Irish Tax Institute

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Proposed Directive on Rules to Prevent the Misuse of Shell Entities for Tax Purposes

Response to the European Commission

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1. About the Irish Tax Institute

The Irish Tax Institute is the leading representative and educational body for Ireland's Chartered Tax Advisers (CTA) and is the country's only professional body exclusively dedicated to tax.

The Chartered Tax Adviser (CTA) qualification is the gold standard in tax and the international mark of excellence in tax advice. We benchmark our education programme against the very best in the world. The continued development of our syllabus, delivery model and assessment methods ensure that our CTAs have the skills and knowledge they need to meet the ever-changing needs of their workplaces.

Our membership of over 5,000 is part of the international CTA network which has more than 30,000 members. It includes the Chartered Institute of Taxation UK, the Tax Institute of Australia, and the Taxation Institute of Hong Kong. The Institute is also a member of the CFE Tax Advisers Europe (CFE), the European umbrella body for tax professionals.

Our members provide tax services and business expertise to thousands of Irish owned and multinational businesses as well as to individuals in Ireland and internationally. Many also hold senior roles in professional service firms, global companies, Government, Revenue, state bodies and in the European Commission.

The Institute is, first and foremost, an educational body but since its foundation in 1967, it has played an active role in the development of tax administration and tax policy in Ireland. We are deeply committed to playing our part in building an efficient and innovative tax system that serves a successful economy and a fair society. We are also committed to the future of the tax profession, our members, and our role in serving the best interests of Ireland's taxpayers in a new international world order.

Irish Tax Institute - Leading through tax education

2. Executive Summary

The Irish Tax Institute welcomes the opportunity to provide feedback on the proposed Directive laying down rules to prevent the misuse of shell entities for tax purposes[1] - known as 'ATAD3'.

According to the Explanatory Memorandum to the Directive, the aim of ATAD3 is to combat tax avoidance and evasion practices which directly affect the functioning of the Internal Market. However, the primary objective of recent EU and international tax reforms, including the first two EU Anti-tax Avoidance Directives (ATAD1[2] and ATAD2[3]), the seven iterations of the Directive on Administrative Co-operation[4] (DAC) and the OECD's Two-Pillar solution has been to combat tax avoidance and evasion.

In our view, the impact and effectiveness of these extensive tax reforms, which have recently been put in place or will shortly be transposed into the domestic legislation of EU Member States have not yet been sufficiently evaluated. We believe it is essential that time is taken to assess the full impact of recent reforms before determining if the additional measures proposed in ATAD3 are necessary. Indeed, it would appear that existing transfer pricing rules and controlled foreign company (CFC) rules tackle many of the issues that ATAD3 is seeking to address.

We consider that ATAD3, as currently drafted, could potentially infringe the EU fundamental freedoms of establishment and movement of capital and does not reflect the judgments of the Court of Justice of the European Union (CJEU) which have determined the circumstances in which tax laws can impose restrictions on the fundamental freedoms.

Finally, ATAD3 raises a number of practical concerns and is likely to give rise to disproportionate outcomes in many circumstances. These concerns, which have been set out in detail in the body of this submission, include the following:

- ATAD3 applies irrespective of the size of the undertaking or its business. In addition, where a tax liability arises on a shell entity's shareholders, it applies to all relevant direct or indirect shareholders, irrespective of the size of their shareholding. In our view, this is disproportionate and overly burdensome for small undertakings and small investors.

- The significant administration burden associated with ATAD3 for companies and tax administrations is unduly excessive and will considerably increase compliance costs for business.

[1] Proposal for a Council Directive laying down rules to prevent the misuse of shell entities for tax purposes and amending Directive 2011/16/EU
[2] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market.
[3] Council Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries.
[4] Council Directive 2011/16/EU of 15 February 2011 on administrative cooperation in the field of taxation and amending Directives

- We believe the economic substance indicators set out in ATAD3, which include an undertaking having their own premises or premises of which they have exclusive use in their Member State of residence, having full-time employees resident in, or near, the Member State where the undertaking is resident and having an active EU bank account, are arbitrary and do not consider the facts and circumstances of the businesses or industries concerned.

- We believe the economic substance indicators which presuppose that all businesses and their employees require a continued physical presence at one fixed location should be reconsidered given the increasingly digitalised economy where remote working has become commonplace.

- In our view, it would appear disproportionate that the exemption for lack of tax motives in Article 10 of ATAD3 cannot apply to an undertaking should a tax benefit accrue to a shareholder with a small or nominal shareholding.

Please note the issues raised in this submission are not exhaustive as we believe there are a number of other items throughout ATAD3 that require further clarification. For example, if the current approach to ATAD3 is retained, we are firmly of the view that a thorough review of ATAD3, in its totality, would be required, to ensure as much additional clarity can be provided as possible.

