The ATAD3 Directive – The crackdown on EU 'Shell entities'

On 22 December the European Commission ("**EC**") published a proposal for a Directive to prevent the abuse of shell entities for improper tax purposes (hereafter: "**ATAD3 Directive**"). Although shell or letterbox entities can serve useful commercial and business functions, they may also be used by international groups and individuals for unintended tax planning or tax evasion purposes. The proposal aims to ensure that EU based shell entities that have no or minimal economic activity are in principle deprived from certain EU and broader tax benefits. However, in-scope shell entities can provide counter evidence in cases of assumed abuse. The ATAD3 Directive should be adopted early 2022, transposed in domestic law ultimately by 30 June 2023, and be effective in all Member States from 1 January 2024.

Overview

The EC has presented a proposal for the ATAD3 Directive that aims to prevent the abuse of shell entities in cross-border situations. The proposal contains model rules that should ensure that shell entities in the EU that have no or minimal economic activity are unable to benefit from certain tax advantages. Clear objective is to discourage the use of shell entities.

Shell entities can be used for tax planning or tax evasion purposes. As a part of classic tax planning, businesses can direct financial flows such as dividends, interest and royalties through shell entities, that benefit from more favorable tax treatment through treaties or EU Directives than would have been the case if the arrangement had been entered into directly and without the interposition of the shell entity. Similarly, some individuals can use shell entities to shield assets, either in their country of residence or in the country where property is located.

In-scope shell entities that predominantly generate cross-border passive income or predominantly hold real estate abroad, will be obligated to indicate whether they meet certain substance indicators. If they do not, then they will in principle be presumed abusive shell entities, as a result of which various adverse consequences should apply. In-scope shell entities that do not meet all substance indicators will still have the possibility to rebut the presumption of being an abusive shell entity.

Exemptions from these rules will apply to entities with certain profiles, such as regulated investment funds and entities with at least five relevant employees that conduct relevant activities.

Abusive shell entities should not be allowed access to tax relief under a tax treaty or EU Directives by an EU source state. In addition, if the shareholder(s) of the abusive shell entity are resident of a Member State, CFC rules should provide that the shell entity's income is picked up at the shareholder(s) level. Finally, the Member State of residence of the shell entity should either deny a tax residence certificate or issue a certificate specifying that the company is a shell.

Proposal

Below we will describe in more detail which entities will be in scope, what substance requirements the in-scope entities should satisfy, and
what the consequences of not meeting the substance requirements are.

In-scope entities

In-scope entities are entities that meet the following three *cumulative* requirements:

- More than 75% of their revenue in the previous two tax years from should comprise of "**Relevant Income**", being: interest or any other income generated from financial assets, including cryptocurrencies, royalties, dividends and income from shares, income from financial leasing, income from immovable property, income from movable property other than typical financial assets with a book value exceeding EUR 1 million (hereafter: "**Qualifying Movable Property**"), income from insurance, banking and other financial activities and income from services which the entity has outsourced to other associated enterprises. Note that entities whose assets comprise for more than 75% of shares, immovable property or Qualifying Movable Property are deemed to satisfy this requirement, irrespective of whether these assets have generated any income in the previous two years;
- The entity should be engaged in cross-border activities based on either of the following grounds: (i) at least 60% of the entities' Relevant Income is earned or paid out via cross-border transactions, or (ii) more than 60% of the book value of the entity comprises of real estate that is located outside the residence state or Qualifying Movable Property with a book value exceeding EUR 1 million;
- The entity has outsourced the administration of day-to-day operations and the decision-making on significant functions in the previous two tax years. The proposal makes clear that this requirement focuses on entities that do not have adequate own resources and engage third party providers of administration, management, correspondence and legal compliance services, or enter into relevant agreements with associated enterprises for the supply of such services. However, only outsourcing certain ancillary services such as bookkeeping services whilst keeping the core activities with the entity is not sufficient to meet this condition, as a result of which the entity should thus not be in-scope of the rules.

