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Update on the ATAD 3 'Unshell' Directive:

European Parliament approves draft Unshell Directive

9 MIN READ

Overview

- As outlined in our previous articles on this topic, in December 2021, the European Commission published a draft proposal with the stated aim of preventing the misuse of shell entities for tax purposes, referred to as the Unshell Directive.
- On 17 January 2023, the European Parliament approved a revised version of the draft Unshell Directive, to which it had made a number of amendments. This article will discuss the European Parliament's proposed amendments.
- The Unshell Directive could potentially impact a wide variety of entities established in Ireland including holding companies, section 110 securitisation companies, fund vehicles, leasing entities and entities forming part of multinational groups which, if they do not satisfy certain substance requirements, will result in them being subjected to additional reporting requirements.
- The proposed penalties for failure to comply are set out in the below article, ranging from denial of tax treaty benefits to being subject to financial penalties based on the entity's annual revenue of at least 2% of annual revenue.
- It is important to note that while the European Parliament's amendments to the draft Unshell Directive will be considered by the Council of the European Union, the Council is not bound to accept these changes and ultimately the final text will require the unanimous support of the representatives of all Member States.

Background

In April 2022, the A&L Goodbody Tax Department published an article (ATAD3 'Unshell' Directive – European Commission proposes to neutralise the misuse of shell entities) in relation to a proposal by the European Commission (the **Commission**) in late 2021 to amend Council Directive 2016/1164/EU, the EU Anti-Tax Avoidance Directive (**ATAD**), with the stated aim of preventing the misuse of shell entities for tax purposes (the **Unshell Directive**). In a follow-up article published in July 2022 (Update on the 'Unshell' Directive: European Parliament Proposes Changes), we then outlined a number of changes to the Commission's draft Unshell Directive that were proposed by the European Parliament's Committee on Economic and Monetary Affairs, in its draft report on the Unshell Directive (the **Draft Report**).

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European Parliament adopts Unshell Directive

The European Parliament's Committee on Economic and Monetary Affairs has now considered the Draft Report and on 11 January 2023, it published its final report which proposed a number of changes to the Commission's draft Unshell Directive (the **Final Report**). On 17 January 2023, the European Parliament considered the Final Report and voted to approve the draft Unshell Directive as amended by the changes proposed in the Final Report.

The changes to the draft Unshell Directive outlined in the Final Report, and as adopted by the European Parliament, generally align closely with the recommendations outlined in the Draft Report in May 2022 and can be summarised as follows:

1. Recitals recognise legitimacy of shell structures while also affirming issues with their misuse

The European Parliament has proposed significant changes to Recital 1 of the draft Unshell Directive. The amended text starts by acknowledging that there are often legitimate purposes for setting up entities with minimal economic substance and this possibility should be safeguarded.

However, the amended text then affirms that '[t]he lack of an international instrument on the misuse of shell entities for tax purposes creates a significant loophole in the global efforts to combat tax fraud and evasion and aggressive tax planning', and creates an uneven playing field among businesses, which 'leads to a reduction in tax liability and tax loss' in the European Union (**EU**). As a result, it argues for stronger minimum substance requirements, facilitation of information exchanges between national tax administrations and that intermediaries should be dissuaded from promoting shell structures.

Recital 5 has been amended to state that undertakings should self-assess, by doing a form of 'gateway test' by themselves.

Recital 16 has been amended by the Final Report in order to emphasise that joint audits between national tax administrations should be encouraged and used wherever appropriate.

2. Scope of the Unshell Directive

The European Parliament has also proposed quite a few changes to Article 6, which sets out the scope and thresholds of the Unshell Directive. Our previous article outlined in some detail that there were three potential 'gateways' which could lead an entity to be deemed within the scope of the Unshell Directive.

Firstly, under the Commission's original proposal, it had been put forward that entities whose revenue for the previous two years consisted of at least 75% passive income would be in scope of the Unshell Directive, but the Final Report proposes decreasing this threshold amount to 65%.

