6 April 2022

Attn Mr Gerassimos Thomas
Director General
DG TAXUD
European Commission
1049 Bruxelles
Belgium

Subject: Comments on the Proposal for a COUNCIL DIRECTIVE laying down rules to prevent the misuse of shell entities and arrangements for tax purposes and amending Directive 2011/16/EU ("ATAD3")

Dear Mr. Thomas

PwC International Ltd on behalf of its network of member firms (PwC) welcomes the opportunity to provide comments on this proposal for a Council Directive (hereinafter referred to as ATAD3).

PwC supports the objective of the European Commission to address instances of tax avoidance and tax evasion that continue to exist despite the various OECD and EU-led initiatives. We recognise and support the political ambition to effectively address the use of shell entities by fraudulent actors, and we recommend a targeted and proportionate approach in doing so. However, we believe the approach of ATAD3 would benefit from being reviewed in principle.

Prior to providing comments, we refer to our previous submission of 26th August 2021 regarding this same matter. A copy of that submission is available here for ease of reference.

The previous PwC submission focused on two key themes:

1. The number and variety of entities and arrangements, contractual or corporate, with or without legal personality, is significant. Generally, the various types cater for a specific personal, societal, investment or business need. If a particular use of an entity or arrangement has tax consequences, the aim should be that these are aligned with relevant tax policy objectives, including those pertaining to tax avoidance;
2. In light of the above we suggested that stock would be taken of the variety of entities and arrangements currently in use, to then determine whether the particular use of those entities and arrangements would violate existing tax policy objectives, and if so, then determine whether the

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existing anti-avoidance rules would be robust enough to address the particular use. If and to the extent that would not be the case, the introduction of further specific anti-avoidance rules could be considered.

In our view ATAD3 does not provide a clear and easily understandable framework.

The consequences arising from classification as a shell entity or arrangement are wide ranging, and resulting outcomes could potentially contravene primary EU law and international law. Furthermore, the rules are in effect not limited to intra-EU situations and it is likely that non-EU entities, and agreements in place with the residence jurisdictions of such entities, will be impacted. The compatibility of the proposed new rules with double tax treaties and international investment agreements, dealing with promotion and protection of international commerce, might be challenged by taxpayers.

The proposed new rules, with an envisaged effective date of 1 January 2024, will have a material retrospective impact, given the fact that businesses are already in the two-year lookback period.

Finally, in our view, the approach in ATAD3 could be more reflective of modern business practices which, for example, require levels of dissociation between a range of investors and their investment. Nor does ATAD3 reflect that remote working has increased significantly as a result of the pandemic. If ATAD3 is passed in its current form, it will have a significant impact on the competitive position of the EU relative to non-EU European countries.

Our detailed comments are set out in the accompanying appendices and relate to:
- Compatibility with the existing EU law and fundamental freedoms (Appendix I);
- Impact on tax and investment treaties (Appendix II), and
- Modern business practices and the use of new and existing concepts (Appendix III).

Fundamental technical as well as practical aspects are addressed.

If you would like to discuss these issues in more detail, please do not hesitate to contact me or one of the persons listed below.

Your sincerely

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Appendix (I) Compatibility with the existing EU law and fundamental freedoms, penalties

As indicated in the impact assessment to ATAD3, as well as in the explanatory memorandum and the preamble itself, ATAD3 is aimed at laying down a common framework for the Member States against practices of tax avoidance and evasion linked to the use of undertakings lacking minimal substance for tax purposes.

In order to pursue the above objective, ATAD3 provides common criteria and processes for the identification of the so-called "shell" undertakings as well as (some) common rules on their tax treatment by the Member States.

In doing so ATAD3, as any other EU secondary law instrument, must comply with EU primary legislation and in particular with the Treaty on European Union ("TEU") and the Treaty on the Functioning of the European Union ("TFEU") as well as the Charter of fundamental rights of the European Union and the general principles of the EU.

As a preliminary remark, in assessing ATAD3 against the TFEU, we note that the provision of mandatory reporting obligations for the EU entities falling within the scope of ATAD3 may itself be considered as a restriction to the free movement of capital under Article 63 of the TFEU (which is also applicable to movement of capital between Member State and third countries) it being substantially applicable only in cross-border contexts. It is in fact evident that an undertaking with "poor" substance but not engaged in cross-border transactions would not fall within the scope of ATAD3, while the same type of undertaking to the extent it receives passive income from affiliates residing in a different country would fall within the scope of ATAD3.

In this regard, assuming that the said reporting obligations could be considered as justified from the perspective of the compliance with the fundamental freedoms of the TFEU in so far as such obligation is aimed at guaranteeing the effectiveness of fiscal supervision and to prevent tax avoidance, it is worth noting that such reporting obligations, in order to be compliant with the TFEU, need in any case to comply with the principle of proportionality, namely they must be appropriate for ensuring the attainment of the objective pursued and not go beyond what is necessary to achieve those objectives.

On this point, we mention that the Directive 2011/16/EU already allows tax authorities to obtain all the relevant information covered by ATAD3 through specific information requests. In our view, the introduction of the automatic exchange of information provided for in ATAD3 raises significant concerns as to whether the information exchanged will be relevant for the purposes of tackling the use of shell undertaking and whether instead they could be used for other purposes not relevant to the objective of the Directive.

Moreover, ATAD3 does not limit itself to introducing specific reporting obligations for EU resident corporations which meet the "gateways" provided in Article 6 of ATAD3, but it also introduces specific "tax consequences" and penalties for the non-compliant entities in chapters III and V of ATAD3 respectively.

