PwC Middle East
Financial Services Tax & Legal Update

June 2022

Introduction

Welcome to the eighth edition of our Middle East Financial Services Tax and Legal update, picking up on a range of current hot topics relevant to the financial services industry. We have a packed offering this month as the rapid rate of change in the tax and legal area for FS businesses continues. This is demonstrated in our updates below, which reflect national, regional and global changes.

In this edition, we have six articles covering the following areas:

1. Introduction of the new Crypto-Asset Reporting Framework
2. Oman VAT guide for the financial services sector
3. FS Exclusion under OECD Pillar 1 - Amount A
4. Proposed changes to the transfer pricing rules in KSA
5. Proposal for the modification of US financial institutions reporting obligations and digital asset exchanges
6. ATAD III and its impact on Middle East businesses

I hope you find the articles relevant and informative. Please get in touch with me or your regular PwC contact for further information or if you would like to discuss how these changes impact your business.

As always I are keen to hear your feedback on this newsletter so would welcome any thoughts or comments.

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Introduction of the new Crypto-Asset Reporting Framework

In brief

On 22 March 2022, the Organization for Economic Co-operation and Development ("OECD") released a new global tax transparency framework, which introduces the automatic exchange of tax information on transactions in Crypto-Assets in a standardised manner ("Crypto-Asset Reporting Framework" or "CARF") and also proposed amendments as part of the first comprehensive review of the the Common Reporting Standard ("CRS").

In detail

Crypto-Asset Reporting Framework

The CRS, published by the OECD in 2014, is a key tool in ensuring transparency on cross-border financial investments and in fighting offshore tax evasion. However, in most instances Crypto-Assets will not fall within the scope of the CRS, which applies to traditional financial assets and fiat currencies. Even where Crypto-Assets may fall within the definition of financial assets, they can be owned either directly by individuals in cold wallets or via Crypto-Asset exchanges that currently do not have reporting obligations under the CRS, and are therefore unlikely to be reported to the tax authorities in a reliable manner.

Therefore, at the behest of G20, the OECD has developed a new global tax transparency framework for the automatic exchange of information on Crypto-Assets. The new proposed **Crypto-Asset Reporting Framework** ("CARF") provides for the collection and exchange of tax-relevant information between tax administrations, with respect to persons engaging in certain transactions in crypto-assets.

The CARF covers crypto-assets that can be held and transferred in a decentralised manner, without the intervention of traditional financial intermediaries, as well as asset classes relying on similar technology that may emerge in the future. Individuals and entities that, as a business, provide services to exchange crypto-assets against other crypto-assets, or for fiat currencies, must apply the due diligence procedures to identify their customers, and then report the aggregate values of the exchanges and transfers for such customers on an annual basis

The rules and commentary of the CARF have been designed around four key building blocks:

1. *the scope of Crypto-Assets to be covered;*
2. *the intermediaries subject to data collection and reporting requirements;*
3. *the transactions subject to reporting as well as the information to be reported in respect of such transactions; and*
4. *the due diligence procedures to identify Crypto-Asset users and the relevant tax jurisdictions for reporting purposes.*

A *Crypto-Asset* is defined broadly in the CARF as "*a digital representation of value that relies on a cryptographically secured distributed ledger or a similar technology to validate and secure transactions*".

Further, the reference to a "*similar technology*" within the definition likely aims to ensure that the reporting requirements will cover new assets that may emerge in the future.

Amendments to the CRS

Seven years after its adoption, the OECD is proposing the first comprehensive review of the CRS with the aim of improving the operation of the CRS across participating jurisdictions.

The proposed amendments can be overall divided into two key work streams:

1.The review seeks **to bring new, digital financial assets, products and intermediaries products within a scope of the CRS** as they may constitute a credible alternative to holding money or financial assets in an account that is currently subject to the CRS reporting. In this regard, the proposal extends the scope of the CRS to:

- Cover new digital financial products;
- Cover the derivatives referencing Crypto-Assets and Investment Entities investing in Crypto-Assets;
- Ensure an efficient interaction between the CRS and the CARF, in particular to limit instances of duplicative reporting.

