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ATAD3 ‘Unshell’ Directive

– European Commission proposes to neutralise the misuse of shell entities

A proposal to prevent the misuse of shell entities for tax purposes was published by the European Commission late last year (the **Directive**). The proposal takes the form of an amendment to Council Directive 2016/1164/EU, the EU Anti-Tax Avoidance Directive (**ATAD**).

The Directive has the potential to 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 be subject to additional reporting requirements. Penalties for failure to comply range from denial of tax treaty benefits to being subject to penalties of at least 5% of annual turnover on a failure to report.

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The Directive is intended to come into effect from 1 January 2024. This is an ambitious timeline, including the aim for adoption by the end of 2022, implementation in Member States by mid-2023, and domestic effect in countries such as Ireland from 2024. The Directive is currently being reviewed by Member States and could potentially be subject to further amendment.

To the extent an entity constitutes a 'shell' (see decision tree below) under the Directive and is unable to rebut that presumption the entity concerned will be denied certain tax benefits otherwise available based on double tax treaties and EU directives. In addition, the data required to be reported by an affected entity will be covered by automatic exchange of information between Member States and potentially subject to tax audit.

The Directive sets out a list of substance-related features, referred to as 'gateways', to determine whether an entity is to be regarded as a 'shell'. It applies to all entities resident in EU Member States, regardless of their legal form. However undertakings that meet one of the following carve outs from the Directive are not required to demonstrate minimum substance (ie. they are out of scope of the Directive).

Carve outs

- An entity with at least five full-time employees exclusively carrying out the income-generating activities of the entity
- Any company with a security listed on a regulated market
- An entity that is an EU regulated financial undertaking,
- An entity that holds shares in an operational business located in the same Member State of the entity where the entity's beneficial owners are also resident in the same jurisdiction, or
- An entity with holding activities that is resident in the same EU jurisdiction as the entity's shareholders or the ultimate parent entity

Entities that do not fall within one of the above listed carve outs from the Directive and have all of the 'gateway' characteristics present (see below) are required to pass a minimum substance test so as not to be treated as a shell entity.

Gateway characteristics

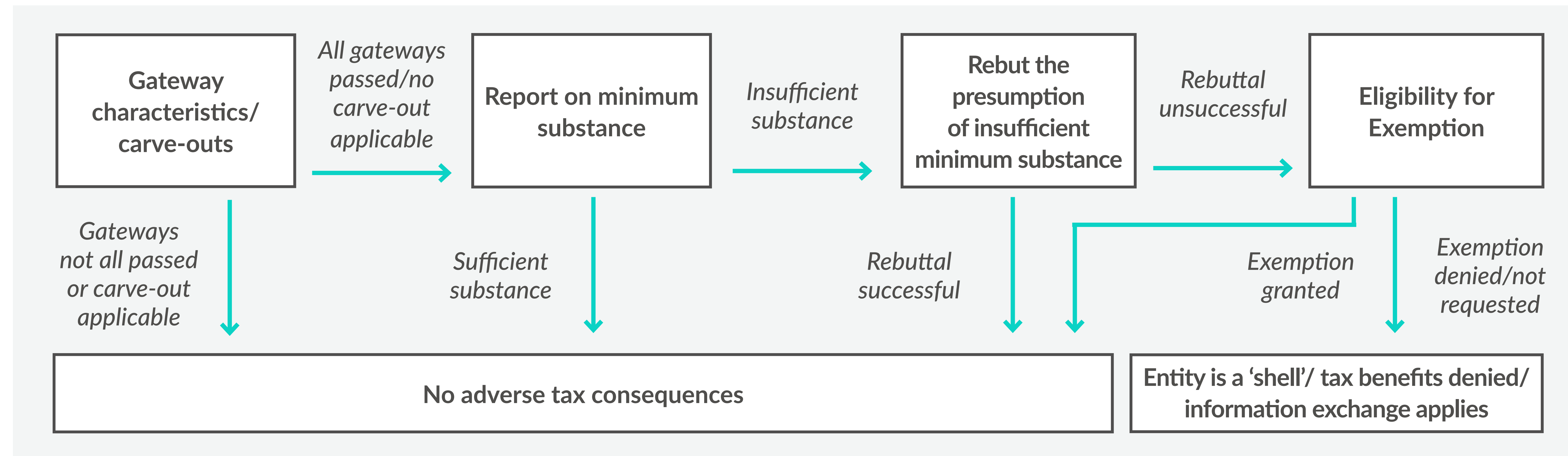
The gateway characteristics look to how the entity's revenue is generated, the presence of a cross-border element and the management and administration of the entity concerned.

