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# ATAD 3: The Unshell Directive

## Where are we now and what are the next steps?

July 2023

The draft ATAD 3 Directive targeting the misuse of shell entities for tax purposes is now with the European Council for further consideration.

This proposal to introduce EU-wide minimum substance requirements has wide ranging tax consequences for entities deemed to be "shells", such as the loss of the benefit of double tax treaties and access to the EU Directives, allowing Member States to tax shareholders on a look-through basis.

Once a final text is negotiated, it will then require unanimous approval from all EU Member States before it can be adopted. Timing for the European Council vote is not yet known. Negotiations at the European Council continue, and compromise texts were circulated amongst the members earlier this year.

The proposal has faced some uncertainty on the likelihood of adoption, but, whilst its final form is not yet settled, there has been no public change to the proposed 1 January 2024 effective date. As the Directive has a two year look back period, it is imperative that groups with cross-border structures and payments, both intra-EU and between the EU and third countries, consider the impact of the proposals at an early stage. Progress is being closely monitored. The look-back period means that the facts and circumstances from 1 January 2022 are potentially relevant for determining the impact of ATAD 3.

We have brought together our thoughts on the amended Directive and the next steps from our EMEA real estate and infrastructure funds tax practice, and how this could impact such businesses.

## Where we are now?

A number of amendments proposed by the European Commission Committee on Monetary and Economic Affairs (ECON) were adopted by the European Parliament as part of the 17 January 2023 approval process.

When applying the Directive, all entities have to go through a number of tests to determine whether they are presumed to be a shell entity. Given the two-year look-back period for many of the tests, it is imperative that groups and asset managers consider the impact of the proposals, particularly in the context of the outsourced management and administration gateway.

The amendments adopted on 17 January affect both the scope of excluded entities and the gateway thresholds, in some cases lowering those thresholds and therefore bringing more entities potentially within the regime. The amendments also affect a number of administrative points around the operation of the exemptions and the consequences of failure to comply with the regime.

# ATAD 3: The key factors

## Territorial scope

Only entities resident in the EU are targeted.

## Excluded entities

As a starting point, a number of entities are excluded from the scope of ATAD 3. These include certain regulated entities such as UCITS, AIFS and AIFMs; entities with transferable securities listed on a regulated market and domestic holding companies (i.e. those holding shares in an operational entity resident in the same Member State as its shareholders). However, this exclusion does not apply on a group basis but instead is assessed on an entity-by-entity basis. Entities held directly/indirectly by a regulated entity, and which are not themselves regulated, are therefore potentially within scope of ATAD 3. (The carve-out for companies with at least five full time equivalent employees included in the initial draft has been removed under the ECON amendments.)

## There are then three cumulative gateways

Designed to identify entities engaged in cross-border activities which are geographically mobile and outsource their management and administration to third parties.

## Annual minimum substance declaration.

Where the gateways are met, the entity must declare, in its annual tax return, whether it meets the minimum substance indicators and must provide documentary evidence to support that declaration.

The minimum substance indicators are that the entity has:

- its own premises (or premises shared with group entities);
- its own active EU bank account or e-money account in the EU through which the relevant income is received;
- either, at least one director tax resident in the entity's Member State or living close enough to perform their duties who is authorised to take decisions in relation to the activities generating the relevant income and/or that most of its full-time employees are tax resident in the entity's Member State or live close enough to properly perform their duties and are qualified to carry out the income generating activity within that entity.

An entity that declares that it meets all the three indicators and provides the required satisfying supporting documentation is presumed to have minimum substance for the tax year.

