Hogan Lovells

ATAD 3 or the importance of adequate substance

July 2022

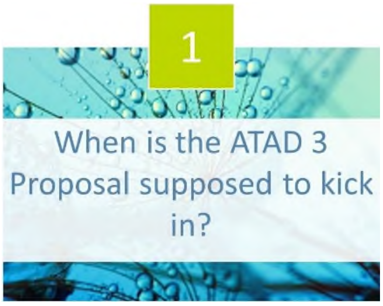
At its dawn, the ATAD 3 Proposal and its adverse tax consequences were considered by some as the demise of international investment structures as, potentially, encompassing all kind of intermediary holding or financing vehicles. Others, however, pointed out the differences in interpretation of key terms and generally, the various uncertainties surrounding the ATAD 3 Proposal. A few optimists saw this proposal merely as a measured extension of the ATAD 1 and ATAD 2 initiatives with no major impact apart in relation to the so-called "letterbox" vehicles.

Needless to say that caution should be taken nowadays as regards any scheme planned by the EU Commission to tackle aggressive tax planning. However, given the resistance of some Member States to the content and even the legality of this proposal, not only its current challenging timing but also its final content, and as such its real impacts, remain uncertain at this date. Indeed, seven months after the publication of the ATAD 3 Proposal, nothing has moved since then and the implementation of this proposal, or at least the timing of it, currently is more than uncertain. An overreaction as regards the ATAD 3 Proposal does therefore definitely not seem to be appropriate, although its possible impacts may be analysed as of now to assess the presence of any risks even in its current wording.

On 22 December 2021, the European Commission (the "**EU Commission**") published a proposal directive, which aims to prevent the misuse of shell entities for improper tax purposes (the "**ATAD 3 Proposal**"). The ATAD 3 Proposal aims to tackle cross-border tax avoidance and evasion practices by means of so-called "shell entities", which in a nutshell can be defined as legal entities or arrangements with no or low substance and lacking commercial rationale. Such entities are indeed viewed by the EU Commission as vehicles likely to be used for aggressive tax planning or tax avoidance purposes. It is indeed considered that by means of shell entities, businesses may channel financial flows towards jurisdictions that have no or very low taxes, or where taxes can easily be circumvented, whilst the shell entity may rely on EU directives or other international agreements to reduce overall taxation of its group.

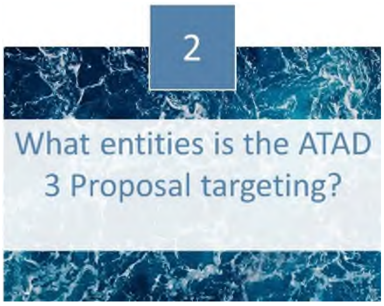
More concretely, the ATAD 3 Proposal introduces reporting obligations (the "**Reporting Obligations**") for potential shell entities that will automatically be exchanged by its jurisdiction to all other Member States of the European Union (the "**Member States**") to improve transparency standards around the use of such entities so that their abuse can more easily be detected by relevant tax authorities. Further, the ATAD 3 Proposal denies the access to the benefits of double tax treaties ("**DTTs**") and EU directives to entities considered a "shell" within the meaning of the proposal. Finally, the ATAD 3 Proposal imposes penalties in case of non-compliance or false indications in relation to the Reporting Obligations.

Below will be addressed the 10 most relevant questions that the ATAD 3 Proposal may raise.



Currently, the ATAD 3 Proposal should be implemented into domestic law of Member States by 30 June 2023 for an application as from 1 January 2024. However, the ATAD 3 Proposal requires the unanimity of adoption and some Member States are doubtful about its benefits considering other recent directives tackling aggressive tax planning such as ATAD 1[1] or ATAD 2[2], or even its legality since it aims to override to a certain extent existing bilateral tax treaties. As such, not only seems the current implementation timing of the ATAD 3 Proposal challenging but it is also uncertain whether an agreement by the Member States would be reached in relation thereto, at least in its current form. As such, unsurprisingly, the rapporteur of the Committee on Economic and Monetary Affairs of the European Parliament on the ATAD 3 Proposal (the "**Rapporteur**") also recommended in its draft report issued on 12 May 2022 (the "**Draft Report**") for an application as from 1 January 2025.

