in tax matters as main hurdles in the EU fight against tax avoidance. Business associations raised concerns on the proportionality of the initiative.

- Is there a detailed statement with qualitative and, where possible, quantitative indicators allowing an appraisal of whether the action can best be achieved at Union level?

The explanatory memorandum of the act contains a statement that the proposal ensures the principle of subsidiarity. Furthermore, Section 3.2 of the Impact Assessment confirms the need for EU action and that the principle of subsidiarity is maintained.

2.2 Does the explanatory memorandum (and any impact assessment) accompanying the Commission's proposal contain an adequate justification regarding the conformity with the principle of subsidiarity?

Statement on subsidiarity to be included in the explanatory memorandum:

This proposal complies with the principle of subsidiarity. The nature of the subject requires a common initiative across the internal market.

The rules of this Directive aim to tackle cross-border tax avoidance and evasion practices and provide a common framework to be implemented into Member States' national laws in a coordinated manner. Such aims cannot be sufficiently achieved through action undertaken by each Member State while acting on its own. Such an approach would in fact only replicate and possibly worsen the existing fragmentation in the internal market and perpetuate the present inefficiencies and distortions in the interaction of distinct measures. If the objective is to adopt solutions that function for the internal market as a whole and improve its (internal and external) resilience against aggressive tax planning practices that affect or can affect equally all Member States, the appropriate way forward involves coordinated initiatives at the level of the EU.

Furthermore, an EU initiative would add value, as compared to what a multitude of national implementation methods can attain. Given that the envisaged anti-tax abuse rules have a cross-border dimension, it is imperative that any proposals balance divergent interests within the internal market and consider the full picture, to identify common objectives and solutions. This can only be achieved if legislation is designed centrally. Finally, if the measures to implement this initiative are enacted according to the acquis, taxpayers can have the legal certainty that they comply with EU law.

Such an approach is therefore in accordance with the principle of subsidiarity, as set out in Article 5 of the Treaty on the European Union.

The following are the main arguments for the principle of subsidiarity contained in Section 3.2. of the impact assessment:

- Tax evasion and tax avoidance by shell entities and arrangements are not limited to one Member State. A key feature of such schemes is that they involve more than one Member State's tax system at the same time. Such schemes involve legal entities or arrangements being established in a Member State, where it has no premises and people, to perform an economic activity and receive profits generated by a related entity in another Member State or even a third country. The cross-border dimension necessitates EU level intervention;

- While some Member States have targeted rules and practices, including economic substance criteria, to counter shell abuse, most Member States do not and rely instead on general anti-abuse rules. The differences between these rules, and how they are enforced, reflect more national tax systems and priorities, than on targeting the Internal Market dimension. Therefore, common EU rules are needed to counter shell entity abuses, otherwise national rule differences will lead to regulatory and tax arbitrage;

- Currently, there is no EU legislation defining economic substance requirements. Although there is EU case law establishing substance requirement general principles, its scope is limited to the specific case in dispute. In addition, although the Code of Conduct Group (Business taxation) has developed economic substance requirements, these are only applied in the context of a specific tax regime.

- Existing instruments, such as exchange of information under the Directive on administrative cooperation in direct taxation[6] (the 'DAC'), do not have mechanisms that allow timely automatic exchange of information on shell entities and arrangements in one Member State that may well affect other Member States.

2.3 Based on the answers to the questions below, can the objectives of the proposed action be achieved sufficiently by the Member States acting alone (necessity for EU action)?

Member States will not on their own be able to achieve this proposal's objectives. Uniform substance criteria are necessary to counter tax abuse in the Single Market. Without which our efforts in tackling it will be significantly compromised as shell entities and arrangements can and would likely move to Member States with weaker substance criteria. Further, working on their own, Member States will not have readily available information to assess shell entities and arrangements, resident or established in another Member State.

(a) Are there significant/appreciable transnational/cross-border aspects to the problems being tackled? Have these been quantified?

There are appreciable transnational/cross-border aspects of the problem. To avoid tax, some multinationals and individuals can exploit different EU tax rules to set up shell entities and minimise their taxation. Among other mechanisms, they take advantage of the current European legal framework, which facilitates the flow of passive income like dividends, interest and royalty payments within the EU to avoid double taxation, while rules on applicable taxes, rates and the fight against artificial tax structures remain national tax authorities' main responsibility.