With specific reference to the tax consequences listed in chapter III, ATAD3, raises more than one concern when assessed against the principle of proportionality set out in the fourth paragraph of Article 5 TEU and the general principle of EU law of legal certainty.

Firstly, as a general comment, the provision of specific common tax consequences for tackling the misuse of shell entities does not seem justifiable in the light of the principle of proportionality to the extent pre-existing EU secondary laws already oblige all the Member States to implement tax measures which are themselves capable of addressing wholly artificial structures lacking economic substance in a common and consistent manner within the EU.

Reference is made in particular to the General anti-abuse rule (GAAR) implemented by the Member States in accordance with Articles 7-8 and Article 6 of the Council Directive 2016/1164/EU (ATAD Directive) as well as the specific anti-abuse rules (SAARs) provided in Article 1, paragraph 1 of Council Directive 2011/96/EU (Parent-Subsidiary Directive) and in Article 5 of the Council Directive 2003/49/EC (Interest-Royalties Directive).

The consistent implementation by Member States of GAARs compliant with Article 6 of the ATAD and the SAARs provided in the Parent-Subsidiary Directive and in the Interest-Royalties Directive has already addressed the potential misuses of shell entities from the EU "payee" jurisdiction perspectives. In addition, from the standpoint of "recipient" jurisdiction (i.e. the "shareholder undertaking jurisdiction"), the application of the GAAR provided for in Article 6 of the ATAD would allow that Member State to counteract where necessary any potential misuse of shell undertakings. To the extent that the application of existing GAARs to the special purpose vehicles used by individuals is uncertain it may be more proportionate to address any perceived need.

Moreover, having regard to these existing tax rules, the Court of Justice of the European Union has already provided in the well-known Danish cases (Joined Cases C-116/16 and C-117/16 and Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16) strong guidance on when an EU entity should be presumed to lack economic substance and the consequences thereof.

Secondly, even under the assumption that the provision of specific tax consequences other than the ones already provided for by the above-mentioned pre-existing EU law is necessary in order to pursue the objective of ATAD3, the specific tax consequences provided in ATAD3 do not appear to achieve this objective in a proportionate manner. Reference is made in particular to the fact that ATAD3 provides for the denial of the benefits of the Parent-Subsidiary Directive also in the hands of the EU corporate shareholder of the shell undertaking which – under the current wording of Article 11, paragraph 1 - should not apply Article 4 of the said directive. This results, in our view, in a disproportionate reaction which gives rise to a double taxation outcome not aligned to the objective of ATAD3. Under the subsequent Article 11, paragraph 2 the income of the shell undertaking is taxed in the hand of its EU shareholder as it was accrued directly by the latter. There is no reason to deny the benefits of the participation exemption regimes to an EU company, i.e. the EU shareholder of the shell undertaking, if it is not considered a shell undertaking itself.

Thirdly, the tax consequences provisions outlined in ATAD3 raise several concerns regarding the general principle of EU law of legal certainty according to which EU rules shall be sufficiently clear and precise. Reference is made in particular to the taxation of the "relevant income" of the shell undertaking in the hands of the undertaking's shareholder. In the absence of more detailed indications, in this respect the rule raises severe concerns on the compatibility of ATAD3 with the EU general principle of legal certainty. Indeed, the rule is not sufficiently detailed as regard its functioning: for example, it does not provide any indications on the rules underlying the computation of such income nor does it provide any indication on whether the related expenses linked to such income will be deductible in the hands of the undertaking's shareholder, and under which circumstances. Moreover, no indications are provided with respect to the interaction between the application of the said rule with the CFC legislations applied by all the Member States in accordance with Articles 7-8 of the ATAD Directive. The existence of the ATAD CFC rules also raise the question of the necessity for having new rules reaching the same result. It would be more proportionate to amend the CFC rules to the extent necessary and create a CFC rule applicable to individuals.

Last, but not least, based on the current version of ATAD3 , it is unclear how other Member States (i.e. not only the one of the shell undertaking) are to assess the evidence provided by the undertaking in rebutting any presumption of lack of substance and how such multiple assessments are to be coordinated (particularly if different conclusions are reached).

Appendix (II) Impact on tax and investment treaties

General remarks

The preamble to ATAD3 explicitly aims to carve out shell entities that are resident in the EU from the scope of two regimes of international public law – double tax treaties (DTTs) and international investment treaties (IIAs). Yet its provisions ensure such effect only in respect of DTTs (Articles 11-12). This confusing approach, however, does not change the observation that ATAD3 takes an attempt to adversely impact the application of DTTs and IIAs, although these regimes are distinct from EU law and a definition of a shell entity does not corroborate with standards of prevention of their abuse. Accordingly, the principle of international public law "good faith" (*pacta sunt servanda*) and the overarching purposes of DTTs and IIAs (promotion and protection of international commerce) may be frustrated by the implementation and application of ATAD3 by the EU Member States.