2. The review seeks to **improve the due diligence procedures and reporting outcomes under the current CRS,** with a view to increase the usability of the information for tax administrations and limit burdens on financial institutions, where possible. Specifically, it is therefore proposed that the reporting requirements under the CRS are expanded to cover the following:

Introduction of new Crypto-Asset Reporting Framework (cont'd)

Amendments to the CRS (cont'd)

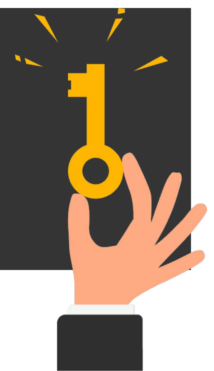
- *Account Holders, Controlling Persons and the Financial Account reporting requirements;*
- *Reliance on AML/KYC procedures for determining Controlling Persons;*
- *Exceptional due diligence procedure for cases where a valid self-certification was not obtained;*
- *Qualification of certain capital contribution accounts as Excluded Accounts;*
- *Broadening of the scope of Depository Institution;*
- *Notions of customer and business in the context of Investment Entities;*
- *Reporting in respect of dual-resident account-holders;*
- *Reflecting Government Verification Services (GVS) within the CRS due diligence procedures;*
- *Look-through requirements in respect of Controlling Persons of publicly traded Entities;*
- *Integrating CBI/RBI guidance within the CRS;*
- *Incorporating FAQs;*
- *Transitional measures.*

Next steps

On the basis of the input received via this public consultation, the OECD plans to finalise the rules and commentary to the CARF and the amended CRS. The OECD will also develop the exchange instruments and technical solutions needed to support reporting and exchanges pursuant to the CARF and the amended CRS.

Key takeaway

These proposals portray a significant change in the CRS and the evolution of automatic exchange of information regimes.



Oman VAT guide for the Financial Services Sector

In brief

Following the introduction of Value Added Tax ("VAT") in Oman on 16 April 2021, the Oman Tax Authority ("OTA") issued on 26 April 2022, a new guide on the application of VAT to the Financial Services sector (the "Guide").

The Guide confirms that VAT exemption applicable to the supply of financial services provided by banks and financial institutions licensed by the Central Bank of Oman or any other competent authority (including persons licensed to conduct Islamic financial banking activities or life insurance activities by the relevant body in Oman) where the consideration is an implicit margin. It also gives guidance on the application of VAT at the standard rate on financial services remunerated by way of a fee, commission or discount.

The Guide covers the application of VAT to various conventional and islamic banking products as well as life insurance, transfers of equity and debt securities, insurance services, warranties, etc. The Guide also clarifies certain administrative practices which the taxable persons may follow and that should be acceptable to the OTA.

In detail

The Guide can be technically divided in the following 4 sections:

1. General clarifications for the financial services industry
2. Clarifications specific to the banking industry (including Islamic finance)
3. Clarifications specific to insurance industry
4. Administrative practices clarified in the Guide

PwC has published a detailed newsletter which can be referred for detailed updates under each of the above sections. We have included certain key updates in the following paragraphs for your information:

- Real estate related supplies
  - Interestingly, financing associated with the provision of real estate (under asset financing arrangement) and insurance taken out over a particular piece of property will be treated as 'real estate related services' and not 'financial services'. This practice is aligned with the practice followed in the KSA, but this is not aligned with the practice followed in the UAE and Bahrain.
- Compensatory or punitive charges
  - The VAT treatment of compensatory or punitive fees, where the fees are typically anticipated in the contractual terms, and form part of the normal revenues received by the financial institution, are subject to VAT at the standard rate (e.g. late payment, early termination fee). However, where the compensation is awarded by a court, arbitration panel, or committee, or received to settle a dispute, the bank or financial institution is not required to charge VAT on such compensation. As such the settlement is outside the scope of VAT.
  - Specific guidance is provided on the penalty charges collected by Islamic financing providers which are typically required to be remitted to a charity; these charges are not subject to VAT.
- Waiving of customer fees
  - Waiving of customer fees may not be treated as deemed supply only if conditions such as genuine commercial reasons, no reciprocal purchase of related goods, a waiver for existing customers who separately pay for other services, are met.
- VAT treatment of deductible under an insurance contract
  - The deductible payable by an insured under an insurance contract/ policy is not treated as a consideration for a supply by an insurance company, and as such is out of scope of VAT.