Yet, some criteria to assess the substance of an entity will be based on its situation of the two preceding years. As the initial application date of 1 January 2024 has not been waived formally yet, careful assessment of the impacts of the ATAD 3 Proposal may be undertaken as of now, especially in the presence of intermediary investment, holding or financial vehicles, to not only avoid the qualification of a "shell" but potentially fall outside the scope of the Reporting Obligations entirely.



The ATAD 3 Proposal is broadly inclusive and intends to apply to all tax resident EU entities engaged in an economic activity and as such eligible to receive a tax residence certificate from its Member State. As such, it includes, besides companies, all types of legal arrangements such as partnerships and alike, which are deemed residents for tax purposes in a Member State.

For the time being, non-EU tax residents considered as shell entities are not yet covered by, and thus subject to, the ATAD 3 Proposal. However, a non-EU source country may indirectly be impacted by such proposal as applying potentially higher domestic withholding taxes in relation to payments to EU tax resident shell entities as the latter will see their tax residence certificate denied for international purposes.

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1 Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market

2 Council Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries

As further detailed under section 4. below, an entity will, in principle, have to comply with the Reporting Obligations provided that it passes through three so-called "gateways". However, the ATAD 3 Proposal currently foresees two types of exemptions, whereby entities falling, in principle, within its scope are nevertheless exempt from making any Reporting Obligations.

1. Automatic exemption

The ATAD 3 Proposal currently excludes explicitly certain entities from the requirement to perform the Reporting Obligations (the "**Exempt Entities**"), which include the following:

- companies which have a transferable security admitted to trading or listed on a regulated market or multilateral trading facility;
- certain regulated financial undertakings, such as, in principle, credit institutions, investment firms, alternative investment fund managers ("**AIFM**") and alternative investment funds managed by an AIFM, UCITS, securitization companies subject to the EU Securitization Regulation[3], central counterparties or securities depositaries, insurance and reinsurance undertakings; pensions institutions; payment and electronic money institutions; crowdfunding and crypto-asset service providers;
- entities whose main activity is the holding of shares in operational businesses in the same Member State with their beneficial owners being also resident in the same Member State for tax purposes;
- entities with holding activities and resident in the same Member State as their shareholder(s) or ultimate parent entity/ies for tax purposes; and
- entities with at least five own full-time equivalent employees or members of staff exclusively carrying out the activities generating the Relevant Income (as defined hereafter).

Whilst the exclusion of those Exempt Entities is helpful, it is unfortunate that their subsidiaries, and in particular those of regulated financial undertakings, are not, at least currently[4], covered by this exemption. As such, entities that are predominantly or even entirely held by an Exempt Entity may have to perform Reporting Obligations, or even be considered as a Shell Entity (as defined hereafter) if they do lack the required minimum substance foreseen by the ATAD 3 Proposal.

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[3] Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation

[4] To be noted that the Rapporteur recommends in the Draft Report to include within the definition of Exempt Entities "entities owned by regulated financial undertakings and which have as their objective the holding of assets or the investment of funds".

2. Exemption upon request

Besides the automatic exemption mentioned before as regards certain type of entities, the ATAD 3 Proposal currently also provides for the possibility to allow an entity to request an exemption from the Reporting Obligations if such entity's existence does not reduce the tax liability of its beneficial owner(s) or of the group, as a whole, of which the entity is a member. In this context, sufficient and objective evidence, including information as regards group structure, activities and overall taxation needs to be provided to ensure the absence of any such tax benefits due to the existence of the requesting entity.

Such exemption upon request will be valid for the relevant tax year and can be extended by the relevant tax authorities for another 5 years if the factual and legal circumstances of the requesting entity and its beneficial owner(s) remain unchanged during the relevant period.

In the absence of any of the exemptions mentioned under section 3. above, EU tax resident entities will nevertheless have first to pass through three so-called "gateways" to be subject to the Reporting Obligations and as such be considered as a reporting entity in accordance with the ATAD 3 Proposal (a "**Reporting Entity**").

