INFORMATION SHEET No. 149

ATAD 3: New EU Directive to prevent misuse of shell entities

March 2023

Introduction

On 22 December 2021, the European Commission published a proposal for a Directive (ATAD_3) to target the misuse of shell companies for tax purposes. An amended draft was approved by the EU Parliament on 17 January 2023. EU Member States need to transpose the Directive into their national legislations by 30th June 2023, with its provisions coming into effect on 1st January 2024.

The Directive targets entities tax resident in the EU that are engaged in cross-border economic activities but have little or no economic substance. Such entities will run the risk of being classified as shell entities and, if classified as such, could face a number of tax consequences.

Summary

The Directive targets undertakings (regardless of legal form) that are tax resident and eligible to receive a tax residency certificate in any EU Member State, and are involved in cross-border activities. The basic premise is to introduce a uniform set of criteria (‘**gateways**’) for identification of entities that are engaged in such economic activities, but do not have minimum economic substance, and may thus be misused for tax purposes.

If an undertaking cumulatively meets all of the gateways (for which there is a 2-year lookback period), and if it does not fall within any of the **carve-out** categories provided for in the Directive, it will be considered to be ‘at-risk’ of being classified as a shell entity.

Entities at-risk shall need to report whether they cumulatively meet a series of **substance indicators**. Entities that do not cumulatively meet all of these indicators will be presumed not to have minimum economic substance and will in principle qualify as shell entities.

Such entities will have the opportunity to either **rebut this presumption** by providing additional supporting evidence of the business activities that they perform to generate their revenues, or to request for an **exemption**, on the grounds that their existence does not create a tax benefit.

Failing to either rebut the presumption or to obtain an exemption, such entities will be classified as shells and will face a number of **tax consequences**, including denial of access to the benefits of double tax treaties or EU Directives, increased transparency via automatic exchange of information, and possible tax audits. Moreover, **penalties** will apply for infringement of the proposed rules.

Details regarding the provisions of the Directive can be found in the **Appendix**.

IMPORTANT: LOOK-BACK PERIOD
The Directive provides for a look-back period of two years for verification of the gateway criteria (2022 and 2023, assuming that it comes into force as planned in January 2024). Therefore, undertakings operating legitimately right now could already be inadvertently coming within the scope of the Directive when/if it is implemented in 2024.

Reactions

Once adopted, the Directive is expected to have a major impact on corporate groups with international activities that make use of EU-established entities. Already, the draft Directive has been met with significant scepticism, as its provisions could potentially contradict the fundamental freedoms of the European Union (free movement of people and capital and freedom of establishment), and also due to the fact that in many ways it does not reflect economic realities (e.g. remote work).

Even though the Directive is primarily targeted towards the misuse of shell entities for tax purposes, it nevertheless goes beyond the improper tax use of shell entities. Vehicles such as companies, partnerships, trusts etc. with little substance are at risk to come within the scope of the Directive, even though the majority of them are set up for perfectly valid business and/or investment reasons.

Bearing in mind that a wide array of EU substance and anti-tax avoidance regulations are already in place (e.g. GAAR, CFC rules, hybrid mismatches, principal purpose test) and with several more being on the way, the ATAD 3 increases the already high complexity and compliance/ operation costs of doing business in or via Europe.

The case of Cyprus

Cyprus has traditionally been a preferred jurisdiction for the setup of, amongst others, holding companies, due to a combination of attractive factors, including its beneficial tax regime. Should the Directive be implemented in its current form, many of these Cypriot holding companies are likely to meet the gateway criteria (nature of income, cross-border transactions, outsourcing of daily operations and decision-making) and thus to be ‘at-risk’ of being considered shell entities.

Cypriot professional associations have been quick to react and to sound the alarm. In a letter addressed to the Cypriot authorities (House of Commons, Ministry of Finance, District Attorney) in January 2023, they point out that the Directive may be contradicting EU primary law, and they analyse the potential negative impact on the country, including loss of tax revenues, loss of attractiveness as an investment hub, and diversion of existing foreign investments away from Cyprus. In the letter, the professional associations proceed further to request that the Cypriot Government takes appropriate measures, in an effort to prevent implementation of the Directive as is. Noting that similar actions/ reactions have been observed in other EU jurisdictions as well.

