To: European Commission

From: KPMG EMA Cooperative
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Ref **KPMG contribution in response to the European Commission public consultation on the proposed Council Directive laying down rules to prevent the misuse of shell entities for tax purposes and amending Directive 2011/16/EU**

Dear Madam/ Sir,

KPMG[1] member firms in the EU (hereafter 'we') are pleased to provide comments on the European Commission's (EC's) proposal for a Council Directive laying down rules to prevent the misuse of shell entities for tax purposes and amending Directive 2011/16/EU (the Directive).

While KPMG believes that the potential misuse of entities lacking economic substance for tax purposes should be given further consideration, we are of the view that the need for EU-wide action should be assessed in the context of the current tax landscape, i.e. subsequent to the entry into force and impact of rules such as the EU Anti-Tax Avoidance Directive (ATAD) and the EU Mandatory Disclosure Rules for Intermediaries and Taxpayers (MDR / DAC6), as well as in the light of further expected changes, such as the entry into force of the OECD Global Anti-Base Erosion (GloBE) Model Rules.

Should the European Commission, following such a review, determine that action is indeed needed at EU level, and decide to move forward with the measures proposed under the draft Directive that is the subject of the current consultation, we have attempted to highlight areas where we believe the proposed rules should be re-considered. Our comments are shaped by our belief in the need to safeguard the principle of proportionality and bearing in mind the administrative burden created for taxpayers and also the need to provide tax authorities with a framework that allows for the targeted investigation of relevant cases. We have also noted open questions regarding the interpretation of the rules due to the absence of specific definitions, lack of clarity of proposed provisions and discrepancies between the Explanatory Memorandum accompanying the proposal and the text of the proposed Directive.

We trust that our comments will assist the European Commission in bringing clarity, legal certainty and alignment with existing case law of the Court of Justice of the EU. We, however, underline the need for further consideration of whether action is indeed needed at this stage and the form that such action should take.

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This comment paper is produced on behalf of KPMG member firms located in the EU forming part of KPMG's Europe, the Middle East & Africa (EMA) region. Throughout this submission, "we", "KPMG", "us" and "our" refer to the network of independent member firms operating in the EU.

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1. Initial Recommendation: monitoring and evaluation of existing and upcoming measures

As noted in our response to the previous stage of this public consultation (submitted to the Commission on August 27, 2021), the Inception Impact Assessment "fighting the use of shell companies and arrangements for tax purposes" (the Assessment) states that shell companies continue to pose a risk of being used in aggressive tax planning structures and defines 'shell companies' as legal entities with no or minimum substance and no real economic activities, used by taxpayers operating cross-border to reduce their tax liability. While KPMG believes that it is appropriate that this issue is kept under review, we note that the concerns raised by the EC, in substance, relate to a tax landscape that has already undergone significant changes.

In recent years the international tax coordination efforts, driven by the G20/OECD Base Erosion and Profit Shifting (BEPS) project and the significant number of EU initiatives aimed at addressing tax avoidance and aggressive tax planning practices, have led to ground-breaking results that have significantly changed the taxation landscape. KPMG especially notes the following developments:

1. The implementation of the general anti-avoidance rule (GAAR) as a result of the EU Anti-Tax Avoidance Directive (ATAD 1[2]). This is especially relevant in view of the Court of Justice of the European Union (CJEU) decisions regarding the EU concept of abuse of law. In this respect we refer to e.g. the Deister-Juhler[3] decision and the decisions in the so-called "Danish beneficial ownership cases".
2. The introduction of controlled foreign company (CFC) rules under ATAD 1, in combination with the EU's continual review of the list of non-cooperative jurisdictions and the introduction by EU Member States of unilateral defensive measures against listed jurisdictions.
3. The implementation of anti-hybrid and reverse anti-hybrid rules under ATAD 1 and ATAD 2[4], which apply to arrangements involving companies, trusts and partnerships.
4. The mandatory disclosure requirements under the fifth amendment of the Directive on Administrative Cooperation (DAC6)[5].
5. The introduction of the principal purpose test in tax treaties concluded by EU Member States as a result of the OECD Multilateral Instrument (MLI), which has been adopted by all 27 EU Member States.
6. The aligning of economic substance and income generating activities under BEPS Action 5, as well as the Transfer Pricing-related BEPS Actions 8-10.
7. The introduction of the Fifth Anti-Money Laundering Directive[6] and the European Commission proposals for additional legislative proposals to further strengthen the EU's anti-money laundering and countering the financing of terrorism rules.[7]
8. The entry into force in the EU from January 1, 2024 of public country-by-country reporting[8] requirements for multinational groups that operate in the EU.

The upcoming implementation at EU level of the OECD's Two-Pillar solution to which 26 EU Member States have signed up as members of the OECD Inclusive Framework (IF) and which Cyprus (not an IF

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[2] Directive (EU) 2016/1164 laying down rules against tax avoidance practices that directly affect the functioning of the internal market.

[3] Deister Holding (C-504/16).

[4] Council Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries.

[5] 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.

[6] Directive (EU) 2018/843 of the European Parliament and of the Council of 30 May 2018 amending Directive (EU) 2015/849 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, and amending Directives 2009/138/EC and 2013/36/EU.

[7] Anti-money laundering and countering the financing of terrorism legislative package | European Commission - https://ec.europa.eu/

[8] Directive (EU) 2021/2101 of the European Parliament and of the Council of 24 November 2021 amending Directive 2013/24/EU as regards disclosure of income tax information by certain undertakings and branches.

member) also supports, will introduce a floor on corporate taxation in the EU and therefore further curtail opportunities for aggressive tax planning.

Given the recent and upcoming anti-abuse and disclosure measures, which would significantly impact the potential abuse of shell companies, we reiterate our recommendation to adopt a period of monitoring and evaluation before a proper determination is made as to whether additional specific anti-shell company rules are required. This would include consideration of how Member States have implemented new anti-avoidance rules both technically and in practice.

Subject to our reservations on the need for additional measures at this stage, we have nevertheless attempted to comment on the measures that the EC put forward in its December 2021 proposal. Our comments are both of a general nature (e.g. on the impact such a proposal could have on the competitiveness of EU Member States) and also address specific flaws we have identified in the design of the proposed rules (e.g. in light of existing CJEU jurisprudence).

2. General Comments

2.1. Level playing field

We note that the Explanatory Memorandum accompanying the proposal comments on the need to adopt "solutions that function for the internal market as a whole and improve its (internal and external) resilience against tax evasion and tax avoidance practices that affect or can affect equally all Member States".

