Feedback on fighting the use of shell entities and arrangements for tax purposes

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INREV is the European Association for Investors in Non-Listed Real Estate Vehicles. We provide guidance, research and information related to the development and harmonisation of professional standards, reporting guidelines and corporate governance within the non-listed property funds industry across Europe.

INREV currently has approximately 486 members. Our member base includes institutional investors from around the globe including pension funds, insurance companies and sovereign wealth funds, as well as investment banks, fund managers, fund of funds managers and advisors representing all facets of investing into non-listed real estate vehicles in the UK and the rest of Europe. Our fund manager members manage more than 500 non-listed real estate investment funds, as well as joint ventures, club deals and separate accounts for institutional investors.

Statement of principles

We hope the views we have expressed in response to the legislative proposal reflect a few clear points. The first is that the primary purpose of real estate non-listed funds is to enable collective investment in real estate assets for multiple institutional investors such as pension funds and insurance companies.

Second, it is an important principle of tax policy that cross-border tax rules should put these investors in the same tax position that they would be in if they had invested in the underlying real estate assets directly. In other words, there should be tax neutrality between a direct investment in real estate and an investment in real estate through a non-listed real estate vehicle, a principle that has been recognised by the OECD in its 2010 CIV report and BEPS recommendations, by the EU in ATAD 1, and by EU Member States.

Third, a non-listed real estate fund generally holds its real estate investments through one or more (controlled) special purpose companies (SPCs) for a number of legitimate commercial and legal reasons. These reasons include the protection of the real estate fund from the liabilities of and potential claims against the fund’s immovable property assets as well as facilitating debt financing, including debt by third-party lenders.

These SPCs ensure ring-fencing of the liabilities of, and potential legal claims against, each asset or relatively small group of assets. To maintain the principle of tax neutrality, it is important that the interposition of SPCs does not cause an additional tax burden that would not arise if the investments were held directly by subjecting the investment income to double taxation. We note further that the income derived from real estate assets owned by a real estate fund is typically subject to full taxation in the country where the real estate is physically located, while the fund structure is designed to facilitate the collective investment and provide for tax neutral income distribution to its investors which is then subject to tax treatment under their domestic tax laws.

Finally, the institutional investors and fund managers in our industry are strong proponents of ethical tax policy and behaviour. In addition to their own internal ethical tax policies, through INREV, our industry has adopted a Code of Tax Conduct (https://www.inrev.org/guidelines/module/EN/code-of-tax-conduct?find=504#inrev-guidelines) that is consistent with the guidelines and principles of the UN Investors' Recommendations on Corporate Tax Disclosure, the OECD's Guidelines for multinational enterprises, the OECD's Building Better Tax Control Framework and the sustainability reporting standard on tax, GRI 207: Tax 2019.

The legislative proposal to prevent the misuse of shell entities for tax avoidance reflects the Commission's clear concern about the risk that investors can use shell structures or other arrangements to avoid or unethically minimise tax. We share this concern but see the approach proposed to lack the refinement necessary to make it successful. If overbroad tax rules that label certain sectors or structures as shell entities used for tax purposes are adopted, they run the risk of unintentionally sweeping up a number of entities that have been adopted for legitimate business purposes, even if they have many or even all the gateways listed in Article 6. For example, a real estate fund established for long-term investment typically has little need for extensive staff or premises given the nature of the activity being undertaken and the staff and premises can often more efficiently be shared between a number of related group entities. We strongly believe that these entities and their characteristics should be analysed considering the commercial context and purpose for which they were put in place. They should not be automatically suspected of being used for tax purposes based solely on a "hallmarks" of organisational characteristics.

Detailed explanation of position

In response to the legislative proposal, INREV would like to make the following comments which we hope will make a constructive contribution to consideration of and potential modifications to the proposal:

1 The proposal for a directive to prevent the misuse of shell entities for tax purposes (the **Proposal**) sets outs several criteria to identify undertakings that potentially do not meet indicators of minimum substance for tax purposes, i.e. the so-called gateways. These undertakings will, depending on their actual substance, be subject to certain annual reporting requirements in relation to e.g. their substance in the Member State in which they are resident for tax purposes.

