taxnotes® international

Volume 105, Number 13 ■ March 28, 2022

The Draft EU ATAD 3 Directive: No Tax Benefits for International Shell Companies

by Raymond Roumen, Hans Drijer, and Suniel Pancham

Reprinted from *Tax Notes International*, March 28, 2022, p. 1517

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Raymond Roumen

Hans Drijer

Suniel Pancham

Raymond Roumen, Hans Drijer, and Suniel Pancham are partners with Tax at Work in Amsterdam.

In this article, the authors provide an overview of the European Union's draft third anti-tax-avoidance directive, focusing on its outsource gateway and director tests.

On December 22, 2021, the draft third anti-tax-avoidance directive was published (hereinafter, "ATAD 3" or the directive).[1] ATAD 3 aims to stop the use of tax resident letter box companies in the EU to obtain tax benefits.

It is proposed that ATAD 3 enters into force on January 1, 2024. However, as the gateway criteria (that is, a set of conditions that are examined to identify potential letter box companies) look back on the preceding two tax years, a material retroactive effect applies as of January 1, 2022. Therefore, how shell companies operate this year and in 2023 to continue obtaining tax benefits beginning January 1, 2024, is key. As the legislative process of adopting ATAD 3 must be started at both the EU and EU member states levels, the directive may be amended.

After a brief explanation of the operation of ATAD 3 in Section I, we focus on two important conditions in sections II and III: "the outsource gateway criterion" and "the directorship sub-criterion."

In Section IV we apply both conditions to two examples of standard international headquarter structures. In the final section of this article, we provide our concluding remarks.

I. ATAD 3: Overview and Operation

A. Introduction

On May 18, 2021, the European Commission presented a strategy to promote a robust, efficient, and fair business tax system in the European Union.[2] The plan includes several actions. ATAD 3 follows from action 2 of the OECD's base erosion and profit-shifting project, which provides for a legislative proposal that establishes EU rules to neutralize the misuse of shell entities for tax purposes.

The objective of ATAD 3 is not necessarily to discourage the use of shell company entities but to

[1] European Commission, "Laying Down Rules to Prevent the Misuse of Shell Entities for Tax Purposes and Amending Directive 2011/16/EU," COM(2021) 565 final (Dec. 22, 2021). This is also known as the "Unshell proposal."

[2] European Commission, "Business Taxation for the 21st Century," COM(2021) 251 final (May 18, 2021).

deny certain tax benefits to them.[3] The directive provides for a minimum level of harmonization and still allows member states to continue operating antiavoidance and anti-evasion rules, provided they are consistent with EU law.[4]

The directive (naturally) addresses EU member states and, from this perspective, does not address shell companies in third states, although the fact that no (unrestricted) residency certificate is allowed to be issued to EU shell companies may also result in additional source taxation in a third state. However, the European Commission also announced the introduction of separate rules in 2022 (ATAD 4)[5] to discourage the use of shell companies located in third states — in particular Switzerland, the United Kingdom, Dubai, Singapore, and Hong Kong — to obtain tax benefits.

The term "undertaking" is central to ATAD 3. It means any entity that is engaged in economic activity (regardless of its legal form) that is a tax resident in a member state. It comprises corporate bodies as well as partnerships. In this article, we use the term "undertaking" or "shell company."

ATAD 3 contains minimum substance indicators for shell companies in EU member states and denies certain tax benefits to shell companies that do not meet these indicators.

Importantly, the directive only denies tax benefits and does not necessarily prohibit the use of shell entities.[6] It applies to companies that are taxpayers in an EU member state and are eligible for a residence certificate.