No previous quantification has been available on the cross-border impact of shell entities and arrangements in relation to tax revenue loss. However, there are significant cross-border flows of passive income between group companies in the EU with direct investment income received by Member States from other Member States amounting to 420 billion EUR in 2019[7]. For the impact assessment, tax avoidance due to the use of Special Purpose Entities (SPE's), one form of shell entities,has been estimated in a range between EUR 23 and about EUR 60 billion per year in the EU.

To evade tax shell entities use complex structures involving multiple jurisdictions. The ultimate goal of such structures is to hide the identity of the beneficial owner of the shell entity or arrangement.

[6] Directive 2011/16/EU for Administrative Cooperation in Direct Taxation
[7] Source Eurostat – direct investment income EU 27 as partner countries.

Due to tax evasion's clandestine nature quantification has not been possible for the EU. However, a number of data leaks (Panama Papers, Paradise Papers, and Pandora Papers), indicate that the use of entities and arrangements to hide wealth is substantial, including entities resident in the EU.

(b) Would national action or the absence of the EU level action conflict with core objectives of the Treaty[8] or significantly damage the interests of other Member States?

Leaving it to national action could potentially damage the financial interests of Member States. For example, if one Member State had weak rules with regard to identifying shell entities and measures to counter such abuse, then this would result in regulatory and tax arbitrage with shell entities more likely to become resident or establish themselves in such a Member State to the detriment of other Member States. Therefore, to be effective there needs to be common substance rules in the EU and exchange of information mechanisms to tackle such abuse in the Single Market.

(c) To what extent do Member States have the ability or possibility to enact appropriate measures?

Member States can and already avail to differing degrees measures at national, EU and international level to tackle abuse by shell entities and arrangements. The rules and how enforced differ between Member States. Such differences lead to fragmentation of measures designed to tackle cross-border tax abuse by shell entities and arrangements in the EU. Further, there is a lack of information currently available to identify the existence of a shell entity or arrangement in another Member State. Through automatic exchange of information, Member States will be made aware of shell entities and arrangements in other Member States which allows them to prevent tax abuse in a cross-border context in a timely basis. Further, there are a number of elements in the proposal which are not available at national level. Existing rules at national level generally do not include objective substance criteria that can be used to identify whether a legal entity or arrangement is a shell entity or arrangement.

(d) How does the problem and its causes (e.g. negative externalities, spill-over effects) vary across the national, regional and local levels of the EU?

There are no reliable statistics available of the number of shell entities and arrangements in the EU. The difficulty of estimating numbers is also compounded by the lack of a common definition of what a shell entity is. Nevertheless, using proxies like FDI to GDP the impact assessment demonstrates the uneven distribution of shell entities and arrangements in the EU. Geographically, the estimate largely depends on the two EU countries showing by far the highest inward foreign direct investment in SPEs, the Netherlands and Luxembourg. The recent Pandora Papers revelations point to shell entities in many third countries but also in some Member States: Cyprus, Ireland and Luxembourg. The Panama Papers also mentioned several shell entities in Cyprus and Malta. Evidence from the impact assessment indicates that this is a national rather than a regional or local issue.

(e) Is the problem widespread across the EU or limited to a few Member States?

Tax revenue loss affects all Member States, the scale of which will depend on a number of factors, including cross-border links and the flows of passive income between group companies. As in (d), there are indications that some Member States are more likely to be used for channelling cross-border payments of passive income through such structures. The tax revenue losses will not be

[8] https://europa.eu/european-union/about-eu/eu-in-brief_en

incurred in these Member States which will offer favourable tax rules to these shell entities on the passive income received cross-border. This will mean in an EU context that the income will neither be taxed where the shell entity is resident nor where the group company making the payment is resident meaning lower revenue collection across the EU as a whole.

(f) Are Member States overstretched in achieving the objectives of the planned measure?

Member States will not be overstretched in achieving the objectives of the planned measure. The initiative will require minimal financial and human resources from national authorities to implement the systems required. Systems are already in place under the DAC to exchange information between Member States.

(g) How do the views/preferred courses of action of national, regional and local authorities differ across the EU?

