NovioTax ATAD3 – Who's In & Who's Out

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In this blog, we provide insight into which companies will be most affected by the implementation of the European Commission's (proposed) Directive – ATAD3 (or the Third Anti Tax Avoidance Directive). The amended draft of the ATAD3 proposal has been approved by the European Parliament and published by the European Commission ("EC") on 17 January 2023. The Member States aim to implement the proposed Directive w.e.f. 1 January 2024. However, some of the provisions of the ATAD3 proposal have a two-year look-back period (i.e., covering 2022 & 2023). For our take on preparing for ATAD3, reference is made to our blog *10 Quick Observations on the EC's ATAD3 Proposal.*

ATAD3 – Implementation & Consequences

In a nutshell, the objective of the proposed Directive is to prevent the misuse of "shell entities" within the European Union ("EU"). Once implemented by the EU Member States, ATAD3 will impose reporting obligations on EU entities that do not meet the "minimum substance requirements" stipulated in the proposed Directive. These entities will be required to provide evidence of actual economic activity (to the relevant tax authorities within the EU). Failing to do so will lead to (a.o.) denial of benefits provided for under double tax treaties and EU directives as well as denial of certificates of tax residence by the Member State where tax residency is claimed. An eventual consequence of this could be the re-allocation of income for taxation purposes, leading to litigation, Mutual Agreement Procedures, etc.

Another consequence of failing to meet the minimum substance requirements and failing to provide acceptable evidence of economic activity is that this information will be shared among all Member States. This will enable tax authorities in all Member States to identify entities within their jurisdictions related to the entities that lack substance and could potentially be used for tax avoidance. This may increase the likelihood of scrutiny and audits, even for entities that meet the ATAD3 substance requirements. This can substantially affect investment returns and may increase tax compliance work.

The ATAD3 timeline is already compelling EU companies to assess if they meet the "minimum substance requirements" of the proposed Directive. Though the proposed Directive is set to take effect on 1 January 2024, some of the minimum requirements laid down in the proposed Directive have a two-year look-back provision. Hence, it is advisable for EU entities to start examining whether they meet these requirements now. It is worth mentioning that the two-year look-back period/ provisions were not modified in the most recent draft of the Directive (i.e., the draft approved by the European Parliament and published by the European Commission on 17 January 2023).

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ATAD3 contains several sequential tests to identify "shell entities". These tests can be seen as what we like to call, "exit avenues". The way we see it, the first carve-out relates to (i) regulated financial undertakings (like AIFMs, UCITS and AIFs), (ii) undertakings listed on a regulated market and (iii) undertakings that have the main activity of holding shares in operational businesses in the same Member State while their beneficial owners are also resident for tax purposes in the same Member State. These entities are entirely excluded from the application of the Directive. This could apply, for instance, to regulated funds and publicly traded companies.

The second exit avenue is three "gateway tests" that determine whether an entity is at risk of being abused for tax purposes. Of the three gateway tests, the first deals with the percentage of income that is derived from passive sources (like dividends, interest and royalties). The second deals with the percentage of that (passive) income that is derived from abroad. The third and most important test deals with whether the administration and control of the entity is outsourced to a third-party. This will pose a problem for EU entities that outsource the administration of day-to-day operations and the decision-making process to unrelated entities, for instance, entities managed via proxy management companies. Entities that do not pass all three tests will be excluded from the scope and consequences of the Directive.

The third exit possibility requires entities that pass all three gateway tests to provide the relevant tax authorities evidence of actual economic activity. Evidence acceptable under this step of ATAD3 (or "minimum substance indicators" as they are called) are in the nature of owning or having exclusive access to premises, having at least one active bank account and employing sufficient (management and other) personnel. To us, this step resembles a ruling process as the evaluation of the evidence and determination of whether an entity possesses the "minimum substance indicators" is left up to the discretion of the relevant tax authorities.

Here, we would like to note that the international tax community has consistently steered away from the ruling practice in recent years (owing to the BEPs initiative, exchange of information mechanisms, etc). Therefore, we expect taxpayers as well as tax authorities to hesitate in implementing this step due to perception, uncertainty, timing and procedural challenges; taxpayers will likely jump directly to the last exit avenue (described few paragraphs below).

However, for taxpayers that do opt for the third exit possibility, the "minimum substance indicators" described above will be the central theme with respect to ATAD3. Since "minimum substance indicators" are only broadly defined and the evaluation of evidence submitted is left up to the discretion of tax authorities, there will always be some open ends. For instance, the definition of having an "active" bank account needs to be clarified. There are also some questions/concerns about whether independent directors (not employed by trust management companies) will qualify as acceptable evidence of sufficient human capital. In addition, it is unclear how directors who serve on the boards of various group companies will be treated w.r.t. the "minimum substance indicators". This could be relevant for trust-managed companies.

If the entities passing all three "gateway tests" fail to provide sufficient and acceptable evidence of economic activity in the step above, they will be assumed to be "shell entities". This brings us to the fourth exit route, which is the "rebuttal" route, involving rebutting the tax authorities' claim by providing additional evidence of conducting genuine economic activity and having sufficient nexus in the jurisdiction in question. In this step, entities can provide evidence in the form of documents, allowing the tax authorities to ascertain the business rationale behind the establishment of the entity, information and documentation relating to employees and their activities as well as concrete proof of the decision-making process being carried out from the particular jurisdiction. This step will likely be most critical for financial services companies.

