ATAD 3 AND INVESTMENT FUNDS: FREQUENTLY ASKED QUESTIONS

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Fund managers often ask us about the implications of upcoming ATAD 3 changes in the context of investment funds. In this article, we summarise their Frequently Asked Questions and our responses.

1 What is ATAD 3, and why is it being introduced?

The Anti-Tax Avoidance Directive III, also known as ATAD 3 or the "Unshell Directive," is the EU directive introduced to prevent the use of shell entities for improper tax purposes in cross-border structures.

The directive addresses concerns that businesses might misuse shell companies, which lack substance and do not engage in significant economic activity in practice, to benefit from double tax treaties and EU tax directives. In doing so, the companies can withhold taxes on dividends, interests, royalties and non-resident capital gains.

The topic of minimal substance in terms of access to EU tax directives and bilateral treaties is not new, and many EU member states have already established their own approaches. In this context, ATAD 3 aims to standardise the minimum substance level requirements by proposing a minimum common standard that member states can build upon with their own higher threshold. It will, therefore, be important to consider the local implementation and seek appropriate advice based on the facts and circumstances of the cross-border transaction.

2 How is ATAD 3 relevant for investment funds?

ATAD 3 has a notable effect on investment funds as it primarily focuses on the minimum substance levels in the holding companies, which are established by funds to hold investments. However, its influence may be beyond that, depending on the fund structure.

ATAD 3 introduces compliance requirements for existing investments that could lead to rising operational costs. If the conditions are not met, investors may experience:

- reduced returns, through the denial of treaty relief for withholding taxes on distributions;
- increased reporting obligations; and
- heightened reputational risk.

The ATAD 3 approach to holding company substance is becoming a crucial factor when selecting holding companies for future investments. This, along with other factors like the "principal purpose test" under BEPS and the Multilateral Instrument, significantly impacts fund managers' decisions regarding ongoing operational efficiency and resourcing. In our discussions with fund managers, we consider ATAD 3 not only as a tax compliance matter, but also as an operational and strategic consideration. For these reasons, it is essential to establish a robust governance framework to address ATAD 3.

If you are a fund manager who wishes to discuss establishing a robust governance framework, please reach out to us for expert advice (see contact details at the last section of this article).

3 Is ATAD 3 relevant for non-EU entities?

Although ATAD 3 only applies to EU entities, EU member states may still assess the substance of holding companies resident in the UK (or another non-EU jurisdiction) to determine eligibility for double tax treaty relief on distributions from EU assets. Therefore, this topic may increasingly be viewed through an ATAD 3 lens.

While a non-EU holding company cannot bypass the consideration of substance in their structure, it may be operationally more efficient for many UK fund managers to maintain and demonstrate the required minimum substance (however that is interpreted in the asset jurisdiction) in a UK holding company rather than an EU holding company. This decision should be based on specific circumstances, considering other tax and non-tax factors when choosing the jurisdiction for the holding company.

4 When does ATAD 3 come into effect?

If ATAD 3 is adopted, then Member States will need to implement the Directive by June 30, 2023 in preparation for application from January 1, 2024. It is important to note that certain tests are applied on a two-year look back basis, meaning they will consider the current situation as of January 1, 2024.

This places investment funds and their managers in a tricky position, as they have to assess and potentially amend existing structures based on rules that are still being determined and not yet in force. Considering the tight timeline for adoption and implementation, there may be some flexibility with the timing, which the European Commission is likely to provide soon.

5 Are there any carve-outs for investment funds?

ATAD 3 includes carve-outs that exclude certain entities from its scope. These exceptions apply to certain regulated financial activities like Alternative Investment Funds (AIFs) and Alternative Investment Fund Managers (AIFMs), as well as holding companies in the same jurisdiction as the asset that generates the profits.

It is important to note that carve-outs are applicable on a per-entity basis. This means that unregulated holding entities may still fall under the scope of ATAD 3, even if they are directly or indirectly held by a regulated entity within a fund structure. For example, holding companies in Luxembourg and Ireland are commonly used in investment fund structures, and they may be subject to ATAD 3.

6 What is the ATAD 3 gateway test for entities?

The ATAD 3 gateway test was slightly amended by the European Parliament. There are three conditions to be classified as a "risk entity:"

1. Relevant income – Over 65 percent of revenue (originally proposed as 75 percent by the European Commission) created in the previous two years is considered "relevant income". This primarily includes passive income, such as interest, dividends, and royalties.

2. Cross-border activity – More than 55 percent of the book value (originally proposed as 60 percent) or more than 55 percent of the relevant income (originally proposed as 60 percent) should be derived from cross-border transactions in the previous two years.

