

Cyprus Tax Alert

10 February 2023

ATAD 3 – MISUSE OF SHELL ENTITIES

The European Commission published a draft anti-tax avoidance directive known as ATAD 3, “laying down rules to prevent the misuse of shell entities for improper tax purposes”.

Although the final form of the directive is unknown, its current content may result in tax and reporting consequences for EU entities that do not meet its substance and economic activity requirements.

Its goal is to tackle the abuse of companies that do not carry out any economic activity (= ‘shell entities’)

It should be highlighted that the draft directive contains a two-year look-back rule that means that if it is adopted in its current proposed format, which includes a timeline of EU member states implementing the directive into their domestic tax legislation by June 30, 2023, and applying its requirements by January 1, 2024, a company’s position and circumstances in the years 2022 and 2023 will act as a reference point.

Below is a summary of the provisions of the draft Directive.

COMPANIES AT RISK

If an entity passes through all the following three gateways, it is considered to be “at risk.” In such a case, they will be subject to the respective reporting, documentation and procedural requirements imposed by the draft Directive.

3 ‘Gateways’

- Relevant income
- Cross border activity
- Outsourced management

Gateway 1: Relevant income

In the preceding 2 years >75%

- interest or any other income generated from financial asset
- royalties or any other income generated from intellectual or intangible property or tradable permits;
- dividends and income from the disposal of shares;
- income from (financial) leasing;
- income from services which the undertaking has outsourced to other associated enterprises

Gateway 2: Cross Border activity

The undertaking is engaged in cross-border activity on any of the following grounds:

- More than 60% of the book value of the undertaking's assets (movable and immovable property) was located outside the Member State of the undertaking in the preceding two tax years, •
- At least 60% of the undertakings relevant income is earned or paid out via cross-border transactions

Gateway 3: Outsourced management

In the preceding two tax years, the undertaking outsourced the administration of day-to-day operations, and the decision-making on significant functions.

Such undertakings tend to

- engage third party service providers of administration, management, correspondence and legal compliance services, or
- enter into relevant agreements with associated enterprises for the supply of such services in order to set up and maintain a legal and tax presence.

Outsourcing of certain ancillary services only, such as bookkeeping services alone, while core activities remain with the undertaking, would not suffice in itself for an undertaking to pass (or fail) this gateway.

Exempted entities

- Where the tested company is resident of the same (Member) State as the UPE
- Undertakings with at least 5 employees
- Listed companies
- Regulated financial entities

If all three gateways are met AND no exemptions the entities need to REPORT on substance:

- Own office (premises)

The entity has its own premises in the Member State or premises for its exclusive use

- Active EU bank account;

The entity has at least one active bank account in the EU.

- Qualified management

The entity must have either of the following alternatives:

At least one director is resident in the relevant Member State or is a commuter (i.e. at a distance from such Member State that is compatible with properly performing directors' duties). Such a director must be **properly qualified and independently authorized to take decisions** on behalf of the entity and neither employed by or a director of other non-associated entities.

The majority of its employees are resident in the relevant Member States and such employees are qualified to carry out the entity's income-generating activities.

Consequences

- Exchange of information within the EU on EU-shell entities
- Denial to issue residency certificates or issue certificate with warning
- No EU-treaty or EU-directive benefits
- EU-shareholder gets CFC-type of taxation on EU shell's income
- Non-compliance with the directive results in penalty of at least 5% of turnover.

Rebuttal and Exemptions

The presumption of shell entity status that emerges from the steps outlined above can be rebutted by providing:

- Evidence of the business activities performed to generate the relevant income. Such evidence could include documentation to explain the commercial rationale behind the establishment of the entity, employee profiles as well as evidence that the decision-making in relation to the relevant activity was indeed performed in the relevant Member State, or

- Entities within the scope of the Directive can apply for an exemption from their reporting obligations by providing evidence of the absence of a tax benefit for the beneficial owner(s) of the entity or the group.

Whilst those entities that are able to rebut the presumption or successfully apply for an exemption will not be subject to the tax consequences of the proposed rules, **they will still be subject to the respective reporting**, documentation and procedural requirements imposed by the Directive.

Exchange of information

Member States will automatically exchange information on the entities 'at risk' irrespective of whether the entities are ultimately deemed to be shell entities or not.

In addition, tax audits can be requested by other Member States if they have reason to believe that the substance requirements are not met.

How we can help you here at PKF:

We want to take a proactive approach on the matter, specifically, we are currently analysing the proposed directive to understand the potential impacts on our clients.

We are happy to discuss with you any enquiries you have and explain how we can assist in assessing whether your entity is in scope and how we can help you comply, if required. We are also happy to assist with a preliminary assessment based on the current status of the company.

For any assistance, please feel free to contact us.

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