taxnotes®
international
Volume 84, Number 5 ■ October 31, 2016

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Reprinted from *Tax Notes Int'l*, October 31, 2016, p. 495

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PRACTITIONERS' CORNER

Luxembourg's New Reserved Alternative Investment Fund

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In this article, the authors discuss new Luxembourg legislation on the reserved alternative investment fund and analyze its tax treatment.

On July 14 the Luxembourg Parliament adopted legislation on the reserved alternative investment fund (RAIF), a new fund vehicle that will revolutionize the Luxembourg fund landscape.[1] The RAIF offers the strengths of the Luxembourg specialized investment fund (SIF) or the investment company in risk capital (SICAR) without being subject to approval by the Luxembourg financial sector supervisor (Commission de Surveillance du Secteur Financier (CSSF)). This article outlines the RAIF's flexible legal and regulatory framework and analyses its tax treatment in Luxembourg.

I. Introduction

The term ''alternative investment fund'' (AIF) basically includes all investment funds that are not covered by the European Directive on undertakings for collective investment in transferable securities, including real estate funds, private equity funds, venture capital funds, debt funds, and hedge funds.

Luxembourg is Europe's leading location for the structuring of alternative investments. The reason for Luxembourg's success as a prime fund location is a legal and regulatory framework diverse and flexible enough to fulfill a range of investor needs. Further, the Luxembourg fund industry provides strong organizational support along the fund value chain with professional service providers experienced in the structuring and management of all investment fund aspects.

The creation of the RAIF is a response to the demand of AIF managers and investors for a fund regime that has the characteristics of a regulated fund but is exempt from prior authorization and ongoing prudential supervision by the CSSF. The RAIF relies only on the regulation of the fund manager under the alternative investment fund manager directive (AIFMD), which significantly reduces the time to market.

II. Legal and Regulatory Considerations

The RAIF is a new fund regime tailored to the structuring of alternative investments that is eligible to AIFs under the law of July 12, 2013, which incorporated the AIFMD into Luxembourg law.[2] It provides significant flexibility in terms of legal forms that can

[1] Law of July 23 published in the Luxembourg official gazette on July 28.

[2] *Id.* at article 1.

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be tailored to investor requirements. The scope of eligible assets is broad, allowing for any alternative investment strategy. The RAIF is reserved to well-informed investors that can assess the risks associated with an investment in the fund.

A. Appointment of a Duly Authorized AIFM

RAIFs are required to appoint a duly authorized alternative investment fund manager (AIFM) as an external AIFM. It follows that RAIFs are subject to all requirements set out under the AIFMD. AIFMs may be established in Luxembourg, an EU member state, or a third country once the passport is available in accordance with the AIFMD.

B. Available Legal Forms

Investment managers have a lot of flexibility when deciding on the optimal vehicle for the RAIF. The RAIF law provides for a range of legal forms, the choice of which depends on commercial and tax reasons.

The RAIF may be established in the following forms:

- A common fund (*fonds commun de placement*, or FCP), which is a co-ownership of assets managed by a management company on behalf of the joint owners. Investors in the FCP subscribe for units in the FCP that represent a portion of the net assets of the RAIF. The liability of the unit holders is limited to their contribution.
- An investment company with variable (*société d'investissement à capital variable*, or SICAV)[3] or fixed capital (*société d'investissement à capital fixe*, or SICAF), which may take the legal form of:
  - — a public limited liability company (*société anonyme*, or SA);
  - — a private LLC (*société à responsabilité limitée*, or Sàrl);
  - — a corporate partnership limited by shares (*société en commandite par actions*, or SCA);
  - — a common limited partnership (*société en commandite simple*, or SCS);
  - — a special limited partnership (*société en commandite spéciale*, or SCSp)[4]; or
  - — a public cooperative company (*société coopérative sous forme de société anonyme*, or Coop. SA).

A RAIF established as a SICAV benefits from flexible corporate rules when it comes to profit distributions and the issue or redemption of shares. The distribution of dividends (annual or interim) is not subject to legal restrictions other than those determined in the constitutive RAIF documents if the fund complies with the ongoing minimum capital requirement of €1.25 million.

Irrespective of the legal form chosen, a RAIF may be established as an umbrella structure with several ring-fenced subfunds or compartments, each representing a distinct portfolio of assets and liabilities.[5] The features of each subfund (for example, investment policy or operating terms) can be freely defined in the fund documentation and vary from one subfund to another.

C. Eligible Investors

The RAIF is reserved to well-informed investors, including institutional investors, professional investors, or any other investor who confirmed in writing his status of a well-informed investor and who:

- invests a minimum of €125,000 in the RAIF; or
- has an appraisal from an EU bank, investment firm, or management company certifying he has the appropriate expertise, experience, and knowledge to adequately understand the investment made in the fund.[6]

That gives sophisticated investors, including high-net-worth individuals, access to the flexible and tax-efficient RAIF regime.