From the consultations with Member States, there was broad support for an initiative to target tax abuse by shell entities with strong support for exchange of information measures. Member States stressed the importance of ensuring that it is compatible with existing measures aimed at tackling shell company abuse at national, EU and international level. Ensuring proportionality and minimizing the administrative burden were viewed as key considerations. Member States acknowledged the challenge of setting of establishing adequate economic substance criteria which targets abusive shell entities and arrangements rather than companies used for legitimate business purposes. Therefore, the rebuttal option in the proposal was welcomed as providing taxpayers with the possibility of demonstrating a legitimate business purpose despite failing the substance criteria. Evidence from the impact assessment indicates that this is a national rather than a regional or local issue.

2.4 Based on the answer to the questions below, can the objectives of the proposed action be better achieved at Union level by reason of scale or effects of that action (EU added value)?

In order to ensure the objectives of the proposal given the significant cross-border nature of tax abuse by shell entities and arrangements, an EU action is required to have uniform substance criteria to ensure a level playing field for both Member States and businesses in the EU. The EU has systems currently in place which facilitate exchange of information between Member States and thus reduce the administrative burden.

(a) Are there clear benefits from EU level action?

A core finding of the impact assessment estimates the foregone tax revenue through the use of special purpose entities in a range between EUR 23 and about EUR 60 billion per year. Special purpose entities are only one specific type of shell entities, as the latter can take different forms depending on their intended use. Even if the intervention reduced tax avoidance and tax evasion by a very small amount, it is expected that benefits would nonetheless outweigh the costs (mainly compliance and administrative costs) associated with this initiative.

In terms of indirect benefits, there are two main categories. First, EU citizens will be the main beneficiary of the positive social impacts which will reinforce the role of the EU and increase the willingness of taxpayers to comply with tax obligations. Secondly, EU companies will also benefit from the initiative. Common substance requirements, combined with exchange of information between tax administrations and a common framework for sanctions, would ensure a uniform treatment for all legal entities and arrangements and remove the risk of fragmentation in the Internal Market. This would also improve transparency and certainty for businesses to operate in the Internal Market thereby ensuring a level playing field for businesses and competitiveness.

(b) Are there economies of scale? Can the objectives be met more efficiently at EU level (larger benefits per unit cost)? Will the functioning of the Internal Market be improved?

There are economies of scale to be obtained from the proposal. In terms of exchange of information on shell entities, Member States will use the common exchange modalities, infrastructure and schemes that are already available for exchange of information under the DAC.

Furthermore, EU action would keep compliance costs to a minimum as businesses would need to adhere to a single set of, rather than different, national rules in the EU. For a group active across the EU, there would be gains in terms of economies of scale, as all its entities, no matter in which Member State, would need to follow only one and the same set of basic requirements.

Under the proposal all entities and arrangements in the EU would face the same minimum requirements for substance, which would promote a level playing field and fair competition which would mean that the integrity and functioning of the Internal Market are likely to be improved.

(c) What are the benefits in replacing different national policies and rules with a more homogenous policy approach?

The initiative does not replace existing national policies aimed at tackling shell entity and arrangement tax abuse. Rather they complement existing national policies aimed at tackling tax abuse by shell entities and arrangements. Uniform substance criteria, exchange of information mechanism and a common sanctions framework are necessary elements to ensure an effective policy approach to tackle cross-border tax abuse.

Through a rebuttal principle, the fundamental rights of taxpayers will be maintained as taxpayers will be able to challenge the outcome of the self-assessment test. Equally structures that are not put in place with the main purpose to obtain a tax advantage may avail of a mechanism to request an upfront exemption.

(d) Do the benefits of EU-level action outweigh the loss of competence of the Member States and the local and regional authorities (beyond the costs and benefits of acting at national, regional and local levels)?

The competence of Member States in tax matters is maintained as this proposal is complementary and contributes to the effectiveness of existing national, EU and international measures like OECD BEPS to combat tax avoidance and tax evasion by shell entities and arrangements. Businesses will not be able to use the fact that they have passed the substance criteria under this proposal to prevent Member States from applying their own legislation when it comes to countering tax abuse by shell entities and arrangements.

(e) Will there be improved legal clarity for those having to implement the legislation?

The proposal provides new mechanisms for combatting shell entity and arrangement tax abuse rather than improving legal clarity for existing legislation. The proposal includes clear reporting and substance criteria to help Member States identify in a timely manner entities and arrangements used for abusive purposes.