The material operation of ATAD 3 consists of the following consecutive steps:

- in the first step, it is determined whether the undertaking has a substance reporting obligation (a gateway test consisting of three criteria) and whether an exemption is available;
- in the second step, a reportable undertaking must indicate whether it meets specified minimum substance indicators, and must provide information on the quality and quantity of their substance; this information is shared with other EU member states;
- in the third step, undertakings that do not meet the minimum substance indicators are presumed not to have the required minimum substance (they are allowed to rebut the presumption by providing additional substance information, which is also shared with other EU member states); and
- in the final step, undertakings that do not meet the minimum substance indicators and are not able to rebut the presumption are denied tax benefits under double tax treaties and directives, and this information is shared with the other EU member states.

B. Step 1: Substance Reporting Obligation

In step 1,[7] three "gateway reporting criteria" are included. These three criteria should be met cumulatively to determine whether an undertaking is obliged to annually report (in its tax return) whether it meets the minimum substance indicators requirements.

The aim is to identify "undertakings that are at risk of being found to lack minimal substance and are used with the main objective of obtaining a tax advantage."[8] The most relevant aspects of the three gateway criteria are:

[3] Section 1 of the explanatory memorandum states, "While there can be valid reasons for the use of such entities, there is a need for further action to tackle situations where taxpayers evade their obligations under tax law or act against the actual purpose of tax law by misusing undertakings that do not perform any actual economic activity." We will not address the weight, or relevance, of the explanatory memorandum for legal reasoning (by the Court of Justice of the European Union). *See also* recital 11 of the preamble to ATAD 3.

[4] Recital 3 of the preamble to ATAD 3.

[5] *See* European Commission, "Questions and Answers on the Commission's Proposal to End the Misuse of Shell Entities," at final paragraph (Dec. 22, 2021).

[6] In fact, the explanatory memorandum that accompanies ATAD 3 emphasizes that there may be valid reasons to use a shell company. *See also* European Commission, "Impact Assessment Report Accompanying the document Proposal for a Council Directive laying down rules to prevent the misuse of shell entities for tax purposes and amending Directive 2011/16/EU," SWD(2021)578 final, at 5 (Dec. 22, 2021): "Shell entities can be used to: ensure limitation of liability; protect investors and maintain the value of the portfolio; meet the requirements of third party lenders to ring-fence assets and liabilities; facilitate joint ventures between funds and other investors; streamline decision making by giving authority to the directors of holding entities; provide a convenient vehicle for sale or partial sale."

[7] Article 6 of ATAD 3.

[8] Recital 5 of the preamble.

- *passive-income gateway*: more than 75 percent of the company's revenue in the preceding two tax years is relevant income;[9]
- *cross-border transaction gateway*: more than 60 percent of the relevant income has been received or paid out via cross-border transactions; and
- *outsource gateway*: in the preceding two tax years, the shell company outsourced the administration of day-to-day operations and the decision-making on significant functions.

There is an exemption for some categories of undertakings,[10] including: (1) passive holding companies in the same member state as (a) the shareholder or intermediate holding company, or (b) a top ultimate parent entity ("same member state exemption");[11] (2) companies with at least five full-time employees (FTEs) engaged exclusively in activities that generate relevant income ("five FTE exemption"); and (3) some regulated financial undertakings or companies with listed securities.

The same member state exemption and the five FTE exemption, in particular, are key to avoiding the loss of tax benefits under ATAD 3 for an international headquarter company of a multinational enterprise, private equity group, or family business — as an international headquarter company typically does not meet the outsource gateway but may have a staff of five FTEs.

C. Step 2: Minimum Substance Indicators

In step 2, shell companies that cumulatively meet the three gateway criteria must indicate in their annual tax returns whether they meet the following minimum substance indicators:

(1) the undertaking has its own premises in a member state or premises for its exclusive use;

(2) the undertaking has at least one active bank account in the European Union;

(3) the undertaking meets at least one of the following indicators ("staff criterion"):

i. one or more directors ("substance directorship sub-criterion"):

(a) is a resident taxpayer in the member state of the company or at such distance that allows a proper performance of their duties;

(b) is qualified and has the authority to make decisions regarding the activities and assets that generate relevant income;

(c) can make active and independent use of its authorizations on a regular basis; and

(d) is not an employee of an enterprise that is not an associated enterprise and does not perform the function of director (or similar function) for other unrelated enterprises.

ii. the majority of the undertaking's FTEs are resident taxpayers or at such a distance to allow a proper performance of duties and are qualified to perform activities that generate relevant income ("employee sub-criterion").

