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*On behalf of the Public Affairs Executive (PAE) of the EUROPEAN PRIVATE EQUITY AND VENTURE CAPITAL INDUSTRY*

# Position paper on the European Commission's Proposal for a Council Directive laying down rules to prevent the misuse of shell entities for tax purposes and amending Directive 2011/16/EU

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Invest Europe is the association representing Europe's private equity, venture capital and infrastructure sectors, as well as their investors.

Invest Europe welcomes the European Commission's proposal to prevent the misuse of shell entities for tax purposes in the EU. We note that a number of initiatives have already taken place during the recent years in order to tackle tax avoidance. Very commendable and strong anti-tax avoidance rules (e.g. ATAD 1, ATAD 2 and DAC) have been drawn up in the EU, which has led to significant advances in tackling abusive tax avoidance.

In relation to the proposal at hand, we call on European policymakers to take into account the below-mentioned considerations and recommendations for amendments.

**Private Equity investment - structure outline**

Private equity (PE) is one form of equity investment into private companies which are generally not listed on the stock exchange. PE is a medium to long term investment, characterised by active ownership. Investments are made by PE and similar alternative investment funds on behalf of global investors into a diverse range of companies across Europe.

As also further laid out below, the use of intermediaries such as holding companies by PE and similar alternative investments funds serves several commercial purposes and is necessary in order to facilitate an easy flow of capital from typically institutional investors such as pension funds, insurance companies, banks, sovereign wealth funds, etc. into investee businesses, many of which are start-ups, scale-ups and SMEs, which would otherwise not have been able to get capital elsewhere or it would have been too expensive.

Institutional investors often lack the resources to be able to identify suitable investment opportunities that match their risk-profile and thus rely on the knowledge and experience of PE managers. PE managers provide the institutional investors with whom they co-invest the necessary skills for finding, analysing, valuing and negotiating the investment into interesting unlisted companies with value creation potential and then, through active board participation, guide and monitor these companies until they are ready to take the next step in their development under the stewardship of new/additional owners. A typical PE fund could hold investments in sectors as diverse as industrial products, life sciences, computer & consumer electronics, energy & environment, transportation and agriculture.

As illustrated in the diagram below, an investment made by an alternative investment fund, in this case a PE fund, typically involves setting up several entities to facilitate an investment or acquisition. These entities all have a commercial purpose.

**The overall aim of the investment structure is to facilitate the pooling of funds to finance investments and to legally separate each portfolio group from others owned by the same fund.**

The entities or vehicles illustrated in green in the diagram below are typically involved for the following commercial purposes:

- The PE fund: Most PE funds use a limited partnership structure, which involves two main types of actors: (1) a general partner/GP (a PE firm) and (2) limited partners/LPs (the investors, i.e. the pension funds, insurance companies, sovereign wealth funds, banks, etc. committing capital).