How to prepare

Provided that the Directive comes into effect as planned (January 2024), and given the two-year look-back period, an entity’s status from January 2022 onwards would be relevant when determining whether it is within scope of the Directive. Therefore, international corporate groups involving holding entities would do well to start considering, sooner rather than later, whether they may fall within the scope of the Directive.

Since the Directive is still in draft form and potentially subject to amendments, it might not be advisable for the time being to take drastic steps such as restructuring or incorporating in a non-EU jurisdiction. Such actions could be costly and risky, and may prove unnecessary.

At this stage, actions that could be considered include:

- Changing the status of the entity in order not to cross the gateways, or
- Meeting the substance requirements of the Directive to the best possible extend, in an effort to avoid the 'shell entity' status (in any case, increasing local substance generally strengthens any international vehicle used), or
- Determining whether it is possible to rebut the 'shell entity' presumption or to request for an exemption.

Simply put, it is recommended to obtain a thorough understanding of the current proposed Directive, and to take actions in order to be in a good position to comply with the Directive if it goes ahead as it is, while also remaining flexible in the event the proposal changes. It goes without saying that any related developments should be closely monitored on a timely basis.

Appendix on the next page …

NOTES
The above is intended to provide a brief guide only. It is essential that appropriate professional advice is obtained. Totalserve Management Ltd will be glad to assist you in this respect. Please do not hesitate to contact us.

APPENDIX - Detailed provisions of ATAD 3

Scope and methodology
The Directive applies to undertakings, irrespective of legal form (including, for instance, partnerships and Trusts) that are tax resident and are eligible to receive a tax residency certificate in an EU Member State, and are involved in cross-border activities. The methodology proposed by the Directive is outlined as follows: 1. Identification of entities being at risk to be classified as shell companies ('gateway criteria') 2. Substance indicators 3. Carve-outs 4. Presumption of being classified as a shell entity for tax purposes 5. Rebuttal of presumption, or obtaining of exemption 6. Tax consequences of being classified as a shell entity 7. Exchange of information, tax audits, penalties

1. Gateway criteria
The Directive provides for three criteria, commonly referred to as 'gateways'. An entity cumulatively meeting all three of them will be 'at risk' of being considered a shell entity. Entities which do not meet any of the gateways or only meet some of them will be considered to be low-risk and thus will fall outside the scope of the Directive. The gateways are as follows: 1. More than 65% of the revenues accruing to the undertaking in the preceding two tax years is relevant income (see **NOTE 1**) 2. The undertaking is engaged in cross-border activities on any of the following grounds: • More than 55% of the book value of certain assets of the undertaking (immovable property, and movable property other than cash, shares or securities, held for private purposes and with a book value of more than €1 million) was located outside the Member State of the undertaking in the preceding two years • More than 55% of the undertaking's relevant income is earned or paid out via cross-border transactions 3. In the preceding two tax years, the undertaking outsourced the administration of day-to-day operations and the decision-making on significant functions to a third party (see **NOTE 2**) ***NOTE 1*** *The term '**relevant income**' shall mean income falling under any of the following:* • *interest or any other income generated from financial assets (including cryptos);* • *royalties or any other income generated from intellectual or intangible property or tradable permits;*

- *dividends and income from the disposal of shares;*
- *income from financial leasing;*
- *income from immovable property;*
- *income from movable property, other than cash, shares or securities, held for private purposes and with a book value of more than €1 million;*
- *income from insurance, banking and other financial activities;*
- *income from services which the undertaking has outsourced to other associated enterprises*

NOTE 2

*The proposal makes it clear that the **outsourcing** gateway focuses on undertakings that do not have adequate own resources and thus tend to engage third party providers of administration, management, correspondence and legal compliance services. The outsourcing of certain ancillary services only, such as bookkeeping services alone, whilst keeping the core activities within the undertaking, would not in itself suffice for the undertaking to meet this condition.*

2. Substance indicators

An undertaking cumulatively meeting all of the gateways (and thus considered 'at risk' of being a shell entity) will need to demonstrate, on an annual basis, that it has sufficient minimum substance in order to carry out the activities that it performs. This will be done via declaring information related to its substance (the so-called '**substance indicators'**) in its annual tax return.

