taxnotes® international

Volume 107, Number 7 ■ August 15, 2022

The CJEU's Arm's-Length Standard And the Unshell Directive's 'Rebuttal Of the Presumption' Carveout

by Costas Michail

Reprinted from *Tax Notes International*, August 15, 2022, p. 783

The CJEU's Arm's-Length Standard and the Unshell Directive's 'Rebuttal of the Presumption' Carveout

by Costas Michail

Costas Michail

Costas Michail is a tax director with Scordis, Papapetrou & Co. (Corporate Services) Ltd. in Nicosia, Cyprus.

In this article, Michail examines the proposed third EU anti-tax-avoidance directive, which aims to prevent the abuse of shell entities, and illustrates how the arm's-length standard may guide the practical application of its "rebuttal of the presumption" carveout.

The European Commission's proposed third anti-tax-avoidance directive[1] (also known as the Unshell directive) will supplement the series of the EU anti-tax-avoidance directives.[2] It sets out the minimum economic substance threshold required for an entity to receive or retain tax advantages in a host member state.

It also provides a "rebuttal of the presumption" carveout for entities that do not satisfy the minimum substance indicators.[3] This article illustrates how the arm's-length standard may guide the practical application of this carveout.

The Unshell Directive

The Unshell directive raises the bar for entities to receive tax advantages by reference to their real economic activity.[4] The directive excludes[5] from its scope specific types of entities (for example, publicly traded companies) or entities that employ a specific number of people.

The directive has a broad scope covering all undertakings (except those explicitly excluded). It creates obligations for entities to report based on three gateways[6]:

- the nature of income;
- cross-border activity; and
- the outsourcing of the administration of day-to-day operations and decision-making.

The gateways do not apply cumulatively.

Article 6 excludes some entities from the reporting obligation, such as an entity with five or more full-time employees,[7] regardless of whether the entity generates "relevant income"[8] for purposes of the directive.

The directive defines relevant income to include royalties, interest, dividends, services, and income from immovable or movable property.

Falling into any of the gateways creates a reporting obligation for the entity, which must declare in its annual tax returns that it meets cumulatively the stipulated minimum substance indicators. These indicators include the owning of premises, having an active bank account in the European Union, and employing tax resident

---

[1] European Commission, Proposal for a Council Directive 2021/0434 (CNS), COM(2021) 565 final (Dec. 22, 2021) (ATAD 3 or the Unshell directive).

[2] Council Directive (EU) 2016/1164 (ATAD 1); Council Directive (EU) 2017/952 (ATAD 2); and Council Directive (EU) 2018/822 (DAC6).

[3] *See* article 9 of the Unshell directive, *supra* note 1.

[4] Recital (3), (4).

[5] Recital (6).

[6] Article 6 of the Unshell directive, *supra* note 1.

[7] *Id.* at article 6(2)(e).

[8] *Id.* at article 4.

director(s) with sufficient competence or full-time employees who are qualified to carry out the activities.

The Unshell directive explicitly states that directors should not be employees or directors of an enterprise that is not an associated enterprise.[9] This limitation curbs the use of nominee directors.

Entities may carry out a genuine economic activity in the host state without meeting cumulatively the stipulated minimum substance indicators. The directive contemplates this situation and introduces the rebuttal of the presumption[10] carveout. The carveout requires that these entities demonstrate that they carry out genuine economic activity.

The directive provides an additional carveout under article 10, allowing entities to escape the repercussions for not fulfilling the minimum substance indicators and not falling within the rebuttal presumption carveout. This carveout will only operate if the entity shows that the ultimate beneficial owners or other group companies receive no tax advantage.

The directive could have far-reaching consequences[11] for an entity that fails to meet the minimum substance indicators and does not fall within the carveouts. Starting from the member state where the shareholder of the entity resides, that country will deny the entity the benefit of double tax treaties and EU directives and include the entity's income in the shareholder's tax base. Host member states will not issue a tax residence certificate to the entity. Finally, the directive sets out automatic exchange of information[12] and enforcement procedures.

The arm's-length standard, as formulated by the Court of Justice of the European Union and recently adopted by the European Free Trade Association Court, may guide the rebuttal of the presumption carveout's practical application.

CJEU Direct Tax Cases

The CJEU has handed down landmark direct tax rulings that invoke freedom of movement principles (for example, the freedom of capital and freedom of establishment principles) to annul restrictive national provisions.

Restriction of freedom of movement involves the unfavorable treatment that may be accorded to a cross-border transaction compared with a domestic transaction. The restriction may be covert or overt.