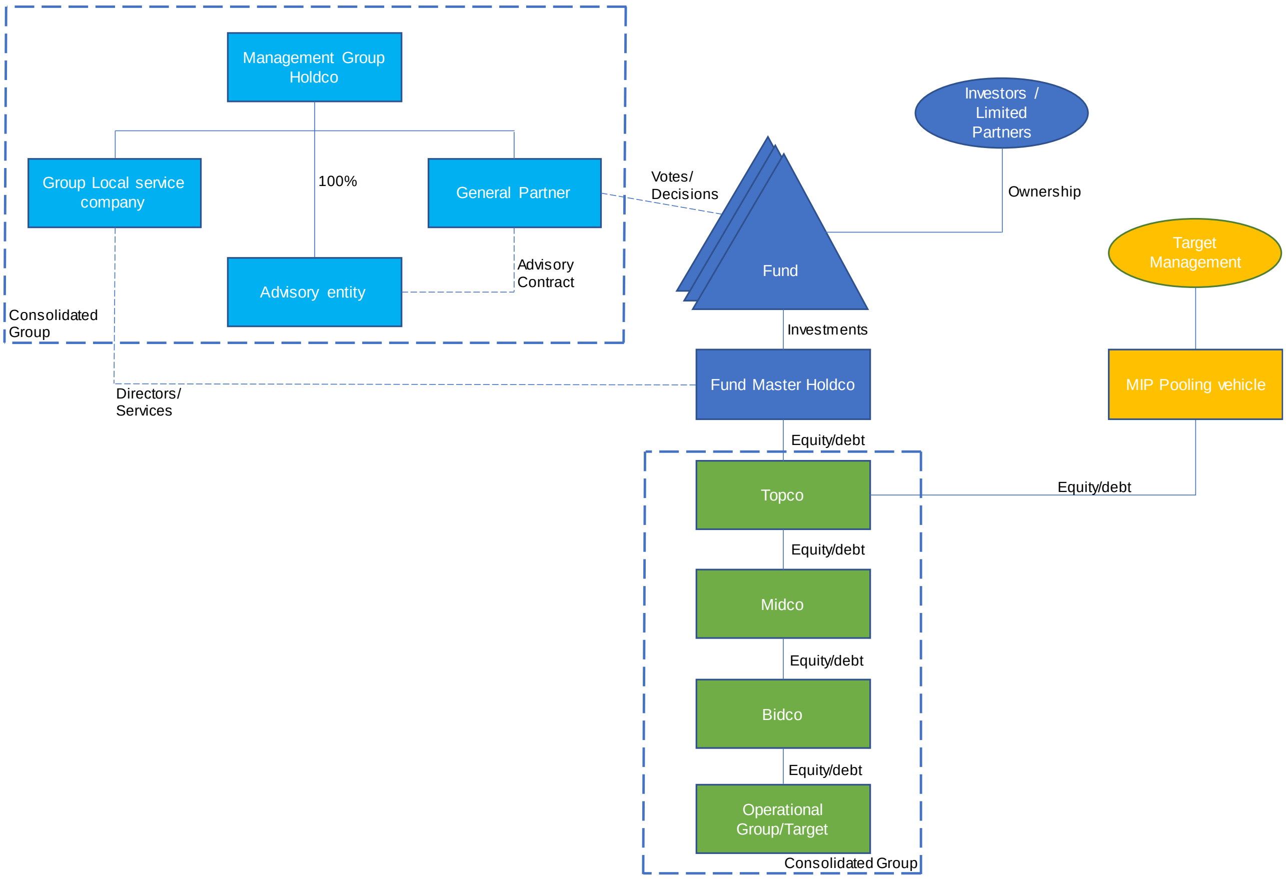
- A designated holding company of the PE fund (PE HoldCo): Created to invest (alongside potential co-investors and management), and to ringfence different investments of the PE fund into separate vehicles. There may be a master HoldCo but typically, one holding company is established per investment or investment platform.

- The management equity plan (MEP) pooling vehicle: Created to 'pool' the investments made by the managers of the target (i.e. the investee company) into a combined investment vehicle with representatives of the PE firm as directors of the pooling vehicle for governance purposes. The management of the target typically invests alongside the PE fund in order to incentivize the management with an investment opportunity.

- The top holding company of the Operational/Target group (TopCo): Created to bring together all equity investors into one combined vehicle, which issues securities to the investors in return for the equity contribution equivalent to the desired capitalization.

- An intermediate holding company for financing purposes or to facilitate future events (MidCo): Created to establish a single point of enforcement for the external lenders with a 'clean' ownership, often a requirement laid down by the lenders providing financing in the transaction.

- A holding company bidding for the acquisition of the target (BidCo): Created to pool the equity and debt capital raised to effect the transaction and to provide a single legal acquisition vehicle to acquire shares in the TopCo of the Operational/Target group.




The overview above and the illustration in the diagram is only one potential structure and should not be perceived as exhaustive. Additional entities or vehicles could be set up depending on e.g. the financing needs, further co-investment requirements and objectives of the investment structure. There are a variety of different structures and approaches, including ones where the local service company is not part of the fund management group but is jointly owned by several funds (typically different vintages of the same fund pursuing similar investment strategies).

Such investment structures are critical to the fund industry and are designed to ensure that the investors enjoy the same economics that would have available if the investors took a direct stake in each underlying group. You will note that the limited partners in the fund own the underlying investments via the fund vehicle which is normal a transparent entity. The investments may take the form of both equity and debt designed to meet the commercial needs of investors and the underlying investments. In particular facilitating flexibility. The fund manager is responsible for managing the investments via the general partner ("GP") with the GP making the key decisions. The GP will normally delegate certain administrative activities to the advisor which is a regulated entity.

