ATAD III: Between fair objectives and uncertain outcome

How the unshell directive will impact your day-to-day operations and investment strategy?

In this issue

In brief

On 22 December 2021, the European Commission released its proposal for a directive setting the rules to prevent the misuse of shell undertakings for tax purposes (ATAD III or unshell or **Proposal**) amending Directive 2011/16/EU on administrative cooperation in the field of taxation.

ATAD III introduces a substance test and reporting requirements for EU tax-resident undertakings in order to allow member states to assess undertakings that do not have a real and substantial presence and economic activity and are hence considered as misused for the purpose of obtaining tax advantages. When an entity is considered a shell, double tax treaties and EU directives benefits will be denied. The Proposal also foresees penalties for reporting failure.

ATAD III is subject to negotiation among all 27 member states and requires unanimous agreement for adoption. If it is finally adopted by July 2023, the new provisions are expected to take effect from 1 January 2024. However, under the current version of the Proposal, the criteria (so-called gateways) for determining whether an entity is subject to the reporting obligations must be assessed with reference to the two preceding years. Therefore, if the current version of the Proposal is approved 1 January 2022 may already be a reference point.

It is worth noting that in a press release the EU Commission announced that it will present in the course of 2022 a similar initiative to respond to the challenges linked to non-EU shell entities.

Key takeaways

- **Gateways**: The gateways will help to determine in the first stage whether an entity is at risk. This preliminary assessment is based on the following three cumulative criteria. These criteria are assessed by reference to the two years preceding the entry into force of the directive: i) percentage of passive income; ii) size of cross-border activities; and iii) type of functions outsourced. If the entity is found to be at risk, information on substance will have to be reported and exchanged.
- **Substance test**: Information on minimum substance, with relevant documentary evidence, including information on the entity's premises, bank account, management and employees should be provided to the Luxembourg tax authorities to assess whether the Luxembourg entity is a shell.
- **Reporting**: The reporting of the substance information is performed through the taxpayer's Luxembourg tax returns.
- **Exchange of information**: The information will be automatically exchanged among all EU member states. The EU member states will have access to information on the newly assessed EU shell at any time and without the need for recourse to request the information.
- **Carve-outs**: The following entities are excluded from the scope of the unshell directive: listed undertakings, regulated financial undertakings (e.g., banks, insurances, reinsurances, UCITs, AIFMs and AIFs managed by AIFMs), and undertakings that employ five full-time employees.
- **Rebuttal of the presumption**: When an entity is presumed to be a shell entity further to the substance test, the shell entity could still rebut the assumption by either bringing additional evidence of the commercial rationale of its activities or producing evidence of the absence of tax benefits.

- **Tax consequences**: When an entity is considered a shell, tax treaties and EU directives benefits may be denied.

In more detail

Under the Proposal, a step-by-step approach will allow to determine of whether an entity will be subject to the reporting requirements and to the related exchange of information.

Attention needs to be drawn to the exclusions. For instance, a regulated investment fund (e.g., AIF managed by an AIFM) will benefit from the carve-out. However, under the current version of the Proposal, undertakings under the carved-out investment fund remain in scope and their status will have to be carefully monitored.

Below, we walk you through the seven steps of the shell assessment process.

Step 1: Are you in scope, are you "at risk"?

Under Step 1 a first distinction is made between "low risk" and "at risk" undertakings.

Low risk undertakings are those that: (i) do not pass the gateways; and (ii) perform activities specifically carved-out.

Carve-out notably includes (i) regulated financial undertakings (AIFMs, UCITS and AIFs); (ii) listed undertakings on a regulated market; (iii) undertakings with at least five full-time employees carrying out the activities that generate the relevant income; and (iv) withholding activities of a group of companies that are resident for tax purposes in the same member state as the undertaking's shareholders.

Undertakings that fall within the scope of any carve-outs do not need to consider whether they cross any gateways.

ATAD III will apply to any EU tax-resident undertaking engaged in an economic activity regardless of its legal form or any minimum threshold and if it meets all of the following three cumulative criteria:

1. **Holding type of income or "relevant income"**: More than 75% of the revenue of the entity during the preceding two years is passive income (i.e., dividend, interest, real estate income, royalties, etc.); or more than 75% of the total book value of the entity's assets is: (i) real estate assets; or (ii) shares with a book value of more than EUR 1 million.
2. **Cross-border activities**: More than 60% of the book value of the assets is located outside the entity's member state in the preceding two years; or more than 60% of the entity's relevant income is generated or paid out through cross-border transactions.
3. **Outsourced management**: During the preceding two years, the entity has outsourced the administration of day-to-day operations and decision-making on significant functions. This latter notion might be clarified and tailored to the activity of the undertaking.