Oman VAT guide for the financial services sector (cont'd)

- Input VAT on repairs under an insurance contract
  - In cases where repair and other services are provided directly to the insured, the insurance company will not be eligible to claim an input VAT deduction in relation to payments of monetary claims to the insured. However, if the third-party contracts with and provides services directly to the insurance company, the insurance company will pay the charged VAT to the supplier. In these cases, the insurance company (if eligible) may deduct the VAT in its VAT return provided the insurer is the recipient of the services.
- Provisional partial input VAT deduction percentage
  - As an alternative to the quarterly calculation of the partial deduction percentage, the taxpayer can provisionally use the percentage of the previous year subject to certain conditions.
- Use of exchange rates
  - As per the Oman VAT legislation, a taxable person is required to use the exchange rates published by the Central Bank of Oman on the date of supply. However, the Guide provides for an administrative practice under which the taxable person may seek clarification from the OTA on alternative procedures for currency conversion.

Next steps

The Guide does not provide clarification on certain areas such as the value of supply that should be reported for an issue or sale of securities, speculative trading, VAT treatment of the travel insurance, invoicing requirements for interchange fee, etc. Therefore, a request for public clarification needs to be filed by the industry associations on these aspects.

How PwC can help?

PwC can assist you in identifying the gaps between the VAT treatments and compliance practices followed by you by providing you with the following services:

- We can assist in review of your VAT treatments and compliance practices followed by you in light of the clarifications provided in the Guide.
- We can assist in preparing and filing the request for further clarification on any of the aspects covered in the Guide.
- We can assist by completing a "health check" on your compliance with the requirements and, if necessary, advise on any appropriate disclosures to tax authorities.

Key takeaway

VAT exemption applicable to the supply of financial services provided by banks and financial institutions licensed by the Central Bank of Oman or any other competent authority is an implicit margin.

FS Exclusion under OECD Pillar 1 - Amount A

In brief

On 06 May, 2022, the OECD released the public consultation document on the proposed exclusions to "Amount A" under its Pillar One initiative for certain financial services companies. Comments on the consultation document are due by 20 May 2022. This is one in a series of public consultations on the Pillar One Amount A Model Rules that the OECD is expected to release over the coming months, with very short comment periods, as part of a 'rolling consultation.' It is particularly important to note up front that these draft rules for the moment represent the work of the OECD Secretariat. The Inclusive Framework has not approved the draft rules yet. They may, therefore, be subject to change, unrelated to the consultation process.

In detail

As detailed under PwC's tax alert on this OECD release, the Regulated Financial Services Exclusion is intended to exclude from the scope of Amount A the revenues and profits from 'Regulated Financial Institutions' (RFIs). There are seven types of RFIs defined in the consultation document:

1. Depository Institution
2. Mortgage Granting Institution
3. Investment Institution
4. Insurance Institution
5. Asset Manager
6. Mixed Financial Institution
7. RFI Service Entity (a service entity that exclusively performs functions for a RFI)

The definition for each type of RFI generally contains three elements, all of which must be satisfied: (i) a licensing requirement; (ii) a regulatory capital requirement; and (iii) an activities requirement as further described.

Licensing requirement

Depository, Mortgage, Investment and Insurance Institutions and Asset Managers must be licensed to carry on specified activities as a business under the law or regulations of the jurisdiction in which the Group Entity does that business, or in the case of a Group Entity that does such business in an EEA Member State, is licensed by a competent authority to carry on such business in an EEA Member State. The rules indicate that the Commentary would explain that this licensing requirement is tested looking at the operations in the local jurisdiction, and may need to be tested at the branch rather than the Entity level. It may also provide for recognition of the licensing decision of another jurisdiction, for example, under equivalence regimes