Within the acquisition structure there will be a number of holding companies, as explained above these exist to deal with financing requirements and meet the needs of the different debt providers. As illustrated, there may also be a need for a management pooling vehicle, to simplify corporate governance where there are numerous management investors.  Many funds these days use a master HoldCo which holds multiple investments, as in the illustration, but some funds still use a separate HoldCo for each investment. The key point being that a fund could hold, directly or indirectly, many companies to facilitate the acquisition of underlying portfolio investments. These entities may remain relatively passive in many periods as the investments are static, the activity will occur as and when there is need, such as change in financing structures, an acquisition, disposal, change of management etc. of an underlying investment of the fund.

One consequence is a requirement to administer the various companies and for efficiency and effectiveness it is normal for the fund manager to provide these services via a local subsidiary ("Local ServiceCo") entity in the same jurisdiction as the HoldCos, providing local directors, accounting services, banking, required to deal with a company on day to day basis. In essence this spreads the cost across the various HoldCos, just in the same manner that a corporate group would provide similar administration services to HoldCos within its group.

However, the key difference to a corporate group is that the fund does not consolidate its investments for accounting purposes as the fund and master HoldCo only hold investments for resale. Preparing consolidated accounts would therefore not be representative of the facts and would distort the position and most funds and their holding entities instead adopting investment company accounting. Consolidated accounts will however typically be prepared for each of the Operational/Target groups below the fund entities. Similarly, the fund manager will ordinarily prepare consolidated accounts to include the accounts of the Local ServiceCo entity, advisory entity and other relevant entities in the investment manager group. The critical point is that whilst the fund manager effectively controls the underlying investments via the GP, there is no corporate or accounting grouping arrangements between them and therefore the exceptions in ATAD 3 need to be adapted to reflect this structure if they are to work for funds and not impede the flow of investment across Europe.

In summary, if an investment structure is designed appropriately, it can encourage and facilitate investors to provide capital, and lead to synergies and efficiencies in the investee businesses, and thereby create economic benefits, additional employment and value optimization.

## Private Equity industry recommendations for changes to the proposal

***The overall rationale of the recommendations***

The overall rationale of the proposed changes suggested by Invest Europe is to better ensure that entities created with the purpose of aggressive tax planning are indeed captured, and at the same time that structures and **entities with genuine commercial purposes will not incorrectly fall within the scope and be impacted unintentionally**.

With regard to the PE industry, it would be detrimental to its continued ability to invest, should the possibility of continuing to use existing investment structures and entities with genuine commercial purposes be limited or disrupted. **This would reduce the economic benefits of these structures, ultimately resulting in fewer investment opportunities and reduced investor appetite.**

PE investments are an essential driver of European growth, employment, innovation, and economic and social prosperity, and should this investment culture be discouraged, it would have serious negative consequences for the EU economy and the many EU businesses and communities depending on these investments, as well as the more than 10 million[1] jobs in the EU deriving from PE and VC investments.

This would particularly be problematic in the times during and in the aftermath of the COVID-19 crisis, where investment in EU businesses and the EU economy is all the more needed. As currently drafted many

[1]10.2 million European employees worked in PE backed companies in 2019. For more information, please see the Invest Europe Private Equity at Work research report (published May 2021).

of the exemptions would not adequately apply to the funds industry nor would the substance tests outlined be easy to apply in the context of the structures outlined above. We have therefore recommended key changes to the proposed directive to help address these concerns, as outlined below.

1. **The exemption for regulated financial undertakings (Article 6(2)(b))**

We consider that it is essential and in line with the principal of proportionally for there to be an exemption for investment funds in these PE industries that adequately protects both the PE Fund entities themselves as well as their holding infrastructure.

We very much welcome the proposed exemption for regulated financial undertakings set out in the proposal. However, for this exemption to be useful in a PE context, it is essential that it also adequately and cohesively covers all types of PE investment vehicles to which these types of investors commit capital in these industries.