The undertaking must provide documentary evidence on the nature of its substance[12] with its tax return, such as the address and type of premises; nature of gross revenue and costs; type of business activities; number of directors, including their qualifications, authorizations, and residence; or the number of FTEs, including their activities related to relevant income and their residence. The undertaking must also report its outsourced activities and information related to its bank account. The information is shared with the tax authorities in the member state of the

[9] The term "relevant income" is defined in article 4 and includes various categories of passive income, such as dividends, royalties, and interest income. The two-year lookback period does not apply to some categories of passive income. *See* article 6(1)(c), final two paras.

[10] Article 6(2).

[11] As defined in Section I, point 7 of Annex III to "EU Council Directive 2016/1164 laying down rules against tax avoidance practices that directly affect the functioning of the internal market" (hereinafter, "ATAD 1").

[12] Article 6(2).

undertaking and with the other EU member states.

D. Step 3: Presumption of Proof

Only if an undertaking meets all three minimum substance indicators will it be deemed to have met the minimum required substance for the relevant tax year. In all other cases, the undertaking is deemed not to have minimum substance for the relevant tax year.[13]

In the latter case, the shell company can rebut the presumption by submitting additional proof of its business activities that generate relevant income, including:

- a document establishing the business purpose of the undertaking's establishment;
- information on the profile of the employees, including their experience, their authorizations in the company, their roles and positions as reflected in the organization chart, the type of employment contract, their qualifications, and the duration of employment; or
- concrete evidence that decision-making regarding the activities generating relevant income takes place in the member state in which the undertaking is established.

An undertaking is considered to have rebutted the presumption when the evidence demonstrates that it has exercised, and continuously exercises control over, and that it assumed the risks of, the business activities that generated the relevant income or, in the absence of income, its assets. This rebuttal may be extended for five years, provided that the factual and legal circumstances remain unchanged during this period. The information shared with the tax authorities in the member state of the undertaking is shared with the other EU member states.

E. Exemption for Non-Tax-Driven Undertakings

There is an exemption for undertakings that do not meet the minimum required substance indicators — when this does not result in an undue tax advantage.[14] To qualify for the exemption, the company must submit a request with sufficient information demonstrating that the shell company does not lead to a tax advantage for the ultimate beneficial owners or, in the absence thereof, the group as a whole. Based on the information provided, it must be possible to compare the total tax payable by the group, with and without the company. The applicability of this exemption may be extended for five years. The information shared with the tax authorities in the member state of the undertaking is shared with the other EU member states.

F. Step 4: Not Meeting Substance Indicators

Shell companies that do not meet the minimum substance indicators and are not able to rebut the presumption are denied tax benefits, and their information is shared with the other EU member states.

Regarding the denial of tax benefits, the following three perspectives are distinguished:

1. the perspective of the undertaking (namely, the shell company);[15]
2. the perspective of the undertaking's shareholder;[16] and
3. the perspective of the undertaking that makes a payment to the shell company (hereinafter the "payer"),[17] whereby:
   - the payer must disregard the double tax treaty with the member state in which the shell undertaking is established, as well as benefits included in the parent-subsidiary directive (2011/96/EU) and the interest and royalties directive (2003/49/EC);
   - the undertaking's shareholder must tax the relevant income in accordance with its national law as if that income had directly accrued to it, and deduct any tax paid on that income ("ATAD 3 CFC rule");[18] and
   - the member state of the shell company may not issue a residence certificate or

[13] Article 8.

[14] Article 10.

[15] Article 12.

[16] As defined in article (3)(6). *See also* article 11(2).

[17] Article 11(1).