3. The Objectives of ATAD3 Overlap with Existing Measures

The Explanatory Memorandum to ATAD3 states that the aim of the Directive is to combat tax avoidance and evasion practices which directly affect the functioning of the Internal Market. However, combatting tax avoidance and evasion has been the primary objective of extensive EU and international tax reforms implemented by Member States in recent years.

These reforms include commitments arising from the OECD base erosion and profit shifting (BEPS) project and within the EU, ATAD1 and ATAD2 and seven iterations of the DAC. The reforms have resulted in the implementation of a range of measures including:

- CFC rules,
- exit tax rules,
- anti-hybrid rules,
- interest limitation rules,
- general anti-avoidance rules,
- transfer pricing,
- transparency measures comprising the automatic exchange of financial account information, tax rulings and country-by-country reports within the EU,
- the mandatory reporting of cross-border arrangements that could potentially be used for aggressive tax planning and
- reporting obligations for digital platforms to collect and report the income realised by sellers offering certain services.

Furthermore, the proposed Directive on ensuring a global minimum level of taxation for multinational groups in the Union[5] provides for a minimum effective tax rate of 15% for in-scope multinational enterprises and large-scale domestic groups. The proposed Directive, which will implement the OECD Inclusive Framework on BEPS international tax agreement on a Two-Pillar Solution to Address the Tax Challenges of Digitalisation[6] into EU law, will further limit the ability of in-scope enterprises to reduce their taxes through the use of shell companies.

In addition, the Directive on Public Country by Country Reporting (CbCR)[7] which enhances existing transparency measures, has recently entered into force, and must be transposed into the domestic legislation of EU Member States by June 2023.

The effectiveness of the range of tax reforms which have been put in place in recent years and the further measures which are in the process of being implemented or will shortly be transposed into the domestic legislation of Member States is not yet apparent.

[5] Proposal for a Council Directive on ensuring a global minimum level of taxation for multinational groups in the Union, SWD(2001) 580 final

[6] OECD/G20 Inclusive Framework on BEPS, Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy, 8 October 2021.

[7] Directive 2021/2101 amending Directive 2013/34/EU as regards disclosure of income tax information by certain undertakings and branches

We firmly believe that it is essential that time is taken to assess the full impact of such reforms before determining if the additional measures contained in ATAD 3 are necessary to combat the misuse of shell companies for tax purposes. Indeed, it would appear that existing transfer pricing rules and CFC rules tackle many of the issues that ATAD3 is seeking to address.

The explanatory memorandum to ATAD3 acknowledges that the anti-abuse rules across Member States are fragmented and notes that such fragmentation could be replicated and possibly worsened, were Member States to take action individually. It notes that a common approach towards shell entities would ensure legal certainty and reduce compliance costs for businesses operating within the EU.

However, where an undertaking has been found to have sufficient substance under ATAD3, this does not prevent a Member State from continuing to operate its own domestic anti-tax avoidance and evasion rules, provided that these are consistent with EU law. This means ATAD3 will compound the number of different rules that would apply in parallel to multinational companies, which is more likely to amplify tax and legal uncertainty for such businesses rather than reducing it.

4. Compatibility with Fundamental Freedoms and General Principles of EU Law

Freedom of Establishment and Free Movement of Capital

Both national measures and secondary EU law (such as Directives) must comply with the EU fundamental freedoms and general principles of EU law.[8] We consider that ATAD3, as currently drafted, could potentially unlawfully infringe the EU fundamental freedoms of establishment and movement of capital.

Article 65 of the Treaty on the Functioning of the European Union (TFEU) allows Member States to take all requisite measures to prevent infringements of national law and regulations, in particular in the field of taxation, or to take measures which are justified on grounds of public policy or public security. However, it provides that these measures and procedures cannot constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments.

Case law has established that tax rules which impose restrictions on fundamental freedoms must not go beyond what is necessary. To justify the introduction of tax laws that would impose restrictions on the free movement of establishment or the free movement of capital, it is a pre-requisite that the issue that needs to be dealt with is one which involves the existence of a wholly artificial arrangement entered into solely for tax reasons.[9]

Articles 6 and 7 of ATAD3 set out standardised general criteria, which if satisfied, lead to a presumption of lack of minimum substance. This presumption can then be rebutted if the criteria in Article 9 of ATAD3 are fulfilled.

In our view, by creating a presumption of lack of substance, irrespective of whether there are objective and verifiable elements making it possible to identify the existence of a wholly artificial arrangement entered into for tax reasons alone, ATAD3 does not appear to take into account case law of the CJEU regarding the requirements for tax laws which impose restrictions on fundamental freedoms.