In particular although the current exclusions cover both AIFs and AIFMs, which is important and we would like to see retained, we note that these exclusions alone do not offer full coverage of the likely low risk fact patterns found in a typical PE Fund structure. International PE Funds are often structured using more than one fund vehicle to which investors subscribe, to facilitate various regulatory, legal and commercial requirements. Investments may be made by investors through parallel fund vehicles and/or feeder vehicles, to allow investment in different currencies, or investments with different fee structures. In addition, aggregator vehicles and/or co-investment arrangements are also a common feature of PE Fund structures. In some cases these entities may not themselves be AIFs, although they would typically be under common management with the other AIFs in the structure.

Whilst we recognise the need for a carefully drawn exemption which does not allow higher risk structures to escape the ambit of ATAD 3, it is equally important to ensure that the exemption is appropriately drawn such that no unintended and arbitrary differential treatment results.

We consider that including a new exempt category for such 'investment funds' would be the most effective way to achieve a robust, coordinated and coherent regime as regards PE Funds, that remains consistent with the wider aim of combating tax avoidance and evasion practices, with a view to consistency with existing policy provisions in the policy area (as noted in the Directive Explanatory Memorandum).

We note in this regard that a central principle behind the creation of ATAD 3 has been to ensure consistency with other Union policies and future initiatives. Given the careful and detailed work already carried out in developing an appropriate and tightly drawn definition of an 'investment fund' in relation to Pillar Two (see below), we propose that this same definition should also be used for the purposes of the ATAD 3 exclusions.

**Recommendation 1**

We suggest adopting the definition of 'Investment Fund' outlined in OECD Pillar 2:

*'investment fund' means an entity or arrangement that meets the following conditions:*
*(a) it is designed to pool financial or non-financial assets from a number of mostly non-related investors;*
*(b) it invests in accordance with a defined investment policy;*
*(c) it allows investors to reduce transaction, research and analytical costs or to spread risk collectively;*
*(d) it is primarily designed to generate investment income or gains, or protection against a*

*particular or general event or outcome;*
*(e) its investors have a right to return from the assets of the fund or income earned on those assets, based on the contribution they made;*
*(f) it, or its management, is subject to the regulatory regime for investment funds in the jurisdiction in which it is established or managed; and*
*(g) it is managed by investment fund management professionals on behalf of the investors;*

**In addition, it is paramount that in addition to the regulated investment fund that the various entities sitting below the fund as outlined in the example structure above, are also covered by the exemption for regulated financial undertakings.** As noted these holding entities are set up for various genuine and substantive commercial or legal purposes.

It is for this reason that the OECD Pillar 2 agreement is such that the exemptions covering investment funds is crafted to al**so cover entities that are owned by excluded entities, such as holding companies**. Should such entities not equally be covered by the proposal at hand, it would create **an uneven playing field to the disadvantage of the EU entities, who would face stricter regulatory burdens than similar third country entities.**

Expanding the definition to cover intermediaries such as holding companies owned by regulated financial undertakings, in line with the Pillar 2 approach, would also be consistent with the aim of excluding undertakings whose activities are subject to an adequate level of transparency and therefore do not present a risk of lacking substance for tax purposes. We recommend expanding the definition of regulated financial undertaking to mitigate this point as outlined below.

**Recommendation 2**

We suggest modifying Article 6(2)(b) as such:

*(b) regulated financial undertakings, and entities that are at least 95% owned, directly or indirectly, by regulated financial undertakings or through one or more such entities, and that have the main function of holding assets or investing funds for their benefit;*

2. **Concept of an 'associated enterprise' (Article 5(1))**

As explained above, it is anticipated that, even if our proposals above are adopted, there may well still be situations where the structures used by PE Funds are not clearly excluded under Article 6(2) and where the other provisions of ATAD 3 are therefore in point.

It is therefore also important to the PE industry to address some specific technical aspects of ATAD 3 that we consider would not operate as intended nor in line with the stated policy intentions of ATAD 3 as they apply to PE Funds.