Such practice is questionable also under constitutional law of EU Member States insofar as it requires their domestic law to be compatible with international public law. Domestic law that represents the implementation of EU secondary law is not exempted from that constitutional requirement. The constitutional law of the EU Member States in principle remains their supreme law in relation to all other laws, including EU law. This supreme law typically stipulates that international law, including DTTs and IIAs, must be respected and in case of its conflicts with domestic statutory law, the international law prevails. To the extent of conflicts between domestic statutory law implementing ATAD3 with DTTs and IIAs, one may raise doubts in respect of constitutionality of the former. At best, it will raise interpretative issues that may end up with protracted domestic litigation and/or international arbitration. In addition, ATAD3 appears to apply with retroactive effect from 1 January 2022 (the beginning of the period for examining the substance criteria). This may undermine the competitiveness of the EU single market globally and trigger disputes under international arbitration procedures beyond the juridical reach of the CJEU and the political influence of the Commission.

The violation of a fundamental principle of the law of treaties

The principle of good faith is one of the most fundamental and universally recognised principles of the law of treaties, governing their interpretation and application. It is enshrined in the Charter of the United Nations, mentioned in several parts of the Vienna Convention on the Law of Treaties (VCLT), and acknowledged by international courts and tribunals, including the CJEU. Notably, in §§ 42-43 of the judgement of 25 February 2009 in the *Brita* case (C-386/08), the CJEU explicitly recognized that the principles codified in the VCLT are binding on the EU [then: the Community] institutions and constitute part of the *acquis communautaire*:

In addition, the Court has held that, even though the Vienna Convention does not bind either the Community or all its Member States, a series of provisions in that convention reflect the rules of customary international law which, as such, are binding upon the Community institutions and form part of the Community legal order (see, to that effect, Racke, paragraphs 24, 45 and 46; see, also, as regards the reference to the Vienna Convention for the purposes of the interpretation of association agreements concluded by the European Communities, Case C-416/96 El-Yassini [1999] ECR I-1209, paragraph 47, and Case C-268/99 Jany and Others [2001] ECR I-8615, paragraph 35 and the case-law cited). Pursuant to Article 31 of the Vienna Convention, a treaty is to be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose. In that respect, account is to be taken, together with the context, of any relevant rules of international law applicable in the relations between the parties.

The strongest legal anchorage for good faith interpretation is found in Article 26 of the VCLT: "[e]very treaty in force is binding upon the parties to it and must be performed by them in good faith." Considering the principle of good faith, all DTTs and IIAs ratified by the EU Member States which are in force must be interpreted and applied by them in such a way as to (1) ensure their effectiveness and (2) give effect to the purposes of these treaties, while (3) at the same time prohibiting interpretations that render the provisions of the treaties ineffective or impossible to apply in practice. ATAD3 appears to explicitly violate the principle of good faith in respect to DTTs and IIAs of the EU Member States by trying to carve out of their scope the EU shell entities, irrespectively of the wording, context, and purposes of these treaties. This effect of ATAD3 would freeze most of the provisions of DTTs and IIAs in respect of the EU shell entities, frustrating their general and main operative purposes to that extent.

Disregarding the definitions of "a resident" (DTTs) and "an investor" (IIAs)

ATAD3 seems to superimpose its own rules on the rules of DTTs and IIAs by disregarding the wording of basic definitions under these treaties that delineate the scope of their application and denying treaty benefits despite the wording of their anti abuse provisions (if any).

The entrance to DTTs and IIAs goes through the definitions of "a resident" and "an investor" of a contracting state and party, respectively. For the reason that ATAD3 "applies to all undertakings that are considered tax resident and are eligible to receive a tax residency certificate in a Member State." (Article 3), it directly and broadly affects all entities that meet the requirements of "residents" and "investors" under DTTs and IIAs, i.e., companies which have been organised in accordance with the law applicable in the contracting state (e.g., a Member State) and liable to tax therein by reason of their residence, place of management or any other criterion of a similar nature. These treaties neither require from entities the minimum substance nor other criteria embodied within Articles 7-10 of the ATAD3 in order to be entitled to the benefits under the treaties. Hence, disregarding these entities for the purposes of DTTs and IIAs, as stipulated in recital 13 of the preamble to ATAD3 in conjunction with Article 7, constitutes a treaty override insofar as it directly and explicitly sets aside the provisions of DTTs and IIAs which define "residents" and "investors". Furthermore, Article 12 ATAD3, which imposes on a Member State the obligation to deny a request for a certificate of tax residence to the shell entity located in that State, or to grant it with a notification that such entity is not entitled to the benefits under DTTs, appears as a dodging of DTTs by omitting the issuing of a certificate of tax residence or doing so in a futile way. In effect, the fundamental definitions under DTTs and IIAs lose importance to the detriment of the operation of these treaties. This may lead to their breach contrary to the principle of good faith.

Misalignment with the DTTs' and the EU standards of prevention of abusive practices

As a result of the implementation of the BEPS Action 6 minimum standard for the prevention of treaty abuse, Member States have in their anti abusive arsenal the principal purposes test (PPT) (Article 29(9) of the OECD Model 2017). They also have in force domestic general anti-avoidance rules (GAARs) that meet the minimum standard for such rules in accordance with Article 6 ATAD. None of these, however, rely on the premises of application relevant to those included in Article. 7 ATAD3, i.e., the minimum substance. ATAD3 operates irrespective of those anti-abuse rules/anti-avoidance rules. Such understanding in respect to interplay between PPT/GAAR (and other anti abusive/anti-tax avoidance measures) and ATAD3 can be derived from the Explanatory Memorandum to ATAD3 (sec. 3, p. 4): "[e]xisting anti-tax avoidance legislation does not include measures targeted to undertakings that do not have minimum substance for tax purposes." and the recital 3) of the preamble to ATAD3: "[w]here an undertaking has been found to have sufficient substance under this Directive, this should not prevent the Member States from continuing to operate anti-tax avoidance and evasion rules [(…)]". Accordingly, the tax authorities will be able to deny treaty benefits under the rules of ATAD3 beyond the scope of application of the PPTs and the GAARs. The prohibition of abuse of tax treaties cannot therefore automatically be used to justify a denial of benefits to EU shell entities under these treaties. ATAD3 will thus likely override tax treaties and violate the principle of good faith in many cases.

