

# Focus on companies with low levels of economic activity 3/17/22



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The European Commission has published proposals for a directive on rules to prevent shell companies from being used for tax evasion and to amend Directive 2011/16/EU on administrative cooperation. ATAD3 is the short title of the proposed directive. It mandates minimum business indicators for companies established in member states and rules on the tax regime for companies falling short of those indicators. The proposed directive would apply to all companies that are considered tax residents, including partnerships, trusts, and other legal arrangements. If adopted, the directive will come into force on 1 January 2024.

## Shell companies

A shell company is one that does not carry out the minimum economic activity and is used fraudulently to obtain tax advantages. The proposed directive will have a greater impact on any EU-resident holding companies that enjoy benefits available under double tax treaties and other EU directives (e.g. the Parent/Subsidiary and the Interest/Royalties directives) but lack the minimum economic content in their activities. These rules will have a lasting effect on the tax treatment of mergers and acquisitions made from 1 January 2022 onwards, and on entities within the existing acquisition and holding structures.

## Tests and checks

The proposal outlines a number of tests aimed at identifying high-risk companies that might be recognised as shell companies. The tests are designed to establish whether a company has a true economic link with its country of residence (the minimum activity level is set to assess whether the company is being fraudulently used for tax evasion purposes).

However, a company that meets one of the criteria set out below will be exempt from the minimum activity requirements:

- A company with a transferable security listed on a regulated market or multilateral trading facility
- A regulated financial company (as defined in the proposed directive)
- A company that holds shares in companies operating and located in the same member state as the company's shareholders or ultimate holding company
- A company with at least five full-time employees dedicated to its income-generating activities

## Gateway criteria

The minimum activity test comprises seven steps. The first step involves establishing whether the

company meets a set of gateway criteria to indicate whether it could be treated as a subject with a low activity content that could be fraudulently used for tax purposes. The relevant gateway criteria are set out below:

- Entities that are geographically mobile because 75% of their revenue for the previous two years was passive income, or if no income has recently been gained from holding particular assets
- Companies doing cross-border transactions (either more than 60% of particular assets according to their book value in the previous two years were located outside the member state or more than 60% of the company's relevant income was gained using cross-border transactions)
- Companies acquiring services related to their day-to-day administration and decision-making on key functions

Assuming the company meets the three gateway criteria, it will have to file information on its economic substance and provide evidence in its tax return that it meets the business indicators.

If the company is unable to meet these criteria, it would have to provide the tax authorities with more information on its commercial objectives and activities, plus any other essential information, as well as trying to obtain consent that it does not qualify as a shell company. Failing that, the company will be denied benefits under double tax treaties and EU directives. It is noteworthy that the obligation to notify the State Revenue Service (SRS) under the proposed directive would apply to any company that meets all three gateway criteria at the first stage, even if it is eventually agreed that this is not a shell company.

The information gathered under ATAD3 will be shared with other member states through automatic exchange of information. Penalties for breaching the rules will be set by each member state individually. Currently the recommended penalty is at least 5% of the subject's revenue.

If the company falls short of the minimum activity requirements and is unable to demonstrate its genuine business purpose, then restrictions will be placed on any benefits the company and/or its shareholders are enjoying under EU directives and double tax treaties.

While companies set up for genuine business reasons have the opportunity to demonstrate this to the tax authorities, it will create a significant additional administrative burden on the taxpayer and the tax authorities. So, although the proposed directive may do a good job in restricting the use of shell companies and preventing tax evasion, it will create an extra administrative burden to be considered by all EU residents and many non-residents.