We also note that these very real concerns also make it particularly important to implement the recommendations set out above, because at present the lack of a clear route through the various tests and exemptions within the Directive for entities owned by PE Funds, even where in common sense terms these do have real substance and commercial purpose, in our view risks creating a disproportionate compliance burden and reliance on the 'rebuttal' procedure as the only realistic route out of the rules in too many low risk situations.

In particular, the proposed definition of 'associated enterprises' is relatively narrow, not taking into account various relations between entities set up in different perfectly legitimate structures.

In the context of a well-run PE Fund management group, it is a likely scenario that there are a large number of local staff employed by a local 'service company' member of that of the Investment Manager or its corporate group. Those staff may for example be dedicated to working on specific types of investment or groups of deals that are owned across several 'vintages' of a fund. As such, it will very commonly be the case that they may work for multiple entities across more than one PE Fund structure. It is clearly important for both these staff and their employer that they have a single and (importantly) continuous employment contract with a single entity, under which they can benefit for their full entitlements as an employee within the supportive framework of European law in this area. Fragmenting their employment or causing them to 'move jobs' every time a particular investment company is bought or sold would clearly be detrimental to both the employee and employer.

In order to enable these tests to apply appropriately in the context of PE Funds and ensure that the valid commercial arrangements described above are appropriately reflected in the regulations, it is necessary to introduce a new part to the definition as outlined in (e) below.

**Recommendation 3**

We suggest modifying Article 5(1) as such:

*1. For the purposes of ~~Articles 4 and 7~~ this Directive, 'associated enterprise' shall mean a person who is related to another person in any of the following ways:*
*(a) a person participates in the management of another person by being in a position to exercise a significant influence over the other person;*
*(b) a person participates in the control of another person through a holding that exceeds 25 % of the voting rights;*
*(c) a person participates in the capital of another person through a right of ownership that, directly or indirectly, exceeds 25 % of the capital;*
*(d) a person is entitled to 25 % or more of the profits of another person.*
*(e) a person that is a regulated financial undertaking pursuant to Article 6 (2) (b) sub category (c), by acting as a fund manager of a person that is a regulated financial undertaking pursuant to Article 6 (2) (b) sub category (i) or (*) [reference to new sub category for pillar 2 investment funds], together with associated enterprises of such persons.*

3. **The exemption for undertakings with holding activities (Article 6(2)(d))**

It appears that the intention behind this exemption is to exempt holding companies and other similar intermediaries situated in the same Member State as their ultimate shareholders.

In PE investment structures, holding companies take the form of a regional investment platform located in the same Member State as the fund itself, its shareholder.

Present wording would lead to such structures not clearly being exempted, because the technical definitions of 'ultimate parent entity' (which requires consolidation) and 'undertaking's shareholder(s)' (which does not cater for 'tax transparent' entities not needing to maintain substance) as drafted would not apply to a typical PE fund. Therefore, it *should be clarified that it also covers holding companies outsourcing activities to associated enterprises (as defined in our expanded definition recommended above) in the same jurisdiction.*

**Recommendation 4**

We suggest modifying Article 6(2)(d) as such:

*(d) undertakings with holding activities that are resident for tax purposes in the same Member State as the undertaking's shareholder(s), ~~or~~ the ultimate parent entity, as defined in Section I, point 7, of Annex III to Directive 2011/16/EU*, ***or an associated enterprise to which activities have been outsourced****;*

In this regard we also consider therefore that, for this exemption to be usable by PE Funds, the definition of 'undertaking's shareholders' should be amended to clarify its application in the context of a PE Fund structure. The definition at present applies so that not only direct shareholders have to be resident in the same jurisdiction as the entity (where this test might reasonably be passed where the PE fund and holding company are based in the same jurisdiction), but also all indirect shareholders in certain circumstances would also need to be resident in the same jurisdiction. This is a very broad concept which looks to target situations where shell companies are used in the chain of ownership. Our view is that this definition is too wide currently, in that it is not clear whether it is intended to apply where there is an ATAD 3 exempt, or transparent entity in the chain of ownership which does not have substance. In a PE Fund structure this could prevent this exclusion being used even if all the ultimate investors were in the same jurisdiction as the underlying entity in question, because the tax transparent fund itself would not typically have 'substance'.