We consider that the indicators of minimal substance as outlined in Article 7 of ATAD3 are arbitrary and are not, in and of themselves, indicators of wholly artificial tax arrangements. For example, factors such as owning an office (rather than renting a premises), having exclusive use of an office (as opposed to sharing it with other group companies), or having an 'active' EU bank account (as opposed to using a bank account in another country such as the UK), could not be considered to be indicators of wholly artificial tax arrangements.

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[8] *Hungary v Parliament & Council*, C-620/18, para. 104 to 117.

[9] *See Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue (Case C196-04), Test Claimants in the FII Group Litigation v Commissioners of Inland Revenue* (C-466/04), *Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue* (C-524/04), *National Grid Indus* (C-371/10) and *European Commission v United Kingdom of Great Britain and Northern Ireland* (Case C-112/14).

In addition, the exemption for lack of tax motives in Article 10 is only available if the taxpayer can demonstrate that the existence of the undertaking does not create a tax benefit (rather than the existence of a wholly artificial arrangement entered into for tax reasons alone).

This test differs significantly to that which generally exists in respect of tax avoidance arrangements, for example, under general anti-abuse rules (GAAR) or DAC6[10], where it is normally the case that the tax benefit must be the main benefit or one of the main benefits of the transaction.

Furthermore, Article 7 provides for indicators of minimum substance by reference to premises in a particular Member State and directors or employees being resident in a particular Member State or at no greater distance from that Member State insofar as such distance is compatible with the proper performance of their duties. We consider these conditions could potentially infringe the EU fundamental freedoms of establishment and free movement of people and capital.

Principle of Proportionality

As currently drafted, it is not clear that ATAD3 provides for a proportionate application of the proposed anti-tax avoidance measures despite the requirement to counter abuse in accordance with the principle of proportionality.[11] In section 5 of this submission we have outlined a number of areas where we believe the rules contained in ATAD3 will give rise to disproportionate outcomes. To ensure that ATAD3 is in line with EU law, we consider the assessment of minimum substance should be made in light of a wide range of criteria, tailored to the specifics of the activity performed by the entity. The assessment should also take into account the wider group structure and the entity's role in that structure, the domestic market in the entity's jurisdiction, as well as the current business landscape.

In compliance with the principle of proportionality, it is important that ATAD3 does not go beyond denying tax benefits that were incorrectly obtained. For example, if a payment by a company in a source Member State to a shell entity were exempt from withholding taxes under an EU Directive and would have been subject to a withholding tax rate of 10% under the terms of a double taxation treaty between the source Member State with the jurisdiction of the ultimate recipient of such payments, the application of the provisions of ATAD3 should not result in a withholding tax rate in excess of 10%, regardless of the domestic rates in the source Member State.

While ATAD3 seeks to impose tax on the shareholders in a shell entity, it does not exempt that income when it is ultimately distributed to these investors, meaning that double taxation will arise. This will lead to disproportionate outcomes where for example, there is a minority investor in a fund structure, who has no part in, or influence over, the

[10] Council Directive (EU) 2018/822 of 25 May 2018 amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements.
[11] *Lexel*, 20 January 2021, Case C-484/19 at para. 51

fund or its investment strategy. This approach is also in contrast with the approach taken for CFC rules which require a controlling relationship.

5. Fundamental Practical Concerns with ATAD3

We have outlined our technical observations regarding the detailed rules in ATAD3 in section 6 of this submission. However, we have fundamental concerns with some of the measures in the Directive which we believe are likely to lead to disproportionate outcomes in many circumstances. These include:

- ATAD3 applies irrespective of the size of the undertaking or its business. Furthermore, where a tax liability arises on a shell entity's shareholders, it applies to all relevant direct or indirect shareholders, irrespective of the size of their shareholding. In our view, this is disproportionate and overly burdensome for small undertakings and small investors.

- We consider that the administration burden for companies and tax administrations, to provide and validate statements and evidence, to file and deal with requests for certainty about the rebuttal provisions and exemption requests, is excessive. Even in circumstances where the five-year extension may be available for the rebuttal or exemption, the requirement that the "factual and legal circumstances of the undertaking remain unchanged" will likely require additional analysis and compliance reviews on an ongoing basis, particularly in the context of multinational groups where the factual and legal circumstances of an undertaking are likely to evolve and change frequently.

  In our view, it is therefore likely that the administrative burden associated with ATAD3 will significantly increase compliance costs for business. Furthermore, it would appear that an assessment of the rules is required irrespective of whether any treaty benefits are sought. This places an undue burden on entities to conduct these assessments, notwithstanding that CFC rules are also likely to apply to address any base erosion concerns.