The **Explanatory Memorandum** states that the provisions of the Proposal are voluntarily broad to also capture legal arrangements such as partnerships that are deemed to be residents for tax purposes in a member state. However, clarification is needed as there may be confusion with domestic legislation as, for instance, in Luxembourg where partnerships are not always considered as resident for tax purposes.

If an entity **meets all of the three above criteria**, the entity will be considered to be "at risk" and will have to report information in its annual tax return.

Step 2: Reporting obligation

An entity identified as "at risk" further to the gateways test is subject to reporting obligation in its annual tax return.

Reporting on substance means providing specific information of minimum substance, with relevant documentary evidence, including the following:

1. Whether the premises are available for the exclusive use of the undertaking;
2. Whether it has at least one own and active EU bank account;
3. Whether it passes one of the following indicators:
   - At least one director is close to the entity, dedicated to its activities, authorized to take decisions, actively and independently using such authorization, and does not perform the function of director of other enterprises that are not associated enterprises.
   - A sufficient number of the entity's employees who are engaged in its core income-generating activities are residents close to the entity. The EU Commission has not considered in its Proposal the case of home-working as a result of the COVID-19 pandemic, although it will certainly become permanent in some industries.

The Proposal leaves it to member states to introduce penalties. However, The directive suggests a penalty of at least 5% of the entity's turnover for incorrect reporting or failure to report.

Step 3: Presumption of minimum substance

The Luxembourg tax authorities will assess the assessed information. The outcome of such assessment will be either of the following:

- The entity complies with minimum substance and therefore the minimum level of substance is valid for one year.
- The report reveals a lack of at least one indicator or in the absence of satisfactory supporting documentary evidence, the entity will be presumed to be a shell.

It is noteworthy to mention that where the substance test is met in accordance with the provisions of the Proposal, the undertaking may still be considered as a shell under other domestic rules, taking into account the documentary evidence produced and/or additional elements.

Step 4: Rebuttal of the presumption of a shell undertaking

When an undertaking is presumed to be a shell, the taxpayer has two possible ways to rebut the presumption, by producing:

- Additional concrete evidence that it is not a shell, such as by evidencing that the entity conducts a genuine economic activity and has sufficient nexus with the member state it claims to be a tax resident;
- Evidence of the absence of tax benefit in comparing the tax liability of the structure in the group to which it belongs, with and without the interposition of the presumed shell.

The Proposal underlines the importance of transfer pricing documentation that prove that the undertaking has performed and continuously had control over, and has borne the risks of, the business activities that generated the relevant income or assets.

The information provided by the undertaking to rebut the presumption will have to be assessed and certified by the Luxembourg tax authorities. It will be possible to extend the validity of the rebuttal within five years after the relevant tax year.

Step 5: Exemptions for lack of tax motives

Undertakings that cross the gateways under step 1 and that do not meet the minimum substance requirements in step 2 may claim exemption from the scope of the directive, on the grounds that they are used for genuine business activities without creating tax benefits for the group of companies of which they are part or for the ultimate beneficial owner(s).

For this purpose, the entity would be required to provide evidence allowing the tax authority to compare the tax lability of the overall group or of the beneficial owner(s), with and without its interposition.

As in step 3, if the tax authority is satisfied that a tax benefit is not created, it should be able to certify that the undertaking is not at risk of being deemed a "shell" for a tax year, and the exemption can be extended for five additional years.

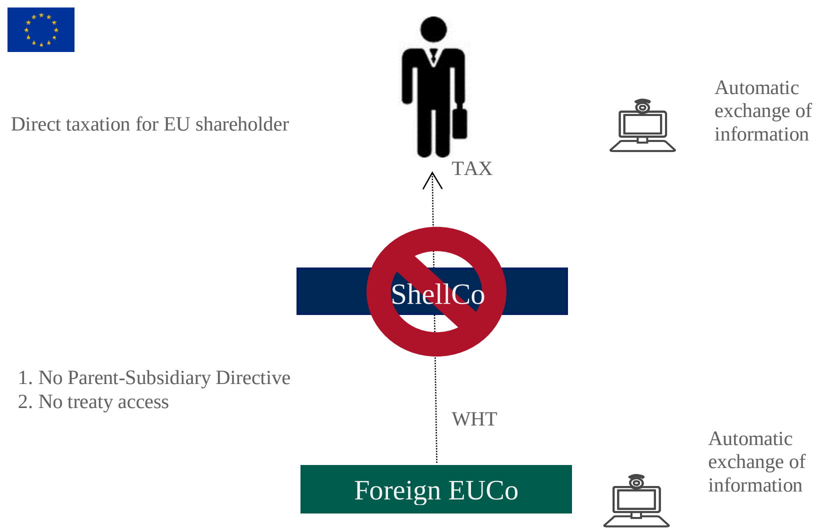
Step 6: Tax consequences

Failure to rebut the presumption will lead to a number of tax consequences:

