ATAD III:

What is it and why do you need to act now?

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Introduction

The European Commission has published draft legislation aimed at preventing the use of shell companies for tax evasion and tax avoidance. Known as ATAD III, this draft Directive will potentially have a significant impact on investment funds which currently benefit from EU tax directives and treaties.

Despite the proposal being very much draft legislation and not scheduled to become effective until 1 January 2024, a two year look back period will apply, meaning that should the legislation be passed, relevant structures will be in scope from 1 January 2022. The implication for fund managers and companies, therefore, is that they should consider these new rules at the earliest opportunity and take appropriate action.

This article sets out what the Directive involves, the key structuring implications and what managers can do to prepare.

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Background and purpose of ATAD III

Addressing the misuse of shell companies

On 22 December 2021, the European Commission published a draft Directive, known as ATAD III, aimed at preventing tax avoidance and evasion in the EU. ATAD III addresses the misuse of shell companies for these purposes by creating a common framework to identify such entities, as well as common sanctions, across Member States. It also includes provisions for the exchange of information between Member States.

ATAD III aims to introduce a common test across the EU to establish whether a company is a shell company for tax purposes. It does this through minimum substance requirements that companies will be required to report on where they are not exempt and pass three gateway criteria. Where a company is deemed a shell company under this directive, it may be denied a tax residency certificate in its Member State and access to tax treaties. There is also a minimum penalty for non-compliance of 5% of turnover for the relevant year.

An extension of current anti-tax avoidance legislation

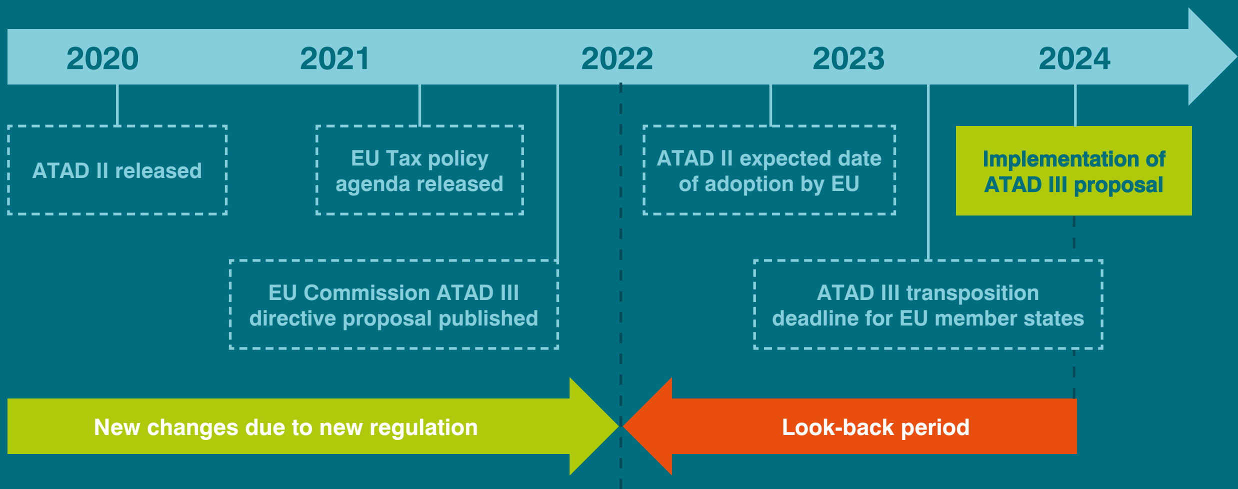
This Directive follows two previous EU anti-tax avoidance legislations. In January 2016, the Commission proposed the Anti-Tax Avoidance Directive (ATAD), which implements the OECD's base erosion profit shifting (BEPS) measures across Europe. This directive intended to provide a level playing field for all businesses in the EU and a minimum level of protection to EU member states against aggressive tax planning. It aimed to achieve this by setting minimum rules in areas such as interest limitation, exit taxation, and controlled foreign companies.

ATAD II was subsequently introduced in January 2020, broadening the original scope of ATAD to tackle the issue of hybrid mismatches between the EU and third countries. It also aimed to provide protection against mismatch outcomes such as double deductions and indirect deductions.

Legislation that looks back

ATAD III is expected to be adopted in the first quarter of 2022, and so EU Member States would have until 30 June 2023 to transpose it into their national law. This proposal is scheduled to become effective as from 1 January 2024.

Due to the two-year look-back period to check if the tests are met or not, the situation of the entities as of 1 January 2022 may be used as a reference point. Companies should now, therefore, consider where these new rules will impact them and take appropriate action.



FAQs: Understanding the implications

What structures are excluded from reporting under ATAD III?

Safe harbour rules exclude, from the scope, undertakings that are not considered at risk, such as:

- Companies listed on a regulated stock exchange
- Regulated financial undertakings, for example AIFs, UCITs, and insurance and reinsurance vehicles
- Undertakings involved in holding activities in the same EU Member State
- Entities performing holding activities resident for tax purposes in the same EU Member State as the shareholder(s) or ultimate parent entity
- Companies with at least five full-time employees involved in the operations generating the relevant income.

