association of the luxembourg fund industry

European Commission
DG for Taxation and Customs Union
Direct taxation, Tax Coordination,
Economic Analysis and Evaluation
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Luxembourg, 6 April 2022

Object: **Draft Unshell Directive - Fighting the use of shell entities and arrangements for tax purposes**

Dear Madam,
Dear Sir,

The Association of the Luxembourg Fund Industry (ALFI) is the representative body of the Luxembourg investment fund community and counts among its members not only investment funds, asset management firms but also a large variety of service providers of the financial sector. In this capacity, ALFI supports the EU initiatives to fight tax avoidance and aggressive tax planning.

ALFI appreciates the opportunity to provide its views on the proposed Council Directive laying down rules to prevent the misuse of shell entities for tax purposes and amending Directive 2011/16/EU (the "Unshell Directive" or the "Directive") and is pleased to share its comments herewith.

ALFI's comments relate both to the application of the Directive in the context of the investment fund industry as such (section I) and to the technical questions raised by the draft text (section II). The main key points are presented in the introduction below.

Business model and tax features of investment funds

Past experiences have shown that, the investment fund industry is not always the intended addressee of certain tax measures but that these measures may nevertheless have unintended consequences for the industry. As regards the operational business model of investment funds, having carefully read the text of the Unshell Directive, ALFI considers that it largely disregards the economic reality and the existing operating model of investment funds. By doing so, it indirectly imposes additional requirements to the existing model and additional administrative burdens and costs on the industry that would ultimately translate into increased costs for end investors.

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Indeed, and as detailed in section I below, the investment fund industry is a highly regulated industry subject to mandatory EU regulatory frameworks. Management companies (and self-managed investment funds) are subject to the authorisation and the supervision of national competent authorities (NCAs) which require their internal organisation and essential elements comply with requirements laid down in the law and in the detailed rules set forth by NCAs locally. Any investment fund manager and/or any investment fund complying with these legal and regulatory requirements will be considered as having appropriate substance at investment fund manager /management company or AIFM level for regulatory and operational purposes. Considering that management companies are entrusted with and legally responsible for the management of the fund and its assets towards the investors, it follows that the essence of the fund's structure substance lies primarily with them. We therefore recommend that this substance is recognised also from an economic and tax perspective for investment funds.

In addition, in the context of a fund structure, outsourcing and delegation of functions to entities belonging to the same investment management structure (as illustrated in Appendix 1), which may be either associated enterprises, directly or indirectly related entities or service providers, some of them also being subject to regulatory requirements and NCAs supervision, are implemented in accordance with strict regulatory rules and are subject to supervision by the management company or the manager.
In this context, it therefore seems inappropriate to consider that substance and adequate own resources have not been put in place within the fund structure, including for entities or special purpose vehicles held by an investment fund.

The entity-by-entity approach of the Directive not only goes against the regulatory and operational model and impairs the tax neutrality regime of investment funds, but it also contradicts the tax analysis of the OECD in its report on the Pillar Two Blueprint,[1] which provides for a carve out not only for funds, but also for the entities that hold assets or make certain investments and that essentially function as part of the infrastructure of the fund itself and should be treated as a part of it.

ALFI thus welcomes the carve out granted to Undertakings for Collective Investment in Transferable Securities (UCITS) and Alternative Investment Funds (AIF) as well as to management companies as indicated in the Directive. However, ALFI can only regret that the logic of this analysis was not followed through and that entities held by investment funds were not also excluded from the scope of the Unshell Directive. ALFI urges the Commission to review the current text to introduce measures for a global approach to funds' structures that recognise their operating model as illustrated in Appendix 1 and builds on the existing substance of the management company rather than applying an entity-by-entity approach.

The easiest manner to achieve this objective is to follow the above-mentioned OECD (and EU) approach on "Excluded Entities" and extend the funds and management companies' carve out of Article 6, point 2, (b) to entities that are directly or indirectly held by an investment fund. This is further developed in Section I.2 below.

[1] OECD/G20 BASE EROSION AND PROFIT SHIFTING PROJECT - Tax Challenges Arising from Digitalisation – Report on the Pillar Two Blueprint, 2.3.1. Investment funds, paragraph 82.

Technical elements of the Directive and implementation policy issues
ALFI has also read the proposed Directive with a view to its practical application by market participants in the current EU and international tax environment. The elements identified are detailed in section II and the main general concerns are summarised below.

Firstly, as a general point, ALFI welcomes this initiative as an EU harmonized approach to assessing the substance of entities and calls for EU substance requirements to become the common standard for all Member States, thus replacing the various national standards and avoiding the application of different sets of domestic substance criteria across the EU.

- ***Proportionality***

With regard to the principle of proportionality, ALFI has identified a number of points to which it wishes to draw the attention.

According to the European Commission, the Directive is designed to gather information and create a tool that would apply ex-ante where all the other existing anti-tax avoidance provisions, such as the ones included in ATAD, apply ex post. ALFI also notes a multiplication of reporting obligations under DAC and wonders how these different obligations can interact with each other to form a coherent and readable whole for both taxpayers and tax authorities in line with the objectives pursued by the Directive and by all other existing measures.

Also, the European Commission explains that there should be between 29,000 and 75,000 entities that would have to go through the processes laid down in the Directive. It would, however, expect that only a minority would qualify as “shell entities”.
If this is the case, it is questionable whether the Directive, as currently drafted, implements the most appropriate way to deal with perceived abuse by entities that do not have appropriate nexus with a jurisdiction. The formalities that will be required, even for entities with sufficient and legitimate economic substance, would increase significantly. ALFI believes that the increase of formalities created by the self-assessment required from the taxpayers that would qualify as reporting undertakings and would have to report on the indicators of minimum substance for tax purposes, the claim of an exemption for absence of tax motives or the rebuttal of a presumption of being shell entities, will cause an unprecedented level of administrative burden on taxpayers, and is at risk of creating a backlog at the level of tax administrations in view of the required assessments. This significant administrative burden for both tax administrations and taxpayers is to be balanced with the very limited result in terms of effective additional tax revenues.

ALFI is in addition concerned that the proposed rules may constitute damage to small open economies, relying heavily on cross-border business relationships and structures, entailing a violation of the equality of Member States by imposing disproportionate administrative burdens on small Member States with an open economy.