Although some of the rules on rebuttal of the presumption to have minimum substance (Article 9) and the exemption from application of ATAD3 (Article 10) appear to be of relevance for the operation of the PPT/the GAAR, e.g., the commercial rationale behind the establishment of the undertaking, others are alien to them, e.g., the type of the employment contract of the undertaking's employees, their qualifications and duration of employment. They also create a significant compliance burden for the taxpayers. Moreover, the rules on rebuttal and exemption under ATAD3 shift the burden of proof to the taxpayer in relation to the commercial rationale and the lack of tax motives from the very beginning. This is at odds with the mechanism of operation of the PPT/GAAR and the CJEU case law. In particular, the CJEU in many judgments stated clearly that the tax authorities under any domestic anti-abuse provision, whether purely domestic or as a result of an implementation of EU secondary law, may not confine themselves to applying predetermined general criteria, but must carry out an individual examination of the whole operation at issue. The imposition of a general tax measure automatically excluding certain categories of taxpayers from the tax advantage, without the tax authorities being obliged to provide even *prima facie* evidence of fraud and abuse, would go further than is necessary for preventing fraud and abuse.

The CJEU reiterated that requirement for compatibility of anti fraud and anti abuse provisions with EU primary law in the Danish cases on beneficial ownership:

> Where a tax authority of the source Member State seeks, on a ground relating to the existence of an abusive practice, to refuse to grant the exemption provided for in Article 1(1) of Directive 2003/49 to a company that has paid interest to a company established in another Member State, it has the task of establishing the existence of elements constituting such an abusive practice while taking account of all the relevant factors, in particular the fact that the company to which the interest has been paid is not its beneficial owner.

The CJEU also affirmed that once the tax authorities prove that the taxpayer is engaged in abusive practice, “the taxpayer must be given an opportunity, without being subject to undue administrative constraints, to provide evidence of any commercial justification”. By contrast, ATAD3 rules on the rebuttal and the exemption subject the taxpayer to significant administrative constraints in order to ascertain the commercial rationale and the lack of tax motives.

The overriding effect of ATAD3 rules on tax treaties cannot be justified by anti abuse purposes, because these rules are clearly not restricted to abusive practices under tax treaties. They even fail to be in line with the CJEU’s limitations regarding the prevention of abuse.

It is true that the CJEU on various occasions underscored the supremacy of EU law, including EU directives, over DTTs. But it is also true that the CJEU set aside the rules of DTTs in favour of EU law for the benefit of taxpayers and the EU fundamental freedoms, i.e., in situations in which the application of DTTs instead of EU law would lead to discriminatory tax results that restrict freedom of establishment. This also regards cases in which DTTs permitted Member States to tax an item of income (i.e., dividends) while the EU Directive (Parent-Subsidiary Directive) forbade it to tax. The effect of supremacy of ATAD3 over DTTs would be quite the opposite; namely DTTs oblige Member States to relinquish their taxing rights on items of income, whereas EU law requires them to tax that income. Therefore, the CJEU case law which points to the supremacy of EU law over DTTs does not constitute a solid legal ground for disregarding shell entities via ATAD3 under DTTs. This conclusion gets support from the previous observation according to which rules under ATAD3 are not in accordance with the CJEU’s limitations regarding the prevention of abuse. It becomes even stronger in light of the further considerations in the section below, which reveals that the application of ATAD3 may likely cause conflicts of income allocations between contracting states and lead to the inverted effect of ATAD3 rules from the intended one. Consequently, an effective elimination of double taxation, as envisaged by DTTs and EU Directives, would be frustrated or, at least, considerably complicated.

Misalignment with the IIAs standard of prevention of abusive practices

The observations from the previous section are, *mutatis mutandis*, relevant to the interplay between ATAD3 with IIAs with a few differences worth highlighting.

First, the arbitral tribunals appointed in accordance with IIAs and the respective procedural rules usually do not deny benefits under these treaties after meeting the formal criteria to obtain them by investors, apart from cases where the investment was transferred to a special purpose entity incorporated in a favourable IIA’s state after the dispute with respect to the investment had arisen. The arbitral tribunals conferred the protection under IIAs even in respect of allegedly sham ‘round tripping’ structures designed solely to benefit from IIAs. ATAD3 rules are in stark contradiction to this approach.

Second, the global regime of IIAs includes a scarcity of denial of benefits (DoBs) clauses with “substantial business operation” criterion. Their interpretation by the arbitral tribunals is very restrictive, meaning that they are effectively applicable to deny benefits under IIAs only to entirely or almost entirely sham structures. ATAD3 rules are not correlated with this approach, which is in any case relevant only in relation to a tiny fraction of all IIAs.