2.1.1. EU internal market

As currently designed, the gateways, several of the substance indicators and the carve-outs provided by the proposed Directive are likely to have an inadvertently disproportionate impact on smaller EU Member States (e.g. carve-outs related to a specific number of employees) and on those that are geographically removed from mainland Europe (e.g. those related to proximity of directors to the entity's state of residence). Bearing in mind the need to safeguard the EU internal market, we recommend that the impact that any measures contemplated would have is thoroughly assessed from the perspective of each EU jurisdiction and that any criteria used do not put certain Member States at a disadvantage.

2.1.2. Global effect

If, after the monitoring and evaluation period suggested above, it is considered that there is indeed a need for additional and specific measures targeted at neutralizing the use of shell entities, we recommend that consideration is given to options for introducing measures with equivalent effect on entities based outside of the EU, in order to ensure a level playing field at global level. Any anti-shell rules that are deemed necessary at EU level following a review of existing and upcoming measures, should be applied consistently in terms of administrative burden, effects and timeline to non-EU entities as well, in order for the aims sought by the Directive to be achieved globally, in line with the OECD's BEPS initiative.

For completeness, we also note that denial of the issuance of a tax residence certificate (or the alternative of issuing a qualified certificate) will have an impact on the application of double tax treaties concluded between Member States and third countries. Concluding and applying treaties for the avoidance of double taxation is the prerogative of Member States and we would therefore question the legality of a measure that is likely to have consequences which would render such treaties obsolete.

2.2. Subsidiarity and aims

We note that the proposed Directive is based on article 115 of the Treaty on the Functioning of the EU and that, according to the European Commission,[9] the proposal complies with the principle of subsidiarity, as the nature of the subject requires a common initiative across the internal market. The aim of the proposed Directive is stated to be, among others, to provide a common framework to be implemented into Member States' national laws in a coordinated manner, in order to ensure legal certainty and reduce compliance costs for businesses operating within the EU.

However, in its current form, we do not believe that the proposed Directive is likely to achieve these aims. We note, in particular, the option given to domestic tax authorities to reverse the assessment made under the proposed Directive where an entity has been found not to be a "shell". According to the Explanatory Memorandum, tax authorities would be allowed to find that the entity is a shell, or lacks substantial economic activity, based on their domestic anti-tax avoidance rules. We believe that the introduction of a minimum standard that gives tax authorities the freedom to apply a stricter approach would involve a waste of resources at the Commission as it would fail to provide the desired harmonization and legal certainty. In a scenario where it would be possible for tax authorities to essentially overturn the assessment made under the EU Directive and hence make this assessment obsolete, groups operating in the EU would ultimately have no certainty that an entity deemed to have substance under the Directive would pass the test in each of the Member States that are relevant to a particular structure.

Furthermore, as detailed in section 4 of this contribution, there are a number of important terms used in the proposed Directive that have not been (sufficiently) defined. In the absence of clear and detailed definitions, Member States would either leave these to the interpretation of tax authorities applying the provisions in practice or introduce their own domestic definitions. This would lead to a patchwork of implementation provisions and undermine the goal of having a consistent application of the new rules across EU Member States.

If a decision is taken to proceed with the proposed Directive, we therefore urge the European Commission to clearly define terms such as "outsourcing", "active" bank account, "own" premises, "at no greater distance" (when referring to the entity's employees), etc. It would also be important that tax authorities apply a harmonized approach when interpreting the proposed Directive and, also, accept the assessments completed by tax authorities in the Member State of residency of the shell undertaking.

2.3. Administrative burden

Given the current broad design of the gateways, it is likely that a significant number of entities will pass through all three gateways contained in Article 6 of the Directive, resulting in the undertaking then being required to:

- Adhere to the reporting requirements as set out in Article 7 of the proposed Directive; or
- Request an exemption from its obligations under the Directive in accordance with Article 10 of the Directive.

In both instances, this is likely to pose a number of issues for taxpayers across the Union. It is unclear from the text of the Directive whether the reporting requirement would be completed as a separate filing or as part of the corporate tax return process in each Member State. It is also unclear how tax

[9] Chapter 2 of the Explanatory Memorandum accompanying the Directive.

authorities will assess (i) applications for the lack of tax motives exemptions and (ii) information submitted as part of the rebuttal of the presumption that the undertaking is a shell entity.

In this regard, we note that tax authorities and many taxpayers across the EU are currently trying to adapt systems for OECD BEPS 2.0 process requirements.

2.3.1. Timing issues

Where there are time-lags between an undertaking being presumed to be a shell and the rebuttal / exemption assessment being completed, it is unclear whether tax residency certificates could be issued during this period. This could create significant issues, both administratively for tax authorities to ensure submissions are processed in a streamlined manner and commercially for taxpayers if withholding tax relief (pursuant to a tax treaty or an EU Directive) is unavailable due to the denial of a certificate of tax residency while submissions are assessed. This would be particularly problematic for undertakings that are ultimately determined to have the required minimum substance for the tax year but have had tax already withheld due to the certificate of tax residency being unavailable.

While we note that the exchange of information provisions in the Directive require tax authorities to exchange information within a 30-day window, this only appears to apply when the relevant tax authority issues a decision to certify that the undertaking either rebutted the 'shell' presumption or availed of the exemption for lack of tax motives successfully. As such, issues are likely to arise during the intervening period while these assessments are completed. We also expect that a 30-day exchange of information requirement will place a significant administrative burden on tax authorities, particularly in light of the comprehensive list of information that needs to be exchanged under Article 13 of the Directive.

A similar problem may arise for entities that were presumed to be shells for a given tax year but in the subsequent tax year have met the minimum substance requirements. Where there are time-lags between the undertaking proving its minimum level of substance and obtaining a certificate of tax residency, cases could arise where withholding tax is applied incorrectly. It is not clear currently if an undertaking would then be able to recover this withholding tax and how cumbersome a process this might be to complete (particularly as the approach to withholding tax reclaims is not consistent across EU Member States).

In our view, these scenarios could arise where entities are scaling up operations in a particular jurisdiction (e.g. during an expansion phase) or where an entity seeks to re-align its levels of operational substance to comply with the new requirements imposed by the Directive. At present, there is no transitional period in which groups can restructure operations to comply with the requirements of the Directive – the Directive in fact retroactively assesses substance across the previous two tax years.

In recent years, multinational groups have made fundamental changes to group structures to comply with the new legislative measures that have been introduced across the EU (as listed in Section 1). However, restructuring and future-proofing corporate structures can prove to be a time consuming and costly process. If the Directive is introduced, we believe that the 'shell' substance assessment should be forward-looking in nature and that a transitional period should be introduced to allow MNE groups to comply with the terms of the Directive. In our view, this would serve to reduce the administrative burden on tax authorities and provide taxpayers with a window to mitigate the risk of the commercial issues noted above arising and becoming widespread across the EU.

