ATAD 3: the Unshell Directive

In December 2021, the European Commission quietly published the ATAD 3 draft directive – or to give it its full name: the Anti-Tax Avoidance Directive. The reason behind the publication was simple – the European Commission wanted to stop shell companies being used for tax evasion and avoidance purposes within the European Union, as Gaëtan discusses.

More than two and half years on from the publication of that initial draft and the European Commission's ambitions of clamping down on shell companies are becoming a reality, with the proposals set to come into force from the beginning of 2024.

But while the Commission's reasons for drawing up the draft directive were straightforward, the work needed to be undertaken by managers was not, and several hurdles and tests now need to be considered, even though some uncertainties around the timing and practicalities involved in complying with the forthcoming rules still exist.

So, what does ATAD 3 propose?

To determine whether an investment structure is at risk of being classified as a shell company – defined as not in fact performing any actual economic activity – the Commission has devised three checks or 'gateway indicators', which are:

- Whether or not most of a company's income is considered passive, i.e. interest income, dividends, capital gains on shares, or rental income.
- Whether activities are mainly conducted cross-border.
- And whether daily management and decision-making is outsourced.

If the answer is yes to any of the three checks or gateways, then the entity would have to complete reporting obligations as part of its tax returns to prove it is not a shell company and that it meets what are known as 'minimum substance requirements'.

Should the entity fail the substance test, which includes having individual premises in a member state, an active bank account in the EU and at least one local director, it would be classified as a shell and lose its tax advantages.

In short, the entity would be denied a tax residency certificate and be unable to claim double tax relief in other jurisdictions. Another consequence would be the automatic exchange of information regarding the entity between any member states that may have an interest in it.

Penalties of at least 2% of the entity's annual revenue will also apply for failing to comply with the substance reporting requirements.

How will the role of Luxembourg middle offices evolve because of substance changes?

There is no doubt the directive will have an impact on Luxembourg and the way things currently operate, but in terms of employee seniority levels, things have already started to change since the publication of the initial draft and the anticipation of the incoming substance requirements.

Entities need to have employees or local directors that are knowledgeable in the activities of the company – a real estate business would need to have senior employees knowledgeable in real estate operations, for example.

And senior managers in Luxembourg are participating more in investment committee meetings, while minutes taken at board meetings are more comprehensive and authentic, all of which reinforces the substance levels of these entities.

What are the implications for you?

Managers need to act now and take a critical look at whether any of their holding companies might fall foul of the incoming directive and lack the necessary economic substance required under the new rules.

It might also be wise for managers to conduct a spring clean of their holding companies and remove any that are no longer in use to reduce any reporting requirements that might arise. Compliance costs will increase because of ATAD 3 and eliminating any unnecessary work is prudent.

The directive will also include a look-back period covering the two years from January 2022, and so current structures could determine an entity's classification. As such a review of structures to determine if they fall within the scope of the gateways and whether this could potentially affect the business is advised as soon as possible.

We can help

We are well placed to guide you carefully through the forthcoming directive, and our tax and industry specialists are on hand to help you carry out a health check of your operations and assist in discussions with your own advisors to determine your status and any actions that may be required to ensure compliance. If you'd like any further information or have any questions, please contact Gaëtan.