MAPLES GROUP

UPDATE

Proposed EU Directive on Shell Entities – the Impact on International Business

On 22 December 2021, the European Commission (the "Commission") published 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".

The new proposals are aimed at entities that do not maintain sufficient substance within the EU. Entities that do not satisfy these substance requirements are subject to additional reporting requirements. They will be unable to access the benefits of double tax treaties and EU tax directives. Significantly, other EU Member States, such as those paying to the entity, or those in whom shareholders are resident, will be entitled to impose tax on the income of the entity.

Implementation and Timelines

Currently, these changes are set out in a proposal by the Commission for a directive. The legal basis for the Unshell Directive is stated to be Article 115 of the Treaty on the Functioning of the European Union ("Article 115"). Article 115 provides for the Council of the EU, acting unanimously and after consulting the European Parliament and the Economic and Social Committee, to issue final directive proposals.

There is no certainty that the Unshell Directive will be adopted, either in its current or any form. If it is adopted, the rules may differ substantially from those originally published.

If unanimous approval of the Council is achieved, the Unshell Directive would then be published in the Official Journal of the EU.

In terms of timing, the Commission proposal is that Member States should implement the final Unshell Directive by 30 June 2023, with the provisions to apply across the EU from 1 January 2024.

Excluded Entities

Certain entities are excluded from the new rules. Excluded entities include:

- Companies having a transferable security admitted to trading or listed on a regulated market or multilateral trading facility. At present, the rules indicate that only EU markets are relevant for this exemption.

- Alternative investment funds (AIFs) managed by an AIFM, credit institutions, UCITS funds, insurance and pension undertakings.

- Holding entities that are situated in the same jurisdiction as their beneficial owners and their operational subsidiaries, and certain defined consolidated holding undertakings which are situated in the same jurisdiction as their shareholder or ultimate parent entity.

- Undertakings with at least five own full-time equivalent employees or members of staff exclusively carrying out the activities generating the relevant income.

- Entities that qualify as securitisation special purpose entities.

These exclusions should mean that many mainstream EU securitisation companies and funds should be exempt.

Entities Within Scope

An entity will be within the scope if it satisfies each of three 'gateway' tests. Those tests ask whether:

1. The entity derives more than 75% of its income from sources defined as 'relevant income'. Relevant income includes 'passive' type income such as dividends and interest, although it is important to note that may be received as part of an active or trading business. The definition also includes royalties and other income generated from intellectual or intangible property as well as income from insurance, banking and other financial activities and financial assets.

2. The entity is engaged in cross-border activity such that more than 60% of its assets or 60% of its income is earned or paid out of cross-border transactions.

3. In the preceding two years, the entity has outsourced the administration of its day-to-day operations and decision-making on significant functions.

The governance of an entity and its decision making processes will be important to the third gateway test. The test applies for the preceding two years. As the Unshell Directive is due to come into force in 2024, measures taken in 2022 and 2023 could be examined as part of this test. As noted below, if an entity meets all three gateway tests, it will then be in scope of the Unshell Directive with a minimum of onerous reporting requirements, so a careful analysis will be needed at this stage.

Reporting Requirements for Entities Within Scope

Once an entity meets all three gateway tests, it becomes subject to a reporting obligation which will add to its compliance burden. The entity is required to report in its tax return to its Member State of residence on certain "substance" characteristics. The entity must show that it has the following substance requirements:

- its own premises, or premises for its exclusive use, in the Member State;

- at least one own and active bank account in the EU; and

- at least: (i) one director with the appropriate qualifications and decision making authority who is not an employee of an unaffiliated entity and does not act as a director of an unaffiliated entity and who is resident in or near the Member State of residence of the entity and / or; (ii) the majority of employees of the entity are resident in or near the Member State of residence of the entity.

An entity that passes the gateway tests and cannot demonstrate the substance characteristics set out above, will be considered a shell entity for the purposes of the new rules.

Options for Rebuttal of Presumption that an Entity is a Shell

The European Commission states that it recognises that the 'substance test' is based on indicators and as such may fail to capture the specific facts and circumstances of each individual case. For that reason, the Unshell Directive allows entities to rebut the presumption that they are shell entities in one of two ways, either by proving that: (i) the entity has substance or; (ii) it is not misused for tax purposes. This latter provision envisages that a comparative analysis be provided to the tax authority to show that the interposition of the entity does not lead to a tax benefit for its beneficial owners, by comparing the amount of overall tax due by the beneficial owners without the interposition of the entity to what would be due with that entity in place.

Where an entity can prove that it is not used to obtain a tax advantage, a Member State can

exempt it from any negative tax implications that would otherwise apply by virtue of it having no minimal substance. Both of the rebuttal exceptions can be applied by a Member State for a period of five years.

Tax Consequences of Being a Shell

Once an undertaking is presumed to be a shell for the purposes of the Unshell Directive, and does not rebut such presumption, certain tax consequences will apply.

- The Member State of residence of the entity should refuse to issue a tax residence certificate for that entity or should incorporate a warning statement on any certificate of tax residence issued.
- Other Member States shall disallow or disregard any double taxation agreements with the Member State of residence, and under certain EU directives, such as the EU Interest and Royalty Directive and the EU Parent Subsidiary Directive.
- The EU Member State of the shell entity's shareholders will be entitled to tax the relevant income of the shell entity while taking a deduction for any tax paid by the shell entity.
- Where a shell entity's shareholders are not in the EU, any EU jurisdiction making payments to the shell entity shall be entitled to apply to withholding tax on payments to the shell entity.

Exchange of Information and Cross - Border Audit

The Unshell Directive provides for the automatic exchange of information between Member States of all entities in scope of the Unshell Directive, regardless of whether these are shell entities or not. This would be done through an amended version of the EU DAC6 Directive. It also allows a Member State to request the performance of a tax audit with respect to a broader group of undertakings that are treated as being at risk (but are not necessarily deficient in substance for the purposes of this Unshell Directive).

Importantly, the proposal also provides that if one Member State has reason to believe that an undertaking that is tax resident in another Member State has not met its obligations under the Unshell Directive, the former Member State may request the other Member State to conduct a tax audit of that entity and communicate the outcome to the former Member State in a reasonable time frame.

Penalties

The penalties applicable for violation of the reporting obligations contained in the proposals are broadly left to the discretion of Member States. However, the proposals provide for a minimum administrative pecuniary sanction of at least 5% of the undertaking's turnover.

Maples Group Commentary

The Unshell Directive develops on a number of trends which are already seen in EU and international tax policy. The focus on 'substance' reflects OECD commentary on double tax treaty access, such as the principal purpose test (or PPT) and recent court cases on intermediate holding companies, including at the European Court of Justice. The increased reporting requirements reflect measures such as the EU DAC6 measures that focus on cross-border structures. There does appear to be a level of duplication and supplementation of existing provisions.

Businesses and EU Member States are expected to raise a number of concerns on the current proposals and their operation, including the impact on double tax treaties, the very broad definition of relevant income and the increased administrative burden that will apply to both taxpayers and tax authorities.

Many international businesses have, for some time now, been building their operational substance in jurisdictions in the EU through the

creation of local investment management functions, boards and employees, and this will no doubt continue.

The Maples Group's Tax team will continue to monitor the progress of the proposals, consider its potential impact and update our clients on any developments. We will also be consulting with tax authorities, industry groups and government departments in relation to the proposals. We shall also be discussing the recently released EU proposal on a global minimum rate of taxation for multinationals in a future update.

Further Information

If you have any questions on the draft proposals, please reach out to your usual Maples Group Tax contact in Ireland or Luxembourg or contact any of the individuals listed below.

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