

UPDATES ON THE PROPOSED EU DIRECTIVE ON SHELL ENTITIES (ATAD III)

ON 17 JANUARY 2023, THE EU PARLIAMENT APPROVED AN AMENDED VERSION OF THE DIRECTIVE LAYING DOWN RULES TO PREVENT THE MISUSE OF SHELL ENTITIES FOR TAX PURPOSES, THE SO-CALLED ANTI-TAX AVOIDANCE DIRECTIVE 3 (“ATAD 3”), WHICH IS SOMETIMES MORE FITTINGLY REFERRED TO AS THE ‘UNSHELL DIRECTIVE’.

This approval follows a little over a year after the EU Commission published the initial proposal for ATAD 3. The initial aim was adoption in 2023 and application of the rules from 1 January 2024. However, due to delays in the negotiation process, the final text and date of application remain uncertain.

EXECUTIVE SUMMARY

The directive targets entities within EU Member States engaged in economic activities but lacking sufficient substance for tax purposes. The directive sets criteria to identify such passive entities, imposing reporting obligations and penalties for non-compliance.

Entities falling under ATAD 3 must demonstrate genuine economic activity through indicators like physical presence, active banking, and local directorship. Penalties are structured based on revenue and total assets, incentivizing compliance. ATAD 3 also facilitates information exchange between EU countries and denies tax residency certificates to shell entities. The directive's pending adoption by the EU Council underscores the need for affected businesses to assess their structures promptly to comply with the new regulations.

SCOPE

Any entity engaged in an economic activity, regardless of its legal form, that is considered tax resident and eligible to receive a tax residence certificate in an EU Member State.

EXCLUSIONS

- > Companies with transferable **security admitted to trade or listed** on a regulated market or multilateral trading facility;
- > Certain **regulated financial undertakings** (credit institutions / investment firms / AIFM / UCITS);
- > Entities that have the **main activity of holding shares** in operational businesses within a given Member State, with beneficial owners also residing for tax purposes within that same Member State;
- > Entities with **holding activities** that are resident for tax purposes in the same Member State as the entity's shareholder(s) or the ultimate parent entity;
- > Entities with at least five full-time employees.

ENTITIES CONCERNED (THE “GATEWAY”)

Gateway Test

ATAD 3 aims to target passive entities that are tax resident in an EU Member State and that do not conduct any genuine economic activity because they are deemed not to have minimum substance.

If an entity meets all three gateway tests, it is considered a risk and is required to meet certain information reporting requirements in its annual tax return:

- > **Relevant Income** — More than 65% (75% in the initial version) of an entity's overall revenue in the preceding two tax years is 'relevant income'. 'Relevant income' broadly covers passive income such as interest, including any other income generated from financial assets, such as crypto assets, royalties, dividends, income from immovable property, income from certain movable property with a book value exceeding one million euros, income from services that have been outsourced to other associated enterprises, etc.
- > **Cross-border activities** – Over the course of the preceding two tax years, at least 55% (60% in the initial version) of the entity's relevant income is earned through or paid out via cross-border transactions. Alternatively, more than 55% (60% in the initial version) of the book value of certain assets (mainly immovable property or movable property with a book value exceeding one million euro) is located outside the Member State of the entity.
- > **Third-party outsourcing element** — The entity concerned has outsourced the administration of day-to-day operations and the decision-making of significant functions in the preceding two tax years. Based on the initial version of ATAD 3, it was unclear whether this condition would be met if such services and functions were outsourced within the group. The European Parliament proposes to clarify this by only requiring outsourcing to "a third party". This would be a welcome clarification for groups with such centralised functions.

INDICATORS OF MINIMUM SUBSTANCE FOR TAX PURPOSES

An entity that falls within the scope of ATAD 3, i.e. there is relevant income, a cross-border activity and outsourcing of management/administration (and the entity is not in one of the excluded categories), must in its annual tax return report and provide supporting documentation on whether the following cumulative indicators of minimum substance are met:

Premises

The entity concerned should have its own premises in the EU Member State of residence, or premises for its exclusive use. The EU Parliament has provided for a third option by allowing shared use of premises by entities of the same group. As such, it would not be required for each group entity to own or have premises for its exclusive use. Considering the increase in working from home, this is a welcome change for businesses.