(1) The entity must generate a relevant income

The first gateway requires an entity to derive, during the preceding two years, at least 75% of its revenues from certain categories, which broadly speaking covers passive income (the "**Relevant Income**"). The Relevant Income definition of the ATAD 3 Proposal includes currently mainly four categories of revenues:

(a) interest or any other income generated from financial assets, including crypto assets;

(b) royalties or any other income generated from intellectual or intangible property or tradable permits;

(c) dividends and income from the disposal of shares;

(d) revenues relating to certain income proceeds, covering income from (i) financial leasing, (ii) immovable property, (iii) movable property, other than cash, shares or securities, held for private purposes and with a book value of more than one million euro, (iv) insurance, banking and other financial activities, and (v) services which the entity has outsourced to other associated enterprises.

As regards the latter category, the income criterion in relation to items (ii) and (iii) is considered being met irrespective of whether income from these assets has accrued to the entity in the preceding two tax years if the book value of these assets is above 75% of the total book value of the entity's assets. The same approach is applied in relation to the category (c) dealing with income from shares.

(2) The entity must carry out cross border transaction

The second gateway requires an entity to carry out mostly cross-border transactions. For this gateway to be passed, the ATAD 3 Proposal currently envisages a threshold of 60% of cross-border transactions.

This threshold is considered to be met not only if at least 60% of an entity's Relevant Income is earned or paid out via cross-border transactions, but also if during the preceding two years, more than 60% of the accounting value of the entity's assets falling within the scope of items (ii) and (iii) mentioned in section 4.(1)(d) regarding immovable and valuable movable property are located outside of the jurisdiction of the entity.

(3) The entity must outsource its day-to-day management and its decision-making functions

The last gateway requires an entity to outsource, during the preceding two years, both its day-to-day management and its decision-making on significant functions. The aim is to cover entities that have no or inadequate own resources to perform core management activities and generally rely for their own administration (e.g., legal and tax compliance services but also merely correspondence administration) on other people such as, in particular, professional third-party service providers (or equivalents).

Yet, the ATAD 3 Proposal seems to allow the outsourcing of certain services, provided however that they may be considered as ancillary, such as bookkeeping services. In addition, the outsourcing to an associated enterprise located in the same jurisdiction should not be considered as outsourcing in line with this gateway[5].

For companies implemented for international investment, holding and/or financing purposes that may not rely on any exemptions foreseen under section 3. above, this gateway will be key to determine whether they fall within or outside of the Reporting Obligations as the two preceding gateways will often be passed for such companies.

Unfortunately, quite some uncertainties remain as regards this gateway, in particular as to the outsourcing of the decision-making operations. For instance, should the use of independent directors be considered as outsourcing? Such directors act independently and are personally liable for the decisions taken in relation to the management of an entity and which need to be in the best interest of such entity. As such, they may easily be considered as part of the own resources of an entity by providing genuine substance to the latter, provided those directors have the sufficient knowledge, experience and time to adequately manage the entity in view of the latter's assets, activities and general risk profile. Another interrogation may be whether one own director of the entity (or its group) would be sufficient to pass this gateway, even in the presence of other directors from an external service provider? If not, would the response change if at least half or a majority of the board would be composed by own directors of the entity (or its group), notwithstanding other directors from an external service provider being part of such board as well? As not the entire decision-making functions would have been outsourced to third parties, it may be argued that such gateway has indeed not been passed.

In view of the above, any amendments or clarifications regarding this gateway will be of utmost importance as in their absence, there is a risk that some, if not a large number of intermediary EU

5 The Rapporteur recommends in the Draft Report to explicitly include in the ATAD 3 Proposal itself that the third gateway only applies if such outsourcing is made to "an entity that is not an associated enterprise within the same jurisdiction as the reporting undertaking".

entities involved mainly/entirely in cross-border investment, holding or financing activities may consider to fall within the requirement to comply with the Reporting Obligations.