1st gateway: Where more than 75% of the entity's revenue for the previous two years is passive income or where 75% of the total book value of the entity's assets comprise of shares, real estate or other valuable private property.

2nd gateway: 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 last two years or where at least 60% of its relevant income (ie. passive income) is earned or paid out via cross-border transactions.

3rd gateway: Where the entity has, in the preceding two tax years, outsourced the administration of day to day operations and decision making on significant functions.

Where all gateway characteristics are present, the affected entity will be required to report certain minimum substance indicators (and furnish supporting documentation) in its annual tax return.



Reporting of minimum substance indicators

These substance indicators focus on three factors:

- the existence of premises available for the exclusive use of the entity
- the entity having at least one own and active EU bank account
- whether there is an adequate nexus to the Member State of claimed tax residence

- In order to demonstrate adequate nexus with the EU Member state of residence, the entity will need to have either:
- one (or more) directors that:
  - i. is tax resident in the EU Member State of residence of the entity (or close enough to properly perform their abilities)
  - ii. is qualified and authorised to make decisions in relation to the income generating activities/assets of the entity and actively exercises that authority
  - iii. is not employed by, and does not perform the function of director (or equivalent) on behalf of, an entity that is not an associated entity

or

- a majority of full-time equivalent employees that are:
  - i. tax resident in the EU Member State of residence of the entity (or close enough to properly perform their duties)

ii. qualified to carry out the income generating activities of the entity

To the extent the minimum substance indicators are satisfied the entity should not be considered a shell. Where at least one of the indicators is not met the entity will be presumed to be a shell. This is a rebuttable presumption.

Rebuttal of presumption of shell status

The presumption that the entity is a 'shell' can be rebutted based on the facts and circumstances of each individual case. This needs to be supported by additional evidence of the business activities performed to generate relevant income of the entity, which evidence looks to the commercial rationale behind setting up and maintaining the entity, information about employee profiles and 'concrete evidence' that decision making concerning the activity generating the relevant income is taking place in the entity's Member State.

Exemption

Notwithstanding that an entity may otherwise be considered to be a shell entity, it may still be entitled to claim exemption from the scope of the Directive if it can be demonstrated by providing 'sufficient and objective evidence' that its existence does not reduce the tax liability of its beneficial owner(s) or otherwise create a tax benefit for the group of companies of which it is part. Where such evidence can be produced that a tax benefit is not created the entity will be deemed not to be a shell for a tax year and that exemption can be extended for a further five years.

Conclusion

Any businesses that potentially fall within the scope of the 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, are at risk of being denied key tax benefits of double taxation agreements. This could result in increased tax bills and administrative burdens.

The Directive as currently drafted could potentially impact a wide range of entities including holding companies, finance companies, section 110 securitisation companies (albeit there may be a carve out to the extent it constitutes a securitisation special purpose entity as defined in Article 2 point 2 of Regulation (EU) 2017/2402 or it issues listed debt) and other special purpose vehicles that have service provider directors and employees.

The Directive is under consultation until 6 April 2022. Many stakeholders have asked for greater clarity on the rules and the exemptions available, before the directive is adopted. As such, the full remit of the Directive will not be clear until the final wording is agreed. There is some speculation that non-EU companies that do not meet the minimum standards of the Directive could also be open to challenge by Member State tax authorities.

Given the two-year lookback period during which minimum substance requirements will be considered, companies should now start considering their position and whether reporting may be required in the future. If the implementation of the Directive proceeds as scheduled, a company's position from 1 January 2022 onwards could be relevant to the application of the rules.