A member state may cite public interest reasons to justify a restrictive national provision. However, a member state must demonstrate that this restrictive provision passes the proportionality test by demonstrating that the provision is proportional. The state should show that the covered national law provision does not go beyond what is necessary to attain its objective, and also should allow the taxpayer to show that the transaction and/or arrangement is genuine.

In its ruling in *PRA Group Europe AS*,[13] the EFTA Court embraced the arm's-length standard as formulated by the CJEU in *Lexel*.[14] The arm's-length standard adds a new element to the proportionality test.

The Arm's-Length Standard

The PRA Group Europe AS case was referred to the EFTA Court by the Oslo District Court under article 31(1) of the agreement on the European Economic Area. The case involved the application of the group contribution rules and limitation of interest provisions under Norwegian tax law. The group contribution rules allow the transferor to claim a deduction under specified conditions. The recipient would include deemed taxable income in its tax base. It is a prerequisite for the transferor and the recipient to be liable to taxation in Norway to be able to apply the group contribution rules. The limitation of interest provisions limit interest deductibility by reference to earnings before interest, taxes, depreciation, and amortization, and the limitation of interest provisions apply on an entity level.

PRA Group Europe Subholding AS, a Norwegian tax resident company (PRA Norway), was a subsidiary of a Luxembourg tax resident holding company, PRA Group Europe Holding

[9] *Id.* at article 5 (defining associated enterprise).

[10] *Id.* at article 9.

[11] *Id.* at article 11 and article 12.

[12] *Id.* at Chapter IV and Chapter V.

[13] *PRA Group Europe AS v. Norway*, E-3/21 (EFTA 2022).

[14] *Lexel AB v. Sweden*, C-484/19 (CJEU 2021).

SARL (PRA Lux). PRA Norway was not able to lay a claim to the group contribution rules, resulting in a higher limitation of interest.

The EFTA Court ruled that the combined effect of the group contribution rules and the limitation of interest provisions created a restriction of the freedom of establishment. Had PRA Norway and PRA Lux applied the group contribution rules, the limitation of interest would have been lower. Norway cited public interest justifications to excuse the apparent restriction, such as balancing the allocation of taxing powers, the fight against tax avoidance and evasion, and safeguarding the cohesion of the national tax scheme. The EFTA Court then applied its proportionality test assessing if the national provision is proportional.

The EFTA Court stated that "such rules may only be applied to deny deductions for arrangements to the extent that they do not have any underlying commercial justification based on *an assessment at arm's length*"[15] (emphasis added). Elaborating on this, the court ruled that the proportionality test requires that "the refusal of the right to a deduction should be limited to the proportion of that interest which exceeds what would have been agreed had the relationship between the parties been one *at arm's length*"[16] (emphasis added).

The decision builds on the arm's-length standard as formulated by the CJEU and supplements the proportionality test. The arm's-length standard is the new element supplementing the proportionality test as applied by the CJEU and EFTA.

Using the Arm's-Length Standard

The arm's-length standard may be used to guide the practical application of the Unshell directive's rebuttal of the presumption carveout. The OECD Transfer Pricing Guidelines for Multinational Enterprises[17] provide a comprehensive rulebook for determining if conditions pertaining to controlled transactions are at arm's length — whether they are comparable to conditions applicable in noncontrolled transactions.

Delineation and Comparability

Comparability analysis is at the heart of OECD transfer pricing guidelines. The analysis entails two main aspects:

- identify the financial or commercial relations, conditions, and prevalent circumstances in a controlled transaction in the pursuit to accurately delineate the controlled transaction; and
- compare the delineated transaction with comparable uncontrolled transactions through selection and application of an approved method.

In this article, I focus on the delineation aspect. The OECD transfer pricing guidelines lay down specific comparability factors[18] that should be identified and evaluated to arrive at the accurate delineation of the controlled transaction. The comparability factors include:

- *Analysis of the contractual terms*. It is the departure point in the delineation analysis involving review of the written contracts to form a preliminary view as to how the risks and rewards are contractually allocated between the parties.
- *Functionality analysis*. It is at the core of the delineation analysis. It aims to establish the functions that the parties perform, the risks assumed, and the type of assets involved. The risk component has an elevated role in the functionality analysis: aiming to determine if the tested party has the competence and capability to undertake and control key risks and the financial capacity to undertake downside consequences if the risks play out.
- *Business and economic analysis*. It identifies the economic environment in which the party operates and its relevant strategies.
- *Characteristics of property or services analysis*. This entails all relevant details for the tested property or services.

[15] *PRA Group*, E-3/21, at para. 52.

[16] *Id.*

[17] OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (July 2017). For example, Chapter I lays out the comparability factors, including a functionality analysis.