A Reporting Entity will have, for each tax year, to declare in its annual tax returns the indicators of substance mentioned hereafter (the "**Substance Indicators**") with the aim to demonstrate that it satisfies a certain required minimum substance. If the Reporting Entity declares not meeting those Substance Indicators or does not declare them properly, it will be deemed not having adequate substance and as a consequence thereof viewed as a "shell" for the purposes of the ATAD 3 Proposal (the "**Shell Presumption**").

In line with the Substance Indicators currently included in the ATAD 3 Proposal, the Reporting Entity needs to comply with the following requirements:

(1) having its own premisses or premisses for its exclusive use.

(2) having an own active EU bank account.

(3) fulfilling one of the following indicators:

a. one or more of its directors:

i. reside for tax purposes in the same Member State as the Reporting Entity, or at a close distance to such Member State to enable them to properly perform their duties;

ii. are qualified and authorised to take decisions in relation to the activities that generate Relevant Income for the Reporting Entity or in relation to such entity's assets;

iii. actively and independently use the authorisation referred to in point ii. above on a regular basis[6]; and

iv. are not employees of an enterprise that is not an associated enterprise and do not perform the function of director or equivalent of other enterprises that are not associated enterprises; or

b. the majority of the full-time equivalent employees of the Reporting Entity are resident for tax purposes in the Member State of the Reporting Entity, or at a close distance to such Member State to enable them to properly perform their duties, and such employees are qualified to carry out the activities that generate Relevant Income for the Reporting Entity.

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[6] To be noted that the Rapporteur recommends in the Draft Report to delete this condition.

In addition to the above, Reporting Entities need to submit documentary evidence with their tax returns, which shall, in principle, include the following:

a. address and type of premises as well as information related to the bank account (number; any mandates granted thereof; activity);

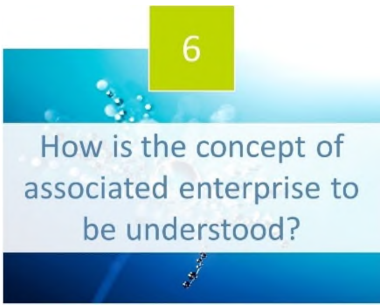
b. amount and type of gross revenue and business expenses;

c. type of business activities performed to generate the Relevant Income as well as outsourced business activities; and

d. information as regards the directors (i.e., number; qualification; authorisations; place of residence for tax purposes) or the full-time equivalent employees performing the business activities that generate the Relevant Income (i.e., number, qualification; place of residence for tax purposes).

If the Substance Indicators are met, the Reporting Entity shouldn't, in principle, be considered a shell under the ATAD 3 Proposal. Yet, the relevant tax authorities may consider, based on their own assessment, the Reporting Entity as a shell despite any evidence submitted by the latter because they consider that, for instance, the proof provided isn't conclusive, there is an obvious lack of substantial economic activity, or the Reporting Entity can't be considered as beneficial owner of the income streams.

This risk is increased by the fact that, unfortunately, all the Substance Indicators lack precision. For instance, what are the requirements for premises to be considered used exclusively by an entity; when is an account to be considered active; when are directors being considered qualified, respectively acting actively and independently?



As for the prior anti-tax avoidance directives, the ATAD 3 Proposal includes its own definition of "associated enterprise", being a person who is related to another person in any of the following ways:

(e) a person participates in the management of another person by being in a position to exercise a significant influence over the other person;

(f) a person participates in the (i) control of another person through a holding that exceeds 25 % of the voting rights or (ii) capital of another person through a right of ownership that, directly or indirectly, exceeds 25 % of the capital (the latter being the "**Capital Ownership Criterion**"); or

(g) a person is entitled to 25 % or more of the profits of another person.

In addition, the ATAD 3 Proposal states that if more than one person participates in the management, control, capital or profits of the same person, or if the same persons participate in the management, control, capital or profits of more than one person, then all persons concerned shall be regarded as associated enterprises.