2.3.2. Issues with current structure of the carve-outs

We note that the proposed Directive includes carve-outs for companies that are considered to be low-risk (as described in the Explanatory Memorandum) and that either would not cross the gateways or, if they did, they would be found to be irrelevant for the purpose of the Directive at a later stage. Companies benefiting from carve-outs are not required to self-assess their activity against the gateways and would not be subject to the subsequent reporting requirements. Carve-outs apply to companies listed on a regulated stock exchange, regulated financial undertakings, holding companies with no / limited cross-border elements, entities with at least five full-time employees engaged exclusively in the activity generating the income. However, neither the Explanatory Memorandum nor the accompanying Impact Assessment provide a detailed explanation of how the exclusion criteria were determined.

There are number of concerns with the proposed carve-outs which we have summarized below:

- ***Subsidiaries of listed companies:*** As noted above, there is an exclusion from the rules for listed companies. However, this exclusion does not currently apply to any subsidiaries of the listed company, including those subsidiaries which are based in the same Member State. It therefore appears that this exception will apply to a very limited number of companies. In our view, it is difficult to understand the rationale for not extending the scope of the carve-out to 'domestic' group companies based in the same jurisdiction as the listed company (as there does not appear to be a material basis for differentiating between them).

- ***Subsidiaries of certain regulated financial undertakings:*** Similarly, while there is a carve-out in respect of certain regulated financial undertakings, this carve-out does not appear to extend to subsidiaries of the regulated financial undertaking (including 'domestic' subsidiaries). In our view, this will also greatly reduce the application of this carve-out, which in turn will increase the number of 'shell' assessments that need to be completed across the EU and the related administrative burdens (as referenced above).

- ***Holding companies with limited or no-cross border holdings:*** Based on the current text of the proposed Directive, this exception only appears to apply where (i) the main activity of the entity is the holding of shares in operational businesses in the same Member State and (ii) the beneficial owners of the entity are also resident in the same Member State. In our view, it is likely that there will be a large number of cases where a regional headquarters location has been established for a jurisdiction but the carve-out may not apply as the holding company either (i) has a subsidiary that is based elsewhere in the EU or (ii) the beneficial owners are not located in that jurisdiction. In our view, the scope of this exception is likely to be narrow as a result.

  In this regard, we note that the current drafting of this exclusion is also likely to favor larger Member States which would be more likely to be wholly domestic in nature. However, we note that the EU fundamental freedoms encourage cross-border investment (particularly the principal of free movement of capital). Moreover, we note that BEPS Action 6 also endorses the concept of regional investment platforms.

- ***Holding companies tax resident in the same Member State as their shareholder:*** This carve-out applies to 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. Based on the definition of "undertaking's shareholder" in Article 3(6) of the proposed Directive, it is unclear

whether a direct shareholder would meet the definition of the "undertaking's shareholder" for purposes of this carve-out where it does not fulfil the indicators of minimum substance as set out in Article 7 of the Directive. This does not appear to capture scenarios where the direct shareholder is not itself within the scope of the Directive (e.g. the direct shareholder itself can avail of one of the carve-outs and is therefore not an excluded entity).

- ***Five full-time employees engaged exclusively in the activity generating the income:*** In line with our comments above, we believe that the current drafting of this exclusion potentially would not apply to a large number of companies that sit within substantive groups. This is due to the fact that it is not unusual for large groups to have multiple entities in the same jurisdiction but for one entity in the group to employ all of the relevant staff. The time and services provided by these staff are then (re)charged (on an arm's length basis in accordance with transfer pricing rules) to the other group entities in the same jurisdiction (and elsewhere). The fact that this common arrangement is not catered for means that, unless the employment profile of the group is restructured, this exception will be available to a relatively small number of entities and groups. In addition, where these employees spend any time on other matters (e.g., generating trading income which is not considered to be "relevant income"), the exclusion will not apply due to the 'exclusivity' requirement. This would appear to be an oversight and we would recommend that this carve-out is re-considered as a result.

  It is also not clear why a threshold of five employees is a good measure of adequate substance. In this regard, we note that the threshold does not appear to be linked in in any way to size of the entity or the group and does not take account of any industry-specific factors, or the specifics of the Member State in question.

- ***Investment funds:*** While we note that there is a broad carve-out in the proposed Directive for management companies and funds (including AIFMs and AIFs), the scope of this carve-out is not extended to investment fund subsidiaries. We would recommend that a broader exemption is included for fund structures, potentially drawing on the scope of the definition of investment funds included in the OECD BEPS 2.0 GloBE Model Rules, to incorporate not only the regulated fund but also entities that sit underneath the investment fund. In this regard, we note that the GloBE Model Rules recognize that investment funds may use special purpose vehicles to hold assets or to make certain investments which become part of the fund's infrastructure.

For completeness, we note that the current carve-outs for regulated financial undertakings and listed entities require the relevant entity to be regulated or listed in the EU. We would however recommend that the scope of the carve-outs is extended to entities regulated outside the EU where there is accepted equivalence in terms of regulatory standards.

2.3.3. Lack of tax motives exemption

While we note that, as currently designed, the lack of tax motives exemption can be completed at any stage in the process, this would still require submissions to be made by undertakings to tax authorities across the EU which does not serve to alleviate the administrative burden being created for both parties.

From a tax authority perspective, it is possible that a large volume of submissions would need to be assessed which, when combined with the rebuttal assessments that will need to be completed, exchange of information procedures and the new processes for issuing tax residency certificates, is likely to have a significant impact on tax authorities from an administrative perspective. From a taxpayer perspective, the process also appears onerous as taxpayers potentially could need to

complete (i) reporting of substance indicators, (ii) complete a rebuttal submission and (iii) make a separate exemption for lack of tax motives. It is also not clear how:

- the lack of tax motives exemption should be completed;
- the process for submitting this exemption;
- what information should be included; and
- the timeframe and process under which that information would be assessed by tax authorities.

In this regard, the current test proposed for the exemption to apply requires that "*the existence of the undertaking does not reduce the tax liability of its beneficial owner(s) or of the group, as a whole, of which the undertaking is a member*". We believe that the current wording of this test is too rigid as the exemption would not appear to be available if any tax benefit is generated by the group. This would preclude cases where a tax benefit is a minor part of a much wider set of commercial factors which require / support the role played the undertaking within the group. Indeed, the European Commission's Recommendation on Aggressive Tax planning notes that *"a given purpose is to be considered essential where any other purpose that is or could be attributed to the arrangement or series of arrangements appears at most negligible, in view of all the circumstances of the case".* In keeping with this approach, any test used in the proposed Directive should refer to the importance of the tax benefit in the overall arrangement, rather than limit the scope of the exemption where even a minor tax benefit is obtained.