The undertaking needs to declare that it has **cumulatively fulfilled all** of the substance indicators, otherwise it shall be presumed not to have minimum substance for the tax year in question.

The substance indicators are as follows:

- Use of own premises, or premises for its exclusive use, or premises shared with entities of the same group (the original draft Directive made reference to premises for exclusive use only; the revised draft also makes allowance for shared premises)
- Evidence of at least one own and active bank account or e-money account within the EU, through which the relevant income is received (the original draft Directive did not provide for the option of an e-money account; now provided in the revised draft).

- One of the following two criteria is met:

  (a) One or more directors of the company are:

    - tax resident in the Member State of the company, or reside no further away from that country that the distance involved would still allow for the proper performance of their duties
    - authorised to take decisions in relation to the activities generating the relevant income of the company, or in respect of the company's assets *(noting that the*

original draft Directive required that the directors be both 'authorised' as well as 'qualified'. The reference to 'qualified' has been deleted in the revised draft).

The original draft contained two additional conditions which have been removed in this revised draft; namely that one or more directors should: (a) exercise their authority actively and independently on a regular basis, and (b) should not hold any other employment or directorship positions, except in other affiliated companies within the group.

(b) The majority of the company's full-time employees have their habitual residence in the Member State of the company, or reside no further away from that country than a distance which would allow them to perform their duties adequately, and the said employees are qualified to carry the activities that generate relevant income for the company.

The above substance indicators will need to be supported by **documentary evidence** that will accompany the tax returns, and shall include the following information:

- 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, authorisations 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 tax residence;
- 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;
- an overview of the structure of the undertaking and associated enterprises and any significant outsourcing arrangements, including the rationale behind the structure, described in the context of a standardised format;
- a summary report of the documentary evidence submitted, containing (i) a brief description of the nature of the activities of the undertaking; (ii) the number of employees on a full-time equivalent basis; (iii) the amount of profit or loss before and after taxes.

3. Carve-outs

Entities that fall within any of the following categories are explicitly excluded from the scope of the Directive, and thus do not need to assess whether they meet the gateways:

- Companies listed on a regulated market;

- Regulated financial undertakings (e.g. alternative investment funds, banks, insurance companies pension funds, investment funds etc.);
- Undertakings having as main activity the holding of shares in operational businesses in the same Member State while their beneficial owners are also resident for tax purposes in the same Member State;
- Undertakings with holding activities that are resident for tax purposes in the same Member State as their shareholder(s) or ultimate parent entity

NOTE: The initial proposal provided for an additional carve-out category, specifically undertakings with at least five own full-time equivalent employees exclusively carrying out the activities generating the relevant income. This provision has been deleted in the amended version of the Directive.

4. Presumption of being classified as a shell entity for tax purposes

An undertaking classified as being 'at risk' of being considered a shell entity (Step 1), but that declares to meet all of the substance indicators (Step 2) and provides satisfactory supporting documentary evidence, shall be presumed to have minimum substance for the tax year in question.

On the other hand, if an undertaking is classified as a 'risk' case and declares **not** to meet one or more substance indicators, or does not provide satisfactory supporting documentary evidence, shall be presumed not to have minimum substance for the tax year in question, and shall thus be presumed to be a shell entity for purposes of the Directive.

5. Rebuttal of the presumption, or obtaining of exemption

An undertaking (e.g. a company) presumed to be a shell entity for purposes of the Directive shall nevertheless be given the opportunity to prove otherwise, i.e. to prove that its minimum substance is sufficient for the specific case, or that it is not misused for tax purposes.

This is very important, since the substance test is based on specific indicators, which may fail to capture the facts and circumstances of each individual case.

There are two options available, namely by rebutting the presumption of being a shell entity or by requesting an exemption on the grounds that the existence of the entity does not create a tax benefit.