[18] No further insight is given as to what extent this requirement effectively implies broadening the effect of controlled foreign corporation rules as included in article 7 of ATAD 1, *supra* note 11.

may issue only a limited residence certificate, which indicates that the company is not entitled to tax treaties or benefits from the parent-subsidiary directive or the interest and royalty directive.

If the payer is not a resident of an EU member state, the undertaking's shareholder should tax the relevant income in accordance with its national law — as if that income had directly accrued to it, without prejudice to the tax treaty with the third country in which the payer is resident. If the undertaking's shareholder is not a tax resident in an EU member state, the payer should withhold tax in accordance with its domestic law, without prejudice to the tax treaty with the third country of the shareholder.

Considering that the three perspectives should be distinguished, it is important to assess not only whether a legal entity qualifies as a shell company for the application of ATAD 3, but also whether a legal entity may be considered the undertaking's shareholder or a payer.

Also, failure to meet the minimum substance indicators and not rebutting the presumption of minimum substance triggers an exchange of information with other EU member states within 30 days of receipt of the relevant information.[19]

G. Penalty, Tax Audit, and Other Aspects

An administrative penalty of at least 5 percent of the turnover will be imposed on shell companies that fail to comply with the gateway criteria and minimum substance indicator reporting obligations.[20] If an EU member state suspects that an undertaking of another EU member state is not fulfilling its ATAD 3 obligations, it can request the competent authorities of another EU member state to conduct an audit.[21] EU member states have to provide information on ATAD 3 to the European Commission annually.[22]

[19]Article 13.

[20]Article 14.

[21]Article 15.

[22]Article 16.

II. The Outsource Gateway

The outsource gateway provides that in the preceding two tax years, the undertaking outsourced the administration of day-to-day operations and the decision-making on significant functions.

A. Practical Importance

True shell entities will habitually meet the passive-income reporting criterion and the cross-border transaction reporting criterion, as adapting to meet either of these criteria will often prove to be difficult in practice.

Therefore, in our view and in practice, of the three gateway criteria, the outsource gateway is the pivotal one and will have to be investigated to determine whether tax benefits can remain available once ATAD 3 comes into force.

As stated in section 2.1.3 of the impact assessment,[23] there is no standard definition of a shell entity.[24] In our view, the key characteristics of a shell entity could be that it has virtually no economic nexus (in terms of substance) to a member state and its presence is almost exclusively driven by legal or tax considerations.[25] Thus, the gateway criteria make it possible to separate true international shell entities from other entities.

B. The Outsource Gateway and Its Sub-Criteria

The outsource criterion comprises three sub-conditions:

(1) the lookback period is two years;

(2) the administration of day-to-day operations is outsourced ("administration sub-criterion"); and

(3) the decision-making on significant functions is outsourced ("outsource director sub-criterion").

Together (2) and (3) are "core activities."

[23]Impact assessment report, *supra* note 6.

[24]*Id*. at para. 2.1.3, 8: "There is currently no standard and comprehensive definition of shell entities, which in itself may partly explain our limited ability to measure and understand the extent of tax avoidance or tax evasion by shell entities."

[25]We emphasize, as mentioned above, that the directive only aims at denying tax benefits to shell entities (and exchanging information) but does not aim to discourage the use of shell entities as such, since valid reasons for using a shell company may be present.

1. Two-Year Lookback Period

If the directive goes into effect on January 1, 2024, shell companies that outsourced core activities during 2022 and 2023 fall within the ambit of the outsource sub-criterion. Consequently, shell companies that stop outsourcing core services in 2022 or 2023 have no reporting obligation. Also, if a shell company hires five FTEs in 2022 or 2023, a reporting exemption will apply as well. (See also Section I.B.)

2. Day-to-Day Operations

Recital 5 of the preamble provides insight regarding the object and purpose of the outsource gateway. From this recital, we learn that it:

- targets undertakings that have no or insufficient resources to perform core management functions;
- covers outsourcing both to third parties (for example, to corporate service providers and corporate trust service providers) and to associated enterprises;[26] and
- is not met by merely outsourcing services of an auxiliary nature by the undertaking (for example, bookkeeping).