It is also not clear which types of taxes would come within the scope of this test. When comparing the amount of tax due by a taxpayer with the amount that the same taxpayer would owe under the same circumstances in the absence of the entity in the group structure, it is important to clarify which taxes should be taken into account for the purposes of this comparison – e.g. is the group's entire tax profile relevant or should the comparison be limited to those taxes that are subject to benefits under that the proposed Directive is intended to remove (e.g. those available under the EU Parent-Subsidiary Directive and the EU Interest and Royalties Directive).

As noted below in Section 3, any measures introduced under a Directive of this nature should be aimed at detecting "wholly artificial arrangements". We therefore believe that, if the Directive is to proceed, a different approach to the lack of tax motives exemption would be needed which, when considered in the round with any re-design of gateway criteria, substance indicators etc., would actually serve to reduce the administrative burden for taxpayers while ensuring that tax authorities only receive information on entities that are indeed at a high risk of being "misused for tax purposes".

3. Consistency with EU law

As a matter of principle, any EU-wide anti-avoidance rules and recommendations should be in line with the fundamental principles of EU law, as interpreted by the Court of Justice of the EU. In this section we have aimed to highlight areas of the proposed measures where we think adjustments are needed in order to bring them in line with EU law and jurisprudence. Subject to our reservations regarding the need for such measures, we recommend that any anti-shell measures introduced should respect the interpretation of the CJEU.

3.1. Interaction with EU fundamental freedoms

The proposed EU Directive does not apply to undertakings located in the same jurisdiction as the shareholder or operational companies of the same group. Such companies are considered as low risk and benefit from an exemption from the self-assessment and the reporting obligations. In practice, this means that holding companies involved in cross-border transactions will be subject to more

burdensome reporting requirements and would generally be required to meet more stringent substance rules than entities that are in a comparable situation and that either do not operate cross-border or are established in the same Member State as the operational companies or shareholders.

This difference in treatment could discourage such entities from operating and seeking financing cross-border and therefore represents a restriction of the EU fundamental freedoms.

3.2. Proportionality concerns

We note that the Explanatory Memorandum to the proposed Directive highlights the aim of combating – through the introduction of specific anti-abuse measures – tax avoidance and evasion practices which directly affect the functioning of the internal market. We further note that both the accompanying Explanatory Memorandum and the Impact Assessment argue – without providing details on the rationale behind this statement – that the proposed measures are appropriate to achieve this objective and that they do not go beyond what is necessary to achieve it (principle of proportionality).

We acknowledge that, according to settled CJEU case-law[10], this aim could potentially justify a restriction of the fundamental freedoms such as that described above. Nevertheless, in order to be justified, the rules must be restricted to situations targeting elements of abuse, and in the particular case of direct taxation, the measures should be aimed at detecting "wholly artificial arrangements"[11].

In this context, we would like to reiterate our comments from our previous consultation response concerning the need for the measures to be founded on settled CJEU case law and therefore to include the possibility of a case-by-case analysis by the relevant tax administration.

Whilst we welcome the fact that the proposed Directive, in compliance with settled CJEU case-law, refrains from proposing irrebuttable presumptions of abuse, we believe that several of the tests and related proposed criteria could be in breach of EU law and may need further analysis and potentially refinement or even removal.

In addition to our general comments, the following section shows areas in the proposed EU Directive that could be drafted in a more proportionate manner which in turn would enhance the compatibility of the Directive with the fundamental principles of EU law.

3.2.1. Proportionality of the gateway criteria

For the purpose of identifying companies at risk of lacking substance, the proposed EU Directive sets-out three 'gateways' – i.e. how the revenue is generated, the existence of a cross-border element, and outsourcing of day-to-day management and administration functions. Companies in scope are required to self-assess against these criteria and, if all three gateways are checked, to report on economic substance.

Given the broad design of the three gateways, it is likely that a significant number of entities will pass through the three gateways and be subject to reporting requirements under Article 7 of the proposed Directive. The exception to this reporting requirement would be cases where the entity avails of the lack of tax motives exemption, which itself necessitates a submission being made by the entity to the tax authorities of the relevant Member State. In our view, it is highly likely that the broad design of the three gateway criteria combined with the possibility to apply for an exemption for lack of tax

[10] Lexel AB (C-484/19; Cadbury Schweppes (C-196/04); X and X (C-398/16 and C-399/16).
[11] Lexel AB (C-484/19; Cadbury Schweppes (C-196/04); X and X (C-398/16 and C-399/16).

motives only as a separate step (which would be subject to tax authority assessment), will create new administrative burdens for both taxpayers and tax authorities across the EU.

We also believe that the current broad design of the gateway criteria does not comply with the principle of proportionality – the gateways should be appropriate for achieving their purpose (i.e. assessing the risk profile of companies and filtering out low-risk entities).

In this context, we refer to the Advocate General's (AG) recommendation in the Thin Cap Litigation case[12], where the AG notes that criteria used to assess whether a transaction is abusive should be "reasonable" in order to enhance both the level of legal certainty for the taxpayers and workability for tax authorities. The EC has also noted in a communication[13] that it shares the AG's views that anti-abuse rules may contain criteria aimed at targeting situations in which the probability of abuse is highest.

We have reservations on whether the three fixed gateways that have been proposed are in fact reasonable and achieve the objective of targeting high risk cases. In the absence of further information on how the European Commission established the threshold of passive income and of cross-border activities, respectively, it is difficult to make that assessment. As it stands, the choice seems to be random and not backed up by clear evidence that could support the view that these particular features indicate a higher risk of entities being misused.

Furthermore, the Explanatory Memorandum notes that that *"shell entities at risk to be misused are more likely to be identified amongst those engaged with the activity of holding and managing equity or intellectual property or with financing and leasing activity"*. This view seems to be in contradiction to settled CJEU case-law[14], which clarifies the fact that the economic activity of an entity consists in the management of assets for the group or that the income of that company results only from such management cannot, per se, indicate the existence of a wholly artificial arrangement which does not reflect economic reality.

Additionally, as noted by the Commission in its Communication on the application of anti-abuse measures in the area of direct taxation[15], the CJEU has also found that carrying out cross-border activities instead of engaging a domestic company does not infer the existence of a wholly artificial arrangement[16]. Using cross-border activity as an indicator of a higher likelihood of an entity being 'misused for tax purposes' seems to go against the very nature of the EU internal market, which is predicated on and indeed aimed at encouraging cross-border activities.

