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Update on the ‘Unshell’ Directive: *European Parliament proposes changes*

Earlier this year, the A&L Goodbody Tax team published an article in relation to the European Commission’s proposed Unshell Directive, which has the stated aim of preventing the misuse of shell entities for tax purposes.

The Unshell Directive could potentially impact a wide variety of Irish entities including holding companies, section 110 securitisation companies 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.

In May, the European Parliament issued a draft report outlining a number of changes to the proposed Unshell Directive. In this insight, we will examine these proposed changes.

5 MIN READ

Overview

In its Draft Report, published in May, the European Parliament has proposed a number of changes to the European Commission's draft 'Unshell' Directive, including the following:

- acknowledging that there can be legitimate reasons to use shell structures, and that this possibility should be safeguarded, but nonetheless asserts that shell structures should be discouraged.
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- changing the thresholds to be considered in scope of the Unshell Directive – the Commission had proposed including entities whose revenue for the previous two years consisted of at least 75% passive income, but the Draft Report proposes increasing this threshold to 80%.
- the Commission had also proposed that an entity would be in scope of the Unshell Directive if it outsourced day-to-day operations and decision-making, but the Parliament has proposed limiting this ground to exclude a situation where day-to-day operations are outsourced to an associated entity in the same jurisdiction.
- the Parliament has proposed excluding entities owned by regulated financial undertakings which have the objective of holding assets or investing in funds from the scope of the Unshell Directive.
- the potential penalties for failing to comply with the Unshell Directive have been reduced in the Parliament's proposals, from at least 5% of the entity's turnover, to at least 2.5%.
- the timeline envisaged by the Commission in implementing the Unshell Directive has been pushed back by one year, from 2024 to January 2025.

Background

Earlier this year, the A&L Goodbody Tax team published an article (ATAD3 'Unshell' Directive – European Commission proposes to neutralise the misuse of shell entities) in relation to a proposal published 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**). As mentioned in that article, 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. Under the Commission's original proposal, 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.

European Parliament's Draft Report

In May, Lídia Pereira MEP, who sits on the European Parliament's Committee on Economic and Monetary Affairs, published her draft report on the Commission's draft Unshell Directive (the **Draft Report**). This Draft Report proposed a number of changes to the draft Unshell Directive. For the most part, these proposed changes are welcome as they provide a certain degree of clarification on the Commission's initial proposals.

In the explanatory statement accompanying the Draft Report, the rapporteur recognised that there can be legitimate reasons to use shell structures, for example, in order to promote investments, to comply with national laws or to operate across different borders. On the other hand, she affirmed that these structures should not be misused to avoid taxation or to pursue aggressive tax planning using entities with no economic substance.

The rapporteur stated that her three main objectives in compiling the Draft Report were to ensure respect for privacy and data protection rights, to maintain a level playing field for companies within the EU by ensuring that all undertakings pay their fair share of tax, and finally, to avoid an excessive administrative burden and compliance cost on companies at a time of economic recovery.

The Proposed Changes to the Draft Directive

The changes to the draft Unshell Directive that were proposed by the rapporteur include the following:

1. Recognition of Legitimacy of Shell Structures

Recital 1 to the draft Unshell Directive has been significantly updated. The amended text now affirms that there are often legitimate purposes for setting up shell structures, and this possibility should be safeguarded. The recitals then affirm that the lack of an international instrument in respect of shell entities has created a 'significant loophole in the global efforts to combat tax fraud and evasion and aggressive tax planning', and that the misuse of shell entities costs the EU approximately €23bn per year in terms of reduced tax receipts. As a result, it argues that stronger minimum substance requirements should be introduced, that the exchange of information between national tax administrations should be facilitated, 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 report, in order to emphasise that joint audits between national tax administrations are to be encouraged and should be used wherever appropriate. It refers to Council Directive 2021/5141 which created a uniform framework for such joint audits.

2. Reducing Scope

Quite a few changes have been proposed 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. Previously it had been proposed 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 Draft Report proposes increasing this threshold amount to 80%.

It had also previously been 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 Draft Report proposes changing these thresholds to 55% and 65% respectively.

Also, under the previous proposals, an entity could also be in the scope of the Unshell Directive if in the preceding two tax years, the entity outsourced the administration of day-to-day operations and the decision-making on significant functions. The Draft Report suggests this should be limited, to only apply in cases where day-to-day operations are outsourced 'to an entity that is not an associated enterprise within the same jurisdiction'. This additional wording provides welcome clarification.

Article 6.2.1 sets out a number of carve-outs from the Unshell Directive, and the rapporteur has proposed extending these carve-outs to include entities owned by regulated financial undertakings which have the objective of holding assets or investing in funds. As outlined in our previous article, there is also an exception in the case of entities with at least five full-time employees exclusively carrying out the activities generating the passive income. In the Draft Report, it is proposed that this should further specify that the five full-time employees must also be working in the jurisdiction where the entity is tax resident.

3. Denial of Certificate of Tax Residence

Further changes relate to Article 12.1, which now states that where an entity does not have minimum substance requirements and it requests a certificate of tax residence for use in a different jurisdiction, this request must be denied by the Member State.

4. Reduced Penalties

Under the Commission's initial 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 rapporteur's new proposals, this minimum penalty has been reduced to 2.5% of the entity's turnover.

5. Deferral of Implementation by One Year

Finally, the Draft Report recognises that the timeframe envisaged in the Commission's initial proposal is unlikely to be feasible. Previously, it had been 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, and that by June 2024, a central directory for administrative cooperation would be in place for Member States to communicate and automatically exchange information. These deadlines have now been pushed back until January 2025.

What is next?

The rapporteur's current proposals are simply in draft form and have not been finalised. When finalised, the Parliament will then decide whether to adopt these amendments. However, the European Council is not legally obliged to adopt any such amendments.

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, 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.

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

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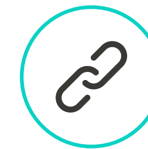
Resources



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