Finally, based on EU case law, a general presumption of abuse is generally not allowed and Member States have to ascertain abuse on a case-by-case basis and have to provide the taxpayer with the right to be heard before considering that their conduct amounts to abuse. As mentioned by the study conducted by the International Bureau of Fiscal Documentation and submitted to the EU Commission, although the need to share information with foreign tax administration is connected with the pursuit of public interest, care should always be taken to ensure that such pursuit is exercised in a proportionate way.[2]

[2] P. Pistone, J. Nogueira, A. Turina, I. Lazarov, “Abuse through the Use of Shell Companies and Arrangements for Tax Purposes in the European Union: Feedback on the EU Consultation by the IBFD Task Force on EU Law”, International tax studies 7-2021, p.24.

- ***Legal certainty and relevance***

Firstly, ALFI has identified a need for introducing definitions and clarifications of certain terms and concepts. ALFI is of the opinion that in order to ensure legal certainty for taxpayers and tax authorities, the text needs to strike a balance between flexibility, understood as an adaptation to specific environments or sectors such as the one of investment funds, on the one hand, and harmonisation of interpretations across the EU, on the other hand.
With regard to the last point, as detailed in particular under points 6 (rebuttal of the presumption), 7 (exemption) and 12 (tax audits) in section II below, the principle of legal certainty requires that administrative procedures are clear and predictable without the burden of proof being practically impossible or excessively difficult for the taxpayer. Past experience has shown that common interpretations of certain concepts and a harmonised application of administrative procedures are essential to avoid taxpayers being confronted with divergent interpretations from one Member State to another, which would increase legal uncertainty and the administrative burden. ALFI therefore calls for clarifications on concepts and administrative procedures to be introduced in the Directive and for their application to be harmonised in the Member States.

Also, as a general principle of constitutionalism or rule of law, new laws should be prospective rather than retrospective. An insufficiently prepared implementation may lead to compromised legal predictability and certainty. ALFI thus believes that a rule that would be applicable as from 1 January 2024 that assesses the status of an entity “in the preceding two years”, while the draft proposal was released on 22 December 2021 requires a longer transitional period based on international practice. [3] This transitional period is needed to understand the reasons and rationale behind the changes as well as for taxpayers to legitimately develop a strategy to respond to the new changes in a lawful, informed and sustainable manner.

Finally, the use of a directive as an instrument to combat treaty abuse is debatable. Indeed, for some of the elements addressed by the OECD BEPS initiative such as anti-hybrid rules, interest limitation rules, general anti-avoidance rules..., there are no existing instruments at OECD or, more generally, at international level. The situation is however different for treaty abuse. The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting ("Multilateral Instrument" or "MLI") dated 24 November 2016 that has been signed, among others, by all EU Member States and all the States in European Economic Area to take measures to combat treaty abuse is already in force. The MLI is an international treaty designed to amend other international treaties, whereas using a directive that is to be transposed in national laws for a Member State to serve as a legal basis to refuse the application of an international treaty can create complex legal issues leading to potentially complex cross-border disputes. The introduction of an additional layer of rules at EU level could also create obstacles to fundamental EU freedoms.

- ***Competitiveness of the EU market***

ALFI believes that the Directive creates a competitive disadvantage in relation to third countries that do not apply similar measures and whose entities simply do not have to bear the associated administrative burdens and costs. It is well established that additional costs have a direct impact on the performance of investment fund structures which will make it more expensive to do business in the EU and may act as a disincentive to investment. These consequences would in particular be harmful, if the substance requirements as per the Directive for investment fund structures would not be aligned with the regulatory substance requirements.

[3] OECD (2015), Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, p. 53. For instance, the OECD BEPS Final Report on action 4 states that transitional provisions to give groups an opportunity to adjust their capital structure should be available for a maximum of 3 years. Similarly, grandfathering rules were an important part of BEPS Action 5.

These latter are at the level of the investment funds manager or the management company, both entities that are from a regulatory passporting perspective required to be domiciled in the EU, as such, allowing for proper tax transparency and prudential rules. If the substance evidencing shifts to entities held by investment funds that would potentially be domiciled outside the EU, a potential loophole is created instead of closed.

ALFI is also concerned about the operational costs and risks for entities with sufficient economic substance that would, e.g., simply need a tax residence certificate for business-as-usual transactions. Such entities may suffer from a lack of responsiveness from the tax authorities due to the depth of the assessments required to issue a mere certificate of residence, and potentially suffer breaches of legal covenants in view of time constraints. The initiative may create an unnecessary impediment to basic non-abusive transactions which is likely to create a significant distortion of competitiveness for EU businesses when compared to non-EU businesses.

Furthermore, as detailed under points 8 and 9 of section II below, the way the sanctions of Articles 11 and 12 of the Directive are currently drafted and operate creates a great deal of uncertainty with regards to access to tax treaties in force with third countries. Combined with the constraints imposed by the Unshell Directive on EU investment vehicles, this could lead to market players favouring the use of third country entities over EU entities, even when investing in the EU, and thus put the whole European single market at a competitive disadvantage.

ALFI strongly advocates that any measure to deal with the perceived abuse of companies lacking appropriate nexus should incorporate the third country dimension from the outset, or at least it should not apply until the measures for non-EU shell entities also apply. ALFI is aware that the Commission will come forward in 2022 with a new initiative to address the challenges of non-EU shell entities and to introduce similar rules for third countries.[4] However, as long as this proposal is not driven by the OECD and does not apply to all jurisdictions, both EU and non-EU, the EU market will clearly be at a disadvantage. As long as the EU does not address non-EU shell entities those EU entities that are covered by the Directive may only move outside the EU, removing the entities also from EU regulatory oversight.

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[4] https://ec.europa.eu/commission/presscorner/detail/en/ip_21_7027

I. Business model and tax regime of investment funds

1. The business operating model of investment funds

As mentioned in ALFI's response to the previous public consultation dated 27 August 2021, the market of investment funds is wide and diversified. It encompasses investment funds open to retail investors including vehicles serving pension funds providing retirement or similar benefits. Investment funds thus play a key social role, in particular by allowing small investors to invest in products that grant access to a number of markets that might be otherwise closed and also gain the benefits of economies of scale of mutualized investment even if they have relatively little to invest.

