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GREAT FUND INSIGHTS

ATAD 3, a new proposal to target the misuse of shell entities in the EU

Speedread

As previously announced, in the context of its ongoing fight against tax evasion and despite the as yet unknown impact of ATAD 1 and ATAD 2 on the EU market, on 22 December 2021 the European Commission published a proposed Directive targeting aggressive tax planning techniques linked to the use of shell companies; the proposed directive is being referred to as "Unshell" or ATAD 3 (the Proposed Directive).

The Proposed Directive introduces reporting obligations for entities having mainly passive income and outsourcing certain operations and functions, establishes minimum substance requirements for these entities, and imposes sanctions, in particular the denial of tax benefits under tax treaties and EU Tax Directives, on entities not meeting these requirements. Regulated or supervised investment funds as well as listed entities will however not be subject to these requirements. The terms of the Proposed Directive require implementation into domestic law by 30 June 2023 and application from 1 January 2024. The reporting obligations will be assessed based on the operational set up of the entity during the two years preceding the year of reporting. Hence, it will be crucial for market participants to evaluate the potential impact of the Proposed Directive based on their current operational set up and make adjustments if required to align their operations with their investment and holding structures ahead of application.

Investment platforms used by asset managers relying on outsourcing arrangements and not having qualified and independent decision makers on the ground might in particular be impacted by the Proposed Directive.

Which entities are subject to the reporting obligations?

As currently drafted, only entities which are tax resident in an EU Member State are within scope of the Proposed Directive (meaning that non-EU tax resident entities will not be subject to the rules, at least for the time being, but see further comments below).

Further, the Proposed Directive will only apply to the EU-resident entities that pass through three so-called "gateways". The gateways seek to identify the kind of entities which are usually considered as being at risk (that is, used for abusive or aggressive tax planning). Specifically, an entity that passes through each of the following three gateways will be subject to the reporting requirements:

- more than 75% of the entity's income over the two preceding tax years constitutes passive income. For this purpose, passive income includes income deriving from typical passive investments, such as interest, royalties and dividends, but also income from financial assets (including cryptoassets), insurance, banking and financial activities, real estate and movable property having a book value over EUR1 million. This income requirement is deemed to be fulfilled if the book value of certain assets (shares, real estate or movable property with a book value over EUR1m) exceeds 75% of the entity's balance sheet;
- the entity engages mainly in cross-border activities (further defined as 60% based on the book value of certain assets or of the income deriving from cross-border transactions); and
- the entity has outsourced its day-to-day administration and decision-making relating to significant functions in the two preceding tax years.

Where the entity passes through each of these gateways, it will in principle be subject to the reporting rules specified in the Proposed Directive.

However, a non-negligible number of vehicles, which are not viewed as entities used for aggressive tax purposes, are not subject to the reporting obligations. Specifically, excluded entities include:

- listed entities, this exemption applies to entities with any kind of transferable securities listed on an MTF or regulated market (including bonds);
- vehicles regulated in accordance with EU directives and regulations, such as AIF managed by an AIFM or supervised under national law, AIFM, UCITS and their management companies, investment firms, pension institutions (please note, however, that holding companies held by otherwise exempted regulated institutions are not themselves automatically exempt);
- holding entities held (directly – or indirectly, under certain conditions) by shareholders or an ultimate parent company located in the same country;
- entities with at least five own full-time employees in charge of managing the activities generating the passive income.

What are the minimum substance requirements and reporting obligations?

Where an entity is subject to the reporting obligations it will be required to specify whether it meets each of the following three minimum substance requirements in its annual tax return, namely having:

- its own premises – or premises for its exclusive use – in the relevant Member State;
- one bank account in the EU; and
- its own appropriate qualified resident managers/directors or employees. It is worth noting that in this respect one manager/director should be able to take decisions independently and cannot have the same functions at the level of other unrelated companies.

Various supporting documents, information and other evidence regarding the substance should be provided with the tax return as required.

What are the consequences of not meeting the minimum substance requirements?

If the entity meets the minimum substance requirements and includes the necessary evidence with its tax return, there will be no further consequences.

However, if an entity fails to meet at least one of these substance requirements (or fails to provide sufficient supporting evidence) it will be presumed to be a "shell" company. This is, however, a rebuttable presumption. An entity may provide additional evidence, by for example demonstrating commercial and non-tax reasons for establishing in a Member State, and therefore argue that it should not be considered a "shell" company. If an entity proves that it has performed and continuously had control over, and has borne the risks of, the business activities that generated the income (or assets), the Member State is entitled to regard the entity as having rebutted the presumption for a six-year period, provided the relevant facts and regulations remain unchanged.

What are the consequences and sanctions for shell companies?

The Proposed Directive provides tax sanctions and penalties in case of non-compliance with the minimal substance requirements or new reporting obligations.

The most significant consequence of an entity failing to demonstrate any of the minimal substance indicators (and therefore being treated as a "shell") is that it will be denied the right to a certificate of residence in the relevant Member State (which may also issue a certificate with a warning to prevent double tax relief) and denied the tax benefits of EU tax directives and tax treaties by other Member States involved. Instead, taxing rights will be ascribed to the shareholders of the shell company. This will have consequences for both a payor making payments to the entity and for the shareholder of the entity.

For example, where the shareholder of the shell company is located outside the EU, the Member State of the payor would apply its domestic tax law and withholding tax ignoring the shell entity, but any agreement or tax treaty entered into between the Member State of the payor and the country of the shareholder may still apply.

In addition, the Proposed Directive provides for penalties (including an administrative fine of at least 5% of the turnover of the non-compliant entity) to be implemented by Member States where the entity does not comply with the substance reporting requirements or the information provided is incorrect.

Communication between Member States

Specific and detailed information regarding the minimum substance elements of the taxpayer entity will be subject to the automatic exchange of information applicable between the tax authorities of the Member States under the Directive on administrative cooperation (DAC). Such mandatory automatic exchange of information should be exchanged by the relevant tax authorities within 30 days.

In case of doubt regarding the substance aspects, a tax audit may also be requested by foreign tax authorities to the tax authorities of the entity's country of residence.

Additional information (for example, relating to the number of entities in scope or exempt from the reporting, substance elements, penalties) should also be communicated by Member States to the European Commission.

What's next?

Rather optimistically, the European Commission has drafted the Proposed Directive on the basis of a transposition deadline of 30 June 2023 and an application date of 1 January 2024. However, the Proposed Directive requires unanimity for adoption, after consultation of the European Parliament.

It is not yet clear whether an agreement on the Proposed Directive, in its current form, will be reached easily between the Member States. Finally, it is worth noting that the European Commission intends to publish a further initiative covering non-EU shell entities in the course of 2022.

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