NovioTax

Preparing for ATAD3

April 2023

In this blog, we highlight the urgency for E.U. companies to examine whether they meet certain "minimum substance requirements" in preparation for ATAD3 – the proposed E.U. Directive aimed at preventing the misuse of "shell entities" in the E.U. Once implemented by the E.U. Member States, the proposed Directive will require E.U. companies that do not meet the specified substance requirements to prove that they perform actual economic activity. The proposed Directive that is set to take effect on 1 January 2024 will apply to all E.U. companies (as in, without any monetary threshold). Consequences proposed under ATAD3 include the denial of TRCs, which will impact the dealings of the affected companies within the E.U. and in third-countries. Since some of the substance requirements proposed under ATAD3 have a two-year "look back" provision (i.e., potentially covering 2022 and 2023), it is prudent for E.U. companies to start assessing how they measure up against these requirements ASAP.

In recent years, we have seen an increase in the number of domestic court cases as well as judgements from the European Court of Justice centred around "substance". These cases typically involve determining whether the taxpayer has sufficient "substance" in a particular jurisdiction to avail the tax benefits thereof and of its treaty network and applicable E.U. Directives by reason of being a tax resident of that jurisdiction.

In the tax law context, "substance" can be understood to mean a group or company's presence in a particular jurisdiction or its connection thereto. Tax authorities around the world have various (and sometimes, diverging but overlapping) parameters for determining whether a particular group or company has "sufficient substance" or "relevant nexus" to their particular jurisdictions. However, there are some commonalities of substance indicators (or if formally mandated, substance requirements) within the E.U.

In its domestic law, the Netherlands already applies minimum substance requirements via various anti-abuse rules. For instance, the regulations dealing with Controlled-Foreign-Companies ("CFCs") focus on substance at the level of the foreign subsidiaries of Dutch companies. On the other hand, the domestic exemption from dividend withholding tax, non-resident taxation rules and rules related to withholding tax on interest and royalties directly or indirectly due to low-tax jurisdictions, all focus on substance at the level of the foreign shareholders of Dutch companies.

Further, specific substance requirements apply to so-called 'financial services entities' ("FSCs"). Not meeting these requirements during the entire year in which the benefits of a tax treaty or E.U. Directive are claimed leads the Dutch tax authorities to spontaneously exchange information on the non-compliance with the tax authorities in the source countries, who may use this information to disallow the benefits provided for under the applicable tax treaty or E.U. Directive.

Lastly, if adopted, the Netherlands (as well as other E.U. Member States) will need to implement the provisions of "ATAD3" (or the 3rd Anti Tax Avoidance Directive proposed by the European Commission) aimed at preventing the misuse of "shell entities" in the E.U. The proposed Directive, set to come into force on 1 January 2024, lays down a "substance test" based on which E.U. entities that are identified as lacking minimal substance can be denied tax benefits. When implemented, ATAD3 will apply to all undertakings that claim tax residency in the E.U. (as in, no monetary or other thresholds). Only regulated financial undertakings (AIFMs, UCITS and AIFs) and undertakings listed on a regulated market are excluded (or "carved out") from the scope of the proposed Directive, along with holding companies that own operational businesses in the same Member State while their beneficial owners also reside in the same Member State. As detailed further in this blog, some of the substance requirements proposed under ATAD3 are already relevant now because they have a two-year "look back" provision.

ATAD3 - Introduction

ATAD3 (also called the "Unshell Directive") is part of the European Commission's central strategy on direct corporate taxation. As such, it complements a number of other policy initiatives of the Commission to implement a robust, efficient and fair tax system within the E.U. The rationale behind the proposed Directive, in the words of the Commission, is "to ensure that shell companies in the E.U. that have no or minimal economic activity are unable to benefit from any tax advantages, thereby discouraging their use".

When it comes to anti-tax avoidance and evasion rules, most E.U. Member States currently rely on general anti-abuse rules, which they tend to apply on a case-by-case basis. This incongruity could be worsened if the Member States were to take action individually and simultaneously. Hence, the rationale behind ATAD3 is for the E.U. Member States to have a common approach towards shell entities, ensuring legal certainty and reducing compliance costs for businesses operating within the E.U.

The ATAD3 proposal lays down a series of steps to help the Member States identify undertakings that do not have minimal substance and could be at risk of being misused for the purpose of obtaining tax advantages. It proposes tax consequences for these "shell undertakings" and also envisages automatic exchange of information between Member States regarding these undertakings as well as potential requests by one Member State to another for tax audits for a broader group of undertakings that are treated as being at risk (because they do not fulfil certain conditions) but are not necessarily deficient in substance (or "shell undertakings").

Since its inception in 2018, there have been a number of drafts of the ATAD3 proposal. The explanation of the ATAD3 provisions in this note is based on the latest draft, made available by the European Commission on 11 January 2023. The European Parliament has approved this draft and called on the Commission to notify Parliament if it intends to depart from the text approved by Parliament.