The first gateway criterion should be met where "*more than 75 percent of the revenues accruing to the undertaking in the previous two tax years is relevant income*". Article 4 of the proposed Directive outlines eight categories of income which are considered to be relevant income for the purposes of the gateway tests. However, this definition of relevant income does not take account of how a group is structured. For example, a group may have a property company which owns the office premises used by the group. This property company may in turn lease the property to an operating company in the same jurisdiction which operates in other countries through different branches and charges the

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[12] Test Claimants in the Thin Cap Group Litigation C-524/04.

[13] Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee of December 10, 2017, on the application of anti-abuse measures in the area of direct taxation – within the EU and in relation to third countries - COM/2007/0785 final.

[14] Deister Holding (C-504/16).

[15] Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee of December 10, 2017, on the application of anti-abuse measures in the area of direct taxation – within the EU and in relation to third countries - COM/2007/0785 final.

[16] Cadbury Schweppes (Case C-196/04).

rental cost to these branches. This could potentially lead to the property company in the group meeting the gateway threshold notwithstanding that the group, when considered as a whole, may not be engaged in a property rental business.

We therefore believe that the gateway criteria should be brought into line with settled CJEU case law, as noted above.

3.2.2. Proportionality of the substance indicators

Based on the proposed Directive, reporting companies need to comply with three cumulative substance indicators, considered by the EC as generally present for entities performing substantial economic activities:

a) existence of premises available for the exclusive use of entity;

b) own and active bank account opened in the EU;

c) adequate nexus to the Member State of claimed tax residence, demonstrated through the presence of relevant personnel being resident close to the entity.

As a general comment, we would like to reiterate our recommendation that a detailed analysis of compliance with EU law is performed, and the substance indicators are amended to meet the principle of proportionality.

Based on settled EU case law, in order to comply with EU law, anti-abuse legislation should:

(i) task the tax authorities with establishing the existence of elements of an abusive practice[17],
(ii) take into account all relevance facts and circumstances of each individual case[18], and
(iii) allow taxpayers the option to rebut the tax authorities' assessment[19].

Tax authorities should not limit themselves to applying a pre-determined set of general criteria when assessing potentially abuse arrangements[20]. Doing so would go further than is necessary for preventing fraud and abuse and would therefore not comply with the principle of proportionality. The Court has previously found[21] that a general presumption of fraud or abuse is introduced where the granting of a tax benefit is subject to compliance with a defined set of criteria without the tax authorities being required to provide prima facie evidence of the absence of economic reasons or of fraud or abuse. According to the Court, such a presumption cannot justify either a fiscal measure which compromises the objectives of a directive or a fiscal measure which prejudices the enjoyment of a fundamental freedom guaranteed by the treaties.

An arrangement may only be deemed abusive based on an overall assessment of the facts and circumstances of each individual case. An examination of the whole operation would need to include economic or other substantial features of the group and the structures and strategies of that group. According to the Court, an assessment of the artificiality of an arrangement may be based on factors such as[22]:

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[17] Joined Cases C-116/16 and C-117/16.
[18] Lexel AB (C-484/19; Cadbury Schweppes (C-196/04); X and X (C-398/16 and C-399/16).
[19] Eqiom and Enka (C-6/16).
[20] Foggia (C-126/10), Euro Park Service (C-14/16), Leur-Bloem (Case C-28/95), joined cases Deister Holding AG (C-504/16) and Juhler Holding A/S (C-613/16, Eqiom and Enka (C-6/16).
[21] Lexel AB (C-484/19; Cadbury Schweppes (C-196/04); X and X (C-398/16 and C-399/16), Foggia (C-126/10), Euro Park Service (C-14/16), Leur-Bloem (Case C-28/95), joined cases Deister Holding AG (C-504/16) and Juhler Holding A/S (C-613/16, Eqiom and Enka (C-6/16).
[22] Lexel AB (C-484/19; Cadbury Schweppes (C-196/04); X and X (C-398/16 and C-399/16).

- the group being structured in such a way that the company which receives income from a debtor passes that income on to a third company which does not fulfil the conditions for a beneficial tax treatment;
- the entity's inability to have economic use of the income received;
- the entity making only an "insignificant taxable profit" and its only activity being that of receiving income and transmitting it up the ownership chain;
- the management of the company, its balance sheet, the structure of its costs and expenditure actually incurred;
- the staff that it employs;
- the premises and equipment that it has;
- the contracts existing between the companies involved in the financial transactions under assessment;
- the way in which the transactions are financed;
- the valuation of the intermediary companies' equity.

We note that, in its decision in joined Cases C 116/16 and C 117/16 (the Danish cases), the Court prescribed the above-mentioned indicia not as an exhaustive list but as examples aimed at guiding the national court in the assessment of those specific cases. The Court also noted that the presence of *a number* of such indicators *could* lead to the conclusion that there is an abuse of rights, but that this should be assessed in light of the circumstances of the specific case. Furthermore, the assessment must be made in the light of the specific features of the economic activity that the entity performs.

Whilst the proposed Directive does give taxpayers the possibility to rebut the presumption of abuse, it introduces a general presumption of abuse, which is very easily triggered by a taxpayer's failure to meet even just one of the three criteria. Furthermore, tax authorities are not charged with providing factual evidence of fraud and abuse. The use of a limited number of criteria of a general nature, without the requirement for a further assessment of the facts and circumstances of each arrangement is in contradiction with case-law cited above.

We note that, under the proposed Directive, each entity is to be assessed against the substance indicators on a standalone basis and, as noted by the Impact Assessment, reporting entities "face the same minimum requirements for substance" irrespective of the industry in which they operate. In this regard, we note that there is a substantial imposition on taxpayers to provide multiple documents as part of their submission to the relevant tax authorities. However, it is not unusual for some groups to split their activities between many entities which might all be in the same jurisdiction. The fact that there cannot be a group assessment means that this burden is very substantial and could give rise to cases where it appears that an entity lacks substance notwithstanding that there might be a great deal of substance domestically in that relevant group.

Additionally, we note that the third indicator mentioned above establishes a link between substance and the physical presence of employees being either in the state of residence of the entity or *"at no greater distance [..] insofar as such distance is compatible with the proper performance of their duties"*. While we acknowledge that the availability of own staff was previously recognized by the Court as a possible criterion for determination of substance, we do however note that, for example, the CJEU's decision in Cadbury Schweppes dates to September 2006, a time when it was common and expected for employees to be located in the same or close to the jurisdiction in which their employer operates. The acceleration of digitization of operations and business models and the impact of the COVID-19 pandemic have led to the advent of "work from anywhere" practices meaning that it has become increasingly common for employees and directors to conduct their functions remotely.

