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

On 22 December the European Commission published a proposal for a Directive to prevent the misuse 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 substance are unable to benefit from certain tax advantages.

Although shell or letterbox entities can serve useful commercial and business functions, they may also be used by international groups and individuals for tax planning or tax evasion purposes. With the objective to discourage the use of shell entities, the European Commission ("EC") has published a proposal for a new Directive to ensure that EU- based shell entities that have no or minimal substance are in principle deprived from certain EU and broader tax benefits. However, in-scope entities can provide counter evidence in cases of assumed misuse.

If the EC has its way, this 'ATAD 3' Directive (the "Directive") should be adopted early 2022, transposed into domestic law ultimately by 30 June 2023, and be effective in all Member States from 1 January 2024.

Background

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, which 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, 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 entities that do not meet all substance indicators will still have the possibility to rebut the presumption of being a misused shell entity.

Exemptions from these rules will apply to entities with certain profiles, such as regulated investment funds and entities with at least five FTE equivalent relevant employees carrying out

the activities that generate the relevant, passive income.

Under the proposed Directive, misused shell entities should not be allowed to benefit from 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.

The Proposal

In this section we will describe in more detail which entities will be in scope, which substance requirements the in-scope entities should satisfy, and the potential consequences of not meeting these substance requirements.

In-scope entities

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

(1) More than 75% of their revenue from the previous two tax years is "**Relevant Income**", which is defined as: 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. Entities which 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;

(2) 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 is comprised of real estate that is located outside the residence state or Qualifying Movable Property with a book value exceeding EUR 1 million; and

(3) 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 within the entity is not sufficient to meet this condition, and therefore the entity should not be in-scope of the rules.

Entities falling under the following categories are excluded from the scope of the Directive:

- Entities that have a transferable security admitted to trading or listed on a regulated market or multilateral trading facility;
- Regulated financial undertakings;
- Holding entities which 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 aforementioned three requirements and do not qualify under any of the exemptions mentioned above are "in-scope entities". Each in-scope entity should report in its tax return whether it meets the following *cumulative* "**Substance Indicators**":

- It has own premises in the Member State, or has such premises for its exclusive use;
- It has at least one own and active bank account in the EU; and
- 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 substantial 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 a non-associated entity and do not perform the function of a director or equivalent role of other non-associated entities; or

  (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 and their place of residence for tax purposes;
- outsourced business activities; and
- 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.

Presumption of minimum substance and Rebuttal Rule

If an in-scope entity does not satisfy the cumulative Substance Indicators, it is presumed not to have the required minimum substance and will in principle qualify as a misused "shell entity". However, the in-scope entity may rebut this presumption of being such 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; and/or
» 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 obligations under the (proposed) Directive. 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 factual and legal circumstances, including of the 'beneficial owner(s)', do not change. This reference is potentially, maybe even intentionally, ambiguous. 'Beneficial ownership' is, after all, a loaded term in European tax law. In this Directive it refers to the concept as defined in the money laundering directive, but not as referred to in the 'Danish cases' (CJEU joined cases C-116/16 and C-117/16, and joined cases C-115/16, C-118/16, C-119/16 and C-299/16).

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 EU residents *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 the 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 domestic 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.

We notice that these tax consequences would apply for all shareholders of the entity, regardless of whether they are natural persons or other entities. The scope of this ATAD 3 Directive therefore exceeds the scope of ATAD 1 and 2. But this also leads to fundamental questions, where even the EU founding principles and freedoms come to mind. And the question whether or not such transparency – even in the absence of abuse – is in line with primary EU law. Finally, this approach may lead

to situations where *bona fide* natural persons are confronted with tax claims due to transparent taxation of passive income of 'misused' entities over which they have no or only limited control. In other words, it is possible that such shareholders are confronted with substantial tax claims, but they may not be able to upstream the necessary funds to pay those taxes. This, again, even in the absence of tax abuse at both the level of the acclaimed shell company and the shareholder himself.

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 residence certificate or (ii) grant a tax residence certificate which prescribes that the shell entity is not entitled to any Directive or treaty benefit. That the EU intrudes into the tax treaties concluded between Member States and third countries, appears to be a very – too? – liberal approach to what the EU is actually allowed to do under its own founding treaties. We hope that this aspect will be further debated and assessed thoroughly before this proposal enters into effect.

Exchange of information on shell entities and tax audits

Member States will have to automatically exchange information on all in-scope entities (i.e. 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 should include tax ID information, countries likely affected and a summary of the evidence. It should also contain a certification by the local tax authority in the event that the shell entity applies the Rebuttal Rule or an exemption, including 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. One may wonder whether such penalty should be linked to an entity's turnover, instead of e.g. its income. And whether there is a justifiable difference in treatment between a high turnover – low margin / low profit entity compared to a lower turnover – high margin / high profit entity. If the in-scope shell entities are considered to be misused for income tax purposes, determining the penalty merely on turnover appears peculiar.

WTS Global Comment

The proposed ATAD 3 Directive is a serious crackdown on tax avoidance and evasion through shell entities. Although the aim and intent is clear, it leaves open quite a number of questions. Although the rules are not intended to impact legitimate entities, we believe that the current proposal goes beyond what is necessary (or desired) given the many other initiatives that are currently changing the international tax landscape.

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.

We expect that this overreach will mainly impact small and medium sized businesses, joint venture entities and collective investment funds which invest through EU holding companies. The rules put bona fide EU entities that do not comply with the Substance Indicators in a position where they will have to rebut the presumption. 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 to 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 relevant employees safe harbor. However, it should also be noted that, for certain multinationals that have segregated their holding and financing functions in separate entities and that rely on services provided by group entities in the same Member State, they may be well advised to take action to make sure that these entities are not in-scope of the new rules. Outsourcing these activities to group companies means that such entities may qualify as in-scope entities, which would mean that information on their substance will be in any event automatically exchanged.

In-scope entities may still satisfy all Substance Indicators or even rely on the Rebuttal Rule, but qualifying as an in-scope entity in and of itself has a number of drawbacks that should preferably be avoided, inter alia: (i) automatic exchange of information, (ii) increased audit risk, (iii) increased risk of challenges, and (iv) the risk of not receiving tax residence certificates or conditional ones that highlight that it is a low-substance entity.

In addition, it is important to note that, shell entities not resident in the EU should not get too comfortable, as the European Commission has already announced another Directive to be published in 2022 to respond to the challenges linked to non-EU shell entities.

Takeaway

We strongly recommend to review all EU (and non-EU) entities that hold passive assets, in order to anticipate on the implementation of the ATAD3 Directive and any other prospective initiatives by the European Commission targeted at shell entities.

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