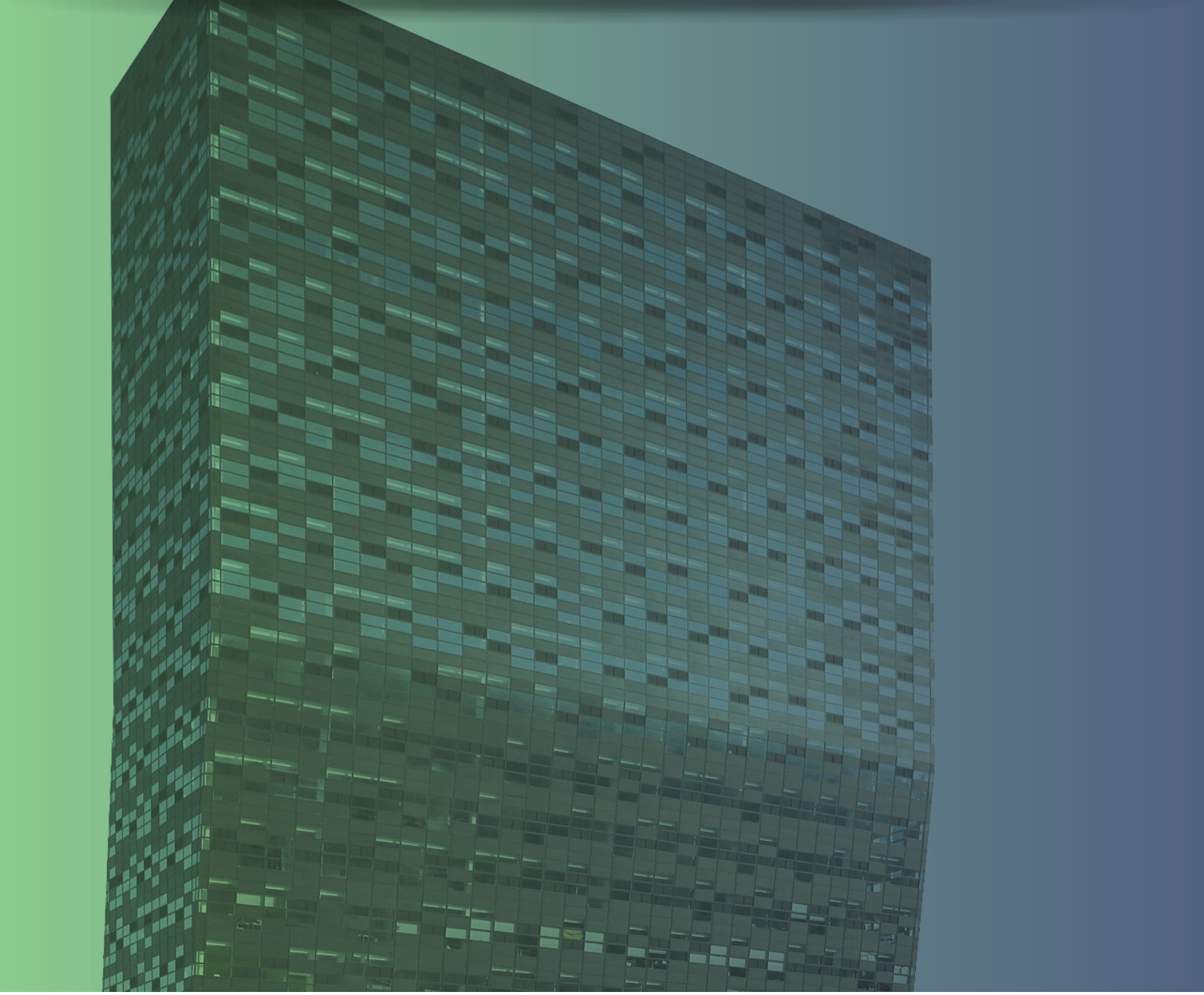
The fifth and last exit option available to companies that cannot (or do not wish to) provide evidence relating to economic activity, is to apply to the relevant tax authorities for an "exemption" from ATAD3 on grounds that they do not create tax benefits for the group of companies of which they are a part or for the ultimate beneficial owner(s). This would involve providing evidence allowing the relevant tax authorities to compare the tax liability of the overall group or of the beneficial owner(s), with and without the interposition of the company in question.

ATAD3 - Preparation

Companies should already be using the minimum substance requirements proposed under ATAD3 to vet their investment and holding structures to ensure compliance. Further, companies should be collecting proofs in real-time by putting in place a robust internal documentation system for their administrative and (especially their) decision-making process/ strategic function. This is relevant for the third gateway test of ATAD3, which deals with outsourcing of administrative and management functions. A gateway breach could lead to a long, drawn-out rebuttal process, potential audits and tax leakages. Therefore, it is necessary to conduct some scenario planning to anticipate and plan for the worst-case scenario.

Further, one of the consequences proposed by ATAD3 is the denial of tax residency certificate ("TRC") by the tax authorities in the Member State where the shell entity claims to be a resident. In effect, the implantation of ATAD3 will lead to a stricter approach towards granting TRCs because tax authorities in the EU will need to vet TRC-applicants against the ATAD3 "minimum substance requirements". This is expected to lead to an increase in the administrative burden associated with obtaining TRCs, along with longer time-frames for obtaining TRCs. The proposed Directive may lead to a permanent change in the procedure for obtaining TRCs in the EU.

Companies that are unable to obtain TRCs in the EU jurisdictions where they claim to be resident (i.e., "resident jurisdictions") will likely have trouble availing tax benefits granted under treaties/Directives in foreign jurisdictions where they derive income (i.e., "source jurisdictions"). This also applies to income derived from third countries (as in, countries outside the EU). Denial of TRCs by the resident jurisdiction in a particular year could also prompt the tax authorities in the source jurisdiction to look back on previous years when the benefits of the relevant tax treaty had been granted.



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