This may particularly be the case where the size of the local market or a jurisdiction's geographical position are such that the local pool of qualified workforce is limited. This new reality seems to have also been acknowledged in the European Commissions' response to a question received from the European Free Trade Association (EFTA) Court as part to the Fred Olsen joint cases[23]. The Commission confirmed that for the purpose of analyzing the existence of a real and genuine economic activity one should not consider that the economic activities need to occur in the European Economic Area (EEA) state of establishment. Instead, it is sufficient that the activity takes effect in the EEA. We therefore recommend that the nexus criteria suggested by the EC are further refined to reflect current work practices and trends, as well as the specifics of each local market.

We believe that, in order for the proposed Directive to be in line with EU law, as interpreted by the CJEU, the assessment should be made in light of a wide range of criteria, tailored to the specifics of the activity performed by the entity and should take into account the wider group structure and the entity's role in that structure, the specifics of the domestic market in the entity's jurisdiction, as well as the current business landscape.

4. Additional structural issues with the proposed Directive

As noted above, we believe that it would be appropriate to monitor and evaluate the impact of existing and upcoming anti-abuse and transparency measures. The proposed Directive will likely place a significant administrative burden on taxpayers across the Union and, in our view, it is necessary to first determine whether the suite of new legislative developments has already addressed the perceived risk of aggressive tax planning.

In the event that the EC determines that creating a new instrument to deal with this issue in addition to the other measures that have been introduced recently is an area where the EC's time and resources are best invested, we believe that there are a number of aspects of the text of the proposed Directive that would require further clarification, in addition to the issues related to alignment with CJEU case-law, noted under section 3 above.

4.1. Alignment of the legal text and the Explanatory Memorandum

We note that the text of the proposed Directive contains an Explanatory Memorandum. Section 5 of the Explanatory Memorandum outlines the consequences that should apply once an undertaking is presumed to be a 'shell' for the purposes of the Directive and does not successfully rebut this presumption. In this regard, the Explanatory Memorandum envisages that the following four scenarios could apply and outlines the expected consequences for each scenario:

1. Third country source jurisdiction of the payer – EU shell jurisdiction – EU shareholder(s) jurisdiction
2. EU source jurisdiction of the payer – EU shell jurisdiction – EU shareholder(s) jurisdiction
3. EU source jurisdiction of the payer – EU shell jurisdiction – Third country shareholder(s) jurisdiction
4. Third country source jurisdiction of the payer – EU shell jurisdiction – Third country shareholder(s) jurisdiction

While the provision of this summary of intended outcomes is helpful, the outcomes listed for the four scenarios do not appear to have been fully reflected in the Directive text. It is not very clear from a reading of the articles of the Directive, what the EC's intention was with regard to the consequences of an entity being deemed a shell, in any of the scenarios outlined above. Clarity regarding these consequences is paramount to the functioning of the envisaged rules. Anything other than absolute certainty with regard to the effects of the assessment would lead to lack of certainty for taxpayers and

[23] Joined case E-3/13 and E-20/13

a patchwork of measures applied by Member States, with the possible consequence of double taxation.

By way of example, in scenario two above (EU source jurisdiction of the payer – EU shell jurisdiction – EU shareholder(s) jurisdiction), the Explanatory Memorandum suggests that the EU source jurisdiction of the payer will not have a right to tax the payment but may apply domestic tax on the outbound payment to the extent that it cannot identify whether the undertaking's shareholder(s) are in the EU. However, this outcome does not appear to be reflected within the text of Article 11 or Article 12 of the proposed Directive. Similarly, the Explanatory Memorandum states that the EU shareholder(s) may be able to claim relief for any tax paid at source, including by virtue of EU directives, however, this outcome also does not appear to be reflected within the text of Article 11 or 12 of the proposed Directive.

There are also a number of issues which are not addressed by either the Explanatory Memorandum or the text of the proposed Directive. For example, it is not clear from the proposal whether, in cases where there is an EU 'shell' undertaking, a 'look-through' approach should be applied when assessing the availability of relief under EU Directives or double-taxation agreements. Similarly, where a payment is made to an EU 'shell' entity and the payment is considered to have been received by the EU shareholder of the 'shell' entity, it is also unclear, for example, whether subsequent payments or distributions made by the EU 'shell' entity to that EU shareholder should be then disregarded if the EU shareholder has already included the initial payment made to the 'shell' in its taxable base.

4.2. Alignment of the legal text and the preamble

Similarly, there are examples of intended outcomes being outlined in the preamble of the proposed Directive which do not appear to have been reflected within Article 11 or Article 12. Most notably, the preamble states that the EU 'shell' entity will continue to be resident for tax purposes in its current Member State and will have to fulfill all relevant obligations under the domestic law of that Member State. While this may be presumed to be the case (particularly in light of the accompanying Explanatory Memorandum), Article 12 of the proposed Directive does not currently provide for this outcome – it simply states that the Member State of the 'shell' undertaking is required to deny a certificate of tax residence or issue a certificate of tax residence that effectively includes a warning.

In the event that the European Commission proceeds with the introduction of the proposed Directive, we would recommend that the legislative text is aligned as closely as possible with the Explanatory Memorandum and the preamble to reduce confusion for taxpayers when assessing the potential impact of the Directive on their existing group structures. In particular, we believe it is of utmost importance for the Directive to include unequivocal provisions on the consequences for the group, in each of the relevant Member States, where the entity under assessment being deemed a 'shell'. Such provisions should also specifically include mechanisms for the prevention of double taxation, as detailed further under section 4.3.2 below.

4.3. Specific aspects of the Directive requiring additional clarification

In addition, there are a number of specific aspects of the proposed Directive where additional clarification / guidance would be required if a decision is taken to proceed with the proposal in its current form. In this regard, there is a need for clear definitions of terms to be provided to ensure a consistent application of any proposed new rules across EU Member States.

4.3.1. Outsourcing

Under the current text of the Directive, an undertaking will pass-through the third gateway criteria if *"in the preceding two tax years, the undertaking outsourced the administration of day-to-day operations and the decision-making on significant functions"*. The term outsourcing is not currently defined in the Directive. It is therefore unclear whether the provision of services to other related group

entities would also constitute outsourcing or if this gateway criterion is solely limited to the engagement of third-party corporate service providers.

It is also not clear if there is a distinction between outsourced services provided by group companies that are tax resident in the same Member State as the 'shell' entity. As noted above, this is partially due to the fact that the text of the proposed Directive suggests that the 'shell' assessment should be completed on a standalone entity-by-entity basis, rather than assessing the level of substance of the group on a jurisdictional basis. If this is the case, it would negatively affect groups that have all of the operational substance structured in a single entity in the jurisdiction which provides management services to the other entities in the group.

