

A.T.A.D.3 AND HOW TO DEAL WITH UNCERTAINTY IN ITS INTERPRETATION: A QUANTITATIVE APPROACH

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Tags

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INTRODUCTION

The European Union ('E.U.') has made significant efforts to change the current tax system, focusing on ensuring fair and effective taxation in the E.U. Important progress has been made in this area, particularly with the adoption of the Anti-Tax Avoidance Directives ("A.T.A.D.1" and "A.T.A.D.2") and the extension of the scope of the Directive on Administrative Cooperation (e.g., the mandatory disclosure rules of D.A.C.6). In addition, it was recognized that legal entities with little or no substance and economic activity, commonly referred to as "shell entities," have the potential to be used for abusive tax practices.

Against this background, the European Commission (the "Commission") published a proposal for a directive to prevent the misuse of shell entities for tax purposes ("A.T.A.D.3" or the "Unshell Directive") at the end of 2021. The Unshell Directive includes rules for the identification of shell entities and provides for certain reporting obligations, automatic exchange of information, and substantive tax consequences.

Since the publication of the Commission's initial proposal, the European Parliament ("E.P.") has adopted certain amendments to the Commission's initial proposal. At the time of writing this article, the Unshell Directive is still pending before the E.U. legislative bodies. As each E.U. Member State has the right to veto tax directives, it is not yet clear whether, and in what form, the Unshell Directive will be implemented.

The mechanics of A.T.A.D.3 under the original proposal have been discussed previously in *Insights*.¹ In our article, we will describe the recent developments and the expected next steps. However, we mainly focus on how to deal with uncertainty in the interpretation of new tax legislation, with A.T.A.D.3 as an example, and how to measure and compare optimization opportunities using a modelling approach.

The Unshell Directive as Originally Proposed by the Commission

The Unshell Directive (i) subjects certain entities to automatic exchange of information and reporting obligations or (ii) categorizes such entities as shell entities, resulting in a number of tax disadvantages. A.T.A.D.3 is scheduled to enter into force on January 1, 2024.

Scope and Explicit Carve-Outs

The Unshell Directive is intended to apply to so-called "undertakings," broadly meaning entities that can be considered resident in a Member State for tax purposes, regardless of their legal form. This includes legal arrangements, such as

¹ Paul Kraan, "Use it or Lose it: The Future of Shell Entities in the E.U.," *Insights* Vol. 9 No. 2 (December 2021).

partnerships, that are considered resident for tax purposes in a Member State, but does not include permanent establishments or tax transparent entities.

The Unshell Directive contains explicit carve-outs for undertakings carrying out certain activities, such as undertakings with a transferable security admitted to trading or listed on a regulated market, regulated financial undertakings, certain purely domestic holding structures, and undertakings with at least five own full-time employees (“F.T.E.”) carrying out activities which generate relevant passive income. According to the Commission, undertakings that carry out these activities are *a priori* considered to be low-risk and therefore irrelevant for the purposes of the Unshell Directive.

Gateways and Exchange of Information

The Unshell Directive is intended to affect only undertakings that lack substance and are misused for tax purposes. Three cumulative criteria – commonly referred to as “gateways” – have been proposed to filter out these types of undertakings:

- More than 75% of the undertaking’s revenue is characterized as passive income (also referred to as “relevant income”) in the two preceding tax years.
- More than 60% of the undertaking’s relevant assets are located outside the undertaking’s Member State of residence and/or at least 60% of its relevant income is earned or paid out via cross-border transactions.
- The undertaking has outsourced the administration of its day-to-day operations and decision-making on significant functions in the two preceding tax years.

If an undertaking passes the three gateways, information on the undertaking will be automatically exchanged between Member States.

Schematically, this can be visualized as follows:

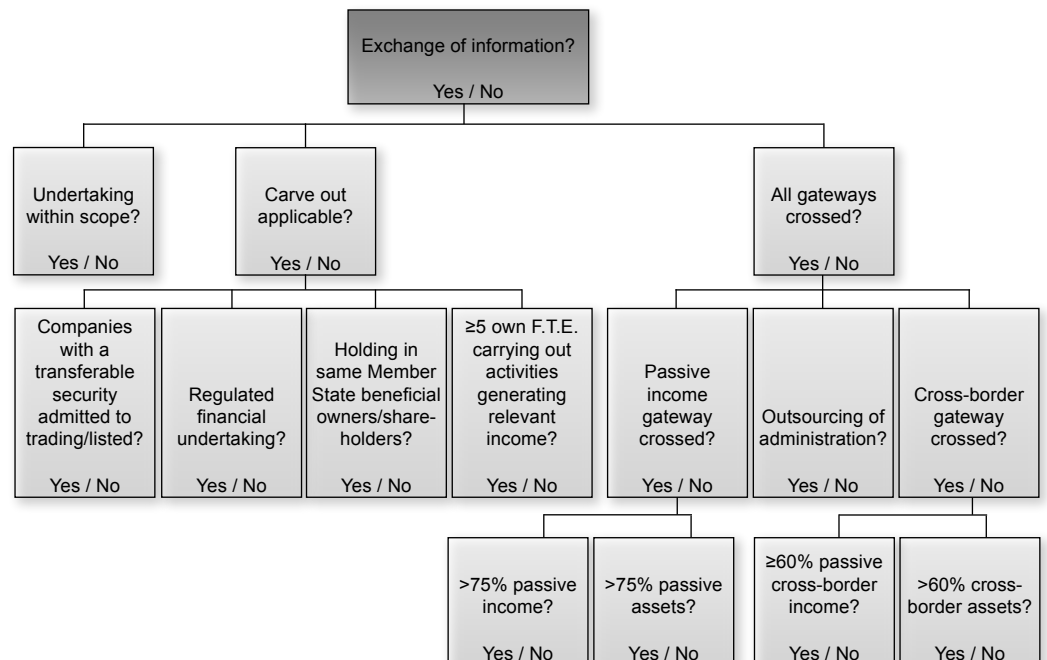


Figure 1: Schematic overview of requirements for automatic exchange of information under original Unshell Directive proposal

