Luxembourg: A prime location for the structuring of Islamic real estate investments

Real estate is the preferred asset class of many Islamic investors, and real properties located in Europe seem to be increasingly more in their focus. With regards to the structuring of real estate investments, Luxembourg has proven to be an efficient and stable gateway to Europe. OLIVER R HOOR depicts the fundamental elements of Shariah compliant real estate investments and demonstrates Luxembourg's competitive advantage.

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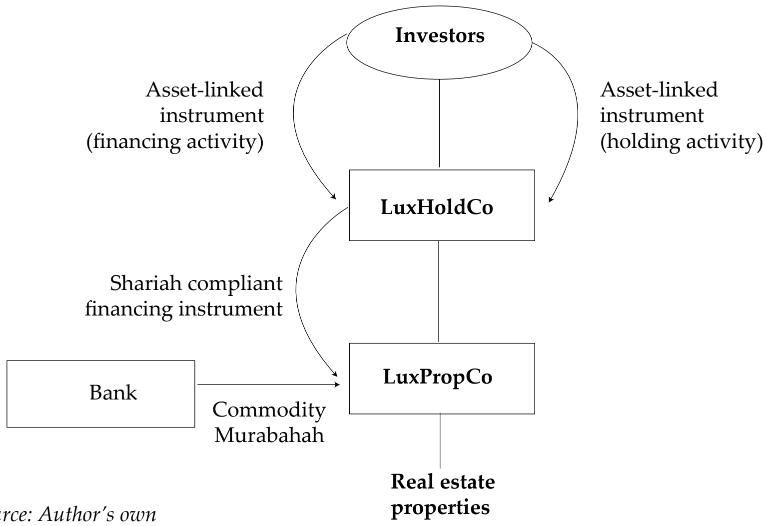
The growth of Islamic finance in Luxembourg has been driven to a large extent by the investments of Middle Eastern investors (investments are predominantly made by institutional investors, sovereign wealth funds and high-net-worth individuals) in European real estate assets. Islamic investors appear to focus on the same locations as conventional investors. Within Europe, investments are currently made predominantly in the UK, France and Germany.

The structuring of Shariah compliant real estate investments is challenging since all transactions must adhere to the principles set out under Islamic law. Accordingly, great care must be taken in structuring the investment vehicles and financial transactions to ensure that they operate in compliance with Shariah precepts.

As one of the leading European domiciles for vehicles investing in international real estate, Luxembourg is perfectly equipped to address the specific needs of Islamic finance investments in and through Europe.

Also, the Luxembourg government is confident that many interesting opportunities can arise from Islamic finance and is particularly keen to position Luxembourg as a privileged/preferred partner for Islamic finance transactions in Europe.

Figure 1: Example of how a real estate investment might be structured via Luxembourg



Source: Author's own

Real estate in Islamic asset management

The pervasive presence of real estate investment throughout the Islamic finance spectrum is in particular linked to the strong preference of investing in productive tangible assets and the fact that, cycles aside, property prices always increase eventually.

The objectives sought by both conventional and Islamic investors have much common ground: capital preservation, yield maximization, a balance between liquidity and profitability, and so on.

However, in contrast to conventional investments, a key characteristic of Islamic real estate investments is that they must be structured, quite naturally, in a Shariah compliant manner.

In light of the aforementioned factors, the structuring of each Islamic real estate investment (and especially the financing instruments used) must be tailored to each individual case with respect to, inter alia, the location of the real estate assets, the investment strategy, the tax profile of the investors and any other specific requirements from a Shariah perspective.

Real estate covers a wide range of assets including, for example, residential properties, office buildings, warehouses, shopping centers, hospitals and various types of infrastructure projects, for example, solar power plants and wind parks.

The challenges faced when selecting real estate assets for investments should, in principle, be no different from those faced in conventional finance, ie maximizing the return while reducing the portfolio risk with a diversification strategy (for example, through investing into different real estate sectors and geographical areas).

However, in addition to the concerns involved in the asset selection of conventional investors, Islamic investors must screen for the use of the properties

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by their tenants beforehand in order to ensure compliance with Shariah principles.

Notably, as long as the property itself is used for Halal (permissible) business activities, it has the potential to form part of a Shariah compliant structure. The properties should not be used for Haram activities such as liquor production, conventional banking or gambling.