However, if a PE fund is a limited partnership, it would not itself be subject to Article 7(1) of the Directive because it is not an undertaking that is 'tax resident' anywhere. Similarly on the basis that the PE fund is a 'regulated financial undertaking' it would itself be outside the scope of Article 7(1).

**Recommendation 5**

The definition of 'undertaking's shareholders' could helpfully be amended to refer to:

"a chain of undertakings none of which ***(if and to the extent that such undertaking is within the scope of Article 2 and is not an exempt entity pursuant to Article 6(2) of this Directive)*** fulfils the indicators of minimum substance…"

4. **The five full time equivalent staff exemption (Article 6(2)(e))**

We consider that as currently drafted the exemption contained in Article 6(2)(e), which requires undertakings to have 'at least five own full time equivalent employees or members of staff exclusively carrying out activities generating the relevant income' is extremely limited, it in essence penalising valid commercial structures where employees are not employed by the correct entity in a structure.

It would be helpful to build in the concept of employees of 'associated entities', as defined above in recommendation 3 above, being allowable in this context and throughout the Directive and for the test to be considered on a group basis rather than on an entity by entity basis, thus securing that the inclusion of expanded associates captures the whole group.

**Recommendation 6**

We suggest modifying Article 6(2)(e) as such:

'at least five ~~own~~ full time equivalent employees or members of staff ***of the entity or its associated entities*** are exclusively carrying out activities generating the relevant income'

## 5. Gateway criteria - Outsourcing (Article 6(1)(c))

There are many legitimate commercial reasons why not every company within the structure of an investment fund and its manager will have its own employees, premises and the other indicators of so-called 'substance', as is no doubt also the case for many corporate group structures .

We would welcome more clarity on the part of the gateway criteria concerning outsourcing of administration and decision-making, and the type of arrangements that are contemplated to be within the scope.

**It is key to ensure that the gateway test will not require all day-to-day operations and decisions to be carried out by persons who are direct employees of a specific legal entity in order for it not to be considered a 'shell'.**

The gateway should differentiate between genuine third-party outsourcing and centralisation of in-country substance within the overall infrastructure of a regulated investment fund and its investment manager.

*The focus on substance should rather be on an in territory basis rather than extremely narrowly applied to a specific legal entity*, without such reading it is inevitable that the proposed directive will capture a much wider range of normal commercial situations than the type of outsourcing it appears to have been aimed to target.

In this regard, specifying that the criteria on outsourcing would not cover situations where the undertaking has outsourced to an associated enterprise within the same jurisdiction would deal with a large majority of potential issues.

**Recommendation 7**

We suggest modifying Article 6(1)(c) as such:

*(c) in the preceding two tax years, the undertaking outsourced the administration of day-to-day operations and the decision-making on significant functions**, other than to an associated enterprise within the same Member State as the reporting undertaking.***

## 6. Gateway Criteria - Retroactive application of Article 6(1)(c)

The proposal provides that the gateway on outsourcing shall be tested by reference to the preceding two tax years. The testing period would therefore encompass the two years before the first year of application of the directive, i.e. a period of time where the directive itself is not yet in force. **This situation creates a**

**serious issue of legal certainty for undertakings,** at risk of being assessed in relation to criteria impossible to know and implement in the two years before the application of the directive.

**Recommendation 8**

We suggest modifying Article 6(1)(c) as such:

*(c) in the preceding two tax years,* ***starting at the earliest from the date of application of this Directive,*** *the undertaking outsourced the administration of day-to-day operations and the decision-making on significant functions.*

## 7. Additional points for consideration

***Application of the substance indicators (Article 7(1))***

Substance in terms of employees, offices, etc. is not the only relevant indicator for determining whether an entity is a shell entity or not. Several company groups establish entities due to legitimate commercial reasons, but these entities might not have so-called 'substance".

**It is imperative that the substance test does not undermine the commercial operation of legitimate businesses, and therefore, the 'substance' should be assessed by reference to the overall level of substance in the Jurisdiction in question of the entity and its Associated Enterprises/rather than at the level of each individual entity.**

In order to take into account the operational set up of a PE investment structure, we believe that the requirements in the substance test would benefit from further clarification or additional guidance on their application to such structures, notably in relation to the following issues:

- On the condition on own premises or premises for exclusive use, clarification is needed on the situation where it is natural for cost efficiency and operational purposes that the office space is pooled between the local entities. A requirement of a single designated space per legal entity does not seem realistic, and would ignore the cost efficiencies that companies and fund managers have to undertake.