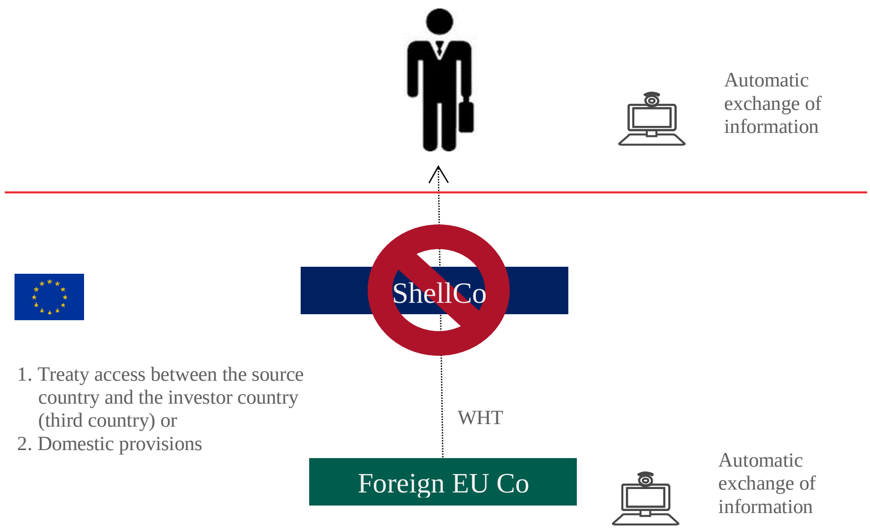
- The member state of residence of the shell company should deny the granting of a tax residency certificate or only a certificate with "shell" indication.
- The member state of the shareholders shall tax the relevant income of the undertaking in accordance with its national law as if it had directly accrued.
- The member state that is the source income state shall disregard any agreements and conventions under the relevant tax treaties and tax directives (e.g., the Parent-Subsidiary Directive and the Interest and Royalties Directive).

The member state of the shell remain free to continue to consider the shell as resident for tax purposes and to apply the tax according to its domestic law.

Example 1 - EU resident - EU shell - EU investment



Example 2 – Third country – EU shell – EU investment



Step 7 – Exchange of information

This Proposal will amend Directive 2011/16/EU on administrative cooperation in the field of taxation. Accordingly, information on the undertakings' substance will be automatically exchanged, meaning that all member states will have access to information on EU shells, at any time and without a need for recourse to request the information.

The exchange should be done within 30 days from receiving tax returns or within 30 days from when the tax authorities issue a decision to certify that an undertaking rebutted a presumption or should be exempt. The information will be exchanged through an existing secure Central Directory used notably for other administrative cooperation obligations (i.e., DAC).

Member states may also request the member state of the undertaking to perform tax audits to ensure it has minimal substance as required under the new provisions. The member state that is the recipient of the request will have an obligation to respond and carry out the tax audit. The anticipated increase in the number of tax audits may have a direct impact on the tax administrations, especially in terms of resources to absorb the requests.

Final remarks

The Proposal has been prepared in the very special context of the COVID-19 health crisis and the tax evasion scandals revealed in the press (i.e., Open Lux, Lux Letters, and Pandora Papers), EU member states were eager to increase their revenue and to that end strengthen their strategy in the field of tax transparency.