Outsourcing of its administration of day-to-day operations and the decision-making on significant functions

2 One of the gateways that – if met – will trigger the potential reporting requirements relates to the outsourcing of the administration of day-to-day operations and the decision-making on significant functions. The Proposal considers that undertakings which would resort to outsourcing of such kind do not have adequate own resources to perform core management activities. INREV is of the view that this gateway should be adapted to industry norms. In fact, a restrictive reading of this gateway may lead to situations in which genuine investment structures that have sufficient own resources to adequately perform their activities are disqualified if they rely on substance, resources and staff that are not organised at the level of the undertaking seeking to obtain the benefits of double tax treaties and European Directives, but in another entity in the same jurisdiction, within the fund initiator's structure, i.e. a group service company.

3 In our view, the Proposal should clarify that as long as the substance, resources and staff on which an undertaking seeking to obtain the benefits of double tax treaties and European Directives relies are organised in another entity in the same jurisdiction, within the fund initiator's structure, that this undertaking is not considered to *outsource* its administration of day-to-day operations and the decision-making on significant functions.

In the same vein, we are of the view that an undertaking which delegates certain activities to an alternative investment fund manager in the same jurisdiction, within the fund initiator's structure, should also not be viewed as *outsourcing* its administration of day-to-day operations and the decision-making on significant functions.

4 In addition, INREV believes that the notions of "day-to-day operations" and "decision-making on significant functions" merit clarification. The Proposal, unfortunately, does not provide any detailed explanations on these concepts nor does it define them. Given that these are key notions that should enable an undertaking to analyse whether the gateways are met, it is vital that all stakeholders have a clear understanding of what these terms refer to. In an effort to guarantee legal certainty, INREV feels that it is especially important to define the gateway criteria as clearly as possible, given that those are the key parameters to determine whether the reporting obligations under Article 7 are triggered or not.

The de facto *retroactivity of the Proposal*

5 The Proposal requires Member States to apply the provisions necessary to comply with the Proposal in their domestic law as from 1 January 2024. INREV wants to point out that this very ambitious timeline does not give a lot of time to all stakeholders to adequately understand, anticipate and prepare the important consequences that this Proposal will have on them. This obviously not only concerns the market participants but, first and foremost, the local tax authorities as well. INREV is of the view that a qualitative transposition of the Proposal into the domestic laws of each Member State requires time so that all stakeholders can duly prepare themselves for the impact these unprecedented rules will have.

6 INREV also wants to stress that this *de facto* seems no longer possible for market participants given that the current drafting of the gateways imposes a two-year look-back period in Article 6, paragraph 1 (c). The *de facto* retroactivity this implies not only leads to a lot of uncertainty in existing investment structures but may also lead to significant costs associated with understanding the impact of legislation, which is currently still at the level of a proposal. INREV therefore proposes that, in view of the principle of legitimate expectations and in order to avoid difficulties of transposing the Proposal into the domestic tax laws of Member States, against the background that tax laws generally are not allowed to have retroactive effect, the two-year look-back period effectively only starts as from the implementation date of the Proposal into the respective domestic laws of the various Member States, i.e. 1 January 2024.

Reporting undertakings and carve outs

7 The Proposal also provides for a list of undertakings which will not be subject to the annual reporting requirements as they are considered to carry out activities that are low-risk and, therefore, irrelevant for the purposes of the Proposal. Those are undertakings whose activities are subject to an adequate level of transparency and therefore do not present a risk of lacking substance for tax purposes.

8 One of these carve-outs, as set out in Article 6 paragraph 2 of the Proposal, targets regulated financial undertakings. The Proposal currently lists alternative investment funds managed by an alternative investment fund manager as well as alternative investment funds which are supervised under applicable national law (both categories of alternative investment funds hereafter together referred to as, **AIFs**) as regulated financial undertakings. AIFs, therefore, are carved out from the reporting requirements under the Proposal. While INREV feels that this is a welcome solution, we propose to extend this exclusion – similar to what is currently proposed under the proposal for a directive on ensuring a global minimum level of taxation for multinational groups in the Union (the **GloBE Proposal**) – to entities that are owned at a minimum of 95%, by a qualifying AIF, directly or through several such entities and that operate exclusively, or almost exclusively, to hold assets or invest funds for the benefit of the AIF or exclusively carries out activities ancillary to those performed by the AIF. This extension would not only ensure consistency among both sets of rules but would also be in line with past OECD proposals, such as the so-called non-CIV examples. It would, furthermore, follow the spirit of recently adopted legislation throughout Europe, for example in Italy, which allows for companies that are owned by AIFs to make distributions to such AIFs under certain conditions free of domestic withholding taxation.