Accordingly, the industrial sector (for example, logistics and warehousing) and the residential sector (for example, apartment buildings and student accommodation) are well-suited markets for Shariah compliant real estate investments.

In contrast, the retail property sector provides a more challenging segment due to prohibited retail operations including leisure (betting shops, pubs, etc) and sales outlets (alcohol, non-Halal meat products and such).

However, although restrictions are imposed concerning investment in office, retail, hotel and leisure property due to the type of activity, there is still substantial investment by Islamic funds in these sectors.

One distinct feature of modern Islamic finance is the role of the Shariah board, which monitors the operations of Islamic financial institutions and plays a central role in transactions, notably in clarifying elements that are doubtful from a Shariah perspective in the form of legal opinions (Fatwas).

The requirement to have a Shariah board applies equally to Islamic financial institutions and to Islamic windows of conventional banks. The issuance of a Fatwa is an important precondition when a fund or an investment is to be marketed as Shariah compliant.

Structuring real estate investments through Luxembourg

The possibilities of structuring real estate investments through Luxembourg, be it in the form of a real estate fund, a joint venture or on a stand-alone basis, are manifold. The Luxembourg structuring toolbox provides for a full range of different tax and regulatory regimes (the Luxembourg holding company, securitization vehicle, specialized investment fund, reserved alternative investment fund, risk capital company, family wealth management company, etc), all of which can be established under different legal forms.

The choice of a real estate vehicle will generally depend on the type of funding that needs to be raised, the proposed investor base, the types of investments to be made and any specific tax, legal or regulatory considerations.

While Islamic finance structuring in non-Islamic jurisdictions must abide by all of the traditional limitations of Shariah law, it generally faces the additional challenge of operating in legal and regulatory environments unaccustomed to Islamic finance techniques. The compatibility of the Luxembourg legal framework with Islamic finance requirements for the implementation of Shariah compliant products is, in this context, of vital importance.

Considerable steps have been taken by Luxembourg to elevate its status to that of a global hub for Islamic finance, including the issuance of a tax circular (Circular L.G.-A No 55 of the 12th January 2010) describing the major principles of Islamic finance and the tax treatment of Islamic finance techniques.

On the 17th June 2010, Luxembourg's indirect tax administration, responsible for value-added tax (VAT), registration duty and other indirect taxes, issued a second circular (Circular No 749) outlining the indirect tax and VAT treatment of Murabahah and Ijarah structures.

Furthermore, in contrast to many other western jurisdictions, the Luxembourg tax treatment of business transactions is generally based less on legal characteristics than on economic reality (ie substance over form approach). Therefore, many Islamic finance techniques may be realized in a tax-efficient manner in Luxembourg.

For example, financing instruments may be linked directly to a particular asset or investment portfolio, bearing a variable yield depending on the income deriving from the asset and participating in the business risk of the borrower as required by the Shariah.

Unlike many other jurisdictions, yield paid on pure income or profit-participating financing instruments may be deductible for Luxembourg tax purposes and not subject to Luxembourg withholding tax, irrespective of the status or residence of the recipient.

Figure 1 illustrates how a real estate investment might be structured via Luxembourg: an Islamic investor structures the acquisition of a European real property through a Luxembourg holding company (LuxHoldCo) and a Luxembourg property company (LuxPropCo). LuxHoldCo and LuxPropCo are financed with a mixture of equity and Shariah compliant financing instruments. In addition, LuxPropCo is financed with Shariah compliant external debt.

Conclusion

There is no denying that real estate is an attractive asset class for Islamic investors wishing to manage their wealth in accordance with Shariah principles. For many Middle Eastern investors pursuing an international strategy to diversify their investment portfolios, European real estate represents an exciting opportunity.

Therefore, it is not surprising that the growth of Islamic finance in Luxembourg has primarily been driven by real estate investments. The flexibility and tax efficiency offered by Luxembourg's Shariah compliant investment structures remain unsurpassed and provide for a level-playing field between conventional and Shariah compliant transactions – cementing Luxembourg's role as an emerging hub for Islamic finance.

Luxembourg employs the substance over form principle when determining the tax treatment applicable to transactions and is flexible in terms of the use of financial instruments. When combined with the country's extensive tax treaty network, access to EU directives and a favorable domestic participation exemption regime, it means that Luxembourg is perfectly equipped to address the specific needs of Islamic finance investments throughout Europe.