Regulatory capital requirement

Depository, Mortgage, and Investment Institutions must be subject to capital adequacy requirements that reflect the Core Principles for Effective Banking Supervision as provided by the Basel Committee on Banking Supervision. Investment Institutions can alternatively be subject to the Objectives and Principles of Securities Regulation as adopted by the International Organisation of Securities Commissions (IOSCO) and the related implementing methodology. Insurance Institutions must be subject to solvency standards incorporating a risk-based capital measure. Asset Managers must be subject to capital adequacy requirements incorporating a risk-based measure. The consultation document notes that future Commentary would explain that this requires that the determination of the amount of capital to be held takes into account an entity's risks. The risks that could be considered in this assessment include assets under management, size, liabilities, execution volumes, credit risk, market risk, or operational risk. This requirement would therefore not be met in jurisdictions that impose a fixed minimum amount of capital for all firms, without any variation according to the facts and circumstances of individual entities.

FS Exclusion under OECD Pillar 1 - Amount A (cont'd)

Activities requirement

The types of permissible activities for each category of RFI are listed below. Generally, the total gross income attributable to the permissible activities of an RFI must equal or exceed [75%] (i.e., this percentage, and other percentages in square brackets, has not yet been agreed) of the Group Entity's total gross income during the Period. For Insurance Institutions, this requirement can alternatively be satisfied if the aggregate value of the assets held to manage risk associated with Insurance Contracts and Annuity Contracts exceeds [75%] of total assets as at the balance sheet data for the Period. For Depository Institutions, this requirement is replaced with the requirement that at least [20%] of the liabilities of the Entity consist of Deposits, as at the balance sheet date for the Period.

Importantly, the exclusion will apply on an entity-by-entity basis. An Entity that meets the definition of RFI will be wholly excluded from Amount A. An Entity that does not meet that definition will be wholly included in Amount A. As noted in the consultation document, the defining character of the Regulated Financial Service sector is that it is subject to prudential requirements based on capital adequacy, which is the regulatory driver that helps align the location of profits with the market. The scope of the exclusion derives from that requirement, meaning that Entities that are subject to risk-based capital measures (and only those) are excluded from Amount A.

Next steps

Financial institutions across the Middle East are likely to be impacted by proposed exclusions to "Amount A" under its Pillar One initiative for certain financial services companies.

Although these are draft rules at this stage, businesses would be best placed to begin an assessment of their group entities to determine whether such entities meet the definition of an RFI, and therefore can be excluded from the scope of Amount A.

Key takeaway

The Regulated Financial Services Exclusion is intended to exclude from the scope of Amount A the revenues and profits from 'Regulated Financial Institutions' (RFIs).

Recent transfer pricing audits in KSA

In brief

In an increasingly interconnected world and with the Middle East's growing role as a global investment hub, it is no surprise that transfer pricing has become a major focus area of international tax disputes in the region. Tax authorities in the Middle East – particularly in KSA - have recently proposed major adjustments to the transfer pricing for MNCs operating in the region. Although these audits have not focused on any one industry, the issues raised are highly relevant for many financial services groups.

In detail

When the OECD began pushing for major international tax reforms nearly a decade ago under the "BEPS 1.0" action plan, governments in the Middle East did not immediately embrace these initiatives. However, they are making up for lost time with many countries in the region now bringing their local law into alignment with the OECD guidance and becoming signatories to the latest "BEPS 2.0" initiatives which are slated to—once again--significantly reform the international tax landscape. Moreover, tax authorities such as ZATCA have already adopted some of the concepts underpinning the latest OECD initiatives in their approach to transfer pricing audits. As tax authorities greatly increase resources to international tax and transfer pricing, these disputes have ballooned recently and several key trends have emerged that are directly relevant to financial institutions.

One of the focus areas of BEPS 2.0 is to ensure that "market jurisdictions" (i.e., where the customers are based) are receiving their fair share of the overall profit. Such a concern has surfaced in different forms during recent audits whereby affiliates selling to major customers locally are remunerated on a cost-plus basis while the lion's share of the profits from these sales are earned outside of the country.

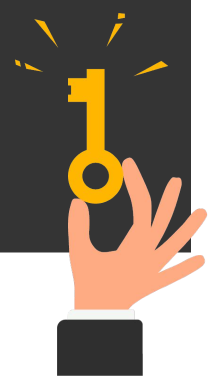
In the financial services sector, groups often apply a cost-plus remuneration for functions that are not considered key value drivers, often including sales and marketing. Although such a policy may be justifiable, the default position often taken by tax authorities is that there is significant value derived from the access and selling to local customers. We therefore recommend that such pricing models are carefully reviewed and documented.