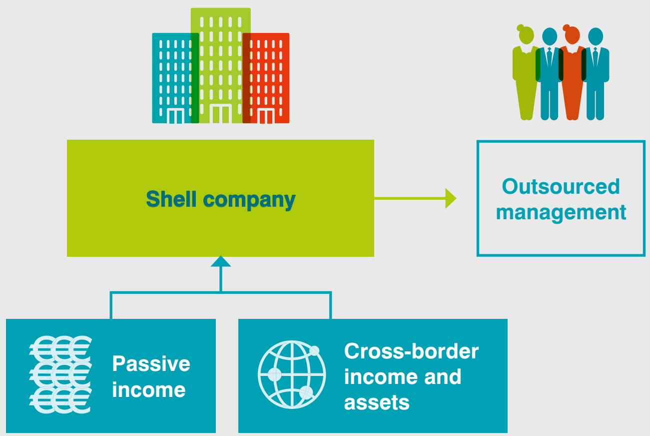
ATAD III also gives the option for entities considered at risk to request from the tax administration a temporary exemption of reporting, if they can prove that their existence does not reduce the tax liability of the beneficial owner(s) or of the group. The exemption can be granted for one year and can be extended to five years.

What structures will be impacted?

The provisions of the proposed Directive would be applicable to any undertaking considered a tax resident or eligible to receive a tax residency certificate in an EU Member State, regardless of its legal form. The targets are entities that do not carry out real economic activities and are solely used to avoid and evade taxes and allow their beneficial owners or group to access a tax advantage.

To be considered at risk of being within the scope of reporting under ATAD III, an entity must meet the following three cumulative gateways:

- Passive income: More than 75% of the overall revenue in the previous two tax years is relevant income, defined in ATAD III as passive income: for example, interest income, dividends, royalties, rental income
- Cross-border income and assets: At least 60% of the relevant income is generated through cross-border transactions or the revenue is passed on to foreign shareholders
- Daily management and decision-making and significant functions of the entity are outsourced.



What are the reporting obligations of at risk entities?

Once an entity has met the three gateway tests and is considered at risk, it is then asked to declare in its income tax return if it meets the following minimum substance criteria:

- It has its own office space, or premises for its exclusive use, in the relevant Member State
- It has at least one active bank account in the EU
- It has an exclusive local director dedicated to the group and/or full-time employees that live close to its activities.

It must provide documentary evidence of meeting these criteria with its tax return, for example the address and type of premises, its bank account number, and the qualification and authorisations granted to directors.

Entities that do not meet these criteria are considered a shell company and in scope of the Directive.

Will there be a right to rebuttal?

Where an entity is presumed to be a shell company it will have a right to rebuttal. This places a burden of proof on the company, and to meet this it would have to provide further evidence that it has continuously performed and borne the risks of the economic activity that generated the relevant income. For example, it could provide evidence of the commercial rationale behind its establishment, profiles of its employees, and proof that decision-making takes place in its Member State tax residence. Successful rebuttals will be applicable for the relevant tax year and extended for five additional years.

This point could potentially differ from one EU Member State to another depending on the application of the Directive into local law.

What are the consequences of being considered a shell company?

Entities that are considered shell companies for the purposes of the legislation face several tax consequences. They will be denied a tax residency certificate in their Member State of residence and will be denied the benefits of relevant tax treaties between Member States and tax directives. In case of non-compliance, such as late or default reporting, the penalties will be established by Member States. ATAD III does, however, provide a minimum penalty for non-compliance: 5% of the undertaking's turnover for the relevant year.

Another consequence will be the automatic exchange of information on the entity between Member States that may have an interest in it. This situation can lead to more frequent audits from the local and foreign jurisdictions.

Actions you can take to prepare

First steps

Although the draft Directive will now move into the negotiation phase between Member States, and it is currently unclear whether Member States will adopt ATAD III in full, we recommend preparing as soon as possible, therefore assuming it will come into force. The Directive has a look-back period which could cover the two years from January 2022, and so current structures could determine an entities classification.

Based on the impact assessment compiled by the EU as part of this initiative, 0.3% of the active enterprises in the EU will be affected. However, due to the lack of definition around key points and the documentation needed, the adoption of ATAD III into local law could mean more entities are impacted. The position of individual EU Member States could potentially lead to a mismatch of rules for the submission of a tax certificate in different Member States.

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.

Consider ATAD IV

The Commission has already announced that ATAD III will be followed up with a draft directive aimed at non-EU shell companies. It is worth bearing this in mind when reviewing potential changes to group structures prompted by ATAD III.

We can help

Our tax team is well placed to guide you through a health check, introducing the rules contained in the draft Directive and assisting in discussions with your own advisors to determine your current status and actions that may be required to ensure compliance.

Get in touch

If you would like to discuss any of the topics in this guide, as well as how the Aztec Group can support you, please talk to either your usual contact or get in touch with:

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