The schematic overview makes it clear that exchange of information can take place even if an undertaking does not qualify as a shell entity under the Unshell Directive.

Exemption Upon Request and Reporting Obligation

Undertakings passing through all gateways have the obligation to report that conclusion in annual tax returns and provide satisfactory documentary evidence that they meet certain minimum substance requirements:

- Premises are available for its exclusive use.
- At least one owned and active bank account in the E.U.
- At least one qualified director with decision-making powers in relation to its core income-generating activities who is resident close to the undertaking or, alternatively, a sufficient number of employees that are engaged in its core income-generating activities being resident close to the undertaking.

If an undertaking is able to provide sufficient and objective evidence to the relevant tax authorities that its existence does not lead to tax benefits for the group as a whole, an undertaking should be exempted from the above reporting obligation. In such case, the undertaking is not a shell entity for purposes of A.T.A.D.3, even if it does not meet the substance requirements. This can be illustrated as follows:

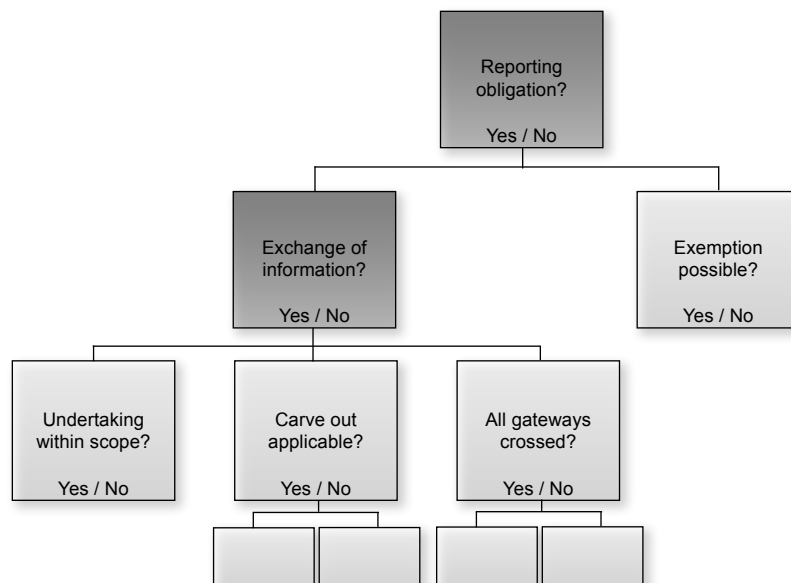


Figure 2: Schematic overview (condensed) of requirements for reporting obligations under original Unshell Directive proposal

Sufficient Substance and Rebuttal of Shell Entity Presumption

If an undertaking is not exempt from its reporting obligation, but it provides satisfactory evidence that it meets the substance requirements, it will not be considered a shell entity under the Unshell Directive. Alternatively, if no exemption is applicable and the undertaking fails to meet the three substance requirements, it will be presumed to be a shell entity for purposes of the Unshell Directive.

An undertaking nevertheless still has the opportunity to rebut the shell entity presumption. To claim such rebuttal an undertaking should provide evidence of each of the following items:

- The non-tax, commercial reasons for establishing and maintaining the undertaking, which does not require compliance with all of the substance indicators.
- The resources used by the entity to carry out its activities.
- The key decisions on the value-generating activities of the undertaking are taken in the Member State in which the undertaking claims to be resident for tax purposes.

This can be schematically depicted as follows:

