ATAD 3 – The fight against shell entities

January 13, 2022

On December 22, 2021, the European Commission presented a draft directive to prevent the use of shell entities for tax purposes. Once the draft is adopted, Member States are required to finalize their national implementation by June 30, 2023, and apply it as of January 1, 2024.

Especially in the case of fund structures, EU shell entities held below their alternative investment fund (AIF) are affected, provided that these EU shell entities have sources of income outside of their country of residence. These cross-border operating EU shell entities are to be denied advantages under double taxation treaties and EU directives. Another novelty – at least from the German point of view – is the possible attribution of the income of the EU shell entities directly to their shareholders.

The prehistory

Let us remind ourselves once again: EU law aims to ensure a free internal market. It is one of the fundamental freedoms under EU law to freely engage in economic activity within the European Union without being subject to disadvantages under tax law. According to the case law of the European Court of Justice, only "purely artificial constructions aimed exclusively at circumventing tax law" are not covered by the scope of protection of the fundamental freedoms (Lieber, jurisPR-SteuerR 14/2006 note 6).

The consequence thereof is that the interposition of a corporation for an indefinite period of time between the taxpayer and the source of income must be treated the same in Germany as well as abroad. The taxpayer does not have to justify this and seek non-tax reasons. The taxpayer exercises its free entrepreneurial right. The requirements imposed by the state of domicile in order to recognize a corporation under civil and tax law are a matter for the state of domicile alone. As we understand it, there was no requirement for additional territorial anchoring in the company's state of domicile outside the legal recognition of the company in the EU domicile state.

Then, in the so-called Danish cases (February 26, 2019, IStR 2019, page 308), the European Court of Justice clarified its definition of purely artificial arrangements more explicitly. An artificial arrangement is said to exist if, in a structure of related companies, a newly established pass-through company is interposed between the company paying interest on a loan and the company that had granted the loan and its function is limited to receiving and passing on interest payments. Due to the purely artificial arrangement thus given,

Documents to beinformed:

- Council Directive Draft to prevent the misuse of shell entities for tax purposes dated December 22, 2021 there is an abuse, so that the company in question cannot claim the fundamental freedoms under EU law due to the lack of economic activity.

This is "replicated" in Section 50d (3) sentence 1 number 2 German Income Tax Act: the mere holding of a source of income and passing on the income (pure conduit) is not sufficient to be deemed an economic activity.

However: a distinction between „good" active economic activity and „bad" passive economic activity did not take place.

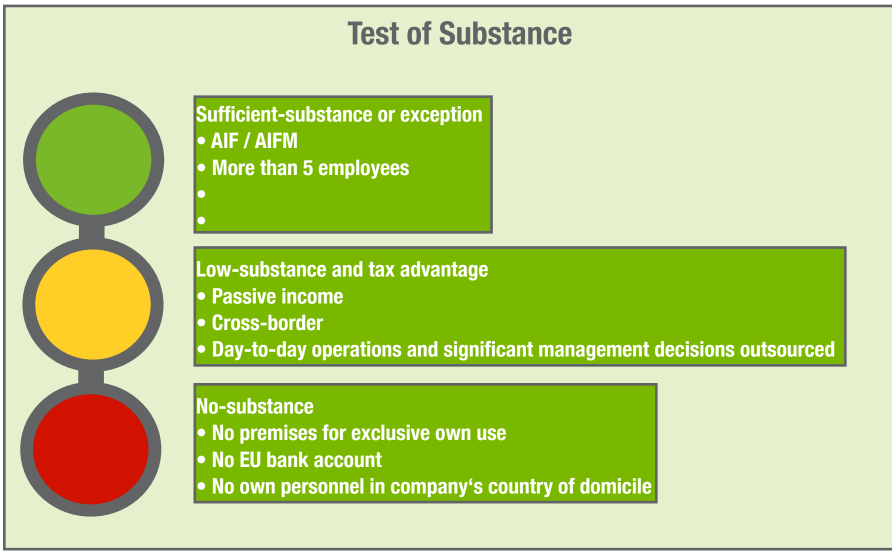
This was a good time for the European Commission to make its approach binding for the Member States in a directive. The first draft of this directive is now available.