3. Outsourcing of functions – The company outsources the corporate management and administration services on significant functions to a third party instead of performing them in-house, again within the previous two years.

7 What are the implications of the gateway test for ATAD 3 on entities?

Our general expectation is that the gateway test would typically be met for many asset holding companies, particularly those utilised by investment funds that are not purely domestic in investment strategy. However, much will depend on the framing of the outsourcing definition and whether, for example, management by non-local directors, employed by the fund manager, is within scope. Additionally, questions regarding the compatibility of these conditions with established EU freedoms still need to be addressed.

If the gateway test for ATAD 3 applies to an entity, it is classified as a 'risk entity.' In such cases, the entity is required to declare in its annual tax return whether it meets certain minimum substance requirements. For further details on these substance requirements, please refer to the next question.

8 What are the minimum substance requirements for entities under ATAD 3?

For the risk entity not to be presumes as a shell, it must meet the following three minimum substance requirements:

1. Office space – The entity should have its own office space, or exclusive use of office space. Shared premises with entities within the same group would be acceptable

2. Bank account – The entity should maintain at least one active bank account in the EU, which should receive relevant income (as described above).

3. Specific directors/employees – At least one of the following two requirements must be met:

i. One or more directors of the entity concerned are (a) tax residents in the EU Member State in which the entity is resident, or reside at a distance that is compatible with the proper performance of their duties, and (b) are authorised to make decisions in relation to activities that generate relevant income, or the assets of the entity.

ii. The majority of the full-time equivalent employees of the entity (a) have their habitual residence in accordance with EU contractual obligations (Rome I), and (b) are qualified to carry out the activities that generate relevant income for the entity.

If an entity declares that it meets all the minimum substance requirements, and provides the necessary documentary evidence, it will be presumed to have the required minimum substance for the relevant tax year. If not, then there will be a presumption against minimum substance, which entities may rebut by providing further supporting evidence.

9 What are the tax implications of being considered a shell entity?

An entity will be considered a shell entity to the extent that it does not fall within a carve-out, does not meet all the above minimum substance requirements, or fails to provide documentation supporting that the minimum substance requirements are met.

When an entity is deemed a shell entity, it can result in tax implications at various levels within the investment fund and/or investment structure. Below is a non-exhaustive summary of potential consequences.

10 What are the specific tax implications for shareholders, shell entities, and subsidiaries under ATAD 3?

1. Shareholder of the shell entity

If the shareholder is established in the EU:

- **Tax treaty relief denied –** Tax treaty relief shall be denied under the relevant double tax treaty between the Member State of the shareholder and the Member State of the shell entity, or the Parent-Subsidiary Directive/Interest-Royalty Directive.
- **Tax on accrued relevant income —** The shareholder shall be taxed as if they accrued the relevant income and held the underlying asset directly, with due regard to the double tax treaty between the Member State of the shareholder and the Member State of the source state, and the Parent-Subsidiary Directive. Also, dependent on local national law in the Member State of the shareholder, the shareholder may or may not be exempt from taxation in that state under a local participation exemption.
- **Deduction of any tax paid on relevant income –** The shareholder shall deduct any tax paid on relevant income in the Member State of the shell entity and may claim relief for tax paid at source under the relevant double tax treaty between the Member State of the shareholder and the Member State of the source state, or the Parent-Subsidiary Directive/Interest-Royalty Directive.

No local direct tax consequences should arise for shareholders outside the EU as ATAD 3 does not apply to entities residing outside the EU.

2. Shell entity (resident in the EU)

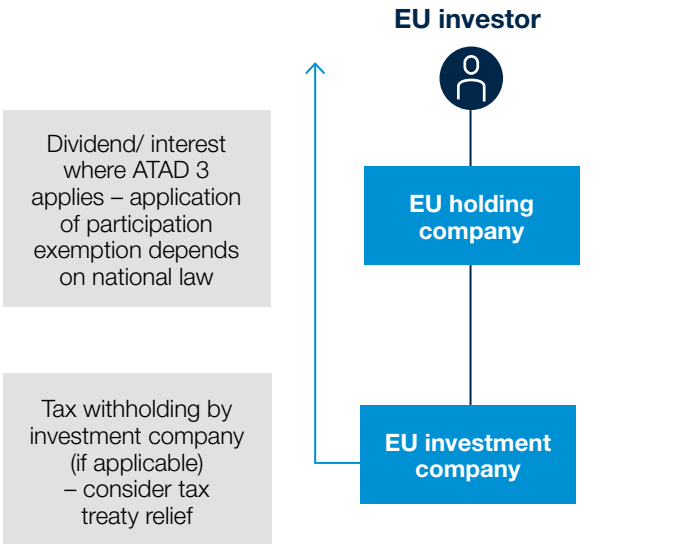
The shell entity should still fulfil tax and reporting obligations as per national law. However, they are not eligible for tax treaty benefits for benefits under Parent-Subsidiary Directive/Interest-Royalty Directive. Therefore, no tax residence certificate would be issued for these entities.