D. Assets and Diversification

The potential investment universe of the RAIF is broad. RAIFs are authorized to invest in any type of asset and to pursue any investment strategy with no restriction. Hence, the RAIF can be used for the structuring of private equity funds, real estate funds, infrastructure funds, hedge funds, venture capital funds, debt funds, or bond funds.

While there are no detailed investment or leverage restrictions, RAIFs are subject to the principle of risk diversification. CSSF guidance regarding the application of the principle of risk diversification in a SIF context serves as a useful source of interpretation.

However, when the RAIF restricts its investment policy in its constitutive documents to investments in risk capital (just like a SICAR does), the risk-spreading requirement will not apply.[7] While there is no clear definition of risk capital, its interpretation is broad. The main criteria that will be considered when assessing whether an investment constitutes risk capital is:

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[3]The capital of a SICAV is increased or reduced automatically as a result of new subscriptions or redemptions, with no formalities.

[4]The main feature of the special limited partnership is that it has no legal personality. It has been inspired by the Anglo-Saxon limited partnership, which has traditionally been favored for private equity investments.

[5]According to the principle of "ring-fencing," the assets of a compartment are exclusively available to satisfy the rights of investors in relation to that very compartment.

[6]*Supra* note 1, at article 2.

[7]*Id.* at article 48(1)(a).

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- investment risk — that is, the investment risk exceeds normal business risk; and
- the intention to realize the investment — that is, the intention of developing an investment followed by its realization through a sale or initial public offering.

Funds investing into venture capital such as biotechnology start-ups and private equity will frequently meet those conditions. Also, other investment strategies such as distressed debt or real estate investments may come within the scope of risk capital if they comply with the criteria set by the CSSF.

III. Tax Considerations

The RAIF law provides for several special tax provisions applicable to RAIFs that are subject to a dual tax regime. The general tax regime is similar to that of a SIF, whereas RAIFs investing exclusively in risk capital are entitled to opt for the SICAR tax regime. A RAIF that is established as an umbrella fund with several compartments has to choose the same tax regime for all compartments.

A. Corporate Tax and Municipal Business Tax

1. SIF Regime

RAIFs are generally subject to the same tax regime as SIFs. RAIFs established in the form of mutual funds (FCPs) or partnerships (SCSs/SCSps) are fiscally transparent and therefore not subject to Luxembourg corporate income tax. While partnerships may be subject to municipal business tax, the RAIF law says RAIFs are not subject to municipal business tax.

RAIFs established in corporate form (SICAVs, SICAFs) are in principle subject to corporate income tax and municipal business tax but have been exempted.

However, a RAIF is subject to an insignificant annual subscription tax (*taxe d'abonnement*) of 0.01 percent, payable every quarter and based on the total net asset value of the fund on the last day of every quarter.[8]

To avoid double taxation, funds that exclusively hold units in other Luxembourg investment funds and some pension funds are exempt from the subscription tax.[9]

2. Case Study: Real Estate Fund

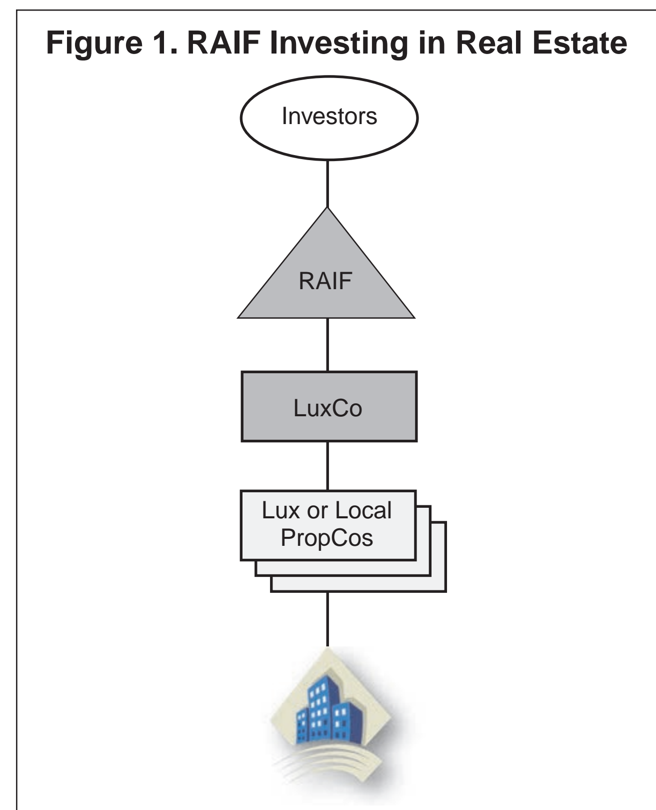
Luxembourg is the leading European domicile for vehicles investing in international real estate. When a RAIF is used as a real estate fund, it will generally structure investments using a fully taxable Luxembourg company (LuxCo) financed by a mixture of equity and debt.