It also includes AIFs that are distributed to professional, institutional and/or well-informed investors and pursue different types of alternative investment policies (funds invested in listed transferable securities, real estate funds, infrastructure funds, private equity funds or debt funds) that play an important economic role in the financing of the economy. The Capital Markets Union action plan considers that they are essential to mobilise private investment in companies and complement public support. An investment fund brings *"a variety of funding alternatives, reduces dependence on a single source or single provider of financing and reduces the funding gap."* Accordingly, one of the objectives of the Capital Markets Union action plan is to favour long term investments through the creation of the European Long-Term Investment Fund (ELTIF). In this context, the European Commission also recommended Member States to create a favourable tax environment for the ELTIF.[5]

From a legal and regulatory perspective, the investment fund industry is a highly regulated industry[6][7] subject to mandatory EU regulatory frameworks for funds and/or their managers that are pursuing their activities on a cross-border basis either through subsidiaries or branches. The investment fund industry, in Luxembourg and more generally in the EU, is subject to the supervision of the respective NCAs with regards to the compliance with those regulatory frameworks.

From an operational perspective, investment funds operate either as self-managed funds or they entrust an investment fund manager with their management in accordance with EU regulatory requirements. In both cases, while always retaining full legal responsibility, the investment fund, if self-managed, or the investment fund manager generally delegate some of their functions to associated enterprises and/or service companies, such as assets managers, advisors, distributors that are entities subject to regulatory requirements and to supervision, that do not always meet the definition of "associated enterprise" of the Directive but could, in some instances, be related to the entities served. Their obligations and responsibilities are codified by the UCITS Directive, in particular in its Chapter III, and by the AIFM Directive. The delegation of those functions and activities is implemented for bona fide commercial reasons, in accordance with laws and regulations applicable to investment funds and fund managers, and should thus not be viewed as a delegation of significant functions as foreseen in Article 6, point 1, (c) of the Directive.

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[5] Final Report of the High Level Forum on the Capital Markets Union set up by the European Commission (https://ec.europa.eu/info/sites/info/files/business_economy_euro/growth_and_investment/documents/200610-cmu-high-level-forum-final-report_en.pdf)

[6] Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)

[7] Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010

In terms of operational set-up, UCITS are generally allowed to invest in securities and, in doing so, must comply with the investment restrictions of article 56 of the UCITS Directive as transposed by Member States, in such a way that they cannot exercise a significant influence on the management of any entity they invest in. One of the exceptions to this provision is investments in subsidiaries carrying out management, advisory or marketing activities in the country where the subsidiary is established for the purpose of redemption of a fund units or shares. Those subsidiaries will usually be regulated entities also subject to taxation on their profits in the countries where they would be established. They would comply with the required substance in these countries.

Alternative investment funds' structures involve the creation and the management of affiliate entities directly or indirectly held. Investment fund platforms that include Luxembourg or foreign holding and/or financing entities are implemented primarily for commercial reasons with the objective to serve a return on investment to investors. It is important to note that affiliate entities to AIFs, acting as holding and financing companies in investment structures are predominantly used to aggregate various type of investors, manage risks on investments, provide legal segregation between various assets or investments, create legal protection and/or structural subordination amongst lenders, investors and managers. The typical revenues earned or dealt with by those entities consist in passive income, including categories of income defined as "Relevant Income" in Article 4 of the Unshell Directive. Their use is recognised, for example, by the proposal amending the EU regulation on ELTIFs, in particular in its recital (12), which considers that investments conducted through the participation of intermediary entities, including special purpose vehicles and securitisation or aggregator vehicles or holding companies are essential to implement funds' investment strategies, to attract more promotors of investment projects and to increase the range of possible eligible target assets.[8] In practice, in an investment structure or platform with several entities, not all of them require to have a large substance. The required substance should instead be looked at and evaluated on an overall economic basis at the platform level and on a case-by-case basis. Please see in Appendix 1 a typical alternative investment fund structure.

As mentioned above, UCITS management companies and AIFMs (and self-managed investment funds) are subject to the approval and the supervision of NCAs. In order to obtain this approval, their internal organisation and the essential elements required to operate must comply with requirements laid down in the law and in the detailed rules set forth by NCAs. For example, in Luxembourg, CSSF Circular 18/698[9] provides rules applicable to the shareholding, capital requirements, governing and management bodies, internal control functions, organisational arrangements, delegation and outsourcing. Contrary to what is stated in recital (5) of the Directive, these entities have sufficient own resources but may still delegate some of their functions in accordance with legal and regulatory requirements.
Any investment fund manager and/or any investment fund complying with the legal and regulatory requirements will be considered as having appropriate substance for regulatory and operational purposes and that substance has to be recognised also from an economic and tax perspective**.**

[8] Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Regulation (EU) 2015/760 as regards the scope of eligible assets and investments, the portfolio composition and diversification requirements, the borrowing of cash and other fund rules and as regards requirements pertaining to the authorisation, investment policies and operating conditions of European long-term investment funds:
Recital "(12) Certain investments by ELTIFs can be conducted through the participation of intermediary entities, including special purpose vehicles and securitisation or aggregator vehicles or holding companies. Regulation (EU) 2015/760 currently requires that investments in equity or quasi-equity instruments of the qualifying portfolio undertaking can only take place where those undertakings are majority owned subsidiaries, which substantially limits the scope of the potential scope of the eligible asset base. ELTIFs should therefore have the possibility to conduct minority co-investment in investment opportunities. That possibility should enable ELTIFs to obtain additional flexibility in implementing their investment strategies, to attract more promotors of investment projects and to increase the range of possible eligible target assets, all of which is essential for the implementation of indirect investment strategies."

[9] CSSF Circular 18/698 on Authorisation and organisation of investment fund managers incorporated under Luxembourg law
Specific provisions on the fight against money laundering and terrorist financing applicable to investment fund managers and entities carrying out the activity of registrar agent. This Circular provides rules applicable to the shareholding, capital requirements/own funds, governing and management bodies, internal control functions, organisational arrangements, delegation and outsourcing etc…

Management companies and managers being entrusted with and legally responsible for the management of the fund and its assets towards the investors as reflected in the AIFMD and other EU regulations, such as the ones on EuVECA and EuSEF,[10] it logically follows the essence of the fund's structure substance lies primarily with them.