Bank Account

The entity concerned should have at least one active bank account in the EU. The EU Parliament adds that an e-money account suffices. This may provide a solution for businesses based in EU Member States in which it is challenging to obtain access to a standard bank account. The EU Parliament also adds that the relevant income must be received through the bank account owned by the entity concerned.

Directors and Employees

At least one of the following two requirements must be met:

- > One or more directors of the entity concerned:
 - > are tax resident in the EU Member State in which the entity concerned is resident or reside at such distance that it is compatible with the proper performance of their duties, and
 - > are authorised to make decisions in relation to activities that generate relevant income, or the assets of the entity concerned.
- > Majority of the full-time equivalent employees of the entity concerned:
 - > have their habitual residence in the Member State of the entity, and such employees are qualified to carry out the activities that generate relevant income for the entity.

If the entity concerned does not meet all above indicators of minimum substance or fails to provide adequate documentation supporting this, that entity will be considered a shell entity.

Failure to comply with the reporting obligation carries a penalty. ATAD 3 imposes as a minimum penalty of at least 2% (previously 5%) of the revenue (previously turnover) of the entity concerned. The EU Parliament added that in case of a false declaration in the tax return, an additional penalty of at least 4% of the entity's revenue would be due. Initially, no distinction was made between failing to report and reporting incorrectly.

REBUTTAL

Entities that are considered a shell entity can provide rebuttal evidence demonstrating that there is a commercial rationale for the existence of the entity concerned and that it is not misused for tax purposes. Certain information must be supplied to substantiate this. A successful rebuttal may remain valid for up to 5 years from the time the decision is issued, assuming the relevant factual and legal circumstances do not change.

CONSEQUENCES OF BEING CONSIDERED A SHELL ENTITY

ATAD 3 provides for automatic exchange of certain information between EU Member States by amending the Directive on Administrative Cooperation in Direct Taxation (DAC). It will also be possible for EU Member States to request another EU Member State to audit specific entities.

The qualification of an entity as a shell entity means that it will not be issued with a certificate of tax residence by its EU Member State of residence. This should ensure that shell entities are disregarded by EU Member States when determining whether tax treaty benefits between EU Member States and tax benefits based on EU directives should be granted.

In the initial ATAD 3 proposal, EU Member States could alternatively issue a certificate of tax residence indicating that the entity is not entitled to certain benefits. This alternative is no longer provided for in the EU Parliament's version.

Note that the EU Member State of residence of the shell entity still gets to decide whether the shell entity is resident for tax purposes in that jurisdiction and which obligations the shell entity must comply with, such as filing tax returns and contributing corporate income tax on its profits.

NEXT STEPS

It now remains to be seen what wording of ATAD 3 the EU Council will adopt, provided unanimity is reached by the EU Member States.

ATAD 3 will potentially have a major impact on businesses carrying out activities in the EU. Given the EU legislator's aspiration for ATAD 3 to take effect as soon as possible and that the current reference period began on 1 January 2022, businesses possibly in scope of ATAD 3 urgently need to assess the impact of ATAD 3 on their group structure and make changes where appropriate.

HOW CAN WE HELP?

Entities should assess their current corporate structures to understand the potential consequences of ATAD 3.

Trident will be able to collaborate with you to review your company's current situation to determine substance and any possible exemptions from ATAD 3, in close cooperation with your tax adviser. We can provide you with the latest information and insights on the detail in the Directive and offer practical guidance to be ready if the proposed Directive is passed and implemented.

For further information contact any of:

Bertrand Party & Kaj Wouters – Trident Trust Company (Luxembourg) S.A. – bparty@tridenttrust.com & kwouters@tridenttrust.com

Janice Copperstone – Trident Trust Company (Malta) Limited – jcopperstone@tridenttrust.com

Marilena Stylianou – Trident Trust Company (Cyprus) – mstylianou@tridenttrust.com

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