Specifically:

a. Rebuttal of presumption

The undertaking provides to its tax authority supporting evidence that it has performed, has control over, and has borne the risk of the business activities that generate the relevant income (or, in the absence of relevant income, the undertaking's assets). This evidence consist of the following:

1. A document allowing to ascertain the business rationale behind the establishment of the undertaking in the Member State where the activity is performed;
2. Information about the full-time, part-time, and freelance employee profiles, namely the level of their experience, their decision-making power in the overall organisation, role and position in the organisation chart, the type of their employment contract, their qualifications and duration of employment, safeguarding high levels of data protection and privacy;
3. Concrete evidence that decision-making concerning the activity generating the relevant income is taking place in the Member State of the undertaking.

The undertaking is free to provide any additional information it sees fit, to further support its case for rebutting the presumption.

b. Exemption

The undertaking can request from its tax authority an exemption from the obligations of the Directive, on the grounds that its existence does not create a tax benefit. The undertaking needs to provide sufficient and objective evidence that its interposition does not create a tax benefit for its beneficial owner(s) or for the group as a whole, as the case may be. Such evidence shall include information about the group's structure and activities (including a list of the full-time employees) and should be sufficient to allow comparison of the tax liability of the beneficial owner(s) or of the group as a whole (as the case may be), with and without the interposition of the undertaking.

Time limit for consideration of requests

Once a request (either for rebuttal or for exemption) has been submitted, the tax authorities will have a period of nine months during which to consider the request. In the absence of a reply after the expiry of the nine-month period, the request shall be considered to be accepted.

Extension of validity

After the end of the tax year for which the undertaking has rebutted the presumption or has obtained an exemption, the tax authorities can extend the validity of the rebuttal/ exemption for another five years (i.e. a total of six years), provided that the factual and legal circumstances of the undertaking, the beneficial owner(s) and the group remain unchanged in the relevant period.

6. Tax consequences of being classified as a shell entity

If an undertaking qualifies as a shell entity, it shall face a number of consequences which in effect will aim to neutralise the shell entity's tax impact, i.e. disallowing any tax advantages that have been (or could be) obtained through the entity in accordance with double tax treaties and/ or EU Directives.

Specifically, the EU Member State of the shell entity shall deny any request for the issue of a tax residency certificate for use outside its jurisdiction. This will ensure that the shell entity shall not be eligible for the tax benefits of the network of double tax treaties of its Member State of residence, or for the application of relevant EU Directives.

Despite this, the shell entity will continue to be resident for tax purposes in the respective Member State and will have to continue fulfilling its relevant tax obligations.

In case where the shell entity's shareholders are tax resident in an EU Member State, then that Member State shall have the right to tax the relevant income of the shell entity in accordance with its national law, as if it had accrued directly to the shareholders (effectively adopting a 'look-through' approach).

Moreover, any relevant income of a shell entity which is sourced in an EU country will be subject to withholding tax (where applicable) in that country, disregarding any exemptions afforded by double tax treaties or EU Directives.

7. Exchange of information, tax audits, penalties

The Directive provides for automatic exchange of information on shell entities between the tax authorities of all Member States. The information to be exchanged shall include, among others, the entity's tax identification number, VAT number, its shareholder(s) and beneficial owner(s), as well as a summary of the substance indicators. The exchange of information shall take place within 30 days from receipt of the relevant information.

Even if an entity rebuts the shell entity presumption or obtains an exemption (Step 5), the tax authority of the relevant Member State shall still automatically exchange information, by communicating the relevant certification (either of the rebuttal or of the exemption) with the tax authorities of all other Member States, within 30 days from such certification.

In addition, the tax authority of a Member State shall be able to request another Member State to conduct an audit to a tax resident entity, if the former suspects that this entity lacks minimum substance.

Finally, Member States shall be free to lay down the rules on penalties for infringements of the Directive, but need to ensure that such penalties include an administrative pecuniary sanction of at least 2% of the entity's revenue in the relevant tax year if the entity does not comply with its reporting requirements, and at least 4% of its revenue if it makes a false declaration in its tax return.