The text clearly includes three sub-conditions that must be met cumulatively to pass the outsource gateway. Considering that according to recital 5, the outsource gateway essentially aims to address insufficient resources to perform core management functions, it seems that more weight should be attributed to the outsource director sub-criterion; this, however, is not reflected in the text of the provision. In our view, a shell company that employs a qualified director and that accordingly incurs salary expenses should not be regarded as outsourced — even when the director is also employed by a different company and properly compensated by that other company.

III. Substance Directorship Sub-Criterion

Undertakings that pass all gateway criteria and cannot apply an exemption must annually report whether they meet the three minimum substance indicators (see also Section I.C), one of which is the staff criterion, which comprises the substance directorship sub-criterion and the employee sub-criterion. In the following discussion, we elaborate upon the substance directorship sub-criterion.

According to recital 8, the minimum substance indicators:

- must be considered a common minimum level of required resources, regardless of the nature of the activities of the undertaking;
- solely aim at identifying the substance of undertakings for tax purposes and should be assessed separately from the anti-money-laundering requirements applicable to trust service providers;[27]
- are based on the existing EU and international standards on substantial economic activity in the context of preferential tax regimes or, in the absence of corporate taxation,[28] to ensure compatibility; and
- should be assessed by the authorities, and if necessary, an audit should be initiated based on facts and circumstances for which documentary evidence must submitted by the undertaking.

Recital 8 provides little or no guidance on the application of the substance directorship sub-criterion. However, it is clear that, beginning January 1, 2024, ATAD 3 aims to deny tax benefits to shell companies that have outsourced the core activities to corporate trust service providers and associated companies within an MNE.

IV. Holding Structure Examples

In this section, we discuss the potential consequences of ATAD 3 on two standard international holding structures. We focus on the outsource gateway and the substance directorship sub-criterion.

[26] As defined in article 5.

[27] Directive (EU) 2015/849 of the European Parliament and of the Council of May 20, 2015, on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, amending Regulation (EU) No. 648/2012 of the European Parliament and of the Council, and repealing Directive 2005/60/EC of the European Parliament and of the Council and Commission Directive 2006/70/EC, at 73 (June 5, 2015).

[28] General Secretariat of the Council, 9637/18 FISC 241 ECOFIN 555, Code of Conduct (Business Taxation), Guidance on the interpretation of the third criterion; OECD, "Countering Harmful Tax Practices More Effectively, Taking Into Account Transparency and Substance, Action 5 — 2015 Final Report" (Oct. 2015).

A. Example 1

In Example 1, X Ltd., situated in a non-EU state, holds one regional international headquarter top holding company, Regional HQ, and three holding companies, Co1, Co2, and Co3, in EU member state A.

Co1 owns 50 percent in JV, a joint venture holding company in EU member state B.

JV owns one operating subsidiary, Co4, in EU member state B.

Co2 owns an operating company, Co5, in EU member state C.

Co3 owns Co6, an operating subsidiary company outside the EU. (Co6 is in the same time zone as Regional HQ and Co3.)

None of the companies have other activities. Together, these companies constitute the group.

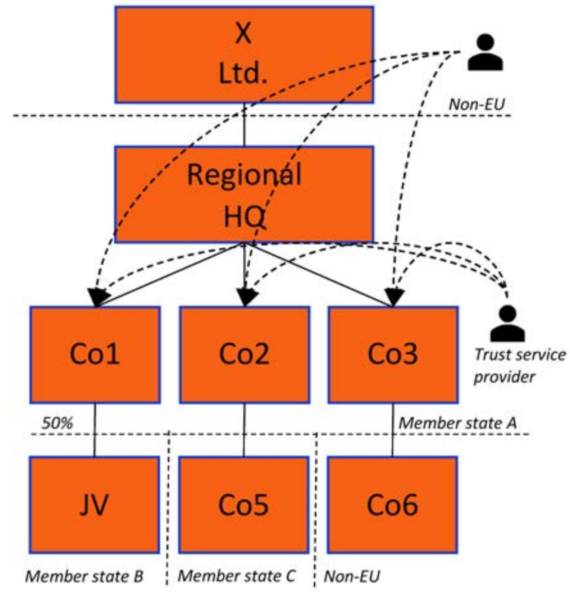
The group has appointed two statutory directors for each company, who can jointly bind the relevant company. This includes: (a) a senior group executive (with a suitable track record); and (b) an employee of a corporate trust services provider ("trust director"), who is also a director of other, non-associated enterprises.[29]