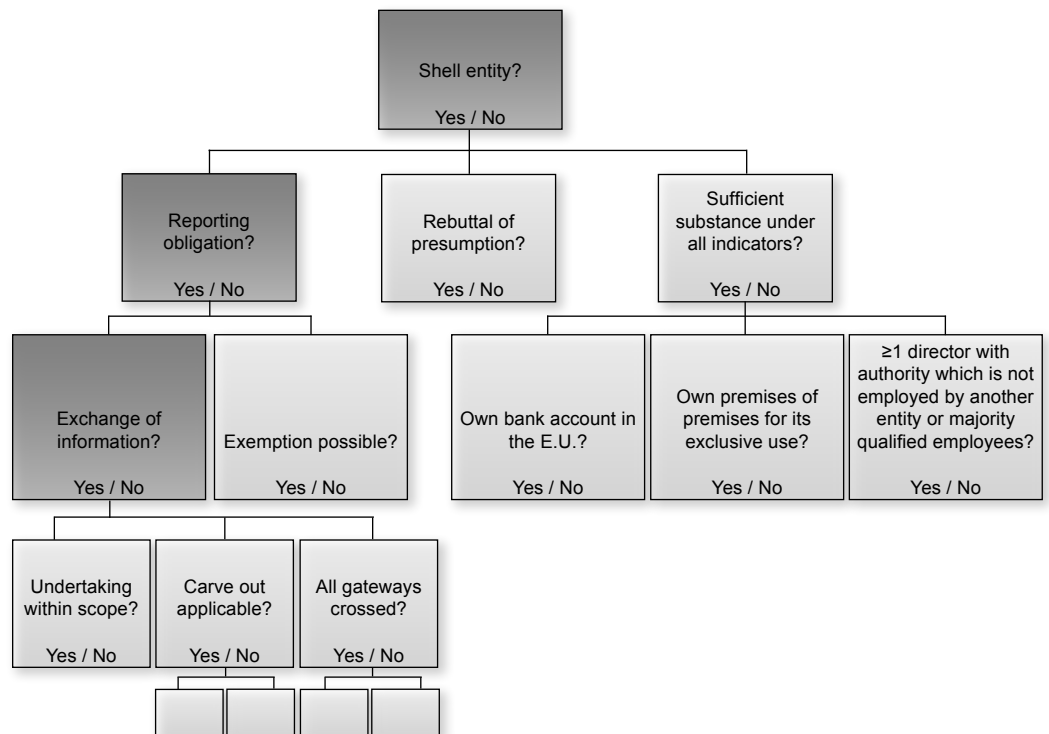


Figure 3: Schematic overview (condensed) of requirements to qualify as shell entity under original Unshell Directive proposal

Although an undertaking is thus able to rebut the presumption of being a shell entity, automatic exchange of information and the reporting obligations may still apply.

Main Tax Consequences of Being a Shell Entity

If an undertaking qualifies as a shell entity, a number of tax consequences arise for (i) the shell entity itself, (ii) the shell entity's E.U.-based shareholder, and (iii) the payer of the shell entity's income flows.² The tax consequences can be summarized as follows:

² For sake of simplicity, this article does not deal with the tax consequences in case of real estate assets or valuable movable assets.



Situation				
Residence jurisdiction shareholder?	E.U.		Non-E.U.	
Residence jurisdiction payer?	E.U.	Non-E.U.	E.U.	Non-E.U.
Combination	1	2	3	4
<div>▼▼▼▼</div>				
Consequences				
Payer				
Tax treaty / E.U. Parent-Subsidiary Directive / E.U. Interest-Royalty Directive?	Tax treaty and/or E.U. directives vis-à-vis shell entity disregarded, application of tax treaty and/or E.U. directives vis-à-vis shareholder	No direct consequences of A.T.A.D.3	Tax treaty and/or E.U. directives disregarded	No direct consequences of A.T.A.D.3
Withholding taxes?	Apply withholding tax as if the relevant income was paid directly to the shareholder, in accordance with the tax treaty between payer's jurisdiction and shareholder's jurisdiction or E.U. directives	No direct consequences of A.T.A.D.3	Apply withholding tax as if the relevant income was paid directly to the (both E.U. and non-E.U.) shareholder, in accordance with the tax treaty between payer's jurisdiction and shareholder's jurisdiction or E.U. directives	No direct consequences of A.T.A.D.3
Shell entity				
Tax treatment of the shell entity?	Shell entity remains tax resident in its jurisdiction			
Tax residence certificate?	Tax administration of shell entity's jurisdiction does not issue a tax residence certificate or issues such certificate stating that the shell is not entitled to tax treaty benefits or E.U. directives			
Shareholder				
Tax treaty / E.U. Parent-Subsidiary Directive / E.U. Interest-Royalty Directive vis-à-vis shell entity jurisdiction?	Tax treaty and/or E.U. directives disregarded		No direct consequences of A.T.A.D.3	
Taxation of income shell entity?	At shareholder level, in accordance with domestic law as if directly accrued to shareholder, minus tax paid on relevant income in shell jurisdiction		No direct consequences of A.T.A.D.3	

Recent Developments: the Amendments to the Unshell Directive Proposed by the E.P.

On January 17, 2023, the E.P. adopted certain amendments to the Unshell Directive as proposed by the Commission. The main amendments are as follows.

Carve-Outs and Gateways

- The carve-out for undertakings with at least five F.T.E. exclusively carrying out the activities generating the relevant (passive) income has been removed
- The thresholds for the gateway tests have been reduced from 75% to 65% and from 60% to 55%.³
- The outsourcing gateway is only met in case of outsourcing to third parties.