In evaluating the transfer pricing model, it is important for groups to conduct a functional analysis as well as to map out their value chain and evaluate how the local affiliate contributes to this value chain. Further a best method analysis should indicate why other approaches besides cost plus, such as the profit split, are not more reliable in determining an arm's length remuneration.

Another recurring issue is around losses and who should bear them. As financial services companies invest heavily in digital products and strategic initiatives, even the most established players may have losses that are incurred in one part of the group or another. Such cases are often quickly flagged by tax authorities who are keen to understand whether local losses are caused by non-arm's length pricing under the group's transfer pricing policy. Transparency measures such as country-by-country reporting have only increased the tendency of tax authorities to bring challenges informed by financial data that may have been taken out of context. Given the sensitivity around this issue, we recommend that groups review their transfer pricing model and evaluate the appropriateness of losses borne by an entity based on its functional and risk profile. Finally, transfer pricing documentation presents taxpayers with the opportunity to tell the story behind their financial results and it is critical to include in such documentation an analysis of any losses.

Key takeaway

Tax authorities in the Middle East – particularly in KSA—have recently proposed major adjustments to the transfer pricing for MNCs operating in the region.



Proposal for the modification of US financial institutions reporting obligations and digital asset exchanges

In brief

On 28 March 2022, the Department of Treasury of the United States of America ("US Treasury") released the General Explanations of the Administration's Fiscal Year 2023 Revenue Proposals ("Green Book"), which proposes the introduction of additional reporting obligations for US financial institutions on non-US account holders based on reciprocal double income tax treaties with other jurisdictions or intergovernmental agreements in accordance with the Foreign Account Tax Compliance Act ("FATCA").

The Green Book also proposes the introduction of digital assets reporting obligations for brokers with respect to their customers and the substantial foreign owners of passive entities.

In detail

As part of Joe Biden, President of the United States of America, fiscal year 2023 budget, the Green Book, a proposal for the modernization and reform of current laws and regulations was included. The cornerstones of this proposal are the information exchange relationships with other jurisdictions, either under reciprocal double tax treaties or under an intergovernmental agreement in accordance with FATCA, and the use of digital assets that has rapidly become a tax evasion issue.

The proposal would require the US financial institutions to report additional information to the Authorities to comply with the US political commitments in respect of the exchange of information with other jurisdictions and would bring into scope digital assets for purposes of exchanging information with other jurisdictions and, in return, receiving information on US taxpayers, either directly or indirectly, holding digital assets outside the United States.

With respect to expanding the US financial institutions reporting obligations, the proposal addresses the US political commitments under the intergovernmental agreements entered into with other jurisdictions under FATCA to achieve similar levels of reciprocal information exchange (i.e., under the current law the US exchanges less information on foreign accounts compared to the information it receives on US accounts).

As of today, the US financial institutions are required to submit the following information to the US Internal Revenue Service ("US IRS"):

1) U.S. source interest paid to a nonresident alien individual (i.e., an individual who is neither a U.S. citizen nor U.S. national) if the aggregate amount of interest paid during the calendar year is 10 dollars or more; and
2) U.S. source dividends, royalties, and annuities paid to any foreign recipient.

Should the proposal be adopted, then the US financial institutions would be required to report the below information (in addition to the already reported information) in respect of a financial account held by foreign persons:

- Account balance (including, in the case of a cash value insurance contract or annuity contract, the cash value or surrender value);
- Non-US source income payments;
- Gross proceeds from sale or redemption of property; and
- Information regarding passive entities and their substantial owners.

With respect to the digital assets for purposes of exchanging information with other jurisdictions, the proposal would introduce the obligation for any person doing business as a broker (under the US Internal Revenue Code Section 6045) to report substantial foreign owners of passive entities holding digital assets in the US. The proposal would require a broker to report gross proceeds and digital assets sales related information with respect to customers and substantial foreign owners, when holding such digital assets through a passive entity.