Both directors are properly qualified and authorized. The senior group executive is not a tax resident of EU member state A and is employed by X Ltd. The executive does not receive a separate remuneration for the directorships of the holding companies.

The effective management of Regional HQ, Co1, Co2, and Co3 takes place in member state A — that is, each holding company's board meetings are physically held in member state A, and board decisions are rendered by both board members in member state A.

Regional HQ, Co1, Co2, and Co3 each have an active bank account in the EU and have no employees. The bookkeeping and corporate secretarial services are carried out by the corporate trust service provider, and the office address is registered at the office address of that corporate trust service provider, which is located in member state A as well.

Figure 1. Example 1



Assuming that the two-year lookback period, the passive-income gateway, and the cross-border transaction gateway criteria have been met, what are the consequences of the application of ATAD 3?

1. Step 1: Outsourcing Gateway

a. Significant Functions

In the case of a pure holding company, arguably the only function is holding under which the director is the most significant element in terms of the highest added value.

The other services, such as bookkeeping and corporate secretarial services, should be considered complementary and as such auxiliary — as the director needs to coordinate and authorize or approve these services. In other words, "significant" should be construed as "adding significant value." Interpreted in this manner, the term "significant" also respects that the outsource gateway, according to recital 5 of the preamble, allows the outsourcing of auxiliary services.

In Example 1, a trust director of an EU member state A resident and a senior group executive can only jointly bind each company while the place of effective management of each company is located in EU member state A. In this regard, a relevant question is whether, in this example, the decision-making on significant or

[29] This board composition is driven by an existing minimum substance indicator in several EU member states that — among other things — requires that at least 50 percent of the directors of a shell company are tax residents of the relevant EU member state.

directorship functions of Regional HQ, Co1, Co2, and Co3 may be regarded as outsourced.

Since neither director is employed by Regional HQ, Co1, Co2, or Co3, they can both be considered outsourced. Recital 5 of the preamble mentions that outsourcing is not just confined to third-party situations but also includes intragroup situations.

In the event that one director (the senior group executive) is employed by a shell company and the other one (the trust director) is not, neither the provision nor recital 5 of the preamble provides any direct guidance on how to deal with a "partial" outsourcing to a third-party trust director. They also don't provide any clue regarding the extent to which it is relevant whether X Ltd. has to charge part of the salary of the senior executive to Regional HQ, Co1, Co2, and Co3. One could argue that if the arm's-length principle requires a charge, that is an indication that services have been outsourced.

b. Day-to-Day Operations

According to recital 5, services of an auxiliary nature are allowed to remain outsourced. Neither the provision nor recital 5 of the preamble provides any direct guidance on when a service should be considered auxiliary. All services at hand, such as bookkeeping, day-to-day administration, and corporate secretarial work, as mentioned, may be considered routine (and complementary to the holding function) and require the approval of the director. In that sense, these functions may be said to be of an auxiliary nature.