In an investment structure which includes several entities created to implement the strategy of the fund and hold its underlying assets, it is generally sufficient that each single entity has adequate substance and/or adequate delegation of services commensurate with the activities performed, both options being, under the law, subject to the oversight of the management company.

Through the substance requirements imposed by the Unshell Directive, such as the one for *"own premises"* or *"premises for its exclusive use"* of Article 7 or the carve out for *"undertakings with **at least five own full-time equivalent employees or members of staff** (emphasis added) exclusively carrying out the activities generating the relevant income"* of Article 6 point 2 (e) which a contrario amounts to automatically pointing at entities with less than five full-time employees or staff as suspicious**, the Unshell Directive entirely disregards the economic reality and the existing operating model of investment funds. By doing so, additional requirements would be indirectly added to the existing model and significant additional administrative burdens and costs would be imposed on the industry.**

2. Tax features of investment funds' platforms

The tax features of investment funds are designed to preserve the tax neutrality of investments made through investment funds compared to a direct investment. This principle has been recognized by the OECD in the 2010 Report[11] in relation to treaty access for investment funds and by the European Commission in its notice dated 19 July 2016 related to State aid.[12] The taxation of income and gains derived from investments made through investment vehicles takes place at several levels in an investment fund structure, i.e.:

- through taxation at source on certain types of income received, almost exclusively passive income, by the fund/fund structure;

[10] AIFMD - Section 3 - Delegation of AIFM functions - Article 20, point 3
"3. The AIFM's liability towards the AIF and its investors shall not be affected by the fact that the AIFM has delegated functions to a third party, or by any further sub-delegation, nor shall the AIFM delegate its functions to the extent that, in essence, it can no longer be considered to be the manager of the AIF and to the extent that it becomes a letter-box entity."
Similar provisions are included in Recital (26) and Chapter II Conditions for the use of the designation 'EuVECA' in Article 8 of Regulation (EU) No 345/2013 of the European Parliament and of the Council of 17 April 2013 on European venture capital funds and in Chapter II "Conditions for the use of the designation 'EuSEF"'in article 8 of Regulation (EU) No 346/2013 of the European Parliament and of the Council of 17 April 2013 on European social entrepreneurship funds

[11] The Granting of Treaty Benefits with respect to the Income of Collective Investment Vehicles (adopted by the OECD Committee on Fiscal Affairs on 23 April 2010)

[12] Commission Notice on the notion of State aid as referred to in Article 107(1) of the Treaty on the Functioning of the European Union - 19 July 2016 - Para. 161: "*It is generally accepted that investment vehicles, such as undertakings for collective investment, should be subject to an appropriate level of taxation since they basically operate as intermediary bodies between (third party) investors and the target companies that are the subject of investment. The absence of special tax rules governing investment funds or companies could result in an investment fund being treated as a separate taxpayer — with an additional layer of tax being imposed on any income or gains by the intermediary vehicle. In this context, Member States generally seek to reduce adverse taxation effects on investments through investment funds or companies compared to direct investments by individual investors and, as far as possible, to ensure that the overall final tax burden on the basket of various types of investments is about the same, irrespective of the vehicle used for the investment.*"

- in the hands of investors in the fund on income received or gain realized in accordance with the tax rules applicable in their country of residence. Exchange of information mechanisms put in place, such as the Common Reporting Standard, have ensured that income and capital gains are effectively taxed in the hands of investors by the relevant States;

- on UCITS management companies and AIFMs pursuing activities of collective portfolio management on a cross-border basis by establishing subsidiaries, branches or in accordance with the freedom to provide services in line with national tax laws and provisions of applicable double tax treaties; and.

- on the net profit realized by distributors on the marketing of funds' units/shares locally in accordance with the applicable tax rules in their country of residence.

The specific situation of investment funds and their platforms has also been analysed by the OECD in its report on the Pillar Two Blueprint. The report considers investment funds as "Excluded Entities". It also recognises entities held by the fund and established for the purpose of fulfilling its policies and objectives as "Excluded Entities". Paragraph 82 of the report clearly indicates that *"**The final part of the definition recognises that an Investment Fund may use special purpose vehicles to hold assets or to make certain investments. Such entities or arrangements essentially function as part of the infrastructure of the fund itself, and should be treated as part of the Excluded Entity (emphasis added).** The exclusion for special purpose vehicles does not extend to entities that carry on or otherwise have responsibility for managing a trade or business of the MNE Group itself. The definition also provides for cases where the entity or arrangement is held by more than one separate Investment Fund, or by one or more Investment Funds together with another Excluded Entity such as a pension fund. The definition also accommodates cases where, for regulatory or commercial reasons, the fund manager may be required to hold a de minimis shareholding in the entity or arrangement."*

This approach to Excluded Entities is duly reflected in the OECD Pillar Two Model Rules[13] and hence also in the proposal for a Council Directive on ensuring a global minimum level of taxation for multinational groups in the Union published on 23 December 2021 in its Article 2, point 3:

"[…]

This Directive shall not apply to the following entities ('excluded entities') unless the filing constituent entity has made an election not to treat such entities as excluded in accordance with Article 43(1):

(a) a governmental entity, an international organization, a non-profit organization, a pension fund, an investment entity that is an ultimate parent entity and a real estate investment vehicle that is an ultimate parent entity; or

(b) an entity that is owned at a minimum of 95 % by one or more entities referred to in point (a), directly or through several such entities, except pension services entities, and that:

(i) operates exclusively, or almost exclusively, to hold assets or invest funds for the benefit of the entity or entities referred to in point (a); or

(ii) exclusively carries out activities ancillary to those performed by the entity or entities referred to in point (a); or

(c) an entity that is owned at a minimum of 85 % by one or more entities referred to in point (a), directly or through one or several such entities, provided that substantially all of its income is derived from dividends or equity gains or losses that are excluded from the computation of the qualifying income in accordance with point (b) of Article 15(2)."