LuxCo typically invests in foreign real estate using Luxembourg or local property companies that may be held via intermediary holding companies. The property companies are typically financed by a mixture of equity and debt in accordance with the domestic tax law of the jurisdictions where the properties are situated. Given typical cash trap concerns at the level of the property companies where cash cannot be repatriated as dividend payments (in the absence of distributable reserves because of the depreciation of the real property), debt funding of the property company is key for organizing regular cash repatriations over the funds' life.

In many target jurisdictions, investments might be considered via real estate investment trusts that usually benefit from a favorable tax regime if a large part of the income is distributed to the investors (the distributions are generally subject to withholding tax). In some cases, investments directly made by the RAIF into the foreign real estate may benefit from a tax exemption abroad.

Figure 1 illustrates a generic structure of a RAIF investing into real estate.

Figure 1. RAIF Investing in Real Estate



3. SICAR Regime

When a RAIF limits its investments to risk capital and specifies that in its constitutive documentation, it is subject to the SICAR tax regime. The tax treatment

[8] *Id.* at article 46(1).

[9] *Id.* at article 46(2).

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depends on the legal form adopted.[10] In contrast to RAIFs subject to the SIF regime, RAIFs that are subject to the SICAR tax regime are not subject to subscription tax.[11]

RAIFs established in corporate form and adopting the SICAR regime are subject to corporate income tax and municipal business tax at an aggregate rate of 29.22 percent (in the municipality of Luxembourg).[12] However, income derived from transferable securities,[13] including income deriving from the transfer, contribution, or liquidation of assets held by the RAIF, is exempt from Luxembourg corporate income tax and municipal business tax.[14]

Other RAIF income that is not derived from investments in risk capital is fully taxable. As an exception, income generated on funds to be invested in venture capital (in a maximum period of 12 months) is exempt from taxation.[15]

Capital losses realized on the transfer of transferable securities, losses that have not been realized but accounted for on the reduction of the value of those assets, and other expenses stemming from tax-exempt income may not be deducted from the RAIF's taxable income.

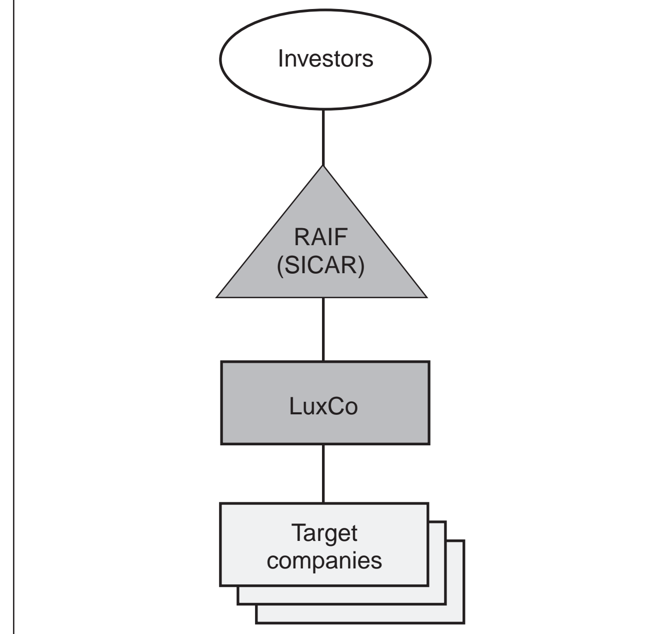
RAIFs in the form of an SCS or SCSp are fiscally transparent and therefore not subject to Luxembourg corporate income tax. Moreover, they are considered not to have commercial activity and thus are not subject to municipal business tax.

4. Case Study: Private Equity Fund

RAIFs adopting the SICAR regime may be used for investments in private equity, for example. Investments in businesses will be structured either directly from the RAIF into the target companies or via one or several Luxembourg and local intermediary companies (LuxCo). LuxCo and the target companies will generally be financed by a mixture of equity and debt. Private equity investments are typically financed by external debt.

Figure 2 illustrates a generic structure of a RAIF investing into risk capital.

Figure 2. RAIF Investing in Private Equity



5. Net Wealth and Withholding Taxes

Luxembourg companies are generally subject to an annual net wealth tax of 0.5 percent on their unitary value — that is, the company's net asset value, which is subject to some adjustments.