For more information on this topic, please contact Amelia O'Beirne, Partner, James Somerville, Partner or any member of A&L Goodbody's Tax team.

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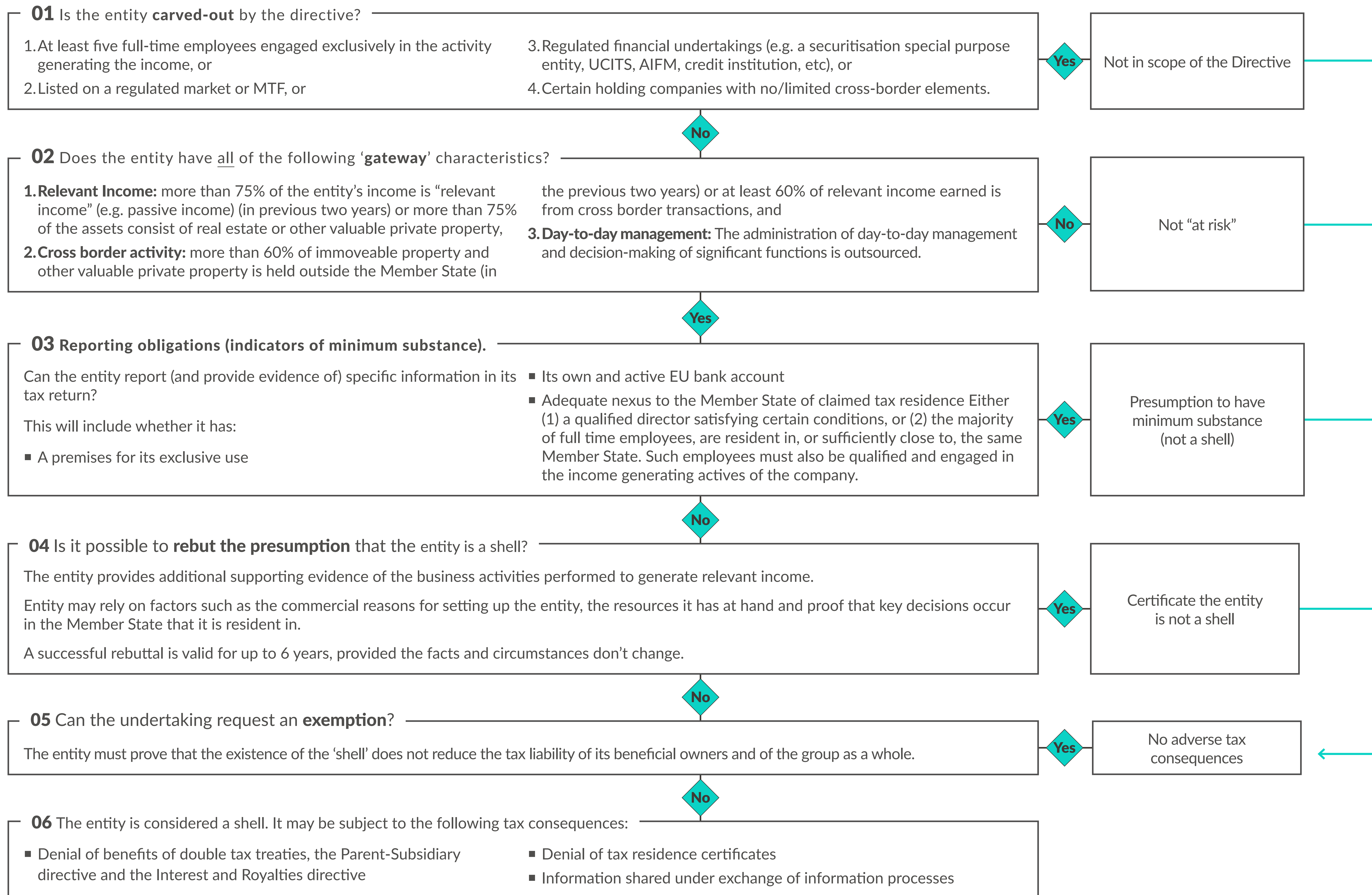

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