The provisions of the draft directive

Let's start with a rough overview:

The regulations begin with a definition of companies that are presumed to be "low substance" companies. This definition focuses at the economic activity of the company. Companies that receive passive and particularly "mobile" income are deemed to be "low-substance". Furthermore, the "low-substance" company needs to engage in cross-border activities related to assets, income or payments. A further element of "low-substance" is that the company does not carry out its day-to-day operations and its significant management decisions itself, but has outsourced them.

If all these characteristics of a "low-substance" company are fulfilled, the economic activity of the company in its country of domicile alone is no longer sufficient. It must now be demonstrated that the company is not a "no-substance" company. For this purpose, special territorial connecting factors must now be proven by the company each year or the company must provide evidence of a lack of tax advantage.



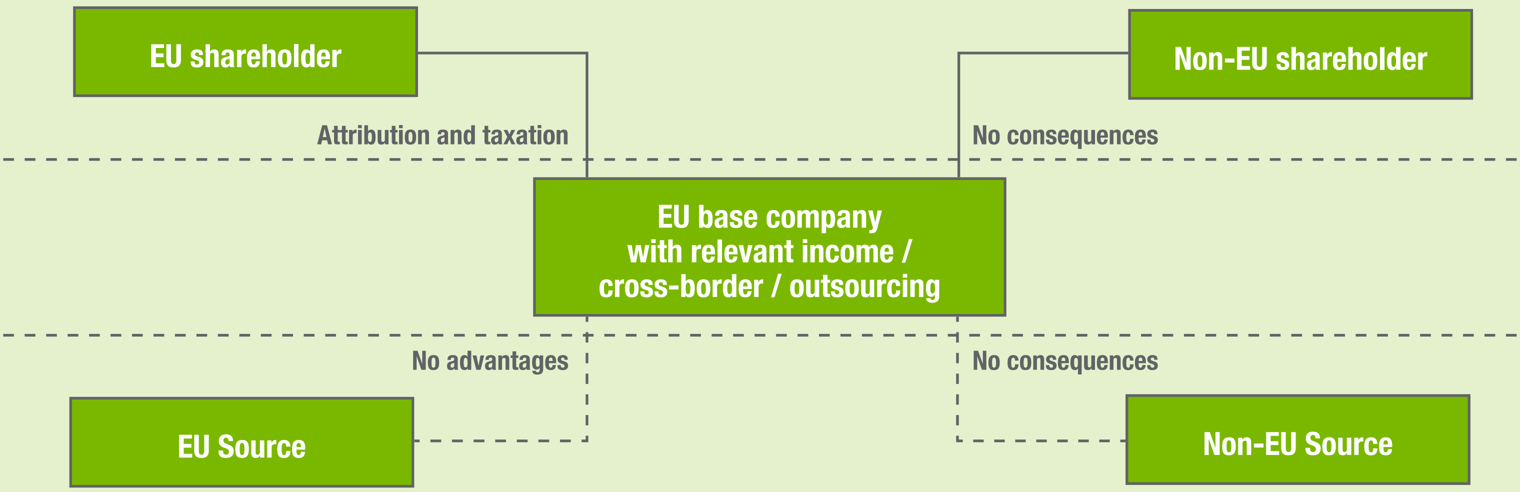
To qualify for the exception to the special territorial nexus requirements, the following must be demonstrated: premises for exclusive own use, EU bank account, own directors or own personnel with tax residency in the company's country of domicile (or at least at no great distance) to carry out the economic activity.

For the exception of the lack of tax advantage, proof must be provided that the "low-substance" company does not create any tax advantages for its shareholders or its group of companies as a whole. The tax authority responsible for the company at its registered office decides whether proof of the lack of tax advantage has been provided. The decision is generally valid for one year, but may be extended to a period of up to five additional years.

If neither the proof of the special territorial connection nor the proof of the lack of tax advantage is provided, the company is to be classified as having "no-substance" on the basis of the typified characteristics. However, it is still possible for the company thus classified to rebut this classification on the basis of its special circumstances. For this purpose, the company must explain why, despite the fact that it fulfills the characteristics of an "no-substance" company, it is nevertheless engaged in a recognizable economic activity in order to generate its income. If it fails to do so, the company is definitively qualified as a “no-substance” company.