3. Proportionality: How the EU should act

3.1 Does the explanatory memorandum (and any impact assessment) accompanying the Commission's proposal contain an adequate justification regarding the proportionality of the

proposal and a statement allowing appraisal of the compliance of the proposal with the principle of proportionality?

The envisaged measures do not go beyond ensuring the minimum necessary level of protection for the internal market. The Directive does not therefore prescribe full harmonization but only a minimum protection for Member States' tax systems. Thus, the Directive ensures the essential degree of coordination within the Union for the purpose of materializing its aims. In this light, the proposal does not go beyond what is necessary to achieve its objectives and is therefore compliant with the principle of proportionality.

3.2 Based on the answers to the questions below and information available from any impact assessment, the explanatory memorandum or other sources, is the proposed action an appropriate way to achieve the intended objectives?

The proposal aims to provide Member States with uniform objective substance criteria to identify shell entity and arrangement's abuse as well as establishing information exchange provisions that are not currently available to them. The proposal complements existing measures to prevent such abuse in the Internal Market through a Directive.

(a) Is the initiative limited to those aspects that Member States cannot achieve satisfactorily on their own, and where the Union can do better?

Yes. This initiative is limited to providing Member States with tools that they cannot satisfactorily achieve on their own. In order to ensure a level playing field between Member States and businesses, uniform substance criteria to identify shell entities and arrangements are required in the EU. Furthermore, Member States require automatic information exchange mechanisms to notify other Member States of shell entities resident in their jurisdiction or established in their jurisdiction in the case of shell arrangements.

(b) Is the form of Union action (choice of instrument) justified, as simple as possible, and coherent with the satisfactory achievement of, and ensuring compliance with the objectives pursued (e.g. choice between regulation, (framework) directive, recommendation, or alternative regulatory methods such as co-legislation, etc.)?

The policy intervention in the form of a directive ensures consistency and clarity in the most effective and simple way possible. It is also proportional to achieve its objectives. The regulatory option is the most appropriate way for meeting the objectives of EU action. The status quo or baseline scenario is the least effective, efficient or coherent option. Differently from the baseline scenario and other options, the reporting of shell entities and arrangements together with automatic exchange of information between tax EU tax administrations and a common sanctions framework will mean that all EU tax administrations have the same tools for combatting abusive shell entities in the Single Market. An EU regulatory action would put all tax authorities on an equal footing.

With regard to proportionality, the carve-outs in the proposal mean that low risk entities and arrangements would not be subject to the reporting requirements. Furthermore, the substance criteria used will mean that only high risk entities and arrangements will be captured and reported as shell.

(c) Does the Union action leave as much scope for national decision as possible while achieving satisfactorily the objectives set? (e.g. is it possible to limit the European action to minimum standards or use a less stringent policy instrument or approach?)

Yes, the proposal is limited to establishing minimum standards and the rules necessary to achieve the set objectives. This will be done via a proposal for a directive the adoption of which requires unanimity in the Council.
(d) Does the initiative create financial or administrative cost for the Union, national governments, regional or local authorities, economic operators or citizens? Are these costs commensurate with the objective to be achieved?
There will be additional administrative costs for businesses both in checking whether they need to report and, if they are required to report, at the self-assessment stage. However, in both cases the costs are estimated to be minimal as the information required is already at their disposal in their accounting and registration records even if not publically disclosed. Availing of the rebuttal provision, businesses would have to provide additional information and documentation to the tax authorities. However, this information is also already readily available to the company therefore compliance costs for businesses are expected to be minimal. The Sanctions Regime will entail regulatory charges for companies that do not fulfil their obligations and expenditure in legal proceedings, however, the principles of sanctions being effective, dissuasive and proportional will be maintained. Minimum sanctions will be proposed to ensure that there is a level playing field in the EU to ensure an effective sanctions regime to avoid regulatory arbitrage. For national tax authorities systems are already in place under the DAC to exchange information between Member States. The annualised cost over 10 years for Member States and the European Commission is expected to be EUR 1.2 million. Further with regard to the Sanctions Regime, Member States will need to execute regular audits and inspections possibly followed by legal proceedings. To minimise costs such audits/inspections would be incorporated into the normal audit process.
(e) While respecting the Union law, have special circumstances applying in individual Member States been taken into account?
Not applicable.