Third, despite several judgments of the CJEU aiming to render investment treaty arbitration (ITA) illegal and ineffective within the EU and irrespective of the termination of many intra-EU bilateral investment agreements (BITs), under the 2020 Termination Agreement, investors are still relentless in pursuing their rights under IIAs ratified by the EU Member States. Most importantly, so far, none of the arbitral tribunals has found that the CJEU case law deprived them jurisdiction over the disputes between investors and the EU Member States. In that regard, one of the arbitral tribunals observed that "no rule of EU law explicitly or implicitly forbids the application of the arbitral mechanism set out in the Treaty and the ICSID Convention. Such a mechanism does not interfere with the jurisdiction of the CJEU and is not incompatible with the TFEU." In relation to ICSID arbitration under the Energy Charter Treaty (ECT), the arbitral tribunal stated that "the EU Treaties are not general international law displacing all other subsystems of international law; rather, they exist side-by-side with other subsystems, including those created by various multilateral treaties". In the same vein, another tribunal stated that "within the system of international law, EU law does not have supremacy, and has no hierarchical priority over the laws of non-Member States, or over rules of international law", including IIAs. This is also in line with the position of the CJEU itself:

Indeed, with respect to international agreements entered into by the Union, the jurisdiction of the courts and tribunals specified in Article 19 TEU [e.g., the CJEU] to interpret and apply those agreements does not take precedence over either the jurisdiction of the courts and tribunals of the non-Member States with which those agreements were concluded or that of the international courts or tribunals that are established by such agreements. Consequently, infringements of IIAs as a result of the implementation and application of ATAD3 by the EU Member States will fall within the purview of arbitration tribunals. This is evident whenever the seat of arbitration is placed outside the EU, since in such cases the CJEU case law should not affect the jurisdiction of arbitral tribunals as EU law would not be applicable to displace the arbitral procedure governed by the non-EU law even if a dispute takes place between an investor from one Member State against another Member State. Bearing in mind that among the seven most preferred arbitral seats worldwide, five are situated outside the EU, such a scenario is very likely.

Considering the scope and the mechanisms of application of ATAD3, its rules may violate some of the standards of investment protection under IIAs. The candidate number one is the fair and equitable treatment (FET), which is the most frequently invoked protection standard contained in IIAs in general, and is equally frequently invoked in cases involving taxation measures. In the rich jurisprudence of the arbitral tribunals, a "consensus emerges as to the core components of FET, which encompass the protection of legitimate expectations, the protection against conduct that is arbitrary, unreasonable, disproportionate and lacking in good faith, and the principles of due process and transparency." At least some of the above-mentioned core components of the FET seem to be violated by ATAD3, as will be explained in more detail in the next sections. In extreme cases, the application of rules stemming from that Directive may also lead to an indirect expropriation of the investment realised by an EU shell entity. It means that investors may bring the disputes against the EU Member States under the international arbitration procedures. Alternatively, they will relocate the seats of the EU entities outside the EU. None of these scenarios appear to contribute to the further development of the Single Market and the competitiveness of the EU.

Unresolved multiple taxation and the inversed effect of ATAD3 rules from the intended one

The Explanatory Memorandum at pp. 13-14 explains four scenarios that arise out of Article 11 ATAD3. In either of these scenarios, the involved EU Member States are obliged to "look-through" the EU shell entity for tax purposes, including DTTs. The look-through approach was considered by the OECD already in 1986 in the report on Conduit Companies as "[m]he most radical solution to the problem of conduit companies", which is as such "incompatible with the principle of the legal status of corporate bodies, as recognised in the legal systems of all OECD member countries, and except in cases of abuse, in the OECD Model". It means that such a solution may be compatible with DTTs only to the extent of its application to prevent treaty abuse, or once the provisions to the effect of that solution are added to DTTs. Clearly, neither of this is the case under ATAD3. Furthermore, Article 7(2) envisages a kind of CFC-type of taxation (allocation of the EU shell entity's income to its EU shareholders) without the content and scope of the typical CFC rules, including those contained in Articles 7-8 ATAD. Thus, the OECD's clarifications regarding the compatibility of taxation under CFC rules with DTTs (however questionable) cannot be transposed to the solution under Article 11 ATAD3.

Perhaps only in scenario (2), which is purely intra-EU, the multiple taxation of the same income may be eliminated (at least partly) through the mechanism of deduction of the tax paid at the level of the EU shell entity by its shareholders in another Member State. Otherwise multiple taxation of the same income and double taxation of the same taxpayer may occur, contrary to the main operative purpose of DTTs (elimination of double juridical taxation) and the EU Directives (elimination of double juridical (the IRD) and economic (PSD) taxation).

In scenario (1), the third country of the payer may fully tax the outbound payment to the EU shell entity, since that entity will not be able to document its tax residency, or the document it receives will state that it is not entitled to benefits under the tax treaty in question. The EU Member State of its shareholders will not be able to claim relief for any tax paid at source, because the source state (third country) will not recognize any income allocation to the shareholders stemming from the payment to the EU shell entity (no treaty application between the source state and the residence state of the EU shell entity's shareholders). As a result, a double taxation of the same income at the level of the EU shell entity may arise.

In scenario (3), the EU source state of the payer will lose the right to tax the outbound payment to the EU shell entity under the tax treaty with a third country, which is the state of residence of the EU shell entity's shareholders. This outcome follows from the exclusive taxing right of the third state which arises from Article 7(1) or 21(1) tax treaty (based on the OECD or UN Model) with the EU source state of the payment. Such payment, following the look-through the EU shell entity approach that must be applied by the EU source state, cannot be classified as a payment of passive nature under Articles 10-12, but rather as "profits of an enterprise" of the residents of the third state (the EU shell entity's shareholders), or "other income" of these residents. In either case, the exclusive taxing rights in respect of such income are allocated to the third state exclusively. Interestingly, this may lead to losing taxing rights by Member States even in situations in which they would retain them under the PSD or IRD because the ownership threshold between companies in the EU – between the company from the EU source state and the EU shell entity – would not be met. This is, obviously, the inverted effect of ATAD3 rules vis-a-vis the intended one, which assumed that their application would increase the collection of tax revenues in the EU Member States. At the same time, the issue of double taxation of the income received by the EU shell entities remains unsolved, as the tax treaty between its EU resident state and the third state will not apply to eliminate double taxation.