[13] OECD/G20 BASE EROSION AND PROFIT SHIFTING PROJECT - Challenges Arising from the Digitalisation of the Economy Global Anti-Base Erosion Model Rules (Pillar Two) – December 2021

An application of the measures introduced by Chapter III of the Unshell Directive to entities included in a fund platform without any consideration for the overall set-up and purpose of the platform, will most certainly impair the overall tax neutrality of a fund structure.

In conclusion, given the regulatory, operational and tax characteristics of investment funds and related structures as described above, ALFI has from the outset advocated an assessment of the required substance on an economic basis considering together all of the entities that constitute an investment fund structure.

ALFI thus welcomes the carve out granted to UCITS and UCITS management companies as well as to AIFs and AIFMs. However, ALFI can only regret that the logic of this analysis was not followed through and that entities held by investment funds were not also excluded from the scope of the Unshell Directive in the same manner as for the fund itself.

ALFI urges the Commission to review the current text to introduce measures for an integrated approach of funds' structures, i.e. the investment fund, the management company and the entities directly and indirectly held by the fund, and that builds on the substance of the management company and its operational model rather than on an entity-by-entity approach.

The easiest manner to achieve this objective is to follow the above-mentioned OECD and EU approach on "Excluded Entities" and extend the funds and management companies' carve out of Article 6, point 2, (b) to entities that are directly or indirectly held by an investment fund.

An alternative approach that would follow from the same principle could consist in carving out all the entities directly or indirectly held by a fund that might fall within the scope of Article 6, point 2, (d) *"undertakings with holding activities that are resident for tax purposes in the same Member State as the undertaking's shareholder(s) or the ultimate parent entity, as defined in Section I, point 7, of Annex III to Directive 2011/16/EU"* where the fund would be considered as the shareholder, irrespective of whether the fund is opaque or transparent for tax purposes.

Any option retained by the Directive must ensure that its implementation (i) is as simple as possible and provides legal certainty for both the taxpayer and the tax authorities and (ii) ensures the recognition of the actual business model of investment funds.

II. Technical elements of the Directive and implementation policy issues

ALFI has reviewed the text of the Unshell Directive and has set out below the elements where clarifications or amendments would be necessary for a proper application of the Unshell Directive in general and to investment funds' structures more in particular.

1. Scope

Article 2 provides *"This Directive applies to all undertakings that are considered tax resident and are eligible to receive a tax residency certificate in a Member State."* The concept of *"undertaking"* is defined in Article 3 as *"any entity engaged in an economic activity, regardless of its legal form, that is a tax resident in a Member State"*.

The scope of the Directive is broad and does not provide any indications as to its application in the event tax transparent entities, such as partnerships or mutual funds, are involved. Only the explanatory memorandum states that *"In this vein, it [the Directive] also captures legal arrangements, such as partnerships, that are deemed residents for tax purposes in a Member State"*. Such type of precisions should be included in the Directive itself to provide legal certainty and ensure a consistent transposition.

In addition, many questions arise in practice on the application of the scope and in particular it will be important to understand under which Member State's legislation the tax transparency or the opacity of an entity is to be assessed as not all Member States or third country jurisdictions look at some entities or legal arrangements in the same way.

2. Definitions

- *"undertaking's shareholders"*

Article 3 (6) provides a definition of *"undertaking's shareholders".* However, the definition does not contain any details as to the level of direct or indirect participation required to be considered as shareholders of the undertaking. As the wording currently stands, any shareholding in whatever form and for whatever level, even a minority shareholding of, e.g., 1% or even less, could cause the carve-out of Article 6, point 2, (d) not being met, thus putting the entity in the situation of being considered as a shell entity. In the context of investment funds, clarifications would be required as to the treatment of shareholdings held through transparent investment funds (vs. opaque funds) or other transparent entities. Also, where an investment fund is widely held, information on investors would be available at a cost that may be disproportionate considering the objectives of the Directive.

- *"Economic activities"*

Article 3 point (1) defines an undertaking as *"an entity engaged in an economic activity"*. It would be useful to define the expression "economic activity" within the meaning of the Unshell Directive.
It may seem a priori contradictory with other areas of EU law where holding companies are considered as not performing an economic activity (e.g. VAT, competition law, …).

- *"Associated enterprises"*

For the sake of completeness, it may be suggested to include the definition of "associated enterprises", that is in current Article 5 of the Directive, in Article 3 "Definitions". The readability of a text is a means of ensuring that the principle of legal certainty is respected when the legislation concerned has to be applied by various stakeholders.

3. Relevant income

Article 4 provides for a definition of the notion of *"relevant income"*, there would however also be a need for clarifications as to the level(s) at which the "relevant income test" should be assessed in funds' structures.

More in particular, the Directive should include provisions on how the definition should be interpreted in relation to the requirements of point 1, (b), (ii) of Article 6, which refers to the relevant income being "paid out" ("*at least 60% of the undertaking's relevant income is earned or paid out via cross-border transactions")*.

4. Reporting undertakings

– *"Two years period"*

The criteria laid down in Article 6 refer to a retrospective period of two years during which an entity's position should be assessed where Article 1 defines "tax year" as "*a tax year, calendar year or any other appropriate period for tax purposes*".

Generally speaking, retrospective effects are not desirable as they introduce uncertainties in the application of a new regime. To avoid those uncertainties, specific measures constitutive of a transitory period to adapt/comply with the Directive should be foreseen.

ALFI notes that the starting point of the two tax years period is not provided for in the Directive. In order to ensure that the assessment of this reference period for this new reporting obligation will be the same in all Member States, clarification is needed to ensure harmonised application and respect for the principle of legal certainty.

Also, a directive is an act addressed to the Member States which must be transposed into national legislations in order to produce effects on natural or legal persons. In this context, and considering the ex-ante effect of the provisions of the Directive as well as the definition of "tax year", the "first two years period" cannot start before the beginning of the first tax year following the transposition of the Directive into the respective national laws. Such an application of the Directive would then be aligned with the way international provisions, such as the provisions of the above mentioned MLI, are set to start their application and would ensure appropriate compliance with the principal of legal certainty. For example, assuming a transposition into national laws before November 2023 and a "tax year" aligned with the calendar year, the first two-year period would start as from January 2024.

In addition, it should also be clarified how the criteria set by Article 6 should be assessed, i.e. on a continuous basis during the entire two years period rather than at any moment during that period of time.

