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10 Quick Observations on the EC's ATAD3 Proposal

May 2023

In this blog, we make 10 observations on how the European Commission's Third Anti Tax Avoidance Directive ("ATAD3") will affect businesses in Europe once implemented. The amended draft has been approved by the European Parliament and published by the European Commission ("EC") on 17 January 2023. The Directive is set to be implemented by the European Union ("EU") Member States on 1 January 2024. However, some of the provisions proposed in the Directive have a two-year look back period (i.e., covering 2022 & 2023). For a detailed explanation of the implementation, consequences and who's in/out of ATAD3, reference is made to our blog *ATAD3 – Who's In & Who's Out.*

1. Need for holistic approach

ATAD3 is part of a larger effort to combat the use of shell companies for tax avoidance. For example, the ECJ's decision in the Danish cases clarified the concept of beneficial ownership; the OECD's Multilateral Instrument, which contains (a.o.) a main purpose clause; and the EU's ATAD1, ATAD2 and DAC6 initiatives. These developments (a.o.) seek to limit the use of holding and investment companies for the purpose of tax avoidance.

ATAD3 goes a step further by focusing on taxpayers who use shell companies solely for tax purposes. So, when preparing for ATAD3, businesses should take a holistic approach, asking themselves questions like what are our operations, where are these operations controlled from, and what infrastructure is appropriate for these administrative and managerial control functions.

For instance, managing a holding/investment company entails managing its investments. This includes choosing what investments to make, when to buy and sell and how to diversify. It also entails monitoring asset performance and adjusting the investment strategy to meet the company's financial objectives. While it is logical that investment and holding companies require fewer employees than a manufacturing or R&D unit, it is pertinent for investment and holding companies to be able to prove that those (few) employees have the capacity and do actually manage the investments.

2. Risk from outsourcing administrative and management functions

The third "gateway test" of ATAD3, which relates to whether an entity has "outsourced the administration of day-to-day operations and the decision-making on significant functions to a third party" and scrutinizes the two previous tax years could already be a cause for concern for EU entities that enlist third-party administrative services as well as have trust-management or third-party ("skeleton") management. The text of the Directive (in its current form) leaves some ambiguity as to what level of outsourcing of functions/activities will cause a company to qualify for this gateway test. It is also unclear what qualifies as "third-party".

Further, while it is easier to document and provide proofs relating to administrative services, documenting and providing proofs related to managing a company is more difficult, complicated and contentious. Hence, EU entities (especially those that are on the fence about this gateway test) should already be meticulously documenting the day-to-day decision-making process, along with the strategic activities/controlling function.

3. Uncertainty stemming from open-ends

As previously mentioned, some of the ATAD3 provisions have a two-year look-back period. Therefore, if the Member States are able to implement the Directive on 1 January 2024, the years 2022 and 2023 will be under scrutiny (from a substance perspective under ATAD3). Since the "minimum substance indicators" that EU entities will be judged on under the Directive 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 and uncertainty.

The current draft of the Directive unfortunately leaves some room for ambiguity. For instance, the definition of having an "active" bank account needs to be clarified. It is also unclear how directors can divide their time between several group companies and/or how this will be viewed in light of the substance requirements. There are also some questions/concerns about whether having independent directors will qualify as acceptable evidence of sufficient human capital.

4. Uncertainty relating to discretion of tax authorities

The "rebuttal" and "exemption" routes out of ATAD3 (described in detail in the blog: ATAD3 – Who's In & Who's Out) require the taxpayer to submit evidence to the relevant tax authorities to prove that the taxpayer meets the minimum substance requirements of ATAD3 or that it was not set up for the group to obtaining a tax benefit. These exit options resemble, or at least seem to resemble, the tax ruling practice (which the international tax community has been moving away from) because it is up to the tax authorities to determine the fate of the taxpayer based on the evidence submitted (or lack thereof).

5. Expectation of stricter procedures for obtaining TRCs

The procedure for obtaining a Tax Residency Certificate ("TRC") is generally standardized across the Member States. However, the implementation of ATAD3 will (in effect) introduce a number of new requirements and thresholds that a company will have to meet in order to obtain a TRC in any Member State. Failure to meet these requirements will result in the company being denied a TRC.