Still, the objective of the directive is to deny benefits to shell companies with no or limited substance. From this perspective, outsourcing all the aforementioned services does not seem to be acceptable. Therefore, the administration sub-criterion is likely not met. But this is not clear — as recital 5 allows services of an auxiliary nature to be outsourced.

c. Exemptions

Regional HQ, Co1, Co2, and Co3 meet the outsource gateway criterion. The same member state exemption (see Section I.B) is not available for Regional HQ. However, Co1, Co2, and Co3 can benefit from it since they, like Regional HQ, are residents of member state A, regardless of the position of Regional HQ. In other words, the text of the same member state exemption provision does not require that Regional HQ itself fails to meet at least one of the three gateway criteria. Thus, the applicability of the same member state exemption for Co1, Co2, and Co3 (while Regional HQ meets the gateways) may violate the objective of the directive. As Regional HQ, Co1, Co2, and Co3 do not have five FTEs, the five FTE exemption does not apply.

2. Step 2: Minimum Substance Indicators

Consequently, only Regional HQ must annually report whether it meets the three minimum substance indicators, as Co1, Co2, and Co3 can benefit from the same member state exemption. Since Regional HQ does not have premises for its exclusive use, this minimum substance indicator is not met. Regional HQ has its own active EU-bank account. Hence, this minimum substance indicator is met. Given that the senior executive is not a resident of member state A, the executive does not meet the substance directorship sub-criterion.

The trust director — as an employee of a corporate trust service provider and a director of other non-associated legal entities — does not meet the substance directorship sub-criterion. Considering that Regional HQ has no employees, the employee sub-criterion also is not met. Thus, two out of three minimum substance indicators are not met.

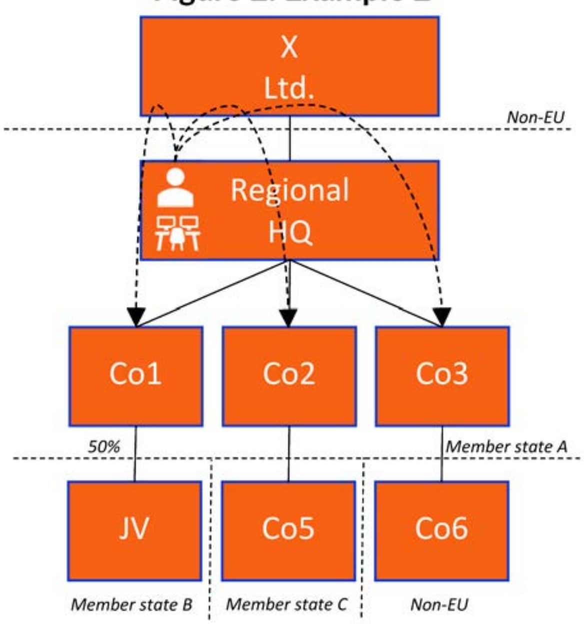
Therefore, the Regional HQ is presumed not to have the minimum substance but is allowed to rebut the presumption. Moreover, if in essence the setup does not result in tax benefits for the MNE, the Regional HQ can request to apply the non-tax-driven exemption.

If the presumption is not rebutted and no exemption is applied, the sanctions of ATAD 3 are triggered for Regional HQ. Tax benefits are denied, potentially resulting in additional taxation. Moreover, information will be shared with all EU member states.

B. Example 2

In Example 2, the same corporate structure and same facts and assumptions apply, except for the following: Regional HQ employs a properly educated, experienced, remunerated, and authorized director who is a tax resident of member state A. This director has also been appointed the sole statutory director of Co1, Co2, and Co3, and does not receive a separate remuneration for those directorships. Regional HQ, Co1, Co2, and Co3 each have an active bank account in the EU. Regional HQ leases an office, which is shared with Co1, Co2, and Co3. Regional HQ employs a qualified staff of four FTEs, all being tax residents of member state A. These FTEs are responsible for the bookkeeping and the corporate secretarial services of Regional HQ, Co1, Co2, and Co3.

Figure 2. Example 2



Assuming that the two-year lookback period, the passive-income, and the cross-border transaction reporting gateway criteria have been met, what are the consequences of the application of ATAD 3?

