

itm IRISH TAX MONITOR

Unshell Directive

The draft ATAD 3 Directive targeting the misuse of shell entities for tax purposes is currently with the European Council for further consideration and is due to come into effect from 1st January 2024. While it remains to be seen if this timeline can be met and what, if any, further amendments will be made to the proposals, what can affected firms do now to prepare, considering that even in the event of a delay in implementation, their current activities and circumstances will likely be considered in the Directives' gateway test which has a two year look back period?

Lynn Cramer, Partner, Maples Group: On 22 December 2021, the European Commission published the first draft of a proposed directive with the stated intention being to prevent the misuse of so-called 'shell' entities for tax purposes, described as the "Unshell Directive".

A revised version of the draft Directive was approved by the European Parliament in January 2023 and recommended a number of changes to the original proposals. Further compromise changes were proposed by Spain, as the current EU Council's president in September 2023.

Application of the Directive

They say that the only certain things



Lynn Cramer

are death and taxes, but the Unshell tax proposals are anything but certain. The original proposed implementation date of 1 January 2024 now seems likely to slip until 2026.

Given the general desire of taxpayers for stability (and, yes, certainty), the two year back and forth in relation to these proposals is highly unsatisfactory. That is particularly true given that aspects of the proposals involve a review of activities and fact patterns during a lookback period (of one year, or two - yet more uncertainty). There are other problems with the proposal, in particular, the fact that they will only apply to EU entities, an unusual act of self-harm on the part of the EU. With everything still

in flux, the question arises as to what, realistically, Irish businesses can or should do now?

The over-arching theme of the Unshell Directive is to discourage the use of entities in aggressive tax planning or tax avoidance structures that do not maintain sufficient substance within the EU. What we do know is that in seeking to discourage the use of such entities, the final Directive is likely to focus on certain gateway tests which, if met, are taken to indicate that an entity is a "shell" entity. The tests described to date have focussed on whether an entity:

1. Earns more than 75% of its revenues from passive sources;
2. Is engaged in cross-border activity where more than 60% of its assets or income are located or derived from a jurisdiction other than the one in which the entity is established; and
3. In the preceding two years, the entity has outsourced the administration of its day-to-day operations and decision making on significant functions to a third party.

If all three of the gateway tests are met, the entity is presumed to be a "shell" entity. Again, there is still some uncertainty as to the final percentage amounts that will be included in the final draft.

The draft proposals tabled to date have contained some important carve-outs and exceptions including for regulated financial entities such as alternative investment funds (AIFs) and UCITs,

certain credit and insurance institutions, as well as for pension funds. For Irish Section 110 companies, important exclusions are contained in the most recent draft Directive for securitisation special purpose entities and for entities which have transferable securities admitted to trading or listing on a regulated market or multilateral trading facility within the EU. For holding companies, there is a potential exemption for holding companies which are resident in the same EU member state as their parent entity.

If an entity meets the gateway tests and is not eligible for any of the exemptions or carve-outs, there is likely to be the option for an entity to “rebut” the presumption that it is a “shell” entity. The rebuttal process requires the entity to provide additional supporting evidence in relation to its activities and the commercial reasons for its existence. To add some jeopardy to the process, the most recent compromise proposal allows that even if the member state of an entity presumed to be a “shell” entity has concluded that the entity has successfully rebutted that presumption, other

member states should not be precluded from applying EU directive anti-abuse provisions. Just when you thought you were out, they pull you back in!

Consequences

The potential consequences of an entity being determined to be a “shell” entity include:

1. Additional reporting requirements in relation to certain “substance” characteristics;
2. Potential denial of a tax residence certificate for use in another jurisdiction which could result in the denial of the benefits of the relevant tax treaty;
3. Potential financial penalties of between 2% and 5% of the entity’s turnover.

To be or not to be?

That is the question. The current expectation is that the final Directive will be adopted and published before the end of 2023 and that Member States will be required to transpose the Directive by the end of 2024. The provisions will most likely apply from 1 January 2025 or 2026, your guess is as good as mine.

Really though, what should businesses do now?

One thing we can say with certainty is that the Unshell Directive is part of a general trend towards a focus on economic and physical substance and transparency in the context of tackling tax avoidance, clearly observed since the start of the OECD’s base erosion and profit shifting (BEPS) proposals. Assuming that the Directive will be implemented in some form, there are probably some steps that Irish businesses can sensibly take now as set out below:

- Review group to identify entities that may be considered be ‘shell’ entities
- Engage with your tax advisors to consider the impact of the proposed directives
- Exclusions: Is the entity covered by a carve-out or exemption?
- Gateways: Does the entity meet the gateway tests
- Rebuttal: Is it possible to rebut the presumption that the entity is a ‘shell’ entity?
- Consider whether steps can be taken to bolster substance and other factors in conjunction with your tax advisor.