Finally, the ATAD 3 Proposal includes certain clarifications regarding the concept of "associated enterprise", being that:

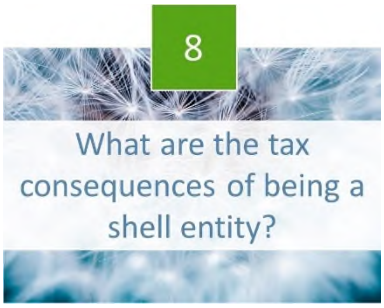
- a person shall each time mean both legal and natural persons;
- a person who is acting together with another person in respect of the voting rights or capital ownership of an entity is to be treated as holding a participation in all of the voting rights or capital ownership of that entity that are held by the other person;
- in indirect participations, the Capital Ownership Criterion shall be assessed by multiplying the holding rates through the successive tiers;
- a person holding over 50% of the voting rights shall be deemed to hold 100% of such rights; and
- an individual, his or her spouse and his or her lineal ascendants or descendants shall be treated as a single person.

As highlighted under section 5. above, a Reporting Entity, which fails to meet all the Substance Indicators, or to adequately evidence such indicators, will be deemed to be a shell entity for the purposes of the ATAD 3 Proposal, except if such Reporting Entity can rebut the Shell Presumption by providing the following supplementary evidence:

- an explanatory document regarding its purpose to assess the commercial rationale behind its incorporation;
- information about its employee profiles (e.g., role and position; experience and qualifications; overall decision-making power; employment contract type and duration); and
- concrete proof that the decision-making in relation to the activity generating the Relevant Income is occurring in its Member State.

A Reporting Entity shall be considered as having rebutted the Shell Presumption if the proof submitted reveals that it has performed and always had control over, and borne the risks of, the business activities that generated the Relevant Income or, in the absence of such income, its assets.

Any rebuttal granted will be valid for the relevant tax year and can be extended by the tax authorities for another 5 years if the factual and legal circumstances remain unchanged during the relevant period.



A Reporting Entity, which fails to meet the Substance Indicators (or fails to comply to provide sufficient evidence thereof) and does not (or is not able to) rebut the Shell Presumption will be considered as a shell entity for the purposes of the ATAD 3 Proposal (the "**Shell Entity**").

The principal result will be that businesses to which the Shell Entity belongs may most probably see their overall taxation increase as they will not be able to get access any longer, via the Shell Entity, to (i) the EU directives, and in particular the Parent-Subsidiary Directive[7] and the Interest and Royalty Payments Directive[8] (collectively, the "**EU Directives**") nor, in principle, (ii) any agreements or conventions concluded by the Member State of the Shell Entity that provide for the elimination of double taxation of income and, where applicable, capital as well as similar international agreements (collectively, the "**Tax Treaties**", and together with the EU Directives, the "**Tax Conventions**").

Yet, the concrete tax consequences following the designation of a Shell Entity are in fact threefold.

1. At the level of the Shell Entity itself

The Member State of the Shell Entity will either:

- deny a request for a tax residence certificate to the Shell Entity for international purposes; or

- continue to grant such a tax residence certificate to the Shell Entity but by specifying therein that the latter is not entitled to benefit from the Tax Conventions.

2. At the level of the source country

Any source country (including non-Member States) may apply higher withholding taxes as the Shell Entity may no longer rely on any reduced withholding taxes available under any Tax Convention.

Importantly though, the ATAD 3 Proposal clarifies that the payer of an EU source country may rely on any Tax Treaty applicable between its Member State and the tax jurisdiction of the shareholder(s) of the Shell Entity (the "**Shareholder(s)**") where the latter's tax jurisdiction is a non-Member State. Unfortunately, the ATAD 3 Proposal is unclear whether the payer of an EU source country may also rely, by means of a look-through approach as regards the Shell Entity itself, on any Tax Conventions in presence of EU tax resident Shareholder(s). Such interpretation would be rational and coherent, and seems also indirectly confirmed by the explanatory memorandum of the ATAD 3 Proposal (the "**Explanatory Memorandum**"), which states that in a purely European context (i.e., where the payer, the Shell Entity and the Shareholder(s) are all tax resident in a Member State), the "*EU source / payer will not have a right to tax the payment but may apply domestic tax on the outbound payment to the extent it cannot identify whether the undertaking's*

[7] Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States

[8] Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States

shareholder(s) are in the EU". As such, the EU source payer, provided that it can identify the Shareholder(s), may apply tax on outbound payments only within the limits of any applicable Tax Treaty in force between its Member State and the tax jurisdiction of the Shareholder(s), or even the EU Directives.