[18] *Id.* at Chapter I.

The delineation aspect of the comparability analysis provides guidance for the practical application of the rebuttal of the presumption carveout.

Case Studies

In these case studies, I elaborate on different scenarios using the arm's-length standard, and specifically the delineation aspect, to guide the practical application of the rebuttal of the presumption carveout.

Case A

A financial company mainly provides intragroup loans to group companies that are located in other EU member states and is managed by a sole director. The director is a tax resident of the host state, he has a financial background and financial experience, and he works regularly for this company. The company does not have premises, but it has an active bank account.

One of the minimum substance indicators is not satisfied — the entity has no premises. This triggers the presumption for not maintaining minimum substance. However, the company should pass the rebuttal of the presumption carveout because of the arm's-length standard and, specifically, the delineation aspect.

The company should be able to demonstrate that it conducts a genuine economic activity by showing that it undertakes key functions and key risks even though it does not maintain premises. The company should point out that the director has the capacity and capability to undertake the key financial risks (credit, currency, liquidity) and that he performs the key functions, such as monitoring and controlling the recoverability of loans. At the same time, the company should show that it owns the intragroup loans and maintains adequate financial capacity to absorb credit risk.

The company performs genuine economic activity, including all key functions — it takes on risks and owns assets from an arm's-length perspective. As a result, the presumption should be rebutted.

Case B

In Case B, a different financial company mainly provides intragroup loans to group companies located in other member states. The company is managed by a sole director who is a tax resident in the host state and has a financial background. He works regularly for the company, but he also works as a director for a company that is not associated with the Case B company. The Case B company does not have premises, but it has an active bank account.

On its face, the company does not satisfy two of the minimum substance indicators — the company has no premises, and the director is also working for a company that is not associated with the Case B company. The presumption for not maintaining minimum substance applies. However, the company should also pass the rebuttal of the presumption carveout because of the arm's-length standard and, specifically, the delineation aspect.

As in Case A, the Case B company should be able to demonstrate that it conducts a genuine economic activity by showing that it undertakes key functions and key risks even though it does not maintain premises. The Case B company would also need to demonstrate that the parallel occupation of its director does not constitute a barrier for the director to undertake his key functions or assume key risks at the Case B company. Elaborating on the company's business and economic environment may also provide support. A director working for two companies that are not associated, but that operate in a similar industry and market, such as providing financing to debtors engaged in real estate in the same jurisdiction, should be able to show that he or she uses his or her special knowledge and expertise for efficiently and effectively carrying out his or her duties with the two companies.

Also, maintaining clear and separate records detailing the time that the director carries out his or her duties at the two companies should also provide support.

If the company demonstrates from an arm's-length perspective that it performs all key functions, takes risks, and owns assets, the presumption should also be rebutted for the Case B company.

Case C

Case C considers similar facts: a financial company that mainly provides intragroup loans to group companies located in other member states and is managed by a sole director. The director is a tax resident in the host state, and he has a financial background based on academics and experience. However, this director is also involved with several other companies that are not associated with the Case C company. The Case C company does not have premises, but it has an active bank account.

The presumption persists. The company could attempt to pass the rebuttal of the presumption carveout. It could try to demonstrate that it conducts a genuine economic activity, showing that it undertakes key functions and key risks, even if it does not have premises and its director is employed by several other companies that are not associated with the Case C company.

However, it will be difficult to demonstrate from an arm's-length perspective that the company handles all key functions, takes risks, and owns assets. It may be able to show that it performs limited functions and takes limited risks, from an arm's-length perspective, but it is unlikely that it will be able to prove that it operates as a full-fledged financial company. It is unlikely that the Case C company will find shelter in the rebuttal of the presumption carveout.

Case D

The company in Case D is, again, a financial company that mainly provides intragroup loans to group companies that are located in other member states and is managed by a sole director. The director is a tax resident in the host state, he has no financial background (or a very limited financial background), and he works for many companies that are not associated with the Case D company. The company does not have premises, but it has an active bank account.

The presumption persists. It will be hard (if not impossible) for the company to assert that it performs limited or full key functions, takes on risks, and owns assets. The delineation analysis may lead to the company's contractual arrangements being disregarded.

Conclusion

The proposed Unshell directive will broaden the scope of the preceding anti-tax-avoidance EU directives. The rebuttal of the presumption carveout provides shelter to entities that carry out genuine activities but do not satisfy the minimum substance indicators. The arm's-length standard, as formulated by the CJEU and recently adopted by the EFTA Court, can guide the practical application of the rebuttal of the presumption carveout. ■