A “no-substance” company loses its eligibility for benefits under double taxation treaties with other EU Member States and benefits under EU directives such as the Parent-Subsidiary Directive, and it does not receive the corresponding residence certificates. In addition, the EU Member State in which the shareholders of such “no-substance” company are resident may directly attribute and tax the income to its shareholders (deducting the taxes levied by the EU Member State of residence of the company). With respect to states that are not Member States of the European Union, the draft directive does not result in any legal consequences.

Overview of Legal Consequences



Some details

By exemption, “low-substance” companies do not include certain regulated companies, such as alternative investment funds (AIF) and alternative investment fund managers (AIFM). However, this exemption does not apply to their subsidiaries. Also excluded from the scope of “low-substance” companies from the outset are companies with at least five full-time employees, holding companies of operating companies with shareholders of the holding company in the same Member State, managing holding companies with tax residence in the same Member State as their shareholders or group parent, securitization vehicles within the meaning of Regulation (EU) 2017/2402 (i.e. securitization of credit risks of an originator/sponsor) and listed companies.

Now let’s take a closer look at the economic activity of a “low-substance” company. According to the definition, a “low-substance” company exists if all three of the following characteristics are met (the period under consideration is the two preceding years):

- Passive income: More than 75 percent of the income is passive income (such as income from interest, licenses, dividends and capital gains from company shares, income from movable assets with a book value higher than Euro 1 million, income from immovable assets, and income from services outsourced to affiliated companies). In the case of assets and holding of company shares, instead of income, it is sufficient if the book value of the assets or company shares exceeds 75 percent of the company‘s assets.
- Cross-border: At least 60 percent of this passive income is received cross-border (source of income in the other state) or paid out cross-border (recipient in the other state). Instead of passive

income, it is also sufficient if the assets located abroad account for more than 60 percent of the company's total assets according to their book value.

- Own activity: day-to-day operations and decision-making on significant functions are outsourced.

If the company is deemed to be "no-substance" within the meaning of the draft directive, it must either provide evidence of a lack of tax advantage or prove special territorial connecting factors in order not to be classified as a "no-substance" company. With regard to the territorial connecting factors, it is clearly stipulated that office space shared with other companies is not sufficient. In view of today's hip co-working spaces, this is probably a rather antiquated feature. According to the draft directive, managing directors who do not work exclusively for a company (working for companies affiliated with the "no-substance" company is not considered harmful) also do not constitute a suitable territorial connecting factor. Nevertheless, a personal residence of the managing director in the vicinity is sufficient if there is no residence in the state in which the company itself has its registered office. As an alternative to the personally resident managing director, the personal residence or at least geographic proximity of the majority of the full-time employees is also sufficient.

Better to get an overview of one's own structures right now

From a German point of view, it is certainly not that difficult to get to grips with many of the features of this draft directive. In Section 50d(3) of the German Income Tax Act, in its various versions over the last 15 years, almost every feature appears in principle or has been discussed by case law, tax authorities, academia or practitioners. In this respect, we are all well trained. Nevertheless, for each structure according to the specifications in the draft, it should be tested whether there is a reporting obligation. Non-compliance with the reporting requirements not only leads to possible tax disadvantages, but may also result in severe penalties of at least five percent of the shell entity's turnover per tax year. We would be happy to assist you with our Substance Check 2022!

be in touch: Any questions? Please do not hesitate to contact us!

Dr. Carsten Bödecker
Partner . Steuerberater . Rechtsanwalt
Tel. +49 211 946847-51
carsten.boedecker@bepartners.pro

Carsten Ernst
Partner . Steuerberater
Tel. +49 211 946847-52
carsten.ernst@bepartners.pro

Friederike Schmidt
Partner . Steuerberaterin
Tel. +49 211 946847-60
friederike.schmidt@bepartners.pro

Nathalie Grenewitz
Principal . US-Attorney at Law
Tel. +49 211 946847-57
nathalie.grenewitz@bepartners.pro