The E.P.'s proposed amendments can be illustrated as follows:⁴

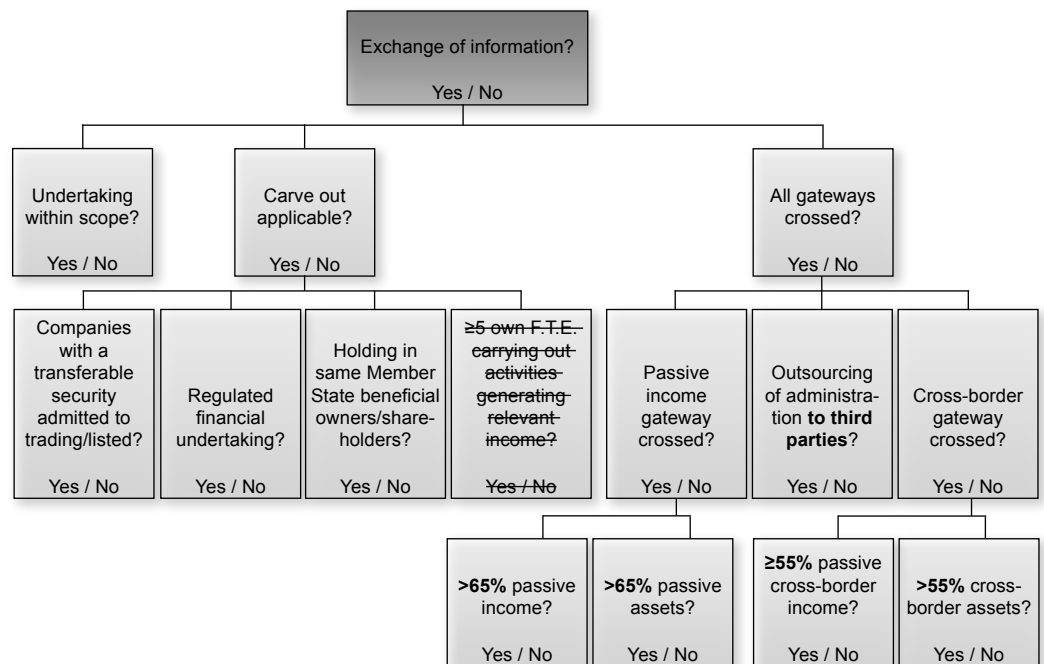


Figure 4: Schematic overview of requirements for automatic exchange of information under the E.P.'s Unshell Directive proposal

³ Note that the original proposal included the requirement that more than 60% of its relevant assets are located outside the undertaking's Member State or at least 60% of its relevant income is earned or paid out via cross-border transactions. In the E.P.'s proposal, this has been changed to more than 55% in both cases.

⁴ Amendments highlighted in red widen the scope of the Unshell Directive, while those highlighted in green narrow the scope of the Unshell Directive.

Substance Indicators

- **Own premises.** If an undertaking shares premises with entities of the same group, this substance indicator is also met.
- **E.U. bank account.** This requirement will be met only if the relevant income is received through an E.U. bank account.
- **Qualified and authorized directors.** It is no longer required for a director to
 - be “qualified” to make decisions in relation to the undertaking's income-generating activities, to meet the relevant substance indicator;
 - actively and independently use the authorization to take decisions in relation to income-generating activities; and
 - not be an employee of a non-associated enterprise or perform the function of director of other non-associated enterprises.

Schematically, the amendments to the substance indicators can be visualized as follows:⁵

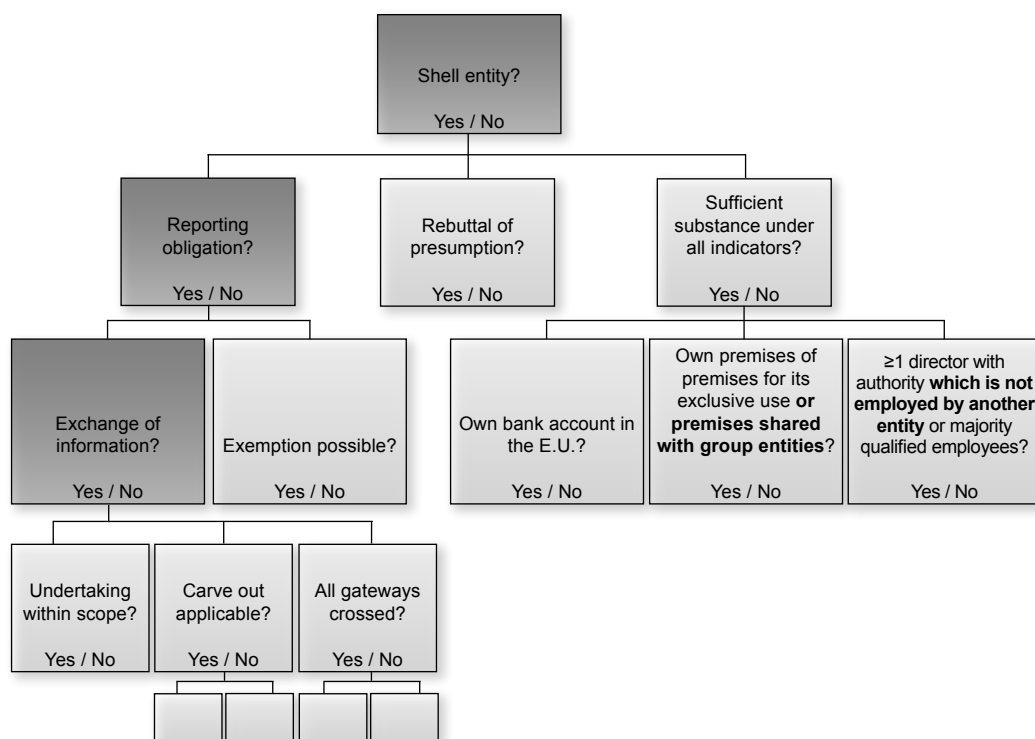


Figure 5: Schematic overview (condensed) of requirements to qualify as shell entity under the E.P.'s Unshell Directive proposal

It is interesting to note that the E.P. did not amend the entry into force date of January 1, 2024.