The preamble to the Directive notes that *"outsourcing of certain ancillary services only, such as bookkeeping services alone, while the core activities remain with the undertaking, would not suffice in itself for an undertaking to meet this condition".* However, it can be the case that third party corporate service providers complete a range of routine administrative services for entities which is wider than bookkeeping services. At present, it is not clear what services could be provided by third party providers as the term "core activities" is also not defined within the text of the Directive. The lack of clarity here is likely to generate significant levels of confusion for taxpayers as they seek to interpret the activities performed by various entities in the group in light of the Directive.

For completeness, we also note that it can be more efficient from a cost perspective for undertakings to outsource administrative functions to third-party service providers rather than employ staff to complete these tasks in-house. This can be due to economies of scale enjoyed by the corporate service providers, groups outsourcing functions as they seek to scale-up during an expansion phase into a new market etc. The current text of the proposed Directive does not take account of these concerns.

Consistent with our comments in Section 3.2.2, we also believe that the gateway criteria should take account of industry / sector-specific factors. We have therefore included in Appendix I an example of how the current drafting of the outsourcing gateway could give rise to issues for the investment funds sector, despite the fact that these structures have been validated from a regulatory substance perspective.

Given the issues identified above, we would recommend that the concept of outsourcing is re-considered in full if the Directive proposal proceeds in its current format, particularly due to the proportionality concerns surrounding the gateway criteria raised in Section 2.3. Where the outsourcing gateway is retained, we would strongly recommend that a more comprehensive definition and additional guidance is provided which clarifies when the gateway threshold will or will not be crossed.

4.3.2. Taxes paid in Member State of undertaking

Article 11(2) of the proposed Directive provides that a deduction can be taken for *"any tax paid on such income at the Member State of the undertaking"* in the Member State of the undertaking's shareholder(s). A literal reading of Article 11(2) would suggest that only taxes actually paid in the Member State of the 'shell' undertaking would qualify for relief. This is possibly the case because the Directive appears to have been designed to examine a single payment from the source jurisdiction (be it a Member State or a third country) and the Member State of the 'shell' undertaking.

In our view, this could give rise to issues, for example, where the 'shell' undertaking makes subsequent payments to third-party lenders. In such a scenario, the 'shell' entity may receive a deduction for this external payment – subject to wider interest limitation provisions – which would seem appropriate given that the level of profitability of the group would also have been reduced by the payment to the

third-party lender. In contrast, Article 11(2) of the Directive would appear to require the Member State of the undertaking's shareholder(s) to tax the amount received by the 'shell' undertaking on a gross basis, with relief only being made available for the tax paid on the net profit in the Member State of the 'shell' undertaking. This seems to create a risk of tax being imposed at a level that is not aligned with the profitability of the group as a whole.

Article 11(2) also does not appear to deal with cases where the 'shell' entity has tax losses available from prior years which are utilized to reduce the tax burden of the 'shell' entity in a given year. As tax has not been paid in the Member State of the undertaking, relief does not seem to be available in the Member State of the undertaking's shareholders (which would tax the payment on a gross basis), despite the fact that the tax losses in the Member State of the undertaking have been eroded.

While we note that the lack of tax motives exemption could possibly be invoked in these scenarios, the application of this exemption is subject to the interpretation of tax authorities and differing approaches could therefore be applied across the EU (as noted in our comments above in Section 2.2. In line with our comments in Sections 4.3.1 and 4.3.2 above, we would therefore recommend that the text of Article 11 is re-considered in full, with a view to providing more comprehensive guidance on how the tax consequence provisions of the Directive are intended to operate in practice.

4.3.3. Substance indicators

While we have more generally recommended above that the substance indicators should be re-visited, we also believe that there are specific aspects of Article 7(1) of the proposed Directive that, based on the current text, would require additional clarification. For example, Article 7(1)(b) states that an indicator of minimum substance is met where *"the undertaking has at least one own and active bank account in the Union"*. However, it is not clear in which circumstances a bank account would be considered to be "active". More generally, it is somewhat unclear why having an active EU bank account affects the assessment of substance. It is not uncommon in certain industries (particularly industries where investment is obtained from the United States) for the European entity to have US bank accounts rather than EU bank accounts. In our view, it would seem unreasonable to suggest that the mere fact that an entity has a bank account outside of the EU but in a jurisdiction with extensive equivalent regulation (e.g. the United Kingdom or the United States) would result in that entity being considered to be a high-risk entity (particularly given detailed reporting of these financial accounts to the relevant tax authorities). In this regard, the requirement that the bank account should be in the EU may itself constitute a restriction of the free movement of capital which also covers relations with third countries.[24]

Similarly, Article 7(1)(a) requires that the *"undertaking has own premises in the Member State, or premises for its exclusive use"*. A strict reading of this substance indicator and the term "exclusive use" could prove problematic for the majority of groups and investment fund structures that have a single property that serves as the office for each of the group entities based in that jurisdiction. Similarly, it would often be the case that businesses would lease office space (e.g. two floors) in an office block. A strict reading of the substance indicator could again prove problematic here. Furthermore, where the entity makes use of leased office space, it is not clear if a minimum lease period would be required in order for the premises to qualify under this criterion. If the intention of the European Commission is for such a minimum period to be used by Member States' tax authorities when performing their assessment under the new rules, the details of the criterion should be clarified so as not to leave room for interpretation and diverging implementation. As noted above, we believe it would be important to ensure that clear criteria, definitions, and guidance are provided if the Commission proceeds with

[24] Article 63 TFEU

the proposed Directive in its current format in order to serve the aims of harmonization and legal certainty.

Issues also arise in respect of the third substance indicator. By way of example, Article 7(1)(c) requires that one or more of the directors are *"qualified"* to take decisions in relation to the activities that generate relevant income for the undertaking, however, no clarity is provided regarding what level of qualification is required. This could give rise to unintended consequences where, for example, the founder of the entity is a director but does not have any formal qualifications – despite the fact that this individual founded the entity concerned. In a similar manner, Article 7(1)(c) requires that the director does not perform the function of director for other non-associated enterprises. Based on a strict reading of this condition, this would preclude a director for holding any other board position that is not within the group (which could include not-for-profit enterprises, industry group boards, semi-state companies etc.). Appointments to these types of board positions usually are reserved for individuals with significant expertise which would, in our view, actually support the level of operational substance in the undertaking being considered.

For completeness, we note that examples above are not intended to be exhaustive in nature and that we believe that there are a number of other items throughout the Directive that require further clarification. If the current approach to the proposed Directive is retained, we would recommend that the Commission undertakes a thorough review the proposed Directive in its totality, with a view to providing as much additional clarity as possible.