- The economic substance indicators in ATAD3 require an undertaking to (i) have their own premises or a premises which they have exclusive use of in their Member State of residence; (ii) to have full-time employees resident in, or near, the Member State where the undertaking is resident; and (iii) have an active EU bank account. These indicators are arbitrary in our view and do not consider the facts and circumstances of the businesses or industries concerned.

  For example, it may be the case that all employees in a domestic group are employed in a single undertaking with that undertaking also holding the premises the employees use. However, no allowance is made for whether this outsourcing was intra-group and domestic. Therefore, other individual undertakings in the group will not be able to satisfy the criteria notwithstanding that there is a substantial presence in the same Member State.

- In addition, the economic substance indicators presuppose that all businesses and their employees require a continued physical presence at one fixed location. We believe that the appropriateness of physical presence at one fixed location as an

indicator of economic substance in an increasingly digitalised economy where remote working has become commonplace should be reconsidered. Following the imposition of public health restrictions by Member States during the Covid-19 pandemic, it has become evident that many companies can conduct their businesses electronically without requiring the ongoing physical presence of directors or employees at one fixed location.

- The exemption for lack of tax motives in Article 10 of ATAD3 only applies if the existence of the undertaking does not result in a tax benefit for any of the shareholders. This means that even if a benefit were to accrue a shareholder with only a small or nominal shareholding, this would preclude the exemption from applying to the undertaking. In our view, it is questionable that the application of the rules in this manner could be considered compatible with the EU law principle of proportionality.

- ATAD3 is intended to come into effect as of 1 January 2024 and applies a two-year "look back" period for determining whether an undertaking satisfies the key gateway tests. As ATAD3 was only published on 22 December 2021, this means that taxpayers have not had an opportunity to review and consider the provisions of ATAD3 and how it might impact their business before it comes into effect. In our view, taxpayers should be provided with the opportunity to consider the potential impact of ATAD3 on their business before the provisions come into effect.

  We also consider that if an undertaking ceases to outsource the administration of day-to-day operations and the decision-making on significant functions within the two-year "look back" period preceding the implementation of ATAD3, it should not be regarded as meeting the criteria in Article 6.

- The operation of ATAD3 in practice from 1 January 2024 is unclear. If undertakings that are regarded as shell entities notify their local tax authorities of this status in their annual tax return for the financial year commencing on or after 1 January 2024, then in an Irish context this information will not become available to the Irish tax authorities until September 2025 at the earliest. Until such time as local tax authorities refuse to issue tax residence certificates (or issue certificates with warning statements) for shell entities it is not clear how the shareholders and payers of income to such shell entities are to apply ATAD3 in practice.

6. Observations Regarding the Detailed Rules of ATAD3

We have set out below some further technical observations on the detailed rules set out in ATAD3 as currently drafted.

Article 4 – Relevant Income

Relevant Income for the purposes of ATAD3 is defined as including *“royalties and other income”* from intellectual or intangible property. The reference to “other income” could, on the face of it, include any other type of income from intangible property. If so, this could mean that the income of a software licensing company, for example, would be income classified as relevant income.

Relevant Income also includes income from financial leasing. However, we do not consider that it would be appropriate to classify income derived from the business of leasing as passive income.

Income from movable property which is held for “private purposes” where the book value exceeds €1 million is considered relevant income. It is not clear what “private purposes” means in this context. For example, if a company runs a private hire business, could this fall within the terms of ATAD3? If it is intended to refer to assets used for non-business purposes, it would be expected that transfer pricing rules would apply in such a scenario.

Relevant Income also includes “*income from services which the undertaking has outsourced to other associated enterprises”.* It is unclear what this means. It could be interpreted narrowly to apply only where a company contracts to provide a service but has no assets or infrastructure to supply it so that it outsources the entirety of that activity to another enterprise. However, if interpreted more broadly, it could include circumstances where a company has an asset which it uses to provide services but lacks the infrastructure to run the business itself and so outsources operational activities. Such a scenario can arise in the context of aircraft leasing where assets are often owned in separate companies, but all employees are employed by a group servicing entity, which may be in the same Member State.

Article 6 – The Reporting Undertakings

ATAD3 is intended to come into effect as of 1 January 2024 and applies a two-year “look back” period for determining whether an undertaking satisfies the gateway tests. As ATAD3 was only published on 22 December 2021, this means that taxpayers will not have had an opportunity to review and consider the provisions ATAD3 and how it might impact their business before it comes into effect. In our view, taxpayers should be provided with the opportunity to consider the potential impact of ATAD3 on their business before the provisions come into effect.

