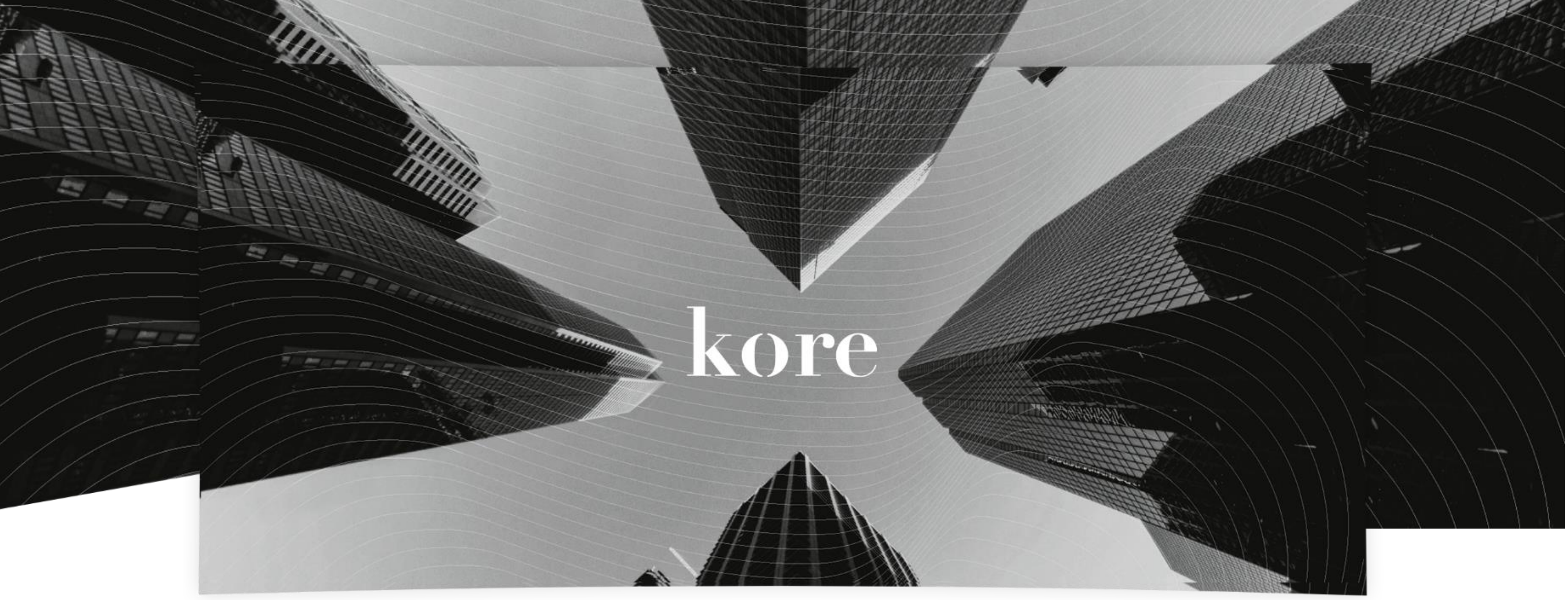

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Time to act: substance requirements for foreign entities

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On 22 December 2021, the European Commission published a draft Anti-Tax Avoidance 3 Directive ("ATAD 3") that opened an important debate within Europe on the need for common approach to minimum substance rules for tax purposes.

This proposal is also called the "Unshell Directive" because of its aim at curbing the misuse of shell entities for tax purposes. With a focus on low-substance entities not performing any genuine economic and business activities that are deemed resident in an EU Member State, the draft Directive introduces reporting obligations and minimum substance requirements for companies mainly deriving passive income (e.g., dividends, royalties and alike).

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How does it work?

The mechanics of the Directive is a seven-step approach designed to identify the risk of falling within its scope, which is to be assessed by the EU Member State where the entity is resident for tax purposes.

- **Step 1** is designed to identify if the entity passes three gateways: (i) more than 75% of revenues in the preceding two tax years consist of passive income, or more than 75% of company's assets consist of private property/immovable assets/dividend or gain generating assets; (ii) it is engaged mainly in cross-border activities; and (iii) the entity has outsourced the administration of day-to-day operations and decision-making on significant functions. If these criteria are met, the entity would qualify as a risk entity entailing a reporting obligation.
- **Step 2** is having the entity reporting substance in its tax return, namely: (i) premises; (ii) at least one active EU bank account; (iii) one director and/or majority employees being resident in the jurisdiction of the entity and having adequate qualifications.

- **Step 3** determines that entity is a shell company if Step 1 and Step 2 are not passed.
- **Step 4** allows for the first rebuttal that entity is engaged in genuine economic activity.
- **Step 5** allows for the second rebuttal if the entity substantiates it does not create a tax benefit.
- **Step 6** determines the consequences if the entity fails to rebut the shell company label under Step 4 and 5, which may include: (i) no certificate of tax residence issued by the country of the entity; (ii) potential no access to double tax treaty or EU directives; (iii) potential look-through with income allocated to the shareholder(s).
- **Step 7** provides an automatic exchange of information mechanism for entities considered at risk under Step 1 and no carve-out rule applies. Financial penalties may also apply with a recommended minimum penalty of at least 5% of the entity's turnover.

The proposal included 1 January 2024 as date of entry into force, with certain retroactive consequences for a "reference period" of two preceding years (FY2022/23).