Exemptions from qualifying as an in-scope entity apply to amongst others to entities falling in the below categories:

- Entities that have a transferable security admitted to trading or listed on a regulated market or multilateral trading facility;
- Regulated financial undertakings;
- Holding entities whose main activity is holding shares in operational businesses in the same Member State as where the UBOs reside;
- Holding entities that are resident for tax purposes in the same Member State as the entity's shareholder(s) or the ultimate parent entity;
- Entities with at least 5 full-time employees who are exclusively carrying out the activities generating the Relevant Income.

Substance Indicators and supporting evidence

Entities that cumulatively satisfy the three requirements and do not qualify under any of the exemptions mentioned above are "in-scope entities". They should report in their tax return whether they meet the following *cumulative* "**Substance Indicators**":

- It has own premises in the Member State, or premises for its exclusive use;
- It has at least one own and active bank account in the EU;
- One of the following indicators:
  - (i) One or more directors of the entity:
    - are resident for tax purposes in the Member State of the entity, or at no greater distance from that Member State insofar as such distance is compatible with the proper performance of their duties;
    - are qualified and authorized to take decisions in relation to the activities that generate relevant income for the entity or its assets;
    - actively and independently use this authorization referred to in point 2 on a regular basis;
    - are not employees of an non-associated entities and do not perform the function of director or equivalent of other non-associated entities;
  - (ii) the majority of the full-time equivalent employees of the entity are resident for tax purposes in the Member State of the entity, or at no greater distance from that Member State than necessary for the proper performance of their duties, and such employees are qualified to carry out the activities that generate relevant income for the entity.

The statements made on the Substance Indicators in the annual tax return need to be accompanied with supporting evidence, which should include:

- address and type of premises;
- amount of gross revenue and type thereof;
- amount of business expenses and type thereof;
- type of business activities performed to generate the relevant income;
- the number of directors, their qualifications, authorizations and place of residence for tax purposes or the number of full-time equivalent employees performing the business activities that generate the relevant income and their qualifications, their place of residence for tax purposes;
- outsourced business activities;
- bank account number, any mandates granted to access the bank account and to use or issue payment instructions and evidence of the account's activity.

<u>Presumption of minimum substance and Rebuttal Rule</u>

If an in-scope entity does not satisfy the cumulative the Substance Indicators, it is presumed not to have the required minimum substance and will in principle qualify as an abusive "shell entity". However, the in-scope entity may rebut this presumption of being an abusive shell entity by providing any additional supporting evidence of the business activities it performs to generate its income ("**Rebuttal Rule**"). This can be done by providing:

- documentation showing the commercial rationale behind the establishment of the entity;
- information on employee profiles, including experience, decision-making power in the overall organization, role and position in the
- organization chart, the type of their employment contract, their qualifications and duration of employment;
- concrete evidence that decision-making concerning the activity generating the

relevant income is taking place in the Member State of the entity.

In cases where it is clear that shell entities are not interposed for tax reasons, because the existence of the shell entity does not reduce the tax liability of its beneficial owner(s) or the group of which it forms part, then they may request to be exempted from the rules with their local tax authority. The exemption should be valid for one year but may be extended for an additional period of five years (i.e. six in total), if the facts and circumstances do not change.

Tax consequences for shell entities to be imposed by the EU shareholder(s) and EU source countries

In-scope entities that do not satisfy the cumulative Substance Indicators and fail the Rebuttal Rule are presumed to qualify as abusive shell entities, and will face the following consequences:

- *Denial of exemptions in the EU Member State of source*
  Tax treaty benefits and benefits derived from the Parent Subsidiary Directive or Interest and Royalty Directive should be denied by the EU source state.

- *Pick-up income at the level of the shareholders ("CFC")*
  If the shareholder(s) of the shell entity *and* the payer reside within the EU, the income paid by the EU payer to the shell entity must be included in the taxable base of the EU based shareholder(s), as if the income was earned directly (i.e. CFC like).

  If the shareholder(s) of the shell entity are resident of a Member State *whilst the entity paying the shell entity is not*, then the EU shareholder(s) of the shell entity should also tax the income as if it was earned directly.