Finally, particular situations should be considered, such as the case of newly created entities with less than two years of existence or the case of reorganisations within funds' structures (e.g. merger, demerger or transfer of entities) in this two-year period.

– *"Revenues accruing to the undertaking"*

Article 6, point 1 (a) refers to *"revenues accruing to the undertaking"* but does not indicate how this is to be understood i.e. whether the fact that the revenue is actually paid to the undertaking is decisive.

– *"Cross-border"*

Article 6, point 1 (b) indicates that *"the undertaking is engaged in cross-border activity".* However, it does not provide any indication as to how this cross-border element is to be assessed in particular in investment funds' structures. As mentioned under section I above, investment funds' structures are to be assessed on an overall basis, whilst the Directive seems to take an entity-by-entity approach.

The difficulty may be best illustrated through a practical example: Would an entity located in a jurisdiction which owns a real estate asset in that same jurisdiction be out of scope of the Directive as its activities are not considered as cross-border activities based on Article 6 point 1 (b) (i)? Or are its activities in scope based on Article 6 point 1 (b) (ii) if the entity pays out e.g. a dividend to an entity located in another Member State? Even in the case of a strict transposition of the text of the Directive, divergent interpretations would still be possible.

Also, the criteria of Article 6 point 1 (b) (ii) of *"at least 60% of the undertaking's relevant income is earned or paid out via cross-border transactions"* should be clarified with regards to the term "paid out" and whether it refers to cash payment made or also to mere accruals of such amounts, e.g. interest accrued vs. interest paid in cash.
For investment structures, it should also be indicated whether either the tax residence of the debtor/payer and the tax residence of the creditor/ payee are to be considered or whether any other reference would be best suited, such as the residence of the last intermediary in the payment chain.

Another example of a possible "cross-border transaction" that may be taken is the one of an entity with a foreign branch or a foreign permanent establishment receiving rental income from a debtor resident in the country where the branch or a foreign permanent establishment is located.

Finally, Article 6 point 1 (b) (i) refers to the *"book-value of the undertaking's assets"*. It is important to provide guidance as to the reference that should be used to evaluate the required threshold (e.g. with local GAAP (amortised acquisition costs vs. fair value approach), based on tax values or on any other basis).

- *"Outsourcing"*

The Directive does not provide any definition of the notion of *"outsourcing".* Further clarification is therefore absolutely necessary, in particular with regards to the expressions "*outsourcing of the administration of day-to-day operations (emphasis added)"* and *"outsourcing of decision making on significant functions (emphasis added)"*.

As mentioned above, the bulk of the substance in an investment fund structure lies with the management company and sometimes with one or more other entities within the investment fund management infrastructure (please see Appendix 1). In the context of a fund, outsourcing and delegation of functions to entities belonging to the investment management infrastructure, which may be either associated enterprises, directly or indirectly related entities or service providers, are implemented in accordance with strict regulatory rules and are subject to supervision by the management company or the manager. In this context, it therefore seems difficult to argue that appropriate substance and adequate own resources have not been put in place within the fund structure.

Also, a director of an entity in the structure that would also be working for other entities in the same structure is not to be considered as an outsourcing of decision making. Indeed, directors bear a legal personal responsibility for each mandate they would have in legal entities. It should thus be made clear that "outsourcing" only refers to external outsourcing and that outsourcing within the same structure or group through service agreements as long as they meet regulatory requirements is not in scope of the Directive. To that end, the reference to delegation in recital (5) of the Directive would have to be amended accordingly.

Clarifications are also required with regards to the notion of "day-to-day operations" for an entity whose activities generate mainly passive income. Indeed, it is economically efficient, and therefore not unusual, to outsource to third party providers or associated enterprises administration, accounting and legal compliance services while core activities remain with the undertaking and are managed by the board of directors or the general partner of the entity.

– *"Holding activities"*

The carve out of Article 6, point 2 (d) for "*Undertakings with holding activities"* does not define what constitutes "holding activities". It would be useful to clarify whether this carve out applies only to entities exclusively carrying on holding activities or whether entities carrying out both holding and/or financing activities or any other activities may also benefit from it. Also, it would be important to clarify what is understood as "holding activities", i.e. by confirming that a company holding a real estate property may benefit from this carve-out.

– *Ultimate Parent Entity (UPE)*

Article 6, point 2 (d) provides for a carve out where an undertaking with holding activities is tax resident in the same Member State as its shareholder(s) or its UPE, whereas the carve out of Article 6 point 2 (c) refers to beneficial owners.

Clarifications would be required as to the distinction that is to be made between the notions of "beneficial owner" mentioned in Article 6, point 2 (c), "UPE" and "undertaking's shareholder" respectively, and as to how these carve outs apply in particular where the UPE or the undertaking's shareholder is an investment fund. It would also be useful to confirm that these notiond apply regardless of whether the fund is either transparent or opaque for tax purposes.

5. Indicators of minimum substance for tax purposes

To the extent that our above-mentioned request to carve out entities held by investment funds would not be considered, they could possibly have to run the tests foreseen by Article 7. The indicators set out in Article 7 represent the first step in the analysis of whether an entity should be considered a shell entity. It is essential that these indicators do not give rise to divergent interpretations in the EU.

– *"Own premises"*

Article 7, point (1) (a) requires an undertaking to have its own premises. In investment fund structures and groups of companies, it is not usual for each undertaking to have a separate lease agreement. In practice, offices rented by one of the entities are shared or sublet with a recharge for the rent due to the lessor. It would be important to understand which practices are acceptable under this indicator and it should be made clear that the practice of shared office spaces complies with the Directive's requirements.

– *"Active bank account"*

Article 7, point (1) (b) refers to an "active" bank account however without providing any indication as to how the term "active" should be interpreted (e.g. by reference to a minimum number of transactions per annum, month, week).

– *Directors' requirements*

The wording of Article 7, point (1) (c) (4) seems to imply that an (independent) director may not serve as a director or in an equivalent capacity in other companies that are not associated companies. Any other mandate held by that director outside this context would result in the indicator not being met.