5. Additional issues

5.1. Dispute resolution

As noted above, the current text of the proposed Directive is likely to significantly increase the level of interaction required between taxpayers and tax authorities across the EU. This is particularly the case due to the fact that entities will be presumed to be a 'shell' and this presumption will then need to be rebutted successfully. While Article 9 of the proposed Directive outlines the approach that an entity should take to rebut the 'shell' presumption, Article 9(1) only requires Member States to take "appropriate measures" when assessing the rebuttal evidence. Article 9(3) states that a Member State *"shall treat an undertaking as having rebutted the presumption if the evidence that the undertaking has provided…proves that the undertaking has performed and continuously had control over, and borne the risks of, the business activities that generated the relevant income or, in the absence of income, the undertaking's assets"*.

However, as noted above, the proposed Directive does not require Member States to complete this assessment within a set timeframe. In addition, the current text does not clarify whether the taxpayer has any recourse if the rebuttal submission is denied by the tax authorities. While we note our comments regarding the wider issues that the 'shell' presumption creates, we would also recommend that Directive clarifies that taxpayers should have a right to wider dispute resolution procedures if it disagrees with a tax authority assessment (e.g. timely processing of appeals, access to a judicial recourse etc.).

5.2. Penalties

We note that the proposed Directive lays down penalties for when an undertaking fails to comply with the obligations set out in the Directive. An administrative pecuniary penalty amounting to 5 percent of turnover is prescribed for cases where an undertaking, meets the gateway criteria in Article 6, but does not comply with the reporting requirements of the Directive in a timely manner or makes a false declaration. Given that the penalty provisions are linked to the failure of an in-scope entity to file the

relevant information in a timely manner, it seems disproportionate to set the penalty by reference to the entity's turnover.

We suggest that a more appropriate approach would be to allow Member States to set the level of penalties in accordance with domestic legislation e.g. on similar obligations, such as filing of annual corporate income tax returns, provided that the penalty is effective, proportionate and dissuasive (in accordance with settled case-law of the Court of Justice of the European Union, e.g. case C-68/88 Commission v Greece).

6. Conclusions

KPMG supports the EC's efforts in ensuring a harmonized approach to substance requirements in the EU with a view to ensuring tax certainty for taxpayers operating across the Union. However, as noted in our comments in Section 1 and in our previous submission on this initiative, we strongly recommend that the importance of achieving this aim is assessed in the context of the current tax landscape, the significant upcoming changes in EU and international tax rules and is also balanced against the burden that a new set of complex reporting and anti-abuse rules would generate for MNEs operating in the EU.

With this in mind, our recommendation is to adopt a period of monitoring and evaluation before a proper determination is made as to whether additional specific rules are required. This would include consideration of how Member States have implemented new anti-avoidance and reporting rules, both technically and in practice. We believe that this approach would allow the better deployment of resources to ensure the effective implementation of newly enacted measures and the smooth introduction of upcoming measures in the coming months.

Notwithstanding the above, any measures that the European Commission does deem necessary, either at this time or in future, should be aligned with existing case law from the Court of Justice of the European Union and should be narrowly targeted at abusive scenarios in order to ensure relevance for tax administrations and to minimize the burden for taxpayers. The measures should also enhance harmonization and legal certainty by not leaving room for differences in interpretation and implementation.

KPMG appreciates the opportunity to contribute to the EU public consultation and is ready to elaborate on the above and discuss this topic at any future occasion.

Yours faithfully,

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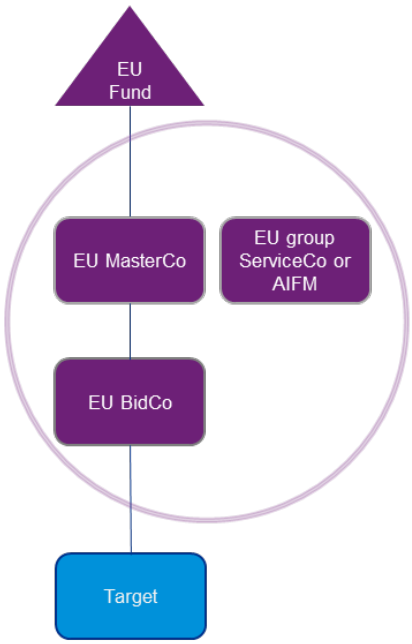
Appendix I

Outsourcing gateway – investment funds sector



Fact Pattern

- Fund and all companies except the Target are in the same EU Member State
- EU ServiceCo / AIFM has employees and either on-charge these cost to EU BidCo or share these employees through a split payroll.

In each EU entity:
- 1 EU independent director.
- 1 or 2 EU group directors (employees of ServiceCo or AIFM)
- 1 Foreign group director.

- Some support accounting and admin services provided by a trust company.
- Assumption relevant income and cross-border tests are met.

Practical issues for investment fund structures in light of the gateway tests

- The centralization of operational substance at the level of the group AIFM or group Service Co is common practice in the investment funds industry. It corresponds to the so-called platform model, which is basically the insourcing of the decision-making process.
- However, based on a strict reading of recital 5 of the pre-amble to the Directive, issues could arise from the perspective of the outsourcing gateway where the AIFM or group Service Co is providing services to EU Bid Co.
- This is on the basis that, under the current text of the proposed Directive, the fact that the cost of employees of the EU group Service Co or AIFM performing activities are recharged to EU Bid Co could qualify as outsourcing.
- While recital 5 of the pre-amble states that "certain ancillary services" (such as accounting) should not qualify as the outsourcing of the administration of day-to-day operations, it is not clear what other ancillary functions would fall within this exclusion.
- In terms of the group directors, issues may arise based on a strict reading of recital 5 as group directors are employed by another group entity in the same Member State (ServiceCo or AIFM), or abroad (with active and - where necessary - physical involvement in the decision-making of EU Bid Co). It is not clear whether this would be considered to constitute outsourcing.

- In the case of the independent director, it is worth noting that these directors assume the same functions and risks as any other directors. They take their decisions diligently for the benefit of the company and must have the necessary expertise, knowledge of the company, its group and activities, as they engage their personal liability. Issues would also arise from the perspective of the substance indicators where the independent directors held any other directorship with a non-associated enterprise.
- It is worth noting that this type of structure is a common investment fund structure that has already been approved from a regulatory substance perspective. This assessment examines the level of substance on a jurisdictional basis (rather than applying a standalone entity-by-entity assessment).
- The application of the assessment on a jurisdictional basis is also aligned with the approach applied under ATAD GAAR and the PPT test in the OECD MLI and is further supported by the concept of regional investment platforms as outlined in the OECD non-CIV report[25].

[25] Discussion-draft-non-CIV-examples.pdf (oecd.org)