9 In addition, while INREV lauds the principle of wanting to carve out undertakings which are situated in the same jurisdiction as their shareholder or ultimate parent entity, the conditions for falling within the scope of this carve out are particularly hard to understand. First of all, INREV believes that it would be beneficial – in an effort of legal certainty – to clearly define the notion of holding activities, especially in view of the fact that the preamble to the Proposal no longer refers to holding activities but to the more restrictive concept of *pure* holding activities. Moreover, INREV believes that it should be clarified whether the Proposal intends for the undertaking's shareholder or the ultimate parent entity to also be *tax resident* in the same Member State in which the undertaking is a resident or whether it would be sufficient for those entities to only be *organised* in those Member States. There is, indeed, a significant difference between both concepts, as the first reading of the carve out would point to an exclusion of partnerships (i.e. entities which are likely not resident for tax purposes in a Member State) from the scope of the carve out, whereas the second reading would not.

10 Moreover, it is unclear to INREV why this carve out should solely be restricted to undertakings with holding activities. A limitation in scope of this carve out for holding activities seems to unfairly distort the level playing field between undertakings that have as a main activity the holding of shares and undertakings that have as a main activity the ownership of real estate, for example. INREV could therefore also imagine that the scope of this carve out would be extended from undertakings with holding activities to undertakings in general.

Clarifications on the indicators of minimum substance for tax purposes

11 Finally, the Proposal requires undertakings that meet the gateways to annually declare, in their local tax returns, whether they meet a certain number of indicators of minimum

substance for tax purposes. INREV is of the view that some of these indicators merit additional clarification.

12 The first indicator of minimum substance requires that an undertaking has own premises or, alternatively, premises for its exclusive use, in a Member State. INREV feels that it is important to clarify the notions of “own premises” and “premises for its exclusive use”. To avoid an unnecessary restrictive reading of the Proposal and in an effort to adapt to market realities, INREV imagines that this substance indicator could be extended to also cover premises occupied by associated enterprises of an undertaking. In other words, an undertaking should be considered to have own premises or premises for its exclusive use also if these premises are occupied by enterprises that are associated, within the meaning of Article 5, to the first undertaking.

13 In addition, the third indicator of minimum substance requires that the majority of full-time equivalent employees of an undertaking are tax resident in the same Member State of the undertaking or, alternatively, within commuting distance. INREV is of the view that it is important to clarify whether it is necessary to have more than one employee in order to meet this indicator in view of the fact that the term “employees” is expressed in plural. The Proposal should therefore, in our view, clarify that also having only one full-time equivalent employee or having a majority of part-time employees that are tax resident in the same Member State as the undertaking they are employed by would be sufficient to meet this indicator of minimum substance.

Clarifications on the interplay between the Proposal and EU directives and double tax treaties

14 If an undertaking qualifies as a shell, the Proposal aims at taxing the investment structure to which it forms part from the perspectives of the countries of the payer as well as that of the undertaking’s shareholder(s), as if the shell did not exist. Unfortunately, it seems that this objective is not fully supported by the wording of the Proposal.

15 The Proposal currently provides that: (i) the Member State of the payer must deny tax benefits that would normally be effective in relation to the shell entity (i.e. article 11 (1)) and (ii) that the Member State of the undertaking’s shareholder(s) should tax the income of the shell entity as if it accrued to them directly (i.e. article 11 (2) first section).

16 On point (i), INREV notes that the Proposal provides that the Member State of the payer that disregards the shell entity should respect the double tax treaty in place with the shell entity’s non-EU shareholder (i.e. article 11 (2) fourth section). The Proposal, however, remains silent on the application of double tax treaties or directives by Member State of the payer when the shareholder is tax resident in a Member State.

17 On point (ii), INREV understands that the Proposal provides that the Member State of the shareholder should apply the double tax treaty with the country in which the payer is resident if that is not a Member State (i.e. article 11 (2) third section). Also here, the Proposal remains

silent on the application of double tax treaties and directives by the Member State of the shareholder when the payer is tax resident in a Member State.

18 This seems to be an omission. Not applying the double tax treaties or a directive between Member States, in our view, conflicts with the spirit of the Proposal. It should therefore be clarified that also in the situations described above, double tax treaties and directives in place shall continue to apply between the Member State of the shareholder and the Member State of the payer notwithstanding the operation of the Proposal. We consider that any impairment of the access to bilateral double tax treaties and to European Union directives between companies which are located solely in the Member States is an infringement of fundamental rights of such taxpayer companies. We do not consider that any disapplication of such double tax treaties or directives is, for companies solely resident in the Member States, a proportionate response to the behaviours which are counteracted in the Proposal.