In scenario (4), neither the source state of the income nor the shareholders of the EU shell entity are residents of the EU Member States. However, a denial of receiving relevant documents confirming the tax residence by the EU shell entity may lead to a denial of entitlements of that entity under the tax treaties in question. As a result, neither the source state of the income nor the shareholders of the EU shell entity will be legally obliged to provide relief from double taxation of the income received by the EU shell entity from the source state and further distributed to its shareholders. The same income may therefore be taxed three times and the same taxpayer may be taxed twice.

The Explanatory Memorandum does not acknowledge the above negative consequences of the application of a look-through approach and the CFC-type of income allocation. It is also silent about the potential effect of Article 11(3) ATAD3, which requires the Member States of the EU shell entity's shareholders to tax that entity's real estate directly, irrespective of the existence of real estate clause in a tax treaty in question and the facts and circumstances that may or may not lead to the application of that clause. This may lead to overriding Article 13(5) of the tax treaty (based on the OECD or UN Model) between the state of residence of the EU shell entity and the state of residence of its shareholders. That provision allocates the exclusive taxing right to the contracting state of which the alienator of assets is a tax resident. Such alienator may be resident in a third country and own shares in the EU shell entity. In this situation, the EU Member State of the shell entity does not have a taxing right in respect of the real estate owned by that entity, unless there is an applicable relevant real estate clause in the treaty with the state of residence of the EU shell entity's shareholders and they dispose of that entity's shares.

Retroactive effect

Although ATAD3 is planned to apply from 1 January 2024 (Article 18), Article 6(1) of ATAD3 effectively introduces its retroactive effect back to 1 January 2022. This follows from the fact that the criteria for the identification of undertakings that are obliged to report information on their substance refer to the preceding two tax years. It means that all investors and businesspersons that realise investment and conduct cross border business activities via the EU intermediaries are already "caught off guard", without any possibility to restructure their investments and businesses in order to not enter the scope of that Directive. Such legislation falls squarely into the category of cases in which the state (respondent) violated the FET standard under IIAs according to the arbitral tribunals. In general, the tribunals have recognized that retroactive legislation "'suddenly and unpredictably eliminates the essential characteristics of the existing regulatory framework" and thus violates the FET standards. This is exactly the likely effect of ATAD3. In that regard, a few conclusions of the arbitral tribunal in *Cairn v. India* case deserve the citation:

> Subject to exceptions where this is justified by a specific public purpose as discussed below, the retroactive application of legislation constitutes a fundamental affront to the principle of legal certainty and runs afoul of the guarantee of predictability of the legal environment. [(...)]

> By retroactively applying, without a specific justification, a new tax burden on a transaction that was not taxable at the time it was carried out, the Respondent deprived the Claimants of their ability to plan their activities in consideration of the legal consequences of their conduct, in violation of the principle of legal certainty, which the tribunal considers to be one of the core elements of the FET standard, and of the rule of law more generally.

The retroactive application of the Indian tax law could not be justified in that case, because it was not confined to prevent abusive tax avoidance. In the same vein, one may conclude that the retroactive application of ATAD3 would most likely fail to be justified, since it is not adequately and proportionally designed to tackle abusive tax avoidance and thus may target many legitimate international structures without the principal purposes to avoid taxation.

The observations of the arbitral tribunal in *Cairn v. India* case are strikingly similar to the ones of the CJEU in many cases, for example the *Commission vs Greece*, *SIAT* and *Itelcar*. These three cases demonstrate that the suitability of anti-tax avoidance rules to prevent tax avoidance is not enough to ensure their compatibility with EU law. To ensure compatibility, such rules must be proportionate, and their proportionality must be closely associated with their precision. If such rules are not clear, precise, and predictable enough to determine their scope in advance with sufficient accuracy, they do not meet the requirements of the principle of legal certainty. The lack of sufficient delineation of their scope invalidates the possibility of deciding whether they may be applied proportionally to achieve their anti-avoidance purpose in accordance with the EU standard of abuse. Likewise such rules may negatively interfere with constitutional principles of precision and predictability of tax consequences. Retroactive application of rules under ATAD3 apparently does not meet the requirements of predictability of tax consequences, which render them not only susceptible to violate the FET standard under IIAs, but also the standard for EU and constitutional laws compliant legislation.

Appendix (III) Reflecting modern business practices and substance, well-developed concepts, practical application and administration, gateway criteria

If ATAD3 is passed in its current form, it will have a significant impact on the competitive position of the EU relative to non-EU European countries. This may leave investors uncertain about investing in the EU as the additional administration requirements set out may be seen as a deterrent. The availability of a high quality workforce for centralised business operations together with access to an extensive tax treaty network and EU membership (allowing access to EU Directives) enhance the EU as a location for activities. However, the very prescriptive nature of ATAD3's substance requirements may mean that these advantages could be reduced if an undertaking is presumed not to have minimum substance and no reasonable rebuttal or exemption is possible.