Article 6(1) - Gateway Tests

ATAD3 sets out three gateway tests. Where all the three gateway tests are satisfied, an undertaking is required to make a report to the relevant competent authority. In our view, the scope of the relevant income captured within the gateway tests is overly broad and as a result generates significant compliance requirements.

The first gateway test is satisfied where more than 75% of the revenues accruing to the undertaking in the preceding two tax years consists of relevant income. But this test does not take internal group structuring into account. For example, a business property, such as the group's offices could be owned by a property company which leases the property to the local operating company, which operates in other countries through a branch and charges a rental cost to the branches. In such a scenario, this entity would come within the gateway test notwithstanding that the group, as a whole, might not be engaged in a property rental business with third parties.

The second gateway will be passed where, in the preceding two tax years, more than 60% of the book value of the undertaking's immovable property or movable property was foreign property. This gateway will also be passed if at least 60% of the undertaking's relevant income is earned or paid out via cross-border transactions and the two-year test does not appear to apply to this specific limb of the gateway. This test is likely to have a significant impact on funds and investment vehicles due to the international nature of many of their investments.

The final gateway will be passed where, in the preceding two tax years, the undertaking outsourced the administration of day-to-day operations and the decision-making on significant functions. It would appear therefore that an undertaking can outsource either (i) the administration of day-to-day operations or (ii) decision-making on significant functions without passing this gateway, provided it does not outsource both of these activities.

No allowance is made in the Directive for outsourcing which is intra-group and domestic. As already noted, it is not uncommon for groups to organise and structure themselves so that all employees are employed by a single entity, with some of their time and services charged to other domestic group entities. Such a scenario is likely to result in the undertaking failing the final gateway test notwithstanding that there might be significant substance at a domestic group level. We consider outsourcing which is performed locally should be excluded in applying the test.

In our view, where an undertaking has ceased outsourcing the administration of day-to-day operations and the decision-making on significant functions during the two tax years preceding the implementation of ATAD3, it would be appropriate for the final gateway not to be regarded as passed.

Article 6(2) - Excluded Entities

Article 6(2) provides a list of undertakings which are excluded from the requirement to report to the relevant competent authority.

(i) Listed Companies

The first type of undertaking which qualifies for the exclusion from the rules are listed companies. However, the exclusion does not apply to the subsidiaries of listed companies, including those which are resident in the same EU Member State. The policy rationale for not permitting a subsidiary of the listed company to qualify for the same exception is not clear, as there is no material basis for differentiating between them. Moreover, there is no apparent policy rationale for differentiating between an EU listing as compared with a non-EU listing.

(ii) EU Regulated Financial Undertakings

There is also an exclusion provided for certain EU regulated financial undertakings. However, as the exception does not apply to their subsidiaries including their domestic subsidiaries, this will limit the application of the exception. In our view, it would be important that the exclusion is extended to domestic subsidiaries of regulated financial undertakings, as many regulated financial undertakings, including banks, investment funds and insurance companies, operate through unregulated domestic subsidiaries. There does not appear to be any clear policy justification for denying the exclusion to domestic subsidiaries of regulated financial undertakings. Moreover, there is no clear policy rationale for distinguishing between EU regulated financial undertakings and non-EU regulated financial undertakings.

(iii) Beneficial owners must be resident in the same Member State

The exclusion for holding companies provided in Article 6(2)(c) is very limited as it is subject to the requirement that all beneficial owners must be resident in the same EU Member State and therefore, will have very limited application. The application of this requirement in the context of takeovers or acquisitions where there are existing structures in place is also problematic.

(iv) Five Full-time Employees

A final exclusion applies to *"undertakings with at least five own full-time equivalent employees or members of staff exclusively carrying out the activities generating the relevant income."* In our view, the threshold of five employees is arbitrary. Depending on the type of business, substantial activities can be carried on in a Member State by a smaller number of employees.

Furthermore, it may be difficult for many corporate groups to satisfy the requirement that their employees "exclusively" carry out the activities generating the relevant income. For example, the employees might be employed in a single local entity but may have other duties, apart from generating the relevant income, which could result in them not meeting the exclusivity condition.

Article 7 – Indicators of Minimum Substance for Tax Purposes

An entity that fails one of the three gateway tests and is not subject to an exception may be able to demonstrate minimum substance. However, this will require the completion of declarations in the annual tax return and the provision of documentary evidence, resulting in a significant administrative burden.

A reporting undertaking is required to confirm that it has its own premises in the Member State or premises for its exclusive use. Within an international group there may be several group companies in one Member State and all the employees and the premises that they use, is often owned in a single company and leased to the local group companies. In such a scenario, as the premises is not exclusively available, many entities in the group will automatically fail this condition notwithstanding that there might be adequate premises available to the group. We do not think it is appropriate to determine substance in this way without having regard to the operations of the whole group.