This view seems too stringent and does not consider the complexity of today's business activities and the mechanisms that have developed to ensure compliance with all legal and regulatory requirements. Independent directors with specific knowledge and expertise can provide supervision in specific areas, and

can play a decisive role from a corporate governance perspective. While it is recognised that an (independent) director with a too large number of mandates is unlikely to be able to exercise her/his mandate properly and could therefore be considered as an indicator of a lack of minimum substance, an independent director could perfectly well assume the responsibilities and perform the duties involved with several mandates in different groups or non-associated companies.

Also, requiring directors and employees to be resident in the same member State as the entity or in the neighboring countries ignores the business realities in an investment fund context and freedom of movement of capital and persons and freedom of establishment within the EU.

ALFI urges the EU Commission to reconsider this issue as well. It would be important to clarify which situations are covered under the Directive, giving examples in the context of investment funds. ALFI is of the opinion that point 1 (c) (3) of Article 7 already imposes a sufficiently robust requirement for an active and independent management and point 1 (c) (4) of Article 7 imposes a too stringent requirement.

6. Rebuttal of presumption

Article 9 gives Member States discretion to *"take appropriate measures"* to enable undertakings to rebut the presumption. The principle of legal certainty requires that administrative procedures are clear and predictable and do not create a burden of proof that is practically impossible or excessively difficult for the taxpayer. Furthermore, past experience has shown that harmonised application and interpretation of administrative procedures are essential to avoid taxpayers being confronted with different interpretations of the same provision or concept by different Member States. ALFI therefore calls for clarifications in the Directive of the entire administrative process and the general principal set by Article 9 point 3, as well as for a harmonized application across Member States.
Such clarifications should in particular include in the Directive a time limit within which the tax authorities must respond to the rebuttal of the presumption so as not to unduly delay or hinder the activities of investment funds.

Also, Article 9, point 2, (a) requires *"a document allowing to ascertain the commercial rationale behind the establishment of the undertaking"*. Clarifications would be required on how the concept of *"commercial rationale"* should be assessed (for example, whether a main benefit test as in DAC 6[14] could be considered) and on the actual elements of proof that are to be provided to the tax authorities.

It would finally be useful to understand the rationale of information required under Article 9, point 2, (b) and (c) considering the information already disclosed for the purpose of Article 7. Indeed, Article 9 requires information on the employees' profiles which is supposed to have been provided based on Article 7 point (2) and should thus already be sufficient.

[14] COUNCIL DIRECTIVE (EU) 2018/822 of 25 May 2018 amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements

7. Exemption

Articles 10 gives Member States full discretion to *"take the appropriate measures"* for an undertaking to request an exemption from its obligations. As for the rebuttal of presumption, the principle of legal certainty requires that administrative procedures are clear and predictable and do not create a burden of proof that is practically impossible or excessively difficult for the taxpayer. Also, harmonised application and interpretation of administrative procedures are essential to avoid taxpayers being confronted with different interpretations of the same provision or concept by different Member States. ALFI therefore requests that further clarifications on these administrative procedures be introduced in the Directive and that their application be harmonised in the Member States.

Such clarifications should in particular include the introduction in the Directive a time limit within which the tax authorities must respond to requests for exemption so as not to unduly delay or hinder the activities of investment funds. Also, it may be noted that the type of information and documentation requested is not clearly defined and potentially implies the disclosure of confidential and sensitive information.

8. Tax consequences in Member States other than the Member State of the undertaking

ALFI is concerned with the potential overlaps between the Controlled Foreign Company rules introduced by ATAD 1[15] and similar rules proposed under the Unshell Directive whereby a shell entity recognized as such would be disregarded for tax purposes and its revenues taxed in the hands of its shareholder(s) or its parent company. This position would potentially create a double standard leading to additional complexity in an already complex tax landscape.

ALFI is also concerned with discrepancies that may be drawn from the reading of Article 11 compared to the scenarios described in the "Detailed explanation of the specific provisions of the proposal" and more in details:

- Scenario (1) Third country source jurisdiction of the payer – EU shell jurisdiction – EU shareholder(s) jurisdiction: while this is clearly provided in the description of the scenario, Article 11 point 2, 3rd paragraph does not provide for the possibility for the EU shareholder to take into account and deduct the tax paid by the shell.

- Scenario (2) EU source jurisdiction of the payer– EU shell jurisdiction – EU shareholder(s) jurisdiction:

    - The scenario indicates that the EU payer *"will not have a right to tax the payment but may apply domestic tax on the outbound payment to the extent it cannot identify whether the undertaking's shareholder(s) are in the EU."*
      This point has however not been explicitly covered in Article 11. Indeed, if the EU source jurisdiction does not have the right to tax, then the EU shareholder does not need to claim relief for tax paid at source.

[15] COUNCIL DIRECTIVE (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market

- As to the tax consequences at the level of the EU shareholder(s), the scenario indicates that *"EU shareholder(s) will include the payment received by the shell undertaking in its taxable income, as per the national law and may be able to claim relief for any tax paid at source, including by virtue of EU directives. It will also take into account and deduct any tax paid by the shell."*
  However, according to Article 11 point (2), *"The first subparagraph shall apply notwithstanding any agreement or convention that provides for the elimination of double taxation of income, and where applicable, capital, in force with another Member State."*
  If the right to levy tax at source is maintained then the detailed explanations should be amended.

It currently looks like Article 11 mitigates double taxation in the hands of an EU shareholder by allowing the latter to claim relief either for tax paid at source (if non-EU source payer) or for tax paid at shell level (if EU source payer). ALFI calls for a clarification of the exact purpose and the impacts of Article 11 with the view to introduce relief in the hands of EU shareholder for both taxes paid at source and tax paid at shell level, irrespective of whether the payer is in or outside the EU.

Also, Article 11 of the Directive should clearly state that, provided the conditions required under EU directives or any relevant tax treaty entered into between the EU source country and the EU country of the shareholder(s) of a shell entity are met, and the EU shareholder of the shell entity has the minimum substance required under the Unshell Directive, EU directives and tax treaties will be applied by the EU source country as regards any payment included by the EU shareholder(s) of a shell entity pursuant to this Directive.