- On the condition on directors, the specific situation of PE fund structures must be considered in relation to the reference to directors that "are not employees of an enterprise that is not an associated enterprise and do not perform the function of director or equivalent for other enterprises that are not associated enterprises" (Article 7(1)(c)(i)(4)). In the context of a PE fund management group, it is likely that a large number of local staff are employed by a local company that is part of the corporate group, dedicated to work on specific types of investments in the jurisdiction. Those staff will very commonly work for multiple entities across more than one PE fund structure. However, as mentioned above, the relatively narrow definition of an 'associated enterprise' in the proposal at hand would not treat different portfolio investments of different PE funds, which are however managed by the same PE fund management group, as associated enterprises of each other or of the fund manager. In order to properly recognise the position of PE fund management groups with substantial local presence, it would be reasonable that this condition is assessed at local group level rather than entity level (with the local 'group' concept for these purposes enabling the fund manager and portfolio investments to be treated as being within the same 'group').

- The condition on employees requires them to be “qualified to carry out the activities that generate the relevant income for the undertaking” (Article 7(1)(c)(ii)). However, it is unclear how this can be demonstrated in practice and what type of qualification might be required, in the case where the undertaking in question derives income from its underlying investments.

Expanding on the definition of an associated enterprise a suggested in the above would help to address these issues.

***Rebuttal of the presumption (Article 9)***

- We believe that the current wording on rebuttal of the presumption raises several issues of uncertainties for a wide range of taxpayers. We would welcome substantive clarificatory guidance on how the presumption of not having minimum substance might be rebutted. In particular further clarification on what the test as to ‘commercial rationale’ and having control over and bearing the risk of the business activities entails is much needed.

- Such guidance should address various different contexts. In the context of PE funds using investment structures with intermediaries such as holding companies, the guidance should make clear that the as regards entities within such structures which are based in jurisdictions where the relevant investment fund or manager has a significant presence, this should be sufficient to rebut the presumption.

  In the absence of any of the above changes being made, a large number of individual entities in PE Fund structures are likely to need to rely on this rebuttal procedure and so it needs to be clearer how this would apply in practice. The administrative burden for tax authorities of Member States to apply this process would be significant and we are concerned that a lack of clearer principles in this area this may lead to inconsistent application of these rules, rather than harmonisation across the Member States.

We hope the above has clarified that Invest Europe welcomes the proposal and our aspiration to be helpful in securing that it achieves its laudable aims. This whilst also securing that no unintended collateral damage is done to perfectly legitimate structures that serves to secure investments streams to European companies. Evidently, we remain at your service, should you have any questions or comments and would to that end be delighted to clarify and discuss further in a meeting, recognising that these are complex issues well worth further elaborations.

## Contact

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## About the PAE

The Public Affairs Executive (PAE) consists of representatives from the venture capital, mid-market and large buyout parts of the private equity industry, as well as institutional investors and representatives of national private equity associations (NVCAs). The PAE represents the views of this industry in EU-level public affairs and aims to improve the understanding of its activities and its importance for the European economy.

## About Invest Europe

Invest Europe is the association representing Europe's private equity, venture capital and infrastructure sectors, as well as their investors.

Our members take a long-term approach to investing in privately held companies, from start-ups to established firms. They inject not only capital but dynamism, innovation and expertise. This commitment helps deliver strong and sustainable growth, resulting in healthy returns for Europe's leading pension funds and insurers, to the benefit of the millions of European citizens who depend on them.

Invest Europe aims to make a constructive contribution to policy affecting private capital investment in Europe. We provide information to the public on our members' role in the economy. Our research provides the most authoritative source of data on trends and developments in our industry.

Invest Europe is the guardian of the industry's professional standards, demanding accountability, good governance and transparency from our members.

Invest Europe is a non-profit organisation with 25 employees in Brussels, Belgium.

For more information please visit www.investeurope.eu.