The substance indicators also require the possession of at least one “active” bank account in a Member State. The policy rationale for assessing whether an undertaking has substance based on having an active EU bank account is unclear. While “active” is not defined in the Directive, it is possible that a holding company may not qualify if it has a bank account that is only used occasionally irrespective of whether it has other bank accounts.

It is not uncommon in certain industries, particularly sectors which invest in the EU from the USA, to have bank accounts in the USA rather than EU bank accounts. It would seem unreasonable, in our view, that the mere fact that an undertaking has a bank account outside of the EU but in a jurisdiction with extensive equivalent regulation, such as the UK or the USA, would present a risk, in particular given the detailed reporting of such matters to the tax authorities. It is possible that such a requirement may also be contrary to the freedom of movement of capital.

Where the independent qualified director indicator is not satisfied, the economic substance indicators require that the majority of fulltime employees are resident in the Member State where the undertaking is resident or “*at no greater distance from that Member State insofar as such distance is compatible with the proper performance of their duties*”. This requirement appears highly subjective and is likely to vary from entity to entity depending on the nature of the business. Businesses located in both geographically remote and smaller Member States are more likely to be required to cast the net wider to attract the right talent. In the modern working environment, employees and directors can perform many duties remotely and can also travel quickly and easily between jurisdictions, so it is difficult to understand why distance from a Member State should be a relevant consideration. We believe that this requirement could potentially be contrary to the EU fundamental freedoms and general principles of EU law. In addition, the subjective nature of this requirement in our view is likely to lead to inconsistency in application across Member States.

As noted above, it may be the case that all employees in a domestic group are employed in a single undertaking and, therefore, other individual undertakings in the group may not have their own employees notwithstanding that there is a substantial presence in the same Member State.

Some of these entities might have limited activities from year to year and, consequently, require limited employee support or director involvement where there are not many transactions to be dealt with in a given year. The absence of activity does not, in our view, suggest that there is a material risk of misuse of the entity.

The employee must also be qualified to carry out the activities which give rise to the relevant income. However, there is no guidance or direction in the Directive on how to assess this requirement. This is likely to result in inconsistent application across Member States.

ATAD3 requires active and independent use of the director authorisation by one director on a regular basis. However, there is no guidance provided in the Directive on how this should be assessed. Again, this is likely to lead to inconsistency in application across Member States.

In addition, the director concerned cannot have other directorships outside the group. As many directors have other directorships, including business, charitable and State boards, we believe this requirement is extremely restrictive and in our view is inequitable.

Documentary evidence is required to be produced regarding directors' qualifications, authorisations and place of residence. However, to pass the minimum substance test only one director must meet the requirements. If there is such a director, it would appear disproportionate to require such evidence in respect of the other directors.

Taxpayers are required to provide multiple documents to the tax authority evidencing that they meet the indicators of minimum substance. In our view, the requirement to produce documentary evidence with the tax return would appear to be contrary to the principle of self-assessment which exists in many Member States.

As noted above, it is not unusual for some groups to divide their activities within many entities which might all be located in the same jurisdiction. However, as there cannot be a group assessment, this means that this administrative burden will be very substantial and, for the reasons discussed above, it might appear in single applications that an entity lacks substance notwithstanding that there might be significant substance present domestically in the relevant group.

Article 8 - Presumption of Minimum Substance for Tax Purposes

Article 8 provides that where an undertaking satisfies all the indicators of minimum substance set out in Article 7 and provides satisfactory supporting documentary evidence, it shall be presumed to have minimum substance for the tax year.

However, there is no guidance in ATAD3 as to how the tax authorities in Member States should assess the documentary evidence provided by the undertaking. For example, what factors are tax authorities to consider in assessing whether a director or employee lives sufficiently close to the Member State or if the director is adequately qualified to take decisions in relation to the activities that generate relevant income?

In our view, the lack of detail provided is likely to lead to substantial variation across Member States with tax authorities interpreting these requirements differently.

Article 9 - Rebuttal of the Presumption

Article 9 requires Member States to take appropriate measures to allow undertakings that are presumed not to have minimum substance under Article 8 to rebut this presumption by providing any additional supporting evidence of the business activities which they perform to generate relevant income.

However, similar to the position which exists under Article 7 regarding assessing indicators of substance, there is no guidance or direction provided in ATAD3 as to how a tax authority will assess the various grounds of rebuttal (for example, the level of experience of employees) if they are presented by a taxpayer. We believe this is likely to result in inconsistency across Members States.