⁵ *Id.*

“The application of A.T.A.D.3 raises many questions for taxpayers. . .”

Next Steps

The E.P.’s proposal will be considered by the Council of the E.U. (“E.U. Council”). The E.U. Council is not obliged to adopt the E.P.’s amendments. The Member States’ representatives in the E.U. Council must agree unanimously on the final text of the Unshell Directive. It appears that negotiations between the Member States are progressing slowly. The current Swedish E.U. presidency intends to put either the progress or agreement on the Unshell Directive on the agenda of the E.U. Council (Ecofin) meeting on May 16, 2023. Once finalized, the Unshell Directive will have to be implemented in the 27 Member States’ domestic laws.

Applying a Statistical Approach to Tax Uncertainty

A.T.A.D.3 adds a layer of complexity to an increasingly complex tax world. While on the surface the rules under the Unshell Directive appear clear, they are nothing short of ambiguous. It also remains to be seen how consistently these rules will be implemented in the Member States’ domestic laws, and how convergent the interpretation of the rules will be by each of their tax authorities and courts. Finally, certain elements of the A.T.A.D.3 analysis depend heavily on the facts and circumstances of the case, which often are not binary.

The application of A.T.A.D.3 raises many questions for taxpayers, for example:

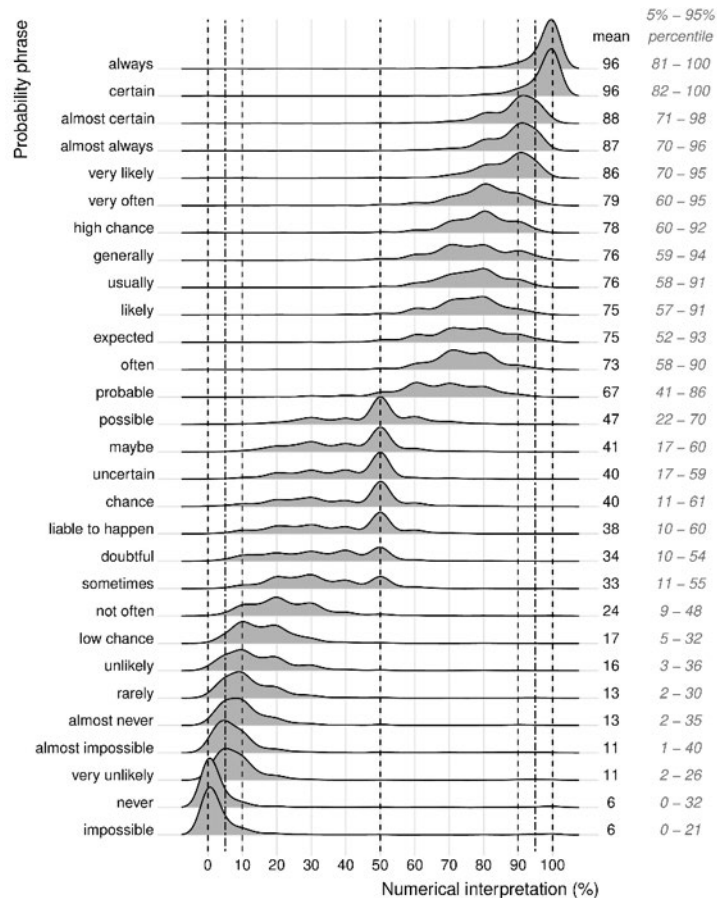
- Is an entity affected by A.T.A.D.3? What is A.T.A.D.3’s expected impact on my structure?
- Should an entity report as a shell entity in the tax return?
- Can a position be improved and is it worthwhile to do so?

These questions must be answered soon, because the answers affect the tax position of taxpayers and taxpayers want to know what they can do now to avoid being caught by the new legislation once it becomes effective. However, it is challenging to answer these questions concretely given the substantial degree of uncertainty about how the new legislation will be applied. Inevitably, this uncertainty will result in risks. In such a case, tax advisors often resort to broad and relatively vague wording when addressing the risks in their advice.⁶

The use of such language is understandable. This is commonly considered to be a nuanced, implicit expression of a level of probability. But using frequency words to express probability is problematic if the sender and recipient of the probability phrase translate such language differently. Research suggests that this is often the case.⁷ In this research, the team of statisticians and a professor of science communication conducted a survey on how both laypeople and statisticians interpret Dutch probability phrases in numbers. For both research groups, the researchers found a large variability in interpretations, as shown in the graph below.

⁶ Examples of such language are “it cannot be excluded that (...)”, “there is a considerable chance that (...)”, and “there are good arguments that (...)”.

⁷ For example: Willems S., Albers C. & Smeets I. (2020), Variability in the interpretation of probability phrases used in Dutch news articles — a risk for miscommunication, JCOM: *Journal of Science Communication* 19(02): A03.