1. Step 1: Reporting Criteria and Exemption

a. Significant Functions

Regional HQ employs a resident statutory director who manages the company. No services are outsourced. Therefore, Regional HQ cannot be said to have outsourced decision-making on significant functions. As Regional HQ does not meet the outsource gateway, it has no reporting obligation under ATAD 3 for the relevant tax year.

Because the director who manages these companies is solely employed by Regional HQ, is it possible to argue that Co1, Co2, and Co3 have outsourced decision-making on significant functions? Recital 5 states that the outsource gateway is aimed at undertakings that have inadequate or no resources to perform core management activities. As the director is appointed statutory director of Co1, Co2, and Co3 (but not employed at the level of Co1, Co2, and Co3), it may be argued that the outsource directorship sub-criterion would be met.

Is it relevant whether Regional HQ makes a management support fee charge at arm's length to Co1, Co2, and Co3 to remunerate the statutory director for their services? Neither the provision nor recital 5 of the preamble provides any direct guidance.

b. Day-to-Day Operations

As the staff of Regional HQ carries out the administration of day-to-day services for Co1, Co2, and Co3, they have also outsourced the day-to-day operations to Regional HQ. In our view, two questions arise. First, which of the services are auxiliary to Co1, Co2, and Co3? Second, to what extent is it permissible to outsource all or a major part of the services, provided that they are auxiliary? The draft directive does not provide any further insight regarding either question.

c. Exemptions

If Regional HQ — *quod non* — would not meet the outsource gateway criterion, it can rely on the five FTE exemption.[30]

Co1, Co2, and Co3 can rely on the same member state exemption[31] — as Regional HQ is resident in the same member state. If Regional HQ were a sister company of Co1, Co2, and Co3 — instead of holding the shares in Co1, Co2, and Co3 — the same member state exemption (at least based on the wording) should not apply. If the objective of the same member state exemption were to exempt other holding companies from ATAD 3 obligations — when at least one related holding company in the same member state meets the substance indicators — it would be reasonable

[30] Article 6(2)(e).

[31] Article 6(2)(d).

to also provide the same member state exemption if Regional HQ were a sister company.

2. Step 2: Minimum Substance Indicators

As the Regional HQ does not meet the outsource gateway — and Co1, Co2, and Co3 are exempt under the same member state exemption — ATAD 3 does not apply to any of the companies.

Given that the outsource criterion is not met, testing whether the minimum substance indicators are met is not required. However, in the example, if the substance indicators were to be assessed, Regional HQ would need premises for its exclusive use, which it doesn't have because it shares the premises with Co1, Co2, and Co3. For Regional HQ to meet the relevant substance indicator, Co1, Co2, and Co3 would no longer be allowed to share these premises and would need to rent separate ones.

V. Concluding Remarks

Following the implementation of ATAD 3, all shell companies within EU member states, their shareholders, and their subsidiaries will have to assess whether ATAD 3 sanctions will apply, including the denial of tax treaties between member states or the EU parent-subsidiary, the interest and royalty directive benefits, and the exchange of information between EU member states.

A treaty residence certificate will not be issued to the shell company. Alternatively, a residence certificate will be issued stating that the shell company is not eligible for tax treaty benefits. This could result in taxation based on high domestic rates without tax treaty relief on payments from third countries to that shell company.

Because of the material retroactive effect of two of the gateway criteria, shell companies should carefully review the ATAD 3 consequences during 2022 and 2023.

In our view, the material retroactive effect violates the principle of legal certainty and is not justified by the abuse qualification. Therefore, the "two preceding tax years" requirement — that is, the material retroactive effect — should be applied beginning January 1, 2024, effectively postponing the starting date of ATAD 3 to January 1, 2026.

Other EU rules and principles that aim to counter the abusive use of shell companies remain in place. Hence ATAD 3, once adopted, could be considered an additional instrument for EU member states to counter the abusive use of shell companies.

Also, to create an international level playing field similar to pillar 2, we look forward to the European Commission's proposal for shell companies of non-EU member states (ATAD 4) this year. ■