The adoption of the digital assets for purposes of exchanging information with other jurisdictions proposal would enable the US to exchange information with other partner jurisdictions on digital assets transactions and, in return, receive information on US taxpayers engaged in digital assets transactions.

The proposal requirements (if adopted) are effective for filings submitted after 31 December 2023.

Proposal for the modification of US financial institutions reporting obligations and digital asset exchanges (cont'd)

Next steps

Due to the stage of these amendments (i.e., proposal) and the lack of clarity on how the impacted financial institutions are to collect and exchange the additional information requirements, it is recommended to monitor and participate in any public consultations (if any).

Upon the release of related regulations and/or guidelines, conduct an impact/gap assessment and define a roadmap to achieve a full compliance of the updated regulations (if the proposal is adopted).

Key takeaway

- The Green Book proposes the expansion of the US financial institutions reporting obligations to comply with the US political commitments under the intergovernmental agreements entered into with other jurisdictions under FATCA.
- The additional reporting requirements for the US financial institutions would mirror the current reporting obligations of a foreign financial institution under an intergovernmental agreement.

ATAD III and its impact on Middle East businesses

In brief

The European Commission ("EC") has published a draft Directive on 22 December 2021 laying down rules to prevent the misuse of shell entities for tax purposes. This proposed Directive provides indicators of minimum substance for undertakings in European Union ("EU") Member States and rules regarding the tax treatment of those undertakings that do not meet the indicators.

The proposed Directive would apply to all undertakings that are considered tax resident and are eligible to receive a tax residency certificate in a EU Member State (subject to some specific exclusions), including SMEs, partnerships, trusts and other legal arrangements. It is likely to result in additional reporting requirements and in some cases, additional tax liabilities for those impacted.

Although the Directive is expected to be applicable from 2024, it has a "look back" period of two years. Groups based in the Middle East which have a presence in the EU should consider the impact of the Anti Tax Avoidance Directive ("ATAD") III and undertake an impact assessment to determine how this will impact their businesses.

In detail

Background

In May 2021 the EC published its '*Communication on Business Taxation for the 21st Century*' with the stated aim to provide a fair and sustainable business environment and EU tax system.

As part of this Communication, the EC pledged to tackle the abuse of entities and arrangements that have no or little substance. This latest proposal referred to as ATAD III is designed to address this. It is one of the short-term targeted initiatives proposed by the EC to ensure fair and effective taxation in the European Union and to make sure the tax burden is shared evenly across taxpayers, in such a way that does not distort internal competition.

This proposal stems from a European Parliament request to counter the misuse of shell entities, in addition to more general requests from some Member States, business, and civil society to deal with tax avoidance. The EC undertook a public consultation during summer 2021.

All respondents noted that tax avoidance and tax evasion remain issues, including through the misuse of shell entities. However, some respondents consider that new targeted measures are premature. Based on feedback from respondents, the EC has noted that entities can be set up with low economic substance for valid reasons and that the proposed directive is designed only for entities set up for the purposes of tax avoidance and evasion and that do not perform any actual economic activity.

Why are these rules important?

The rules are important for companies operating in the EC to determine whether they are compliant with the requirements of the minimum substance as set out by the proposed directive in order to determine if they are eligible to obtain a tax residence certificate in the respective EC countries. For large groups this may have an impact on their tax policies and the ability to obtain credit under double tax agreements between the respective jurisdictions.

What is the scope of the rules?

The proposed Directive provisions apply to all entities that are eligible to receive a tax residency certificate in any of the EU member states and are undertaking any economic activity. This includes any other legal arrangements and structures that are deemed residents for tax purposes in a Member State.

The Directive is not applicable to entities in third countries and as such the entities based in the Middle east are not likely to be affected directly by the directive.

In the case of payments to/from a deemed shell entity and a third country, the allocation of taxing rights should be determined by existing double tax agreements. Certain entities have been derogated from the rules and are not required to demonstrate that they meet the minimum substance test. These include:

- A company with a transferable security listed on a regulated market or multilateral trading facility,
- An entity that is a regulated financial undertaking (as defined in the proposed Directive).

ATAD III and its impact on Middle East businesses (cont'd)

What is the scope of the rules?