Graph 1: The distribution (density) of the interpretation of the probability and frequency phrases, as follows from the research cited in footnote 7.⁸

The above graph displays two different types of uncertainty: (i) uncertainty about the likelihood that something will happen (y-axis) and (ii) uncertainty about the *interpretation* of that likelihood (x-axis). The latter is the area where there is a risk of misunderstanding between tax advisors and clients. One way to overcome this noise in the “interpretation” of probability is to use numbers instead of words to talk about probabilities. Tax advisors would then equally use their professional knowledge and experience to assess a situation, and equally speak out about their probability estimate (albeit, perhaps, more explicitly), with the only difference being that their views are now expressed in a (range of) probability percentage(s) instead of a probability phrase that may be interpreted very differently from what they meant.⁹

Statistical Thinking Applied in the Context of A.T.A.D.3

The statistical thinking approach described above can also be applied to tax situations, when a decision is to be made while the outcome of one or more options is uncertain. Normally, the analysis starts with setting out the various choices one has,

⁸ Note that the distributions are smoothed versions of histograms, which causes them to pass the boundaries of 0% and 100%.

⁹ A lot has been written on how to improve estimating probabilities. Discussing those techniques, such as the Fermi estimate, however, goes beyond the scope of this article.

such as, settle or litigate a tax dispute. It can also apply to report or not report as a shell entity in the tax return. The second step is to determine what might happen if a certain choice is made. We will explain this using a basic example, based on the Unshell Directive as amended by the E.P.

Example

An E.U.-based legal entity does not fall under any of the carve-out categories and passes through the “cross-border income” and “outsourcing” gateways. The income statements for the two years under review give the following percentages of relevant income:

Relevant Income	
Threshold >65%	
Year 1	54.0%
Year 2	75.5%
Average of %	64.7%
Average	67.4%

Table 2: Percentages of relevant income based on income statements in example

Do the percentages in the table above lead to the conclusion that this entity passes the “relevant income” gateway? The text of the Unshell Directive only mentions that this gateway is passed if “more than 65% of the revenues accruing to the undertaking *in the preceding two tax years is relevant income*.” In the absence of clear guidance as to how exactly the >65% threshold is to be measured (e.g., whether it is sufficient to exceed the threshold in only one of the two years), this is uncertain. The taxpayer ultimately seeks advice to decide whether to report as a shell entity in its tax return.

One way to start this analysis is to structure the tax rule under review in a conceptual model, such as set out in Figures 1-5.¹⁰ It allows for a structured, concise approach to estimating the probabilities. To do that, the professional judgment of the tax advisor is required. Let us assume that the tax advisor considers that it is “defensible” to take the position that the relevant threshold will not be exceeded, and translates this into a probability of 30%.

If we incorporate this 30% probability into the conceptual model, it becomes clear that the probability of running into automatic exchange of information is 70% and that – in the absence of any other “escape” – there is also a 70% chance of running into the reporting obligation and being qualified as a shell entity. This is very obvious and it would not normally require a conceptual model to draw such a conclusion. However, how would this probability change if the tax advisor additionally considers it “likely” (in this case converted into a 60% probability) that it can be argued that the

¹⁰ Another way is to firstly calculate the worst-case impact of a new tax rule, as it may well be that given the amounts involved, further analysis would no longer be required.

administration of day-to-day operations is not outsourced? This 60% probability is then included in the conceptual model, as shown in Figure 6.

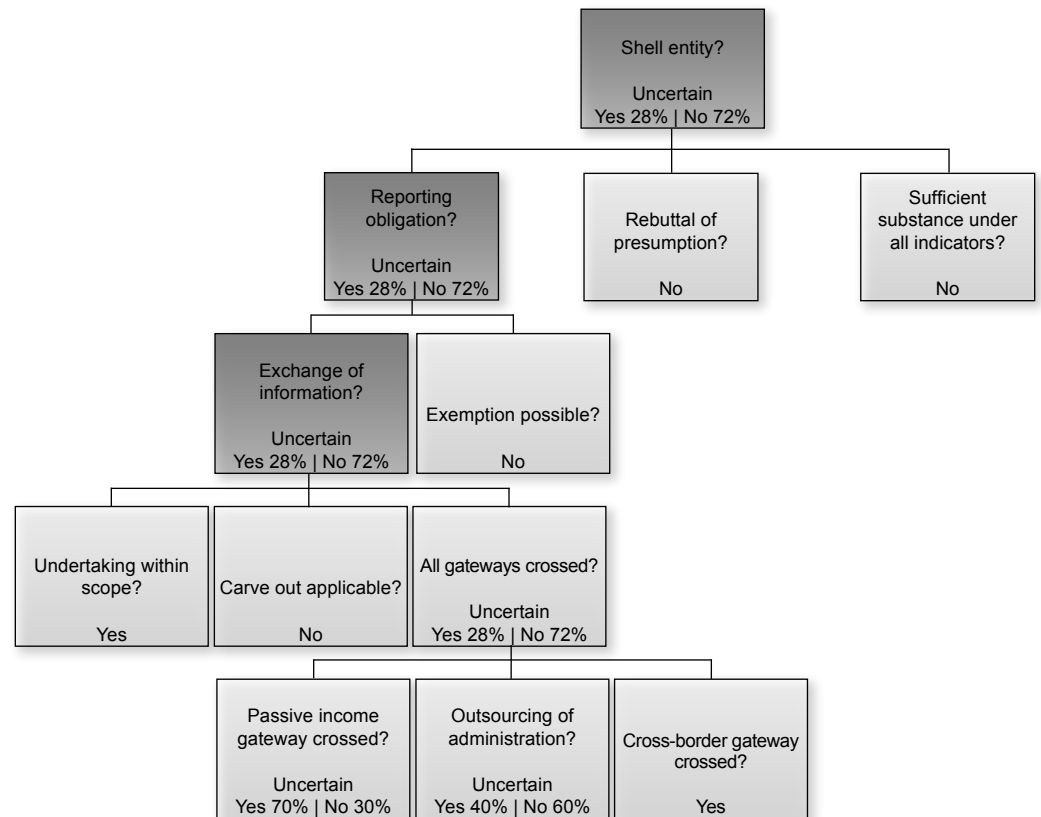


Figure 6: Schematic overview (condensed) of requirements to qualify as shell entity under Unshell Directive (E.P. proposal), including probabilities from example