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| Passive income | More than 65% (previously 75%) of the entity's revenue in the preceding two tax years consists of "relevant income" under ATAD 3. Relevant income is primarily looking at passive income such as interest, other income generated from financial assets (such as crypto assets), royalties and dividends, as well as income from financial leasing, immovable property and some movable property. This test is also met if more than 75% of the book value of the entity's assets consist of real estate (or other private property of high value) or if more than 75% of the book value of the undertaking consists of shares, even if the assets are not income generating. |
| Cross-border activities | More than 55% (previously 60%) of the entity's relevant income is earned or paid out via cross-border transactions. Alternatively, more than 55% (previously 60%) of the book value of its real estate (or other private property of high value) was located outside the jurisdiction of the entity in the preceding two tax years. |
| Outsourced management and administration | Day-to-day administration and decision-making on significant functions have been outsourced in the preceding two tax years. The proposal does not provide for any guidance how to determine day-to-day administration or significant functions. |

There is some scope for provision of additional supporting information in respect of its business rationale, employees and decision-making in order to allow an entity to rebut a presumption that it does not have minimum substance. A successful rebuttal can remain valid for up to five years from the time the decision is issued, assuming the facts and circumstances do not change.

### Exemption where the shell does not give rise to a tax benefit.

This is an important exemption which may be helpful to a number of investment structures designed, broadly, to achieve the same tax treatment for investors as if they were investing directly in the underlying assets. Where the minimum substance test is not met but the interposition of the shell entity does not lead to a tax benefit for the entity's beneficial owners or its group, the entity can apply for an exemption, initially for one year. This can be potentially extended for a further five-year period if circumstances of the entity, including of the beneficial owners and group do not change. It is not clear whether all or only a specific entity needs to be taken out of the picture to test the impact on the beneficial owner. Given that typical structures may include a number of layers with potential shell entities, a tax benefit may arise from the combination of entities (and their dealings) but not from an individual entity.

There is a new nine-month time limit for the Member State to respond; if they fail to respond in this time period the exemption is deemed to have been agreed. Analogies can be drawn between this exemption and other tests such as the "equivalent beneficiaries" concept under in double tax treaties which enables ultimate shareholders in an intermediate entity which does not meet the relevant substance requirements to access treaty benefits where those shareholders would have been entitled to benefits if they had held the shares directly. Another area in which a "look-through" approach is seen is the Netherlands exemption from dividend withholding tax where the tax position with and without imposition of an intermediate entity is compared and an exemption may be available where a direct holding would not give rise to a higher tax liability. Recent French case law has admitted the possibility of such look-through approach for double tax treaty benefits provided the taxpayer is able to justify the effective residency of the ultimate beneficial owner. In practice, such proof may however be difficult to provide.

The use of this exemption will most certainly lead to additional administrative costs for any investment fund with numerous non-domestic investors.

### Failure to comply

Tax audits and penalties. Entities deemed to be "shells" are denied the benefit of double tax treaties and the EU Directives. Despite the fact that the Directive does not aim to trigger double (or multiple) taxation, the provisions of the draft do not provide for a relief mechanism.

There are also penalties of at least 2% and 4% of the entity's annual revenue for, respectively, a failure to comply with the ATAD 3 substance reporting requirements or for making a false substance declaration.

## Commentary

ATAD 3 gained some momentum in early 2023 While there remain a number of moving parts, it does seem that we are edging closer towards its implementation although whether this is with effect from 1 January 2024 remains to be seen. The draft Directive is now with the European Council for further consideration, following which it would require unanimous approval from all EU Member States before it could be adopted. It seems likely that further changes will be made before it is adopted.

The Directive would then have to be transposed into domestic law – perhaps leading to a fragmented implementation, although we have seen Member States simply adopt the text of other directives largely unaltered in other contexts (such as DAC 6). In addition, local guidance may lead to differences of interpretation, perhaps in relation to the gateway tests and the question of whether an arrangement gives rise to a tax benefit.

If implemented, ATAD 3 is expected to increase compliance costs for investment funds which operate across the EU, or which have EU based entities within the wider structure.

At this stage, the UK has not indicated that it will adopt the ATAD 3 proposals; as such, entities within an investment fund structure which are based in the UK are not expected to be subject to ATAD 3.

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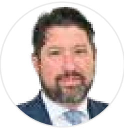

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