ATAD3 not only has the potential to create competitive disadvantages for EU entities in comparison to non EU entities, it also has the potential to create competitive disadvantages among member states along the lines of geographical size and position. For example, some countries will be limited in their ability to meet the indicators of minimum substance set out in Article 7(1) which is the ability to hire directors or employees that are not resident in the state but are resident nearby to the Member State. EU countries that have a practice of Non-Executive Directors (NEDs) being appointed to various company boards will be particularly disadvantaged vis-a-vis countries that have the geographical ability to hire Directors for a sole Directorship. Small countries are particularly exposed as NEDs frequently hold several offices. From a corporate governance perspective NEDs are generally regarded as a positive attribute to bring specialist expertise and perspective to a board and can sometimes be an investor requirement. ATAD3 appears to rule out the possibility of NEDs being on multiple boards of enterprises that are not associated enterprises under Article 7(1)(c)(4). The way the measures are currently drafted would seem to put entities located in some EU member states at a disadvantage, not only to non EU entities but also in comparison to other EU entities..

There are a number of characteristics of modern business models which raise specific considerations in relation to the ATAD3 proposals.

Number of employees, premises and online businesses, etc

The derogation for "undertakings with at least five own full-time equivalent employees or members of staff exclusively carrying out the activities generating the relevant income" appears contradictory when viewed alongside recital (6) unless a broad interpretation of the word 'employee' is intended. This is also relevant to the indicator for residence and qualifications of "the majority of the full-time equivalent employees of the undertaking". Recital (6) refers to undertakings that engage an adequate number of persons, full-time and exclusively, in order to carry out their activities. Persons engaged on secondment or as independent contractors should qualify here in the same manner as for the substance based income exclusion under Pillar Two (in accordance with the Commentary) and for the Draft Council Directive on ensuring a global minimum level of taxation for multinational groups in the EU.

In terms of the five full-time employees' derogation provided for under Article 6, it is difficult to see how such an arbitrary number of employees can be applied across the board to all undertakings without taking into account the size and nature of the undertakings or a particular industry sector's commercial or business need for five full time employees. In a modern business environment, the need for employees in certain businesses is considerably reduced. This derogation of five full-time employees may be difficult to achieve for start up companies or indeed unnecessary for companies in certain industry sectors that do not require five full time employees.

The minimum substance indicators require an undertaking to have its own premises or premises for its exclusive use. In today's reality, where business is mobile, undertakings use flexible working spaces. Applying the commercial reality to what is envisaged by ATAD3 may result in a far broader reach of ATAD3 than anticipated and should be weighed against other factors as well as considering that premises are typically not for exclusive use within a group of companies.

Externally managed or centrally controlled risk business models

In the early stages of their development corporate service providers may play a more detailed role in the operation of a business. As businesses grow, the inclusion of outsourcing of the administration of day to day operations as a gateway criteria in Article 6(1)(c) of ATAD3 is problematic. Typically, or at least what we are seeing as a recent trend in relation to certain funds, is that they may have hundreds of companies in the same country centrally employed through a service/management company but who carry out activities of all the companies in this territory. We believe the minimum substance indicators would work more effectively on a same country basis as opposed to examining groups of companies on an entity per entity basis.

Entities which are part of investment funds structures, including private equity, real estate, renewables etc., are externally managed by their nature based on the genuine business model of the investment management industry. Such business models have developed based on the commercial (non tax driven) relationship agreed between the investors in such funds and businesses earning their profits from managing these funds. These business models - which cannot be considered tax-abusive - do not match with the requirements in the hallmarks of the gateway nor the substance requirements. Based on the entity by entity approach of ATAD3 the relevant companies will be considered "shells" solely because of the business model of the investment management industry. In this respect it should be considered that the fund manager may not always be considered a group entity or related entity of the companies forming part of the fund structure holding the assets. For the purposes of the gateway, outsourcing to a fund management company should not be considered outsourcing for the purpose of the directive. It is also worth noting that the special treatment afforded to investment entities under the global minimum tax agreement (and EU proposed implementation) extends down the chain, unlike the regulated investment entity derogation under ATAD3. The focus on substance here should presumably be at the management companies and not with the asset owning and holding companies within the fund structure. In the instance of an external asset manager managing real estate for the account and risk of the real estate company, there should be sufficient economic nexus with the country where the real estate is located and managed for the real estate company not to be considered a shell. A country approach (relevant substance at the management company in the same jurisdiction) would much better facilitate the objectives than the current entity approach.

Asset-backed security (ABS) deals play a huge role in the finance industry. There are legitimate legal and commercial requirements, rather than tax requirements that require ABS deals to be structured the way they are. Securitisation companies don't operate with substance, as the trading company could just borrow the cash, but the lender is then at risk to the company's insolvency. Moving the asset to a special purpose vehicle allows the bank to assess the risks by reference to the asset only and removes any other contingent liabilities (e.g. arising from having employees). Thus, securitisation regimes will be heavily impacted by these rules. Securitisation vehicles play a role in modern financing structures and these rules disregard this. In order to mitigate this impact we think securitisation companies should be able to rely on substance in their broader corporate group or be exempt completely from ATAD3 given that they are not legally allowed to have employees.