Finally, as the Directive is not binding on third countries, in scenarios involving third countries either as payer or as shareholder(s), the mere fact of providing that it applies *"Where the payer is not resident for tax purposes in a Member State"*, *"without prejudice to any agreement or convention that provides for the elimination of double taxation of income, and where applicable, capital, in force between the Member State of the undertaking's shareholders and the third country jurisdiction of the payer;"* or *"Where the undertaking's shareholder(s) is not resident for tax purposes in a Member State"*, *"without prejudice to any agreement or convention that provides for the elimination of double taxation of income, and where applicable, capital, in force with the third country jurisdiction of the undertaking's shareholder(s)."* does not ensure that third countries will agree to apply agreements or conventions using an approach that looks through the shell entity, that reclaims of excess taxes paid in that context will effectively be implemented and successful and that double taxation would then be avoided.

It is well known that these situations have a direct impact on the performance of investment funds' structures and, as a consequence, on the competitiveness of the EU Single Market as promoted by the European Commission. ALFI is of the opinion that the extension of the currently proposed measures to third countries the Commission is planning to implement in a second step should instead already be an integral part of this proposal for an Unshell Directive and that this Directive should not apply as long as those measures on third countries do not apply.

Such an approach would be in line with the approach taken in the AIFMD review that is currently being discussed[16] and which indicates in its recital (33) "*The requirements for third-country entities with access to the internal market should be aligned to the standards laid down in the Council conclusions of 2020 on the revised EU list on non-cooperative jurisdictions for tax purposes and Directive (EU) 2015/849 of the European Parliament and of the Council. In addition, non-EU AIFs or non-EU AIFMs that are subject to national rules*

[16] Proposal for a Directive of the European parliament and of the Council amending Directives 2011/61/EU and 2009/65/EC as regards delegation arrangements, liquidity risk management, supervisory reporting, provision of depositary and custody services and loan origination by alternative investment funds

and that are active in individual Member States should satisfy the requirement that they are not located in a third country that is deemed un-cooperative in tax matters."

9. Tax consequences in the Member State of the undertaking

Article 12 provides that the shell entity would either be denied any request for a tax certificate or would receive a certificate which prescribes that the undertaking is not entitled to the benefits of agreements and conventions or directives. Issuance of tax certificates is key in that respect. The Unshell Directive as currently designed is intended to tackle intra-EU situations or situations where, in addition to the shell entity itself, the payer or the shareholder is EU based and the extension of the currently proposed measures to third countries would be implemented in a second step.

Scenario (4) Third country source jurisdiction of the payer – EU shell jurisdiction – third country shareholder(s) jurisdiction seems to imply that any convention or agreement that may apply would solely be an agreement signed between the third country shareholder jurisdiction and the source jurisdiction (*"Third country shareholder(s): while the third country shareholder jurisdiction is not compelled to apply any consequences, it may consider applying a treaty in force with the source jurisdiction in order to provide relief.")*

Article 12 should clarify the treatment of these situations which are supposedly not in the scope of the Directive. Indeed, the mere fact of not being able to obtain a tax residence certificate or obtaining a limited tax residence certificate would make it difficult for the shell entity to apply a double tax treaty with a third country, thus de facto already extending the scope of the Directive to third countries.

ALFI notes that the use of a directive as an instrument to combat treaty abuse is to be questioned where treaty abuses are already tackled through the Principal Purpose Test introduced in tax treaties through the MLI dated 24 November 2016 signed by all EU Member States and all the States in European Economic Area. The use of a directive for a Member State to refuse the application of an international treaty can create complex legal issues, leading to potential complex litigations.

It is important to also mention that competitiveness issues similar to those detailed under Article 11 would also be at stake as third country shell entities would be preferred to EU entities, even EU non-shell entities, (which would have to go through the sieves created by the Directive), including to invest in the EU. ALFI is of the opinion that the extension of these measures to third countries shell entities should already be an integral part of the proposal for an Unshell Directive and that this Directive should not apply as long as those measures on third countries are not applicable.

10. Exchange of information

While there is an obvious need for tax administrations within the EU to communicate the position of entities towards substance requirements, the outcome of the rebuttal of presumption or of the exemption request, it may be disproportionate, considering the objectives of the Unshell Directive, to exchange the underlying taxpayer file and/or some of the data contained in it. In some instances, this may result in privacy concerns, leakage of data or misuse of the taxpayer data for other purposes than the ones of the Directive.

As long as the requirements set by the Directive are clearly stated and are consistently applied throughout the EU, Member States should be able to legitimately rely on the conclusions reached by another Member State that would have adequately followed the rules as laid down in the Directive.

It should finally be ensured that the provisions of the Unshell Directive are consistent with the scope and taxes covered by DAC as amended. It may for example be questioned why the information to be communicated to and subsequently exchanged by a competent authority under DAC shall notably include the VAT number (where available) of the undertaking where VAT is out of the scope of DAC (VAT is not a "covered tax" as defined by DAC).

11. Penalties

Article 14 refers to a penalty *"of at least 5% of the undertaking's turnover in the relevant tax year"*. ALFI notes the term "turnover" is not defined by the Directive (only the term "revenue" is) and the notion of turnover does not generally apply to investment funds, holding companies or entities receiving passive income.

12. Requests for tax audits

ALFI notes that DAC 7[17] already provides a framework for joint tax audits carried out by several Member States.
In general, the option to request tax audits should be accompanied by clear and harmonised procedural rules to ensure legal certainty for taxpayers and tax authorities. It should be ensured that EU Member States adopt a consistent approach as regards the criteria to be applied for requesting tax audits. In particular, the statement of "*has reason to believe that an undertaking which is resident for tax purposes in another Member State has not met its obligations under this Directive"* should not lead to Member States to act without any justification. To that end, the expression "reason to believe" should be interpreted in compliance with the principle of proportionality i.e. the requested tax audit is necessary and the reasons for the tax audits are disclosed and duly justified. In other words, tax audits under the Directive should not be construed as opportunities for fishing expeditions.

We are grateful in advance for your attention and remain at your disposal for any additional information or any assistance you may wish to receive.

Sincerely yours,

ALFI

Appendix 1: Typical alternative investment fund structure and set up

[17] COUNCIL DIRECTIVE (EU) 2021/514 of 22 March 2021 amending Directive 2011/16/EU on administrative cooperation in the field of taxation in relation to platform operators and joint tax audits

Appendix 1 - Typical alternative investment fund structure and set up