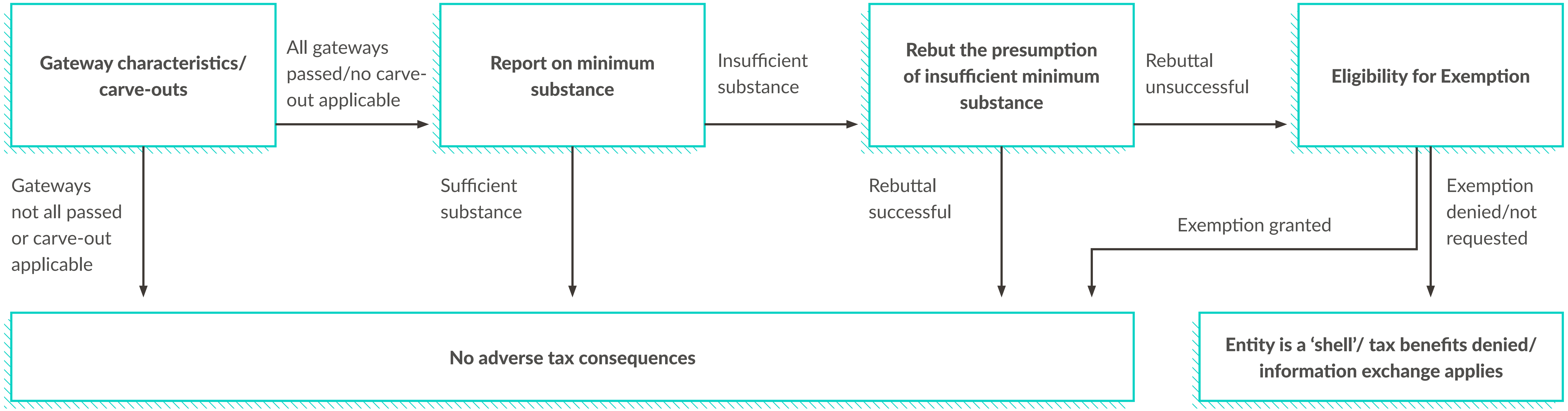
Secondly, the Commission had proposed that entities would be in scope where more than 60% of the book value of the entity's real estate assets and other valuable private property were located outside the Member State of the affected entity in the preceding two years, or where at least 60% of its passive income is earned or paid out via cross-border transactions. The European Parliament now proposes reducing both these thresholds to 55%.

Thirdly, an entity would be in scope of the Unshell Directive if in the preceding two tax years, the entity outsourced day-to-day operations and decision-making on significant functions. The Parliament's amended proposal specifies that an entity should only be in scope where these functions are outsourced 'to a third party'. This additional wording provides welcome clarification that outsourcing operations and functions to another group entity will not bring an entity within scope of the Unshell Directive.

In the European Parliament's Final Report, it has clarified that the three gateways, as outlined above, should be cumulative in nature.

Article 6.2 sets out a number of carve-outs from the Unshell Directive, including for regulated financial undertakings and for holding companies in the same Member State as their beneficial owners' or parent entity's residence, and where an entity falls within the scope of one of these carve-outs it will not be in scope of the Unshell Directive. The Commission originally proposed a carve-out for entities with at least five employees exclusively carrying out the activities generating the passive income, but the Parliament's amended proposal removed this carve-out.

Additionally, there is an exemption under Article 10 in circumstances where the existence of the entity does not reduce the tax liability of the group as a whole or its beneficial owner. Finally, the Unshell Directive shall only apply to EU-resident entities, and as such, any companies outside of the EU would therefore not be in scope of the Unshell Directive.



3. Reporting

In the event that an entity meets the three gateway tests under Article 6 set out above, and does not qualify for an exemption, it will be required to report in its annual tax returns whether it meets the following indicators of minimum economic substance, set out in Article 7.1:

a. Premises – whether the entity has its own premises, premises for its exclusive use, or shares a premises with group entities in the Member State.

b. Bank Account – whether the entity has an active bank account or e-money account in the EU through which its income is received.

c. Directors and Employees – whether one or more of the entity's directors is locally resident and authorised to take decisions, or a majority of the entity's employees are locally resident and qualified to carry out the activities that generate the entity's income.

In addition to the above reporting requirements, in-scope entities must also provide certain documentary evidence with their tax returns, including the address of the premises, the amount and type of the entity's gross revenue and expenses, the type of business activities performed as well as details of the directors or employees' qualifications and tax residence, details of outsourced activities and bank account details.

The European Parliament's proposals also include additional documentary requirements including an (i) overview of the group structure, outsourcing arrangements and the rationale behind the structure and (ii) a summary report of the documentary evidence submitted, including a brief description of the nature of the entity's activities, the number of employees and the amount of profit or loss before and after taxes.

4. Consequences of Non-Compliance

a. Denial of Certificate of Tax Residence

Further changes relate to Article 12.1, which has been amended by the European Parliament to now state that where an entity does not meet minimum substance requirements in the Member State where it is a tax resident and it requests a certificate of tax residence for use in a different jurisdiction, this request must be denied by the Member State. The Member State shall also issue an official statement justifying this decision and stating that the entity in question shall not be entitled to claim the benefits of tax treaties.

b. Request for Tax Audit

Under Article 15 of the draft Unshell Directive, where a Member State has reason to believe that an entity which is a tax resident in another Member State has not met its obligations under the Unshell Directive, this Member State may request the other Member State to conduct a tax audit of the entity in question and such Member State will be required to initiate the tax audit within one month of the date of receipt of the request and must provide feedback on the outcome of the audit to the requesting Member State. As noted above, the European Parliament has included amendments to the draft Unshell Directive to encourage joint tax audits by multiple Member States where feasible.

c. Financial Penalties

Under the Commission's original proposals, failure to comply with the Unshell Directive would have resulted in a penalty of at least 5% of the entity's turnover for the relevant tax year. Under the European Parliament's new proposals, this minimum penalty has been reduced to:

- at least 2% of the entity's revenue if the entity does not make a report, as required within the required deadline, or
- at least 4% of the entity's revenue if the entity makes a false declaration.

Further, Article 14 has been amended by the European Parliament to specify that in the case of an entity with zero or low revenue, the penalty should be based on the entity's total assets rather than revenue.