Despite the fact that there are now multiple uncertain elements, the conceptual model still provides a simple overview of the relationships between the various input variables. More importantly, a closer look at the effect of these additional arguments brings a logical mathematical effect to the surface: while there now is an additional element that, by itself, carries a 60% probability that the entity will not run into any of the consequences of the Unshell Directive, the cumulative probability drops from 60% to 28% (*i.e.*, 32 percentage points). This mathematical effect is important to keep in mind when deciding which elements of the analysis to best focus on.

Based on the advisor's judgment, the (cumulative) probability that the entity qualifies as a shell entity is 28%.¹¹ The entity acknowledges the inherent uncertainty, but still faces a binary decision: should it include in its tax return that it is a shell entity or not? While there are two choices, there are essentially three scenarios, as shown in the table below.

¹¹ Namely: the 70% probability that the relevant income gateway would be crossed multiplied by the 40% probability that the entity fails to successfully claim that outsourcing did not take place.

Shell entity or not?			
Choices			
Tax return position	No automatic exchange of information, no reporting obligation, no shell entity		Shell entity
Option	1		2
Scenarios			
Ultimate outcome	No shell entity	Shell entity	Shell entity ¹²
Probability	72%	28%	100%
Scenario	1a	1b	2

Table 3: Options and scenarios in example

Some parties will choose Option 2 and pay whatever amount of additional tax is due, as they want to avoid discussions with the authorities and additional tax interest at any cost. Often, however, a client will first be interested in the value – for example, the additional tax and interest due – of making a choice. Let us assume that the maximum additional cash-out is € 1,000,000, including € 100,000 of tax interest. We could then combine the scenarios and the corresponding cash-outs, as shown in Table 4 below.

Shell entity or not?			
Choice to be made by entity			
Tax return position	No shell entity ¹³		Shell entity
Option	1		2
Scenarios			
Ultimate outcome	No shell entity	Shell entity	Shell entity
Probability	72%	28%	100%
(Additional) tax due	nil	€900,000	€900,000
Tax interest	nil	€100,000	nil
Scenario	1a	1b	2

Table 4: Options and scenarios in example, including cash-out per scenario

¹² Assuming that the tax authorities would not themselves take a position contrary to the position taken by the entity itself.

¹³ And no automatic exchange of information or reporting obligation.

The entity would face the maximum downside if scenario 1b were to occur. However, the probability of this scenario occurring was estimated to be 28%. The probability-weighted average additional cash-out, commonly referred to as the expected value, of choosing Option 1 is therefore € 280,000.¹⁴ Compared to Option 2, which in this example would result in a guaranteed cash-out of € 900,000, Option 1 would in principle be the rational, economic choice. That being said, it is the client's choice – it will ultimately come down to its risk appetite. The aim of using the structured, statistical approach to tax uncertainty as described above is to help the client make an informed decision by providing the client with a picture that is as objective as possible.

Comparing Optimization Alternatives

As a final note, the (expected) values attributed to the “base case”¹⁵ choices can also serve as a benchmark against which potential optimization alternatives can be tested. For example, if an advisor sees an opportunity for an internal reorganization that would “probably” (let us say 60% probability) make a carve-out applicable to the entity, the costs associated with such internal reorganization can be compared to the reduction in expected cash-out under Option 1. The conceptual model would then look as follows:

