# International Tax update – OECD Pillar 2 model rules and the EU Directive on shell entities (ATAD III)

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This article provides an update on recent international tax developments that could have a significant impact on private fund structures.

## OECD Pillar 2 model rules

On 21 December 2021 the OECD published model **Global Anti-Base Erosion ("GloBE") rules**, which are the main component of Pillar 2 of the BEPS 2.0 international tax reform project .

***What do the rules do?***

The GloBE rules ensure that multinational groups with revenues of at least €750m pay **an effective tax rate ("ETR")** of at least 15% on a country-by-country basis. They do this by identifying a group's profits that are taxed at lower rates and then charge a top-up tax to raise the ETR to the minimum.

The ETR is measured by comparing a group's accounting tax expenses – including both current and deferred tax – with its accounting profits, subject to adjustments including a participation exemption for dividends and gains from 10%+ shareholdings. Where the ETR is below 15%, a top-up tax will be collected by the group's ultimate parent jurisdiction under a CFC-type charge known as the **Income Inclusion Rule ("IIR")**. If the ultimate parent jurisdiction doesn't implement Pillar 2, the top-up tax will instead be collected by intermediate holding companies in the group under the IIR, with any residue being collected by other companies in the group in proportion to their tangible asset value and payroll costs.

***How will the rules affect private equity?***

PE structures that meet the €750m revenue threshold will need to consider whether the GloBE rules apply to them.

How PE structures are treated will depend on two things:

**1.)** Group identification – the GloBE rules define groups by reference to accounting consolidation. Provided, therefore, that a fund or an asset holding company ("AHC") is not required to consolidate its investee businesses for accounting purposes, the investee business will be treated as separate groups for GloBE purposes.

**2.)** Application of the investment fund/entity exclusion – investment funds and their AHCs that meet certain conditions are excluded from the GloBE charging provisions. That ensures that, in any cases where a fund/AHCs isn't excluded as a result of accounting consolidation, no top-up tax will be charged at the level of the fund.

***What next?***

The OECD commentary on the rules is expected later in Q1 2022. The UK government is currently running a consultation on the implementation of Pillar 2 implementation which aims for a 1 April 2023 commencement. The EU Commission has published a draft implementing directive which envisages Member States bringing the Pillar 2 rules into effect from 1 January 2023.

## ATAD 3 – EU Directive on shell entities

On 22 December 2021 the EC published a Directive putting forward measures to tackle the misuse of shell entities in EU Member States. The Directive proposes to introduce a minimum substance test and would deny entitlement to treaty/directive benefits to entities not meeting the new standards, as well as introduce new reporting requirements and exchange of information protocols between EU Member States.

***What do the rules do?***

Entities that meet three gateway criteria are subject to reporting requirements on a number of substance indicators. These entities are considered “at risk” of being considered shell entities. The gateway tests to determine whether an entity will be required to report on its substance is threefold:

**1.)** Mobile or passive income – more than 75% of the entity’s income is from passive income sources, for example, interest, royalties, dividends, leasing, and real estate;
**2.)** Cross-border activity – more than 60% of assets are located outside of the Member State or at least 60% of income is earned or paid out from cross-border transactions; and
**3.)** Outsourcing – day-to-day administration and decision-making on significant functions is outsourced.

Entities deemed at risk are then required to report on certain substance indicators which will be shared with tax authorities under an exchange of information programme. An entity must then go on to satisfy all three substance indicators in order to declare it meets the minimum substance requirements and not be considered a “shell entity”. The substance tests require that the entity must:

**1.)** Have its own or exclusive use of premises in the entity’s Member State; and
**2.)** Hold an active bank account in the EU; and
**3.)** Either
    (i) have at least one director who is tax resident in the entity’s Member State and passes a number of tests outlined in the directive; or
    (ii) employ a majority of full-time employees who are tax resident in the entity’s Member State (or as close-by as can sufficiently carry out activities) and who are qualified to perform their duties.

There are a number of questions as to how and at what level these tests are applied within the structure. If the entity fails to meet one of the indicators, then the entity is presumed to be a shell entity. This presumption can be rebutted where additional supporting information can be provided to the tax authority supporting the commercial rationale and risks borne by the entity or if it can be demonstrated that existence of the entity does not confer a tax advantage. The consequences of identifying a shell entity include proposals to deny the benefits conferred by EU directives or double tax treaties with EU Member States, a tax authority denying to issue a tax residence certificate to a shell entity; and/or a new CFC style rule to impute the income of the shell entity within the shareholder.

A number of exemptions are provided under the Directive to take certain entities out of scope of the rules. The exempt entities list includes regulated financial undertakings; certain holding entities with domestic shareholders; and entities that have at least five full-time employees exclusively carrying out income-generating activities.

*How will the rules affect private equity?*

The proposals, as they currently stand, will present some risk to the asset management industry, certainly in terms of increased reporting requirements for "at risk entities" but may also extend to a denial of treaty / Directive benefits if an entity is labelled as a shell entity.

It is unclear how a number of the exemptions will apply in the context of common private fund structures. In particular the exemption for "regulated financial undertakings" may be helpful in exempting the fund entity itself but holding companies further down the chain will prove more difficult. Similarly, the exemption for holding entities with domestic shareholders seeks to relieve entities who are resident in the same Member States as their Ultimate Parent Entity, a definition which itself may be problematic to apply in the context of fund entities that do not ordinarily prepare consolidated accounts. As such asset holding companies sitting beneath the fund will likely need to either look at one of the other exemptions and rebuttals available or meet the required reporting requirements and associated substance under the Directive to relieve themselves.

The Directive only applies to entities resident in EU Member States, therefore the UK Asset Holding Company regime is somewhat timely for the investment management industry willing to consider an alternative to an EU-based jurisdiction, however, the EC intends to launch a new initiative to tackle non-EU shell entities in 2022.

*What next?*

Assuming the Directive is adopted (which requires all Member States to vote unanimously on the proposal), the EC proposes that the Directive would be transposed into EU Member States' domestic law by 30 June 2023, and take effect from 1 January 2024. Some EU Member States have voiced their concern around the measures, including Luxembourg. Therefore the proposed timeframe may be ambitious. It should be noted that the tests have a two-year look-back period, so despite some uncertainty around implementation, arrangements in place now may be taken into consideration.

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The BVCA Taxation Committee, alongside Invest Europe on EU matters, will be engaged on both developments and further updates will be published in our monthly Policy & Technical & Update. Please contact Chris Elphick for further details.