Where the payer is located in a non-Member State for tax purposes, it seems doubtful that such non-EU source country, even though not being bound by the provisions of the ATAD 3 Proposal, would still apply any Tax Treaty in force between its jurisdiction and the Member State of the Shell Entity. However, the interrogation remains to what extent such country would apply any Tax Treaty in force between its jurisdiction and the tax jurisdiction of the Shareholder(s) by means of a look-through approach as regards the Shell Entity itself.

2. **AT THE LEVEL OF THE SHAREHOLDER(S)**

Where the Shareholder(s) are resident for tax purposes in a Member State, the latter may tax the relevant income of the Shell Entity as it would have been accrued directly at the level of the Shareholder(s) themselves by means of a look-through approach, by deducting any tax paid on such income at the level of the Shell Entity as well as in the source country.

Importantly though, the ATAD 3 Proposal clarifies that the Shareholder(s) may rely on any Tax Treaty applicable between its Member State and the tax jurisdiction of a non-EU source payer. Further, based on the clarifications included in the Explanatory Memorandum, the Shareholders may be able to rely, in relation to the payment received by the Shell Entity and to be included in their tax base, on the EU Directives in a purely European context (i.e., where the payer, the Shell Entity and the Shareholder(s) are all tax resident in a Member State). Astonishingly though, the Shareholder(s) may, in such purely European context, not be able to rely, based on the current wording of the ATAD 3 Proposal, on any available Tax Treaty in force between the source country of the EU payer and their tax jurisdiction.

Finally, as regards property owned by the Shell Entity, the ATAD 3 Proposal specifies that:

- the Member State in which any immovable property of the Shell Entity is located shall tax such property as if directly owned by the Shareholder(s), subject to any applicable Tax Treaty in force with the jurisdiction of these Shareholder(s); and

- the Member State of the Shareholder(s) shall tax any property owned by the Shell Entity and related to Relevant Income as if it would directly be owned by the Shareholder(s), subject to any applicable Tax Treaty in force with the jurisdiction where such property is located.

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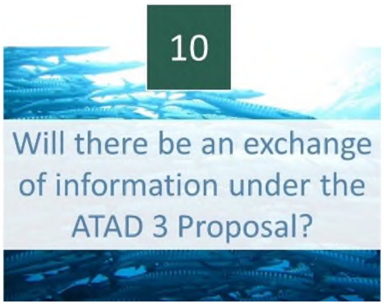
In addition to the tax consequences enumerated above, the ATAD 3 Proposal provides also for penalties (including an administrative fee of at least 5% of the Reporting Entity's turnover if such Reporting Entity fails to comply timely with its Reporting Obligations or makes incorrect declarations in this context), which shall, according to the ATAD 3 Proposal, be "be effective, proportionate and dissuasive". As such, penalties to be implemented by the various Member States may, in the end, be rather significative[9].



The ATAD 3 Proposal indeed envisages an automatic exchange of information to all other Member States in relation to the information received by a Reporting Entity, whether the latter will or will not be considered *in fine* as a Shell Entity.

In addition, the exchange of information will also cover those entities, which are benefitting from an exemption upon request (as further described under section 2 above) from the Reporting Obligations.

The information will, in essence, be communicated by the competent tax authorities of a Member State to the other Member States by means of an automatic exchange within 30 days of either the receipt of the reporting information, the Shell Presumption rebuttal, the granting of the exemption from the Reporting Obligations, or the audit result concluding that an entity does not meet the Substance Indicators.

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9 The Rapporteur recommends in the Draft Report to decrease the administrative fee to a minimum of at least 2.5%.

Should you have any question, feel free to get in touch.

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