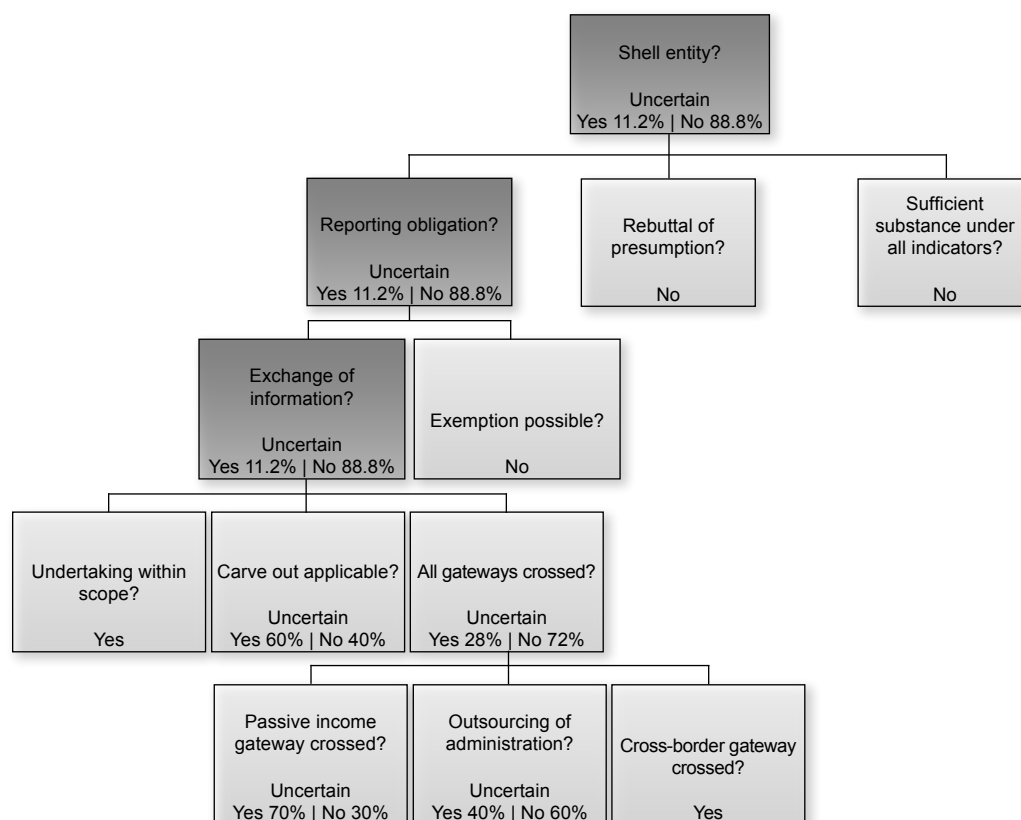


Figure 7: Schematic overview (condensed) of requirements to qualify as shell entity under Unshell Directive (E.P. proposal), including updated probabilities from example

¹⁴ Namely: 72% multiplied nil (scenario 1a) plus 28% multiplied by EUR 1,000,000 (scenario 1b).

¹⁵ Base case is referred to here as the as is situation, *i.e.*, without any optimization effort. This is also referred to as the “zero position.”

The corresponding values per scenario would be as follows:

Shell entity or not?			
Choice to be made by entity			
Tax return position	No shell entity		Shell entity
Option	1		2
Scenarios			
Ultimate outcome	No shell entity	Shell entity	
Probability	88.8%	11.2%	
(Additional) tax due	nil	€900,000	€900,000
Tax interest	nil	€100,000	nil
Scenario	1a	1b	2

Table 5: Options and scenarios in example, including cash-out per scenario and updated probabilities

If the internal reorganization were implemented, the probability of qualifying as a shell entity would decrease from 28% to 11.2%. This leads to a decrease in the expected value of Option 1 of €168,000.¹⁶ From an economic point of view, it would thus only make sense to proceed with the internal reorganization if the associated costs were lower than €168,000.¹⁷ In this case, too, the pros and cons of a possible optimization exercise are objectified to facilitate a client's decision-making as much as possible.

CONCLUDING REMARKS

As discussions on the Unshell Directive are still ongoing, it remains to be seen whether and, if so, in what form and when the Unshell Directive will be implemented and become effective. In addition, there is likely to be considerable uncertainty in the application of the Unshell Directive, for example due to ambiguous interpretation of the rules or unclear qualification of facts and circumstances.

Where a decision has to be made while the outcome of one or more options is uncertain, it may be difficult to give concrete advice. However, it is not impossible: the aim of this article has been to present a method by which tax uncertainty can be communicated in a rational and (as far as possible) objective manner. This method expresses uncertainty (and risk) in percentages rather than words. This avoids noise in the "interpretation" of probability, which will otherwise easily come into play between the sender (e.g., a tax advisor) and recipient (e.g., a client) of a probability expressed in words.

¹⁶ From €280,000 to €112,000.

¹⁷ This is a basic example based on one year of cash-out, but the mechanics are in principle the same for a multi-year analysis (albeit that discounting the future cash flows would likely be required to make an appropriate comparison).

"As discussions on the Unshell Directive are still ongoing, it remains to be seen whether and, if so, in what form and when the Unshell Directive will be implemented and become effective."

In this article, we illustrated the abovementioned method using the uncertainty in the application of A.T.A.D.3. However, this approach can be used in any other tax-related decision under uncertainty, such as when choosing between several alternative investment structures or when faced with a decision to settle or litigate a tax dispute.

The approach involves the following steps:

1. Set out the various choices one has (e.g., to report or not report as a shell entity in the tax return) and determine what scenarios can occur (e.g., what can happen if a certain choice is made).
2. Structure the tax rule under review in a conceptual model.
3. Evaluate the case at hand and, for each option that exists for the decision at hand, assign probabilities to the elements in the conceptual model that are uncertain (if any).
4. Determine the interdependencies among the elements and calculate the total probabilities of the various scenarios associated with a choice. Once this is done, each scenario has a probability (e.g., there is a 40% probability that the entity will qualify as a shell entity, even though it is not reported as such in the tax return).
5. Determine the (financial) outcome of each scenario (e.g., tax cash-out and interest).
6. Compute the expected value of each option. This is the sum of the financial outcome of each scenario multiplied by the probability of each scenario.

Following the steps above provides an overview of the expected impact of making a decision. It allows for a comparison of the various options one currently has, based on a single financial metric (i.e., the expected value of a choice).

However, if an alternative presents itself, for example because optimization opportunities have been identified and the question thus comes up whether to proceed with such optimization exercise, the same six steps can equally be applied. In such case, the (expected) values assigned to the “base case” choices serve as a benchmark against which potential optimization alternatives can be tested.