ATAD3 - Provisions

The ATAD3 proposal lays down three "gateway" tests for undertakings established in the E.U. to self-assess whether or not they need to report additional information to the tax authorities in the Member State of establishment. The tests are based on the operational structure of the undertakings in the two years preceding the year of reporting and help identify undertakings that the European Commission determines may be at risk of being misused for the purpose of obtaining tax advantages. An entity will be at risk if it meets all three following "gateway" tests:

- More than 65% of revenues accruing to the undertaking in the preceding two tax years is "relevant income" whereas "relevant income" is inter alia interest income, royalty income, dividend income and income from financial leasing; or more than 75% of the total book value of the entity's assets are "relevant assets" made up of real estate assets or shares with a book value of more than EUR 1 million.
- More than 55% of the "relevant income" is earned or paid out via cross-border transactions; or more than 55 % of the book value of the undertaking's "relevant assets" were located outside the Member State of the undertaking in the preceding two tax years;
- The undertaking has outsourced the administration of day-to-day operations and decision-making on significant functions to a third-party during the preceding two tax years.

Undertakings that meet all three gateway tests will have to provide proof of minimum substance to the relevant tax authorities along with the annual tax return. The indicators of minimum substance according to the proposed Directive are:

- Owning or having exclusive access to premises within the territory of the Member State or premises shared with other entities of the same group within the territory of the Member State;
- Having at least one own and active bank account or e-money account in the E.U. through which the relevant income is received; and
- Having at least one director authorized to take decisions in relation to the activities that generate relevant income for the undertaking or in relation to the undertaking's assets, who is resident for tax purposes in the Member State of the undertaking (or resides at no greater distance from that Member State insofar as such distance is compatible with the proper performance of his/her duties), or having a sufficient number of full-time equivalent employees, who habitually reside in the Member State of the undertaking (or at no greater distance from that Member State insofar as such distance is compatible with the proper performance of their duties).

If an undertaking does not meet all the indicators listed above or cannot provide sufficient proof that it meets all these indicators, the undertaking will be presumed (by the relevant tax authorities) to be a "shell undertaking". Information regarding undertakings that are identified as shell entities will be shared with the tax authorities of all Member States.

The presumption that an undertaking is a shell entity can be rebutted by the undertaking by providing additional evidence that it is not a shell, such as by evidencing that the undertaking conducts genuine economic activity and has sufficient nexus with the Member State it claims to be a tax resident of. Acceptable additional evidence under the proposed Directive could be in the following forms:

- a document allowing to ascertain the business rationale behind the establishment of the undertaking in the Member State;
- information about the full-time, part-time, and freelance employee profiles, such as the forms of their contract, decision-making powers and education (while safeguarding high levels of data protection and privacy);
- concrete evidence demonstrating that the decision-making regarding the activity is taking place in the particular Member State.

Alternatively, undertakings that meet all the gateway tests and do not meet the minimum substance requirements (or cannot provide proof thereof) may claim an "exemption" from the scope of the proposed 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 a part or for the ultimate beneficial owner(s). For this purpose, the undertaking would be required to provide evidence allowing the relevant tax authorities to compare the tax liability of the overall group or of the beneficial owner(s), with and without its interposition.