This stricter approach towards granting TRCs is expected to lead to an increase in the administrative burden associated with obtaining TRCs, along with longer time-frames for obtaining TRCs. It may also lead to a permanent change in the procedure for obtaining TRCs in the EU. Hence, we expect to see an increase in applications for TRCs across the EU in advance of the implementation of ATAD3. This is especially true if dividends, interest and royalty payments are expected to be received from outside the EU in the near future.

6. Risk of higher withholding taxes in third-countries

Denial of Tax Residency Certificates (by the EU member state where the shell entity claims to be resident) is one of the consequences under ATAD3. TRCs are required by companies to prove their entitlement to tax treaties based on being a resident in a particular jurisdiction ("resident jurisdiction"). Therefore, companies that are unable to obtain TRCs will likely have trouble availing tax benefits granted under treaties in foreign jurisdictions where they derive income (i.e., "source jurisdictions").

For instance, if a Dutch company cannot obtain a TRC from the Dutch tax authorities, it will likely be hit with domestic Indian withholding tax ("WHT") on dividends received from its Indian subsidiary; the Indian tax authorities will likely insist on a valid TRC for granting the beneficial WHT rates prescribed in the India-Netherlands tax treaty (i.e., 5/10/15%).

Denial of a TRC 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 tax treaty had been granted (as far back as the domestic law allows – 5/7/10 years) to see if the TRC would have been granted if the ATAD3 "minimum substance requirements" already applied.

7. Impact within the EU

Along the same lines as the point above, TRCs are also required for availing of tax benefits granted under EU Directives (such as the Parent-Subsidiary Directive and the Interest & Royalties Directive). Therefore, the Dutch company that is unable to obtain a TRC could also be denied the benefits under the Interest and Royalties Directive relating to, for instance, interest/royalties received from its Italian/French/Spanish subsidiaries and/or trigger beneficiary ownership or residency discussions/scrutiny.

Also, under ATAD3, information regarding an EU entity identified as "shell entity" by the tax authorities in one Member State will be shared with the tax authorities in all Member States. This flagging of entities could tempt tax authorities to start looking closely at entities in their own jurisdiction that have dealings with or are related entities of the flagged entities. This could potentially result in increased scrutiny, tax audits and litigation throughout the EU.

8. Risk of income re-allocation

A consequence under ATAD3 is that the tax authorities will also be able to re-allocate income (from the shell entity to the shareholder(s) for tax purposes). Of course, this is also possible in the absence of ATAD3 (under CFC rules, etc.), but ATAD3 will shine a spotlight (so-to-speak) on EU entities that lack substance, making it easier for the tax authorities to identify and scrutinize these entities, leading to litigation, Mutual Agreement Procedures and, in the worst case, income re-allocation for tax purposes. For example, if the Spanish subsidiary of a Dutch parent company is found to be a "shell entity" under ATAD3, its income could be re-allocated to the Dutch parent for tax purposes.

9. Increasing importance of maintaining substance

Companies worldwide should be aware that the regulations and standards established in the EU are now being used as a model for countries in the EU as well as third-countries. This means that what begins in the EU could easily be adopted elsewhere/everywhere. As a result, we advise clients to take note of minimum substance requirements under ATAD3 as well as Section 50(d)3 of the German Income Tax Act, which aims to prevent the misuse of benefits granted under double taxation agreements and on the basis of EU law for income subject to tax deduction through the interposition of foreign companies (also known as "treaty shopping"). Since the requirements under Sec. 50(d)3 are currently the most stringent requirements in force, companies should be vetting their holding and investment structures against these (as well as the requirements proposed under ATAD3) in order to stay ahead of any changes in the applicable laws. This would be the best way to set up sustainable holding and investment structures.

10. What's next for the EU?

In close connection with ATAD3, the European Commission is developing a new taxation package, which includes the so-called "SAFE" and "FASTER" proposals. The SAFE-proposal targets facilitators of non-EU shell entities, while the FASTER-proposal aims to implement a new EU-wide WHT-system to reduce tax avoidance within the EU. These proposals aim to further limit the use of shell companies for aggressive tax planning. More information on these proposals is expected in early June 2023.

