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Preventing misuse of shell entities for tax purposes – is Portugal ready for ATAD 3?

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On 22 December 2021, the European Commission released a proposal for a directive to prevent the misuse for tax purposes of shell entities and amend the Directive on Administrative Cooperation in the field of taxation (DAC). The implementation of Anti-Tax Avoidance Directive 3 (ATAD 3) will impact the current legal framework applicable to companies that are resident in Portugal for tax purposes, as well as their access to benefits and tax regimes under Portuguese tax law.

ATAD 3

The proposed directive, which is widely called the "Unshell Directive" or "ATAD 3", follows recent efforts to strengthen the international legal framework against tax avoidance by setting criteria to help member states identify entities with no "economic substance" in the European Union and preventing such entities' access to benefits under EU law.

With respect to Portuguese companies, ATAD 3 will be applicable to any entity, regardless of its legal form, that is a tax resident and eligible to receive a tax residency certificate in Portugal, irrespective of profitability or turnover volume.

Entities that, due to the nature of their activities, do not risk being considered as having "low economic substance" for tax purposes are excluded from the proposed directive. These include listed companies, regulated financial entities and holding companies that are that are resident for tax purposes in the same member state as their shareholders or the ultimate parent entity.

Only entities that are deemed to have a high risk of having low economic substance are subject to the reporting obligations and subsequent scrutiny by the tax authorities in Portugal.

An undertaking is considered a "high-risk entity" if the following requirements are met:

- in the preceding two tax years, more than 75% of the income was derived from interest or other income generated from:
  - financial assets (including crypto assets);
  - royalties;
  - dividends;
  - income from financial leasing;
  - immovable property;
  - income from services outsourced to associated enterprises;
  - insurance;
  - banking; and
  - other financial activities (also referred to as "relevant income");
- it is predominantly engaged in cross-border transactions, meaning that a majority of the aforementioned income is received or passed to a jurisdiction other than Portugal; and
- in the preceding two tax years, the day-to-day management and the decision-making on significant functions of the entity is wholly or partially outsourced.

Entities that are considered to have a low risk of low economic substance are not subject to the reporting obligations.

High risk entities will be required to disclose additional information in their tax returns each year, including:

- address and type of premises;
- amount and type of gross revenue and business expenses;
- nature of business activities performed that generate relevant income;

- the qualifications, authorisations, place of residence and number of directors for tax purposes or the qualifications, place of residence and number of full-time employees performing the business activities that generate the relevant income for tax purposes;
- outsourced business activities;
- bank account number;
- mandates granted to access the bank account and to use or issue payment instructions; and
- evidence of the account's activity.

Entities that are required to report the above information will be considered as having economic substance if all the following criteria are met:

- the entity has its own premises or has premises for its exclusive use in Portugal;
- the entity has at least one active bank account in the European Union;
- the entity has qualified directors or five full-time equivalent employees who are resident for tax purposes in Portugal or within commuting distance.

Entities that are deemed not to have minimum substance for tax purposes will be denied a request for a certificate of tax residence for use outside of Portugal, as well as access to any agreements, conventions and other instruments that eliminate double taxation.

ATAD 3 is expected to be implemented in 2023 and be applicable from 1 January 2024, with a lookback period of two years (ie, to 1 January 2022).

Impact of ATAD 3 in Portugal

Several recent economic issues have impacted tax in Portugal, such as the implementation of rules that are applicable to transactions concluded with controlled foreign companies and disputes between taxpayers and the national tax authorities. ATAD 3, however, presents challenges that are not usually considered by the tax authorities – namely, corporate structures that are incorporated in Portugal.

Despite the necessary legal requirements for a company to be considered a tax resident in Portugal, the attribution of tax residence certificates has not yet been subject to an assessment (prior or subsequent to the attribution of said tax residence certificates) of the resident company's economic substance. Further, the concept of "economic substance" has not been defined or clarified under national legislation or case law. In fact, it has mainly been applied in the context of tax audits, notably regarding specific transactions in which companies are involved (mostly linked to anti-abuse rules), but not to their structure or to the economic substance of companies incorporated in Portugal.

ATAD 3 will be a major development for tax in Portugal. It is expected to empower the tax authorities to apply the concept of economic substance more often and in more circumstances, which will subsequently impact resident companies. Such companies will face new tax-related challenges as they will need to comply with the requirements imposed by ATAD 3 and demonstrate that they have met the economic substance criteria.

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