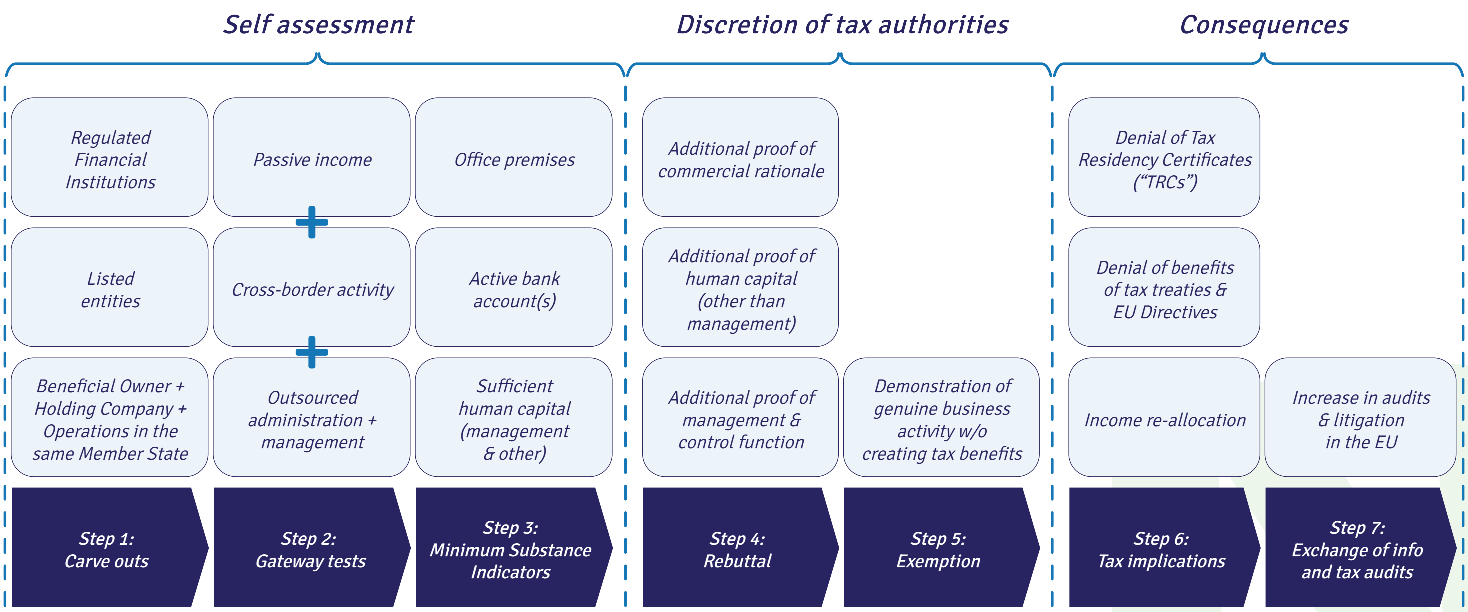
ATAD3 - Consequences

Failure to obtain an exemption based on the lack of tax motives, and alternatively, failure to rebut the presumption of being a shell undertaking, could lead to a number of tax consequences, including:

- denial of certificates of residence by the Member State where tax residency is claimed;
- denial of benefits provided for under double tax treaties and E.U. Directives;
- re-allocation of taxing rights (to the shareholder(s) of the shell undertaking).

The proposal leaves it up to the Member States to introduce penalties for incorrect reporting on minimal substance and failure to report upon meeting the three gateway tests but suggests an administrative pecuniary sanction of at least 2% of the undertaking's revenue in the relevant tax year if the undertaking that is required to report does not comply with such requirement within the prescribed deadline and an administrative pecuniary sanction of at least 4 % of the undertaking's revenue if the undertaking that is required to report makes a false declaration in the tax return. In the case of an undertaking with zero or low revenue, the proposal states that the penalty should be based on the total assets of the undertaking.

The constituent steps of the ATAD3 proposal (outlined above) are depicted in the diagram below.

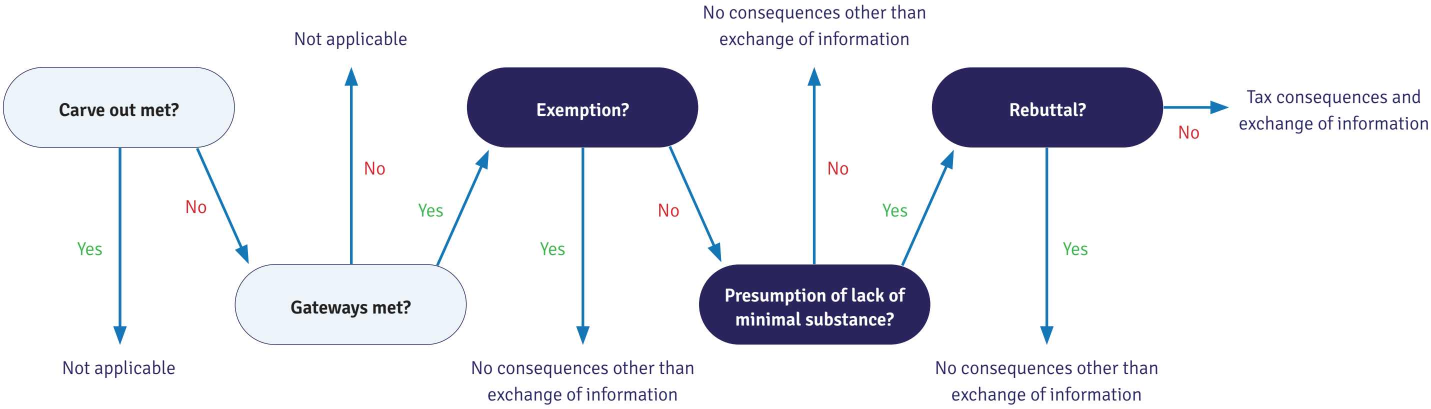


ATAD3 - Concluding remarks

The draft of the ATAD3 proposal approved by the European Parliament on 17 January 2023 (discussed herein) is not the first draft put forth by the European Commission. Since its inception in 2018, the proposal for the Directive has been amended based on public consultations. The proposed Directive is part of the Commission's central strategy on direct corporate taxation and should also be viewed in light of the global initiative to discourage the use of companies with no or limited substance for obtaining tax advantages (such as the OECD's BEPs initiative and MLI as well as unilateral provisions implemented by some third countries). Courts around the world, including the European Court of Justice, are more and more inclined to deny benefits granted under tax treaties and Directives to companies that lack substance.

In a nutshell, ATAD3 targets E.U. companies that derive more than 65% of their income from "relevant sources" (notably, interest, royalties and dividends), that are mainly involved in cross-border activities and whose day-to-day management and decision-making are outsourced to third parties. Such E.U. companies will be required to provide proof of actual economic activity to the relevant tax authorities. Failure to do so could lead to consequences such as denial of benefits provided for under double tax treaties and E.U. Directives, denial of certificates of tax residency by the Member State where tax residency is claimed and re-allocation of income for taxation purposes, leading to litigation, Mutual Agreement Procedures, etc.

The following flowchart helps determine whether an undertaking will be impacted by ATAD3.



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