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What the EU's 'Unshell' Directive Means for Private Equity Firms

By Orla O'Connor, Alistair Pepper, and Raluca Enache

With the latest installment of the EU's anti-tax avoidance directive likely to become its next tax focus area, private equity firms should prepare for more questions about whether their structures are genuine and whether decisions on where to locate holding companies reflect reality, say Orla O'Connor, Alistair Pepper, and Raluca Enache of KPMG LLP.

In December 2021, the European Commission presented yet another initiative to combat perceived tax avoidance in the European Union—the third installment of the EU's Anti-Tax Avoidance Directive, or the more snappily titled Unshell. If adopted, it would be a coordinated response to concerns about the misuse of shell entities to achieve inappropriate tax benefits through reduced tax.

Although ATAD 3 isn't targeted at any specific member state, an impact assessment by the European Commission identifies member states with significant flow-through foreign investment and/or no withholding taxes on many outbound payments, as those that could be most affected.

Now that member states have agreed to implement the EU's global minimum tax directive, ATAD 3 seems likely to become the EU's next tax focus area.

How Could ATAD 3 Operate?

In the European Commission's original proposal, EU entities not subject to specific exclusions would be required to self-assess against three "gateway" tests:

- A relevant income/asset test;
- A cross-border activity test; and
- An outsourced management and administration test.

An entity meeting each test would be deemed to be at high risk of lacking substance. An entity at high risk of lacking substance would then report on three substance indicators through its annual tax return:

- Owning or leasing premises;
- Holding an active bank account; and
- Having relevant personnel close to the entity.

An entity would be deemed a shell if it failed any one of these indicators, in which case substance information would be shared automatically between EU member states—and the entity could be denied access to relevant tax treaties and/or the parent-subsidiary and interest and royalties directives. That could expose the entity to withholding taxes, subject to an opportunity to rebut the shell presumption and/or claim an exemption based on lack of tax motive.

It's uncertain where the final design of ATAD 3 will land. That the EU has yet to agree on a

proposal first published in 2021 shows the divergence in views among member states. However, it seems likely that the core elements of the original proposal—the focus on substance proxied through premise and personnel, particularly those with decision-making powers—will be retained in any revisions to ATAD 3.

The implementation timeline is uncertain. Sweden, which holds the rotating Presidency of the Council of the EU, is seeking ministerial level discussion on ATAD 3 before the end of its presidency in June.

Potential Impact on the Private Equity Industry

Private equity firms generally structure European investments through holding companies that could be caught within ATAD 3. The potential impact on private equity is arguably greater than for, say, multinational corporations, on account of several factors unique to the industry.

Private equity firms typically expect to hold their investments for a defined holding period—frequently five to seven years—and plan up front for exit. Because most EU countries tax non-residents on their capital gains from share disposals, private equity firms must assume the tax rate that will apply to their capital gains (their primary return from investment) unless treaty relief applies.

Additionally, the performance of private equity firms is typically measured on an internal rate of return basis, which means private equity firms are rewarded for returning capital to investors as quickly as possible. The confluence of these factors usually results in more cross-border cash flow compared to multinational corporations that are more likely to recycle capital within a given holding structure.

Private equity firms typically house employees within their investment manager entities, which are compensated by the private equity fund entities through management fees. There is tension between this structure and potential requirements to locate decision-making with local employees at the holding company level.

Finally, private equity fund capital usually comes from a dispersed investor base with different tax profiles; some investors may be treaty eligible, and others may not. Although holding companies may be used primarily for administrative ease, certain investors may benefit from favorable treaty withholding rates as compared to a direct investment. It is unclear how "lack of tax motive" would be evaluated in this case.

Why Should Private Equity Firms Care?

First, ATAD 3 is likely to apply (at least in some form) to structures that are put in place today. The planned implementation date of Jan. 1, 2024, is likely to be deferred. But even if ATAD 3 is only implemented in 2025, 2026, or 2027, this will be before most firms exit investments made this year.

Moreover, some of the gateways and substance indicators include look-back provisions, meaning the application of ATAD 3 can account for periods prior to its implementation. The European Commission initial proposal noted that regulated financial undertakings, including parts of the asset management industry, would be excluded from the scope of ATAD 3. However, there always has been a question whether this exclusion would be retained in a final directive or whether it would be pared down or removed entirely.

Second, if ATAD 3 results in the denial of treaty relief on capital gains, dividends, or interest, it

may adversely impact the returns to investors and the private equity fund's carried interest remuneration. This isn't the case for many US tax issues around cash extraction to non-US investors, which arise above the level of the carried interest allocation to the private equity firm.

Third, even if ATAD 3 doesn't require the denial of treaty relief, automatic exchange of information requirements could expose private equity to additional tax scrutiny. ATAD 3 could result in substance information being shared with non-EU member tax authorities.

What Should Private Equity Firms Do Today?

Aside from monitoring developments at the European Commission, private equity firms should be thinking about new structures through the lens of ATAD 3 gateways and substance indicators. More generally, private equity firms should be prepared for more questions about whether the structures they put in place are genuine and whether decisions on where to locate holding companies have a commercial rationale that reflects economic reality.

Even without ATAD 3, the issues it seeks to address are firmly on the radar of EU member states. EU tax administrations and national courts are currently focused on substance, governance, and beneficial ownership.

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