"The aim and intent of the ATAD 3 Directive may be clear, but the discussion since its release has opened several important questions"

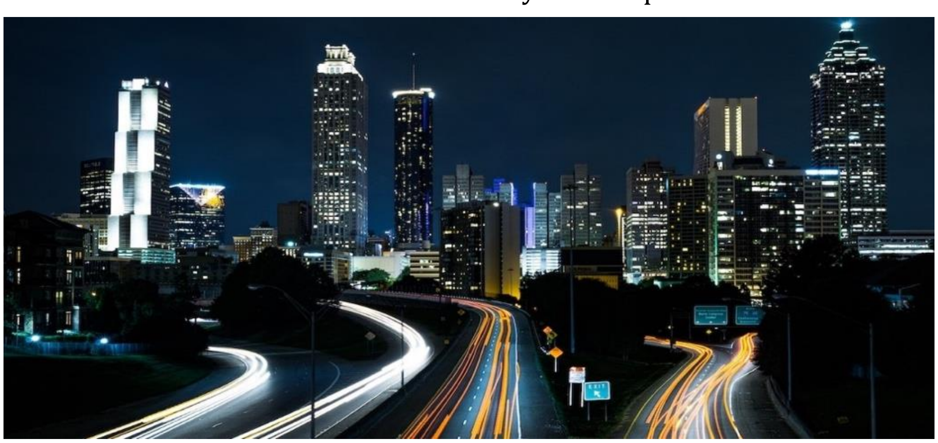
Issues (still) under discussion

The aim and intent of the ATAD 3 Directive may be clear, but the discussion since its release has opened several important questions regarding its overreach and real impact on the international tax landscape.

The hallmarks or gateways are very broad and apparently discussions are underway to reduce the scope of the gateways. The use of undefined concepts and complex procedure fully in the hands of the tax administration to qualify an entity as shell company is another of the drawbacks. For example, shifting the burden of proof to the taxpayer is a rather questionable procedure and certainly open to legal discussion.

It has been said that the "*limited liability corporation is the greatest single invention of modern times*." One may question why we are now tackling companies without substance, when corporate law permits limited liability entities (i.e. a company separate from shareholder with legal personality and separate assets that alone serve to cover its debts) to be incorporated with so-called "minimum substance".

Another point requiring discussion is the reason for advancing with an intra-EU mechanism without rolling out symmetrically a mechanism that also applies to non-EU countries. Perhaps EU principles require proportionality analysis and the analysis of how to engage with third countries. It was announced that the European Commission intended to present a new initiative to respond to the challenges linked to non-EU shell entities in 2022 but no further details have been yet made public.



From the latest discussions (including a recent report from the EU Parliament), amendments are being proposed to broaden the scope of carveouts, for example, by excluding subsidiaries of regulated financial undertakings and also reducing the compliance burdens. Finally, entry into force is being suggested as to be delayed to 1 January 2025 but nothing is being said of grandfathering rules to avoid any retroactive consequences.

Time to act is close

In times when results of other EU and international measures are still to be measured (namely ATADs, DAC6 and BEPS actions), the far-reaching consequences of this proposal may create a shift in international tax misaligned with the rest of the world.

The overkill may even result in double taxation and denial of treaty benefits, something that is generally seen as a last resort situation. If the rules are rolled out as proposed, uncertainty and legal disputes will likely arise affecting bona-fide EU entities.

We do agree with the statement that the use of conduits with a lack of substance is coming to an end, either via this initiative or because of other tax rules also play a role in tackling entities with minimal economic substance. 9 months may have passed since the publication of ATAD 3 draft and there is no definite news on the realistic chances of approval and timetable.

The "how to act" needs to be thought first

Holding structures may have had a particular objective and hence may become inappropriate or unnecessary, group structures may have grown over time or trading companies may have become redundant. There is a need to reconsider (first internally) what is needed and also address the benefits of simplifying the corporate structures. Redundant corporate structures may well become an unnecessary risk for the investors/shareholders, especially in the wake of initiatives that entail automatic exchange of information that leads to tax presumptions.

The timing is right to reconsider cross-border corporate structures and evaluate all the options available, which may include revisiting the tax residence of the entities or redomiciliation of legal entities to the main shareholder country. Other cases may require mergers or share for share transactions to simplify the group structure or liquidation of entities.

By excluding regulated funds from its scope, these vehicles will become even more appealing for EU-based family offices and the private equity space.

Finally, day-to-day-management and corporate governance models will require to be revisited to reduce exposure, at the same time that real substance is enhanced.

The proposal is still a proposal, but the outcome of the political game is unexpected specially in Europe. The Directive still needs to be approved by Member States and then transposed to domestic law, which means urgency is for tomorrow not yesterday. The possible ramifications are the critical aspect and even if this initiative does not advance, we expect that certain countries may well develop unilaterally minimum substance requirements. It is now time to act.

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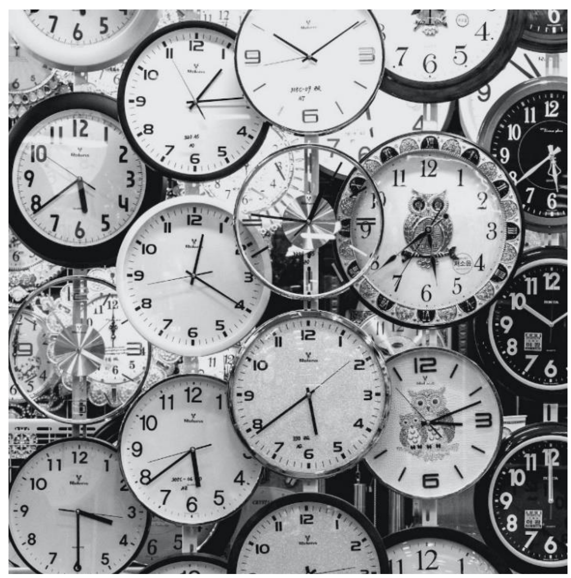

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