The rebuttal conditions also assume that the undertaking has its own employees and that they are not outsourced, either to related entities in the same Member State or for example, to asset managers who might be providing the services professionally from the same jurisdiction.

Each undertaking which satisfies the gateway tests must go through the full assessment process for minimum substance first, before attempting a rebuttal of the presumption that they have minimum substance. Therefore, even if an undertaking is ultimately successful, the administrative burden for taxpayers in rebutting will be considerable and will require additional compliance costs which could be substantial. Similarly for tax authorities, the administrative burden will be significant, especially in year one where they will be required to consider applications for entities that share premises, that have no active bank accounts or that have multiple directorships.

Article 10 – Exemption

An exemption for lack of tax motives applies where the existence of the undertaking does not reduce the tax liability of its beneficial owner(s) or of the group, as a whole, of which the undertaking is a member. This requires a comparison of the amount of overall tax due by the beneficial owner(s) or the group as a whole, as the case may be, as a result of the interposition of the undertaking, with the amount that would be due under the same circumstances in the absence of the undertaking. However, ATAD3 does not provide any guidance as to how these counter-factual outcomes should be assessed. We believe this will result in varying criteria being used across Member States.

As outlined above, the exemption for lack of tax motives only applies if none of the shareholders have a tax benefit. We consider the application of the rules in this manner to be disproportionate as it means that even if a benefit were to accrue to a shareholder with a small or nominal shareholding, this would preclude the exemption from applying to the undertaking. It is possible that the tax benefit may be a minor part of a much wider set of commercial factors which necessitates the role played by the undertaking within the group.

It is also unclear which types of taxes would come within the scope of this test, i.e., the group's entire tax profile or withholding taxes only.

We consider that it would be appropriate for a different approach to the exemption for lack of tax motives to be taken so that, when considered in the round with any re-design of the gateway criteria and substance indicators, it could serve to reduce the administrative burden for taxpayers, while ensuring that tax authorities only receive information on entities that are indeed at a high risk of being "misused for tax purposes".

Article 11 - Tax Consequences of not having Minimum Substance for Tax Purposes in Member States other than the Member State of the Undertaking

Article 11(1) applies where an undertaking passes the gateway tests and has not rebutted the presumption of minimum substance in accordance with Article 9. However, the application of any exemption granted under Article 10 in considering the application of Chapter III of the Directive is unclear and needs to be clarified. Article 10 appears to be drafted to provide an exemption from the obligations under ATAD3. Therefore, this gives an exemption from the reporting obligation. However, a question arises whether the tax consequences under Chapter III of the Directive could apply notwithstanding the exemption from the obligations in Article 10. As the tax consequences in Chapter III are ultimately imposed by reference to what is reported (i.e., the substance criteria and the related presumptions), it would appear that if there is no report then no such presumption can arise. Accordingly, the implications in Chapter III should not apply where an undertaking secures the exemption.

Those with an indirect shareholding or participation through one or more of undertakings which themselves are shell entities (though it is not clear if only EU tax resident undertakings can be shell entities for this purpose) are also treated as shareholders. Consequently, it is not enough to establish if the undertaking itself is a shell entity, but one must also establish the status of each direct and indirect shareholder or participator.

It would appear that any direct or indirect shareholder in a shell company which is subject to the terms of ATAD3 (i.e., is an EU resident) is obliged to tax their share of the relevant income. This could potentially capture an EU taxpayer holding a single share in a large EU group which would appear disproportionate. The taxpayer would need to know whether there were any EU based shell companies within the corporate structure to which the rules might apply. However, the taxpayer may not have such information and even if they did, they may not have the relevant details necessary to tax the underlying share of income.

In our view, some degree of proportionality should be incorporated into the rules as otherwise they will impact significantly on investments in listed groups, joint venture structures and fund structures (particularly where there are multiple tiers of funds, such as a fund of funds structure).

Where there is an indirect shareholder in a chain of shell companies, clarity is required as to how tax will be applied. ATAD3 does not clearly state that tax can only apply at the level of one EU shareholder. Thus, on the face of it, a shareholder could potentially have to impose tax on the income of all shell companies in the chain meaning the same income could be taxed multiple times and, in many countries.

The tax consequences imposed by ATAD3 on the shareholder entity do not allow for credit or reduction of taxation in respect of taxes that would be paid by the shareholder on the actual receipt of income from the shell company.

In relation to indirect ownership, for example, where there is a chain of ownership where no entities in the chain meet the substance requirements, it is not clear how to deal with non-EU companies in the chain. Do they have to be assessed against substance criteria? If so, how is that to be considered against the various criteria, such as a bank account in the EU?