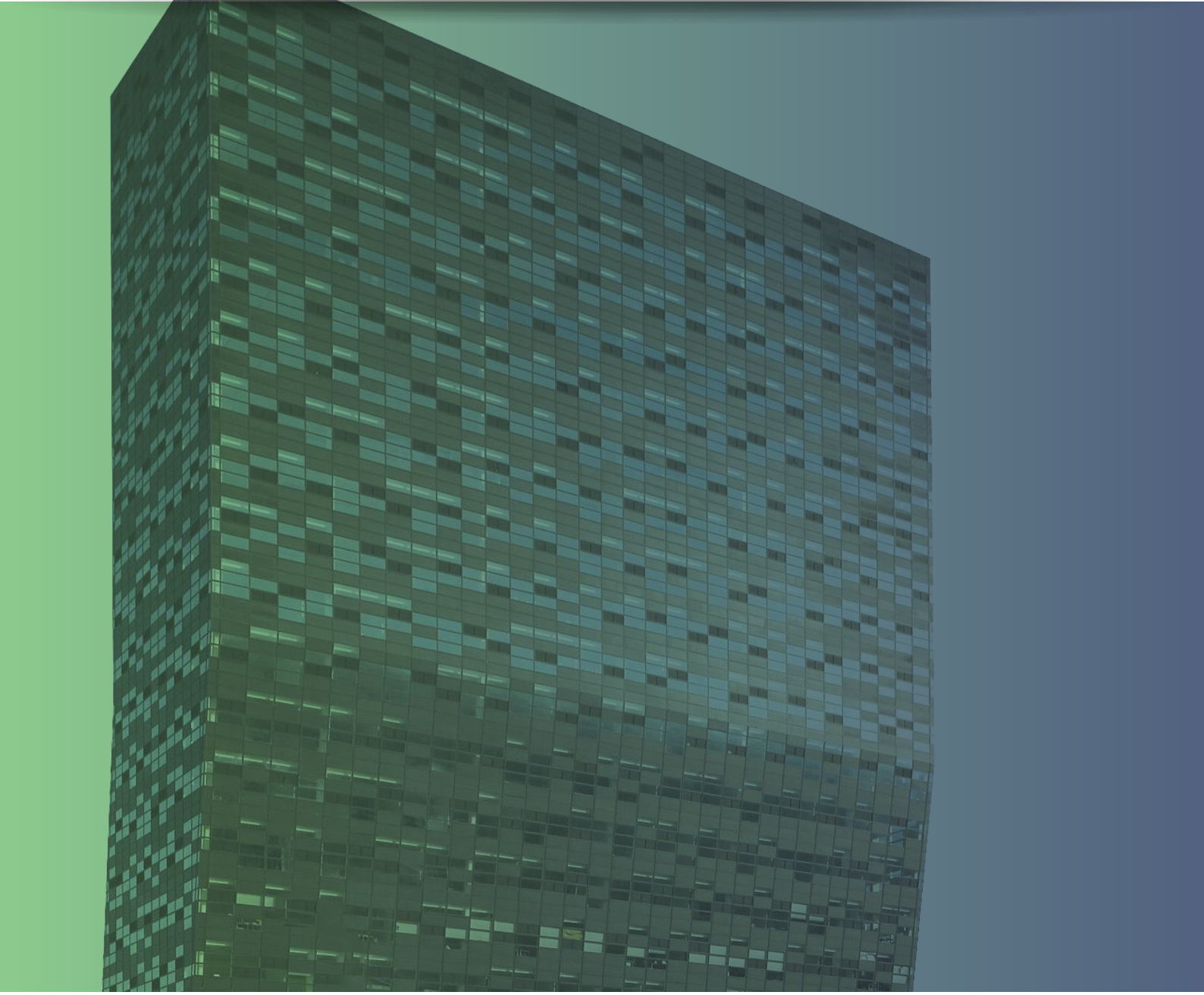
Recommendation

Despite already high levels of transparency in the compliance department, the implementation of ATAD3 will impose an additional burden on businesses in the EU. In this context, it's important to consider the proposed Directives' potential consequences and take the two-year look-back into account. Companies should already be using the minimum substance requirements proposed under ATAD3 to vet their investment and holding structures to ensure compliance.

One of the consequences proposed by ATAD3 is the denial of TRCs 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 increase the administrative burden associated with obtaining TRCs, along with longer time-frames for obtaining TRCs. The proposed Directive will lead to a 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 for 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 tax treaty had been granted.

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 the administrative and management functions. A gateway breach could lead to a long, drawn-out rebuttal process, potential audits and tax leakages. Therefore, it is also necessary to conduct some scenario planning to anticipate and plan for the worst-case scenario.



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