3. Subsidiary of the shell entity

If the subsidiary is established in the EU:

- **Tax treaty relief denied —** Tax treaty relief shall be denied under the relevant double tax treaty between the Member State of the subsidiary and the Member State of the shell entity, or the Parent-Subsidiary Directive/Interest-Royalty Directive.
- **Withholding tax applied —** Withholding tax shall be applied by the Member State of the subsidiary as if the relevant income was paid directly to the shareholder subject to tax treaty relief. The Member State of the subsidiary shall tax the property as if owned directly by the shareholder subject to tax treaty relief. Also, dependent on national law, the shareholder may or may not get participation exemption.

No direct tax consequences should arise if the subsidiary is established outside the EU as ATAD 3 does not apply to entities residing outside the EU.



11 What are the reporting obligations and penalties for shell entities under ATAD 3?

Aside from providing information in relation to the minimum substance indications, shell entities have a reporting requirement where they must provide certain documentation along with their tax returns.

The documentation should include:

- overview of the entity's structure
- nature of activities
- type of business activities performed to generate relevant income
- details of outsourced business activities
- number of employees on a full-time equivalent basis
- amount of profit or loss

Failure to comply with the reporting requirement results in a penalty, with a fine of at least 2 percent of the entity's revenue. An additional penalty of at least 4 percent of the entity's revenue would be due if there is a false declaration in the tax return.

Furthermore, information received from shell entities as part of the reporting requirements shall be automatically shared between Member States within 30 days. This increases the risk of tax enquiries and audits, similar to cases observed in relation to the Common Reporting Standard.

12 What are other implications of non-compliance with ATAD?

Non-compliance with ATAD 3 can raise concerns for third-party lenders and investors, due to potential increased risk of tax leakage, enquiries, and negative publicity consequences.

13 Would a UK Qualifying Asset Holding Company be viable in an investment structure for EU assets?

While UK Qualifying Asset Holding Companies (QAHC) and other non-EU companies are not subject to ATAD 3, EU asset jurisdictions may still consider substance requirements for non-EU holding companies seeking double tax treaty relief. However, for UK fund managers, using a UK resident holding company can offer operational ease in meeting minimum substance requirements and avoiding unintended tax residency elsewhere. Further review should be undertaken in relation to local views of using QAHCs and other non-EU companies.

The viability of non-EU companies such as QAHCs, depends on various factors, including cost considerations and meeting specific eligibility requirements. To learn more about the QAHC regime, including eligibility requirements and associated benefits, please refer to our article *Update on the UK's qualifying Asset Holding Companies Regime*.

Additionally, it is important to note that there is a consultation for a new directive broadly targeting arrangements or schemes in non-EU countries, which may lead to tax evasion or aggressive tax planning in EU Member States. Monitoring such developments is important to ensure that there are no adverse implications.

14 How can A&M assist with ATAD 3 compliance for your investment fund structures?

For investment funds, ATAD 3 does not only pose tax issues, but also operational issues i.e. choosing where and how to operate asset holding companies. We can help in several ways, including:

1. Review and assessment: We can review your fund and investment structures to determine if they fall within the scope of ATAD 3. We will help you assess the minimum substance conditions and advise on necessary steps such as enhancing existing substance or restructuring, considering the two-year look-back period, which, with reference to the proposed effective date of 1 January 2024, has already started!

2. Guidance on evolving rules: Given the uncertainty surrounding the final rules and their local implementation, we can help you understand market best practices and the evolving landscape. Our expertise can support you in navigating this uncertainty.

3. Governance framework implementation: We can assist in designing and implementing a robust governance framework to ensure proper compliance with ATAD 3. This includes both existing and future structures.

4. Strategic planning: We can help you to develop a long-term strategic response to ATAD 3 developments. This involves making operational and resourcing decisions and discussing alternative entities, such as UK QAHCs and other non-EU entities, which may not be directly impacted by ATAD 3.

Please note that our responses are provided at a high-level and do not take into account the specific background facts and circumstances of a particular fund or investment structure. If you would like to discuss ATAD 3 and its implications for your specific investment fund structure, including alternative options, or any other related matters, please feel free to reach out to your regular contact at A&M, Daniel Parry, Joe Macklin-Gray or Shirley Ly. You can also contact us through our website for further assistance.

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