Date of Implementation

The Commission had originally envisaged that the Unshell Directive would enter into force in January 2024 and that automatic exchange of information on entities required to report on indicators of minimum substance would also commence at this time. It also envisaged that by June 2024, a central directory for administrative cooperation would be in place for Member States to communicate and automatically exchange information. The Draft Report had sought to push these deadlines back to January 2025, however the European Parliament has rejected this deferral of implementation and has reverted to the timeline originally proposed by the Commission. This has the effect of dramatically bringing forward the proposed implementation date of the Unshell Directive, though as outlined below, it remains to be seen whether this timeline is achievable in the circumstances.

What is next?

The European Parliament has now approved an amended version of the Commission's initial proposal. The European Parliament's proposal will now be considered in detail by the Council of the EU. The Council of the EU is not legally obliged to adopt the European Parliament's amendments and, as such, it is not clear to what extent the Parliament's proposals will ultimately be adopted. Essentially, what this means is that the process is not yet over and that it remains to be seen what will be contained in the final iteration of the Unshell Directive, noting that the final text will require the unanimous support of the representatives of all Member States.

For the above reasons, the timing of the adoption of the finalised text is not clear, though noting that the Commission and Parliament have both now set out an objective of the Unshell Directive coming into force from 1 January 2024. This means that Member States would need to transpose the Directive into domestic law by 30 June 2023.

Conclusion

Any businesses that potentially fall within the scope of the Unshell Directive should be examining their group structure to identify any companies that may be considered a 'shell'. Entities that do not fall within one of the carve-outs, have all the gateway characteristics present and are considered to be a shell entity under the minimum substance test, will be liable to significant reporting requirements and are at risk of financial penalties and of being denied tax treaty benefits. This could result in increased tax bills and administrative burdens. The Directive as currently drafted could potentially impact a wide range of entities.

Finally, the proposed implementation date of the Unshell Directive of 1 January 2024 is fast approaching, with the result being that potentially in-scope entities should now be examining how this proposed Directive may impact their business.

For more information on this topic, please contact **James Somerville** (Partner) or any member of **A&L Goodbody's Tax Department**. This insight was prepared with assistance by **Darragh Noone** (Senior Associate) and **Cian Ryan** (Solicitor).

STEP 1

Is the entity carved-out by the directive?

1. Listed on a regulated market or MTF; or

2. Regulated financial undertakings (e.g. a securitisation special purpose entity, UCITS, AIFM, credit institution, etc); or

3. Certain holding companies with no/limited cross-border elements.

YES → **Not in scope of the Directive**

NO → Step 2

STEP 2

Does the entity meet all of the following 'gateway' characteristics?

1. Relevant Income: more than 65% of the entity's income is "relevant income" (e.g. passive income) in previous two years or more than 65% of the assets consist of real estate or other valuable private property;

2. Cross border activity: more than 55% of immoveable property and other valuable private property is held outside the Member State (in the previous two years) or at least 55% of relevant income earned is from cross border transactions; and

3. Day-to-day management: The administration of day-to-day management and decision-making of significant functions is outsourced to a third party.

NO → **Not "at risk"**

YES → Step 3

STEP 3

Reporting obligations (indicators of minimum substance).

Can the entity report (and provide evidence of) specific information in its tax return?

This will include whether it has:

- premises for its exclusive use or shared with other group entities;
- Its own active bank account or e-money account in the EU through which its relevant income is received.
- Adequate nexus to the Member State of claimed tax residence. Either (1) a director satisfying certain conditions, or (2) the majority of full-time employees, are resident in, or sufficiently close to, the same Member State. Such employees must also be qualified and engaged in the income generating actives of the company.

YES → **Presumption to have minimum substance (not a shell).**

NO → Step 4

STEP 4

Is it possible to rebut the presumption that the entity is a shell?

The entity provides additional supporting evidence of the business activities performed to generate relevant income.

Entity may rely on factors such as the commercial reasons for setting up the entity, the resources it has at hand and proof that key decisions occur in the Member State that it is resident in.

A successful rebuttal is valid for up to 6 years, provided the facts and circumstances don't change.

YES → **Certificate the entity is not a shell.**

NO → Step 5

STEP 5

Can the undertaking request an exemption?

The entity must prove that the existence of the 'shell' does not reduce the tax liability of its beneficial owners and of the group as a whole.

YES → **No adverse tax consequences**

NO → Step 6

STEP 6

The entity is considered a shell. It may be subject to the following tax consequences:

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- Denial of benefits of double tax treaties, the Parent-Subsidiary directive and the Interest and Royalties directive.
- Denial of tax residence certificates.
- Information shared under exchange of information processes.
- Failure to adequately report information could result in a fine of at least 2% of the entity's annual revenue, rising to at least 4 % of the entity's revenue in the case of a false declaration.

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Resources

- ATAD3 ‘Unshell’ Directive – European Commission proposes to neutralise the misuse of shell entities — READ MORE
- Update on the ‘Unshell’ Directive: European Parliament proposes changes — READ MORE
- A&L Goodbody’s Tax Department — READ MORE