The „Unshell“ EU draft Directive for preventing the misuse of shell entities (ATAD 3)

As part of the „Business Taxation for the 21st Century“ initiative, the EU Commission released a proposed Directive on December 22, 2021, with the aim of preventing the tax abuse of so-called “shell” entities. Potentially affected are all companies engaged in an economic activity, regardless of their legal form, if they are resident in a Member State of the European Union. The partnerships according to German understanding are not included, as these cannot be resident for tax purposes. However, the Directive focuses on shell entities, i.e., companies that are abused without a minimum set of substance to obtain tax advantages.

With a view to effectively preventing this misuse, the tax authorities are focusing their considerations and measures on a multi-level substance test. The substance test is intended to identify companies with weak substance in order to be able to specifically assess their activities and functions, thereby preventing the misuse of tax advantages and ensuring fair and effective taxation within the European single market.

The proposal for the new Directive should be transposed into national law by June 30, 2023 and is expected to be applicable for the first time from January 1, 2024.

SCOPE OF APPLICATION:

The substance test covers all companies that are resident in the European Union and are consequently eligible to receive a tax residency certificate. This is a regular prerequisite for tax relief or tax advantages.

The substance test does not apply to companies, which are no risk of misuse intermediation in the opinion of the Directive‘s issuer. These are the following companies:

- listed companies;
- specific regulated financial companies;
- holding companies which hold shares in operating companies also carry-on business in the same Member State, provided that the beneficial owners are also resident in the same Member State;
- holding companies that are resident for tax purposes in the same Member State as their shareholders or the ultimate parent company of the group;
- companies with at least five own full-time equivalent employees exclusively carrying out the activities generating the relevant income.

SUBSTANCE TEST:

In the first step, identification is carried out by means of three criteria. An entity may potentially qualify as a „shell entity“, if it has the following cumulative characteristics in each of the two preceding fiscal years (i.e., scheduled to begin in fiscal year 2022).

- at least 75% of the income of the foreign entities under consideration have consisted of so-called relevant revenues („relevant income“ = passive income such as dividends, interest and royalties, et al.)
- it is a cross-border operating entity. This is to be determined based on the location of the business assets or the origin of the „relevant revenues“ and
- the entity has outsourced the administration of day-to-day operations as well as decision-making on significant functions (substance requirements).

ABOUT BDO

With over 2,100 employees across 27 different locations, BDO is one of the leading companies for auditing and audit-related services, tax and business law consulting, and advisory in Germany.

BDO AG Wirtschaftsprüfungsgesellschaft is the founding member of BDO International (established in 1963). With over 95,000 employees across 164 countries, it is currently the only globally active auditing and consulting organisation with European roots.

www.bdo.de

CONTACT

BDO AG
Wirtschaftsprüfungsgesellschaft

GORAN PERANOVIC
Certified Tax Advisor, Partner,
International Tax Services &
Transfer Pricing
Phone: +49 201 87215 – 172
goran.peranovic@bdo.de

CHRISTIAN FISCHER
Certified Tax Advisor, Partner,
Tax & Legal
Phone: +49 461 9090-193
christian.fischer@bdo.de

10/2022

If an entity meets these criteria of the first step, it is subject to an information obligation vis-à-vis the tax authorities of the country of residence and for the second step must disclose information on its substance as part of the annual tax declaration. For this purpose, the entity must provide evidence of its own business premises or the right to exclusive use of premises (i.e. a corresponding lease agreement), its own active bank account within the EU and its own staff.

If the entity cannot sufficiently demonstrate the necessary minimum substance in this step, the existence of a shell entity within the meaning of the Directive is initially assumed. However, the entity then has the possibility of providing counterevidence and can refute the assumption of the tax authorities by providing that the involvement of the entity is caused by economic reasons and not the achievement of a tax advantage. Finally, evidence must be provided of where the authoritative decisions are made with respect to business operations.

This favorable determination is then valid for a period of one year, which may be extended to up to five years, provided that the actual circumstances of the foreign entity do not change.

Whether the above provisions are intended to replace the Anti-Treaty-Shopping Rules of Section 50d (3) of the German Income Tax Act (EStG) is currently still open. The ATAD 3 regulations could also be applied alongside the regulations of Section 50d (3) German Income Tax Act.

CONSEQUENCES IN THE PRESENCE OF AN INSUBSTANTIAL ENTITY:

If the draft Directive's presumption of an entity without substance is not rebutted, the entity is classified as a shell entity. As a result, there are significant tax consequences:

- The draft stipulates the general non-applicability of Double Taxation Conventions and EU Directives (e.g. Parent-Subsidiary and Interest and Royalties Directives). Consequently, no benefits will be granted to these entities in the future.
- Certificates of residence should not be issued to the „shell entity“ itself, or only with a reference to its qualification as a „shell entity“.
- In relation to its shareholders, the „shell entity“ is treated as non-existent for tax purposes; assets and income are therefore taxed as if they were held or earned Directly by the shareholder.

RECOMMENDATION FOR ACTION

The draft Directive of EU Commission is likely to have significant effects and tax restrictions for foreign companies with a weak substance. Based on the experience with ATAD 2, it can be concluded that this draft will also be adopted by ECOFIN more or less in the form proposed. It is therefore advisable to analyze the existing structures at an early stage and to examine the effects of this aggravation. In this context, possible restructurings or the upstream examination and, if necessary, compliance with the substance requirements should also be considered.

The BDO AG team will be happy to assist you with our comprehensive expertise. Please feel free to contact us.