While RAIFs that adopt the legal form of an FCP or a partnership are not subject to Luxembourg net wealth tax, corporate RAIFs have been exempted from the net wealth tax.[16]

Despite that, corporate RAIFs subject to the SICAR regime must pay an annual minimum net wealth tax of €3,210 (to be increased to €4,815 in 2017) if the financial assets, transferable securities, bank deposits, and receivables against related parties of the RAIF exceed 90 percent of the total assets and €350,000. If the RAIF does not meet those requirements, the minimum net wealth tax varies between €535 and €32,100, depending on the total balance sheet.

Under Luxembourg tax law, interest payments are not subject to withholding tax. In contrast, dividend payments of Luxembourg companies are subject to a withholding tax of 15 percent unless a domestic withholding tax exemption or a reduced withholding tax rate applies under a tax treaty.

However, the RAIF law exempts corporate RAIFs from the dividend withholding tax. Further, payments made by RAIFs established as an FCP or partnership are not subject to Luxembourg withholding tax.

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[10]RAIFs that adopt the SICAR regime cannot be established as FCPs.

[11]*Supra* note 1, at article 48.

[12]The Luxembourg corporate income tax rate will be reduced from 21 percent to 19 percent in 2017 and 18 percent in 2018, resulting in aggregate tax rates of 27.08 percent in 2017 and 26.01 percent in 2018.

[13]The concept of transferable securities is broad, covering shares, units, and other equity securities; ordinary debt instruments such as bonds, promissory notes, and other transferable securities; and convertible debt instruments.

[14]*Supra* note 1, at article 48(2).

[15]*Id.* at article 48(3).

[16]*Id.* at article 45(1).

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6. International Tax Aspects

When RAIF investments are made abroad, the question arises whether RAIFs come within the scope of tax treaties concluded by Luxembourg. RAIFs established as FCPs or partnerships are generally excluded from tax treaty benefits because of their fiscal transparency.[17]

Corporate RAIFs must be distinguished between those subject to the SIF tax regime and those subject to the SICAR tax regime. Forty-nine of Luxembourg's 76 tax treaties apply to SICAVs and SICAFs. RAIFs that are taxed like SICARs should, at least from a Luxembourg perspective, benefit from the EU parent-subsidiary directive[18] and the tax treaties concluded by Luxembourg because they are fully taxable companies.

Investments may, however, also be structured via a Luxembourg fully taxable company that benefits from Luxembourg's extensive tax treaty network[19] and the EU parent-subsidiary directive.

7. Taxation of Nonresident Investors

Nonresident investors in Luxembourg companies are subject to nonresidents capital gains taxation if they dispose of an important participation of more than 10 percent within six months from the acquisition of the shares (unless a tax treaty excludes the Luxembourg tax right).

Nonresident investors in a corporate RAIF are not subject to any taxation on their capital gains.[20] Likewise, capital gains realized on the exit from one compartment and the entering into another compartment in the same RAIF do not give rise to any taxation in Luxembourg.

8. VAT

The standard VAT rate in Luxembourg is 17 percent, the lowest in Europe. However, management services provided to a RAIF benefit from a VAT exemption. The concept of management services is broadly interpreted and includes portfolio management services, investment advisory services, and some administrative services. The exempt services may be provided to the RAIF by a management company (for example, the general partner if the RAIF is a partnership) or, under some conditions, by a third-party manager or adviser.

IV. Conclusion

The RAIF is a flexible fund regime tailored for the structuring of alternative investments through Luxembourg. Although it has the characteristics of a regulated fund, it is exempt from prior approval and supervision by the CSSF, which allows an attractive time to market that can be organized in just days.

There is no further limitation in terms of eligible assets or fund strategy. The RAIF can be established as an umbrella structure with several compartments that invest into different assets or pursue different investment strategies. It is managed by an authorized AIFM and therefore enjoys the benefits of the AIFMD regime, including ''passporting'' through the use of the AIFM distribution passport.

The RAIF is subject to an efficient dual tax regime. While the general tax regime is similar to that of a SIF, RAIFs investing exclusively in risk capital are entitled to opt for the SICAR tax regime. RAIF investments can be structured either as direct investments or via intermediary companies established in Luxembourg and abroad. The RAIF is expected to become the vehicle of choice for the structuring of alternative investments. ◆

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[17]For a RAIF established as an FCP, the FCP unit holder may apply the tax treaty concluded between its residence state and the country where the FCP's investments are. Similarly, for a RAIF established as a partnership, the partners may apply the tax treaty concluded between their residence state and the country where the fund's investments are.

[18]Council directive of November 30, 2011, on the common system of taxation applicable in the case of parent companies and subsidiaries of different member states (2011/96/EU).

[19]Tax treaties may restrict or even exclude the tax rights of the other contracting states if dividends or capital gains are derived from the shares in a company that is resident in that state.

[20]Article 156 No. 8 (c) of the Luxembourg Income Tax Law.

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