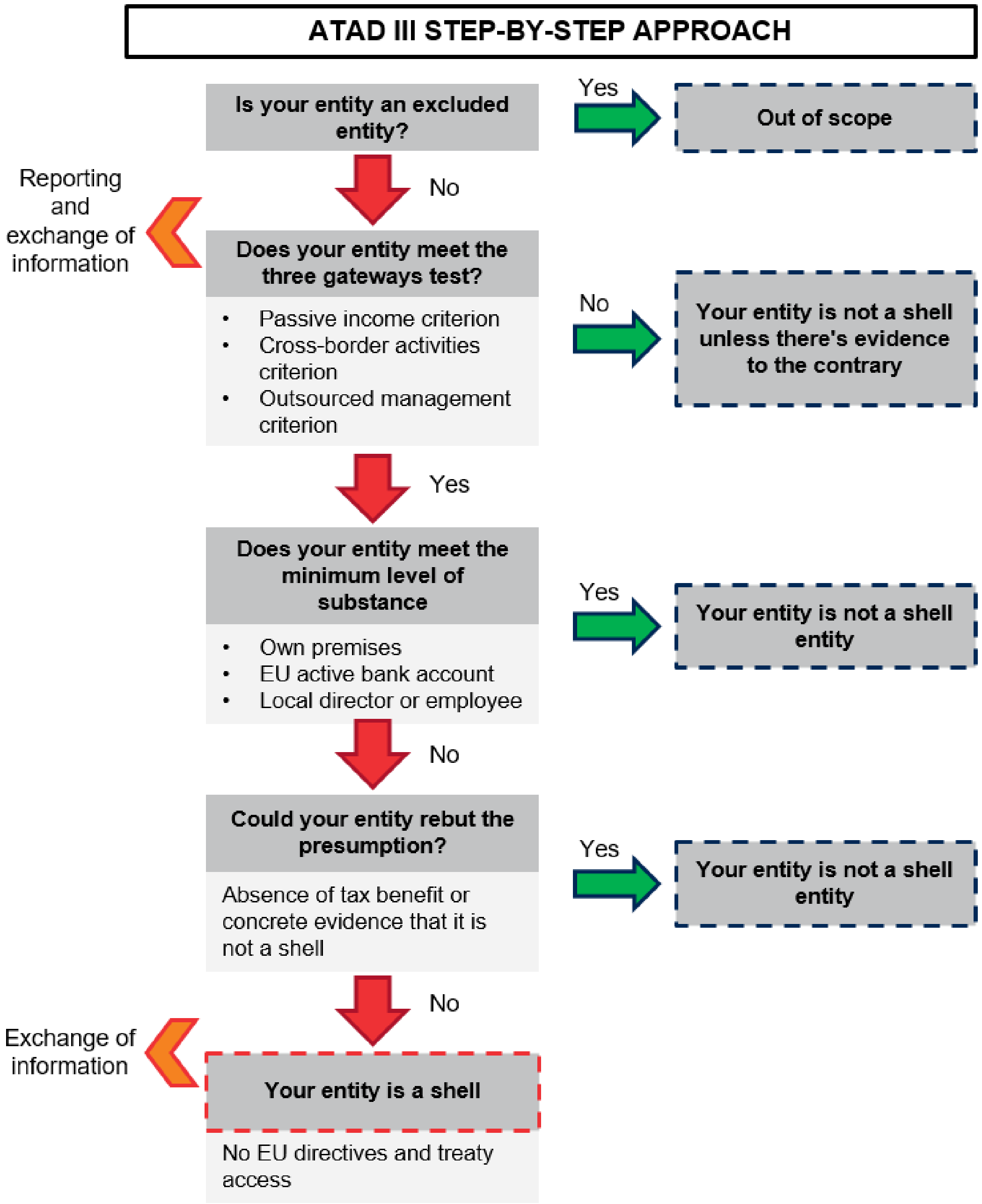
After an important number of directives already applicable in that area (e.g., Anti-Tax Avoidance Directives I and II, the Directives on automatic exchange of information from 1 to 8), the EU has added another layer of obligations for taxpayers and tax administrations without being certain of the need and efficiency of such measures.

The directive will require unanimity of member states, and there is little doubts that amendments (potentially significant) to the Proposal will be brought, considering that the current wording is also likely to affect genuine businesses(which were not supposed to be impacted by the new provisions according to the intention of the EU). Consequently, the final version of the directive may differ from the current Proposal under review.

While the directive is still in the proposal phase and potential changes are expected, in-scope undertakings should already consider the potential implications of ATAD III.

According to the EU Commission, a similar initiative will be launched later in 2022 to respond to non EU shell entities

For further information and to discuss what this development might mean for you, please get in touch with your usual Baker McKenzie contact.


ATAD III STEP-BY-STEP APPROACH
Is your entity an excluded entity?
Yes
Out of scope
No
Reporting and exchange of information
Does your entity meet the three gateways test?
• Passive income criterion
• Cross-border activities criterion
• Outsourced management criterion
No
Your entity is not a shell unless there's evidence to the contrary
Yes
Does your entity meet the minimum level of substance
• Own premises
• EU active bank account
• Local director or employee
Yes
Your entity is not a shell entity
No
Could your entity rebut the presumption?
Absence of tax benefit or concrete evidence that it is not a shell
Yes
Your entity is not a shell entity
No
Exchange of information
Your entity is a shell
No EU directives and treaty access

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