- Undertakings that hold shares in operational businesses located in the same Member State as the entity's shareholders or ultimate parent entity, or
- An undertaking that has at least five full-time employees exclusively carrying out the income-generating activities of the undertaking.

What are the rules to apply the minimum substance test?

Under the proposed directive there are three main criteria, also referred to as "gateways" which determine whether an entity is at risk of being considered a shell company. An assessment of whether an entity is "high risk" will be done cumulatively on the basis of whether:

More than 75 percent of the entity's revenue in the previous two years was in the form of "passive income." These income sources include interest, dividend, royalties and capital gains on shares and other such sources which are identified as "relevant income" for the purpose of this proposed Directive.

More than 60% of the entity's relevant income is passed on to foreign entities through cross-border arrangements.

The administration of day-to-day operations and decision-making on significant functions have been outsourced.

How do you demonstrate minimum Substance?

Where an entity is identified as being "high risk" it will be subject to certain reporting obligations as part of its annual tax returns. In order to demonstrate that they meet certain indicators of minimum substance the entity will need to demonstrate that:

- It has its own premises, or premises for its exclusive use;
- It has its own active bank accounts in the EU; and
- It meets one of the following indicators:
  - having at least one qualified director who is a tax resident in the same Member State or sufficiently close to the undertaking and who is dedicated to its activities; or
  - the majority of full-time employees engaged with the entity's core income generating activities are tax resident in the same Member State as the undertaking or sufficiently close by.

Where an entity is unable to demonstrate all of the above requirements it is presumed to as not meeting the requirements of minimum substance. However, an entity may be able to rebut this presumption by evidencing the following:

- Commercial rationale of setting up an entity
- Employee profiles and the level of their experience
- Concrete evidence that the decision making takes place in the Member State where the entity is established

Where an entity is able to provide a positive rebuttal, the Member State may allow the submission to be valid for one year or an additional 5 years after the first year (6 years in total).

Timeline

Although currently in a proposal form, once adopted, this proposed Directive should be transposed into national law by the Member States before 30 June 2023 to come into effect from 1 January 2024.

Implications for Middle east businesses

Businesses operating in the Middle East may have group entities and operations in the EU are which are likely to be impacted by the implementation of the Directive.

Middle East group companies' if caught by the rules should determine the implications on their entities based in the EU.

Failure to comply with the minimum standard test could result in the non-issuance of a tax residence certificate to these group entities based in the EU and this may have an impact on businesses in the Middle east particularly where double taxation relief is being claimed with respect to taxes paid in the EU.

ATAD III and its impact on Middle East businesses

Key takeaways

The proposed Directive is likely to have a large impact on both commercial and personal undertakings that are in scope. When an entity is unable to demonstrate that it meets the minimum substance requirements, the relevant Member States may refuse to issue a Tax Residence Certificate to such entities or issue a Tax Residence Certificate which prescribes that the certificate cannot be used to obtain the benefits of double taxation relief.

This Directive is likely to place significant additional administrative burden this process will place on both the taxpayer and the tax authorities. This will create an added layer of complexity that all EU resident, and many non-EU resident, entities will need to consider.

The Directive is expected to be applicable from 2024. However, considering that the Directive will look back two years to determine whether the minimum substance requirements are met, entities need to start preparing to meet these requirements in advance.

Next steps

Middle east businesses should determine whether any group entities could be inscope of the ATAD III requirements and identify:

- Whether they fall within the definition of entities which are in scope for the Directive;
- Whether they have any reporting obligations under the Directive;
- Whether they are likely to meet the requirements of the minimum substance test;
- What further information and documentation will be required to report under the Directive.

Key takeaway

The European Commission has published a draft Directive on 22 December 2021 laying down rules to prevent the misuse of shell entities for tax purposes. When an entity is unable to demonstrate that it meets the minimum substance requirements, the relevant Member States may refuse to issue a Tax Residence Certificate to such entities or issue a Tax Residence Certificate which prescribes that the certificate cannot be used to obtain the benefits of double taxation relief. The Directive is expected to be applicable from 2024. However, considering that the Directive will look back two years to determine whether the minimum substance requirements are met, entities need to start preparing in advance.

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