While we recognise that the rebuttal and exemption processes allow for some of the above entities to show they are set up for legitimate business reasons we believe it would be preferable to avoid a 'guilty until proven innocent' premise in European tax legislation. The Commentary to the OECD Model Tax Convention on Income and Capital now includes examples that illustrate the application of the Principal Purposes Test (Article 29, paragraph 9 in that Model), including specifically examples D, K, L, M relating to financial services and the investment management industry, indicating the legitimate use of an entity in a certain jurisdiction on the basis of a wide range of reasons in which having own employees and exclusive management are clearly not decisive factors. ATAD3 would probably result in the entities in these examples being presumed to be shell entities forcing these entities to go through rebuttal and exemption to avoid adverse tax consequences. It might also increase the cost of finance, given that some banks may be wary of lending to a company that may be in uncertain standing with their relevant tax authority. We also believe the exemption under Article 6(2)(a) for companies which have transferable security on regulated markets or multilateral trading facilities should be widened sufficiently to encompass the vast majority of stock exchanges on which companies may trade their securities, given the administration already involved in gaining admittance to these exchanges.

Third party bank accounts

Similarly, more and more entities do not have "third party" bank accounts but operate with "internal" banks or treasury companies meaning they may fall foul of Article 7(1)(b). We recommend that ATAD3 will recognise that internal bank accounts will satisfy this indicator of the minimum substance test as long as they are actively managed by the taxpayer. This will be to ensure ATAD3 is aligned with the reality of how businesses are run in modern times.

Timing and uncertainty

All EU territories will be impacted by ATAD3 in terms of the additional administrative burden that will be placed on them in terms of the significant volume of information required under ATAD3, along with the various rebuttal and exemption requests being submitted to Revenue authorities. Smaller EU territories, in particular, may be impacted even more so as Revenue authorities in smaller EU countries may not have the resources or capabilities to scale their operations quickly enough. This in turn could create timing issues for entities in these countries receiving exemptions under Article 10 or being notified if they meet the required minimum substance indicators in Articles 7 and 8. In addition to this point, obtaining tax residency certificates and certainty is fundamental for some taxpayers, especially those interacting with non-EU territories. How can investors/taxpayers be comfortable that ATAD3 will not cause a delay in their capacity to get a tax residency certificate, which may create cash-flows issues and result in a long and costly administrative process to obtain refunds when deadlines have already passed to submit tax residency certificates?

We believe Articles 9 and 10 of ATAD3 which outline the rebuttal and exemption processes, may be open to subjectivity in their application by various Member States. For example, the level of evidence required by one Member State to rebut the presumption of a "shell entity" or obtain an exemption from the rules, may be less stringent than what is required in another Member State. Where there is not a consistency of approach in applying these rules, it may serve to create competitive disadvantages between various entities located in the EU.

Other concepts leading to uncertainty

It is noted that the number of companies in scope of ATAD3 is expected to be low (less than 0.3% of all EU companies) (see impact assessment) whereas terms not clearly defined and new concepts could result in ATAD3 having a broader reach than anticipated, thus overreaching its stated objective. ATAD3 applies the following concepts that are not clearly defined:

A. Article 6 defines the entities that are required to report information. The 3rd condition is that the undertaking, in the preceding two tax years, would have outsourced the administration of *day-to-day operations* and the decision making on significant functions.

- The time periods are imprecise. Para 1(b)(ii) does not include a time period at all. It is unclear whether the reference to "in the preceding two tax years" in para 1(a) and 1(b)(i) means the 75% and 60% test apply to the 24 months as a whole or each period separately. Does the similar reference in para 1(c) refer to outsourcing taking place at any time during the 24 months, throughout the 24 months or for part of the period, say the majority of the 24 months?
- It is not clearly defined what is to be understood under day-to-day operations. Depending on the nature of the activities of the companies, a great deal of judgement may be required to understand what the day-to-day operations include.
- In addition, the use of the concept of outsourcing in this article is confusing. It is not defined what exactly is to be understood by outsourcing.
- It is furthermore unclear how the day-to-day operations are the relevant concept to understand - in light of the purpose of ATAD3 - to identify companies that lack relevant economic substance. There are multiple reasons why companies would outsource certain tasks to service providers. The mere reference to outsourcing of day-to-day operations does not distinguish between situations that are different in light of the objective of ATAD3, i.e. those situations where outsourcing of certain activities is not impacting the relevant economic substance and those where it does.

B. The minimum substance indicators place the main focus on the presence of directors or employees that are 'qualified' to take decisions or carry out activities. There is no guidance on what is a qualifying employee or director. There are long-standing principles that are considered critical for other purposes e.g. transfer pricing that define when an employee or director is able to control risk and whereby one should recognize that such employees or directors may be housed in a central entity within the group of companies but acting for the risk and account of the undertaking. Referring to full time employees may create difficulties for practical application and can result in broader reach than anticipated.

C. The minimum substance requirements focus on decision making, referred to under existing doctrine as 'significant people functions', but there are many other aspects of control over risk (like sufficient equity structure, etc.) - this has been addressed in the OECD Transfer Pricing Guidelines 2022 already as well as in ECJ cases.

D. There is no shortage of commentary available on the concept of economic substance. It would be meaningful to link ATAD3 to these existing concepts and leverage from the established doctrine (i.e., to not deviate from existing concepts and case law). One central concept is the 'control over risk' concept, which is very well developed in literature and case law.

E. ATAD3 strongly emphasises that employees or directors need to be tax resident or in close proximity in order to meet the relevant minimum substance requirement. In the EU internal market, where freedom of movement of workers is a fundamental freedom, this requirement does not seem appropriate.