While ATAD3 permits an EU shareholder to take credit for taxes paid by the EU shell company against any tax imposed under ATAD3, it does not apply an equivalent relief in respect of third country taxes suffered by the subsidiary company. For example, the EU shell company may pay less tax in its own country due to tax credits available with respect to amounts received from a third county. These may reduce the amount of tax paid by the shell company and, consequently, the amount of credit available to the EU shareholder according to ATAD3. However, if the EU shareholder is taxed as if it received the income from the third country directly, it is not clear whether those same credits can be claimed by the EU shareholder.

ATAD3 requires an EU shareholder to be taxed on the income of the shell entity as if it received it directly. No consideration is given to the fact that the shell entity might use some of that money to fund its expenses. For example, a holding company might fund an investment in another company with third-party debt which it services with dividends (and perhaps interest) it receives. The EU shareholder will receive no deduction for such genuine costs.

There is a presumption that where the shell entity is located in a Member State that double taxation agreements between the shareholder jurisdiction and that Member State can be ignored. In our view, this is highly problematic. Apart from the question of conflicts of national law with those of the double taxation agreement, it needs to be borne in mind that the shareholder jurisdiction can be both a direct and indirect shareholder jurisdiction.

In a scenario where a shareholder is resident in a third country and the source Member State taxes the outbound payment according to a double taxation agreement in effect with the third country of the shareholder, the third country is not compelled to apply a

double taxation agreement in force with the source jurisdiction in order to provide double tax relief (as acknowledged in scenarios (3) and (4) included in the section headed *Consequences* in Section 5 (*Other Elements*) of the Explanatory Memorandum to the Directive). As a result, double taxation is likely to arise in such scenarios.

It is presumed that there would be a cascading effect whereby one would start with the nearest shareholder to the shell company and work upwards until one reached an EU entity if one so existed. If there are intermediaries in non-EU jurisdictions, the double taxation agreement between those jurisdictions and the EU shell company may have precedence. In these circumstances, to override the double taxation agreement between a third country and the shell company jurisdiction would seem highly problematic. Indeed, in the absence of some form of multilateral instrument, it is not clear how the terms of a directive could override a double taxation agreement between Member States or between a Member State and a third country.

ATAD3 also provides for the disregard of benefits under the Parent-Subsidiary Directive[12] and the Interest & Royalties Directive[13]. However, it is unclear why such provisions should be disregarded given these Directives already contain anti-avoidance provisions.

Where the shell entity's shareholders are not resident for tax purposes in the EU but the person paying the relevant income to the shell entity is EU resident, it must apply withholding tax on those payments, in accordance with its local law, without prejudice to any double taxation agreement of that Member State and the jurisdiction of the shell entity's shareholders. This requirement applies equally to third parties. This assumes that those third parties will know the status of the recipient itself and the residency status of all shareholders, which may be direct or indirect, depending on whether there are other shell entities in the ownership chain. In our view, it would not be possible to satisfy this requirement in practice.

While ATAD3 seeks to impose tax on the shareholders in a shell entity, it does not exempt that income when it is ultimately distributed to those investors which is likely to cause double taxation. This could, for example, include a minority investor in a fund structure, who has no part in, or influence over, the fund or its investment strategy. There is no clear policy rationale why a minority investor should be penalised in this way. This approach contrasts with the CFC rules which require the existence of a controlling relationship.

Article 12 - Tax Consequences of not having Minimum Substance for Tax Purposes in the Member State of the Undertaking

Article 12 provides that where an undertaking does not have minimum substance for tax purposes in the Member State where it is resident for tax purposes, that Member State shall deny a request for a certificate of tax residence to the undertaking for use outside

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[12] Council Directive 2011/96/EU
[13] Council Directive 2003/49/EC

the jurisdiction of the Member State or alternatively it can grant a certificate of tax residence which is qualified.

In our view, the denial of a request for a tax residence certificate generally by a shell company may contravene double taxation agreements with third jurisdictions. The policy rationale for denying a tax residency certificate with respect to an entity which has multiple different activities, where only one such activity is giving rise to shell company status, is also unclear.

There are also practical concerns regarding potential timing issues related to the denial of tax residence certificates. It is possible that withholding tax relief may not be obtained due to the denial of a residence certificate while a submission from a taxpayer is being assessed by the tax authority.

Article 14 – Penalties

ATAD3 proposes an administrative pecuniary penalty of at least 5% of the undertaking's turnover in the relevant tax year. We believe that a more appropriate approach would be to allow Member States to set the level of penalties in accordance with the approach adopted in the Member State for similar obligations, such as the filing of annual corporate income tax returns, provided that the penalty is effective, proportionate and dissuasive in accordance with the case law of the CJEU.[14]

[14] See Case C-68/88 Commission v Greece