  If *the shareholder(s) of shell entity* are not resident of a Member State, then the Member State of which the payer is resident should apply a withholding tax under its domestic laws on income paid to the shell entity.

- *Disregarding of real estate holding companies*
  Real estate held by a shell entity in another Member State should be taxed according to the national law of the Member State in which the real estate is located, as if the real estate was owned by the shareholder(s) of the shell entity directly.

  The Member State of the shareholder(s) of the shell entity that owns real estate company should tax the property in accordance with its national law as if the shareholder(s) owned it directly.

Tax consequences for shell entities to be imposed by the EU residence country

The Member State of residence of shell entities that do not satisfy the cumulative Substance Indicators should either (i) deny the issuance of a tax residency certificate or (ii) grant a tax residency certificate which prescribes that the shell entity is not entitled to any Directive or treaty benefit. The wording of this provision leads to believe that these consequences should apply irrespective of the Rebuttal Rule.

Exchange of information on shell entities and tax audits

Member States will automatically exchange information on all in-scope entities, being entities that satisfy the three cumulative requirements. The information exchange will thus cover in-scope entities that satisfy all Substance Indicators and shell entities that do not. The information exchanged contains tax ID information, countries likely affected and a summary of the evidence. It will also contain a certification by the local tax authority if a shell entity has successfully applied the Rebuttal Rule or if it is exempt because it does not reduce a tax liability, with the supporting documentation. Member States will be allowed to request another Member State's tax authority to conduct a tax audit, in case they suspect that the in-scope entity or shell entity does not meet its obligations, which must be conducted expeditiously.

Penalties

Member States should include rules on penalties applicable to infringements of the proposed rules. These penalties should be "effective, proportionate and dissuasive". The proposal provides that the penalties include a sanction of at least 5% of the entity's turnover in the relevant tax year in case of failing to report within the deadline or making a false declaration.

Notes Atlas

The proposed ADAD3 Directive is a serious crackdown on tax avoidance through shell entities. Albeit the aim and intent is clear, it leaves open quite a number of questions and does not excel in clarity. Although the rules are intended to not impact legitimate entities, we believe the current proposal goes beyond what is necessary (or desired given the many international landscape changing initiatives at play). In our view, exchange of information of in-scope entities that do not comply with the substance indicators or rebuttal rule, combined with (a) increased cooperation in resulting substance audits and (b) the adjusted declaration of residency should be sufficient for source countries to act on. Since the Danish cases, we already know that EU source countries have an obligation to combat abuse.

We expect that this overreach will mainly impact small and medium sized business, joint venture entities and collective investment funds which invest through EU holding companies. The rules put legit EU business that do not comply with the Substance Indicators in a position where they will have to be rebut against the classification as a shell entity. Even though the proposal attempts to objectify the Rebuttal Rule to a certain extent, it remains a rule that is subjective in nature and is likely to cause much uncertainty going forward, which may in turn result in challenging legal disputes and litigations.

We expect these rules should have less impact on large multinationals, especially for regional EU holding and financing entities, as it should often be easier for these to comply with the 5 relevant employee safe harbor. However, it should be noted that also for certain multinationals that have segregated their holding and financing functions in separate entities and that rely on services provided group entities in the same Member State, may be well advised to take action to safeguard these entities are not in-scope of these rules. Outsourcing these activities to group companies means that these entities would likely qualify as in-scope entities, which would mean that information on their substance will in any event be automatically exchanged. In-scope entities may still satisfy all Substance Indicators or even rely on the Rebuttal Rule (e.g. by arguing that it has significant operations elsewhere in the country), but qualifying as an in-scope entity in and of itself has a number of drawbacks that are preferably avoided, being: (i) automatic exchange of information, (ii) increased audit risk, (iii) increased risk of challenges,

and (iv) the risk of not receiving tax residency certificates or conditional ones that highlight that it is a low-substance entity.

Takeaway

We strongly recommend to review all EU entities that hold passive assets, in order to anticipate on the implementation of the ATAD3 Directive.

Let's Talk!

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