Luxembourg Corporate: unregulated securitisation vehicles

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Introduction

With more than 1,000 securitisation vehicles and thousands of related compartments, the Luxembourg securitisation market has enjoyed a continuous and steady growth. It is also forecast that this well-established trend will continue to gain further strength in the coming years.

As a leading hub in Europe for securitisation and structured finance transactions, Luxembourg offers a pragmatic and secure legal and tax regime which allows the securitisation of virtually an unlimited range of risks, through different forms of securitisation vehicles (**SVs**) with reduced complexities and almost full tax neutrality.

The regime that developed in practice following the statutory framework created by the Luxembourg Securitisation Law of 22 March 2004, as amended from time to time, (the **Securitisation Law**) and the regulatory guidance issued by the Luxembourg Financial Sector Supervisory Authority (the **CSSF**) in the form of published Q&As has therefore led to a widespread market usage of SVs to cover a range of activities from (i) regulated, continuously offered securities to the public, through (ii) institutional capital raising and (iii) private, unregulated financial instruments-issuing investment vehicles.

On 9 February 2022, a new law amending the Securitisation Law was voted in, bringing further flexibility and clarification to the applicable SV regime and confirmation of certain practices that had developed over time in the market.

In this briefing, we set out an overview of some of these changes and the resulting modernised Luxembourg SV regime, together with its latest tax related salient points.

What is securitisation under Luxembourg law?

Securitisation under the Securitisation Law means the transaction by which an SV (cumulatively):

1. acquires (true sale securitisation) or assumes (synthetic securitisation), directly or through another undertaking, risks relating to claims, other assets, or obligations assumed by third parties or which are inherent to all or part of the activities of third parties
2. issues financial instruments, whose value or yield depends on such risks

The Luxembourg SV may therefore be used for a diverse range of economic purposes, including:

1. structures that would be recognised as classic capital markets structures set up with a view to being bankruptcy remote, taking on either a true sale assignment or a synthetic exposure to a portfolio of numerous assets which are secured to a fiduciary for the benefit of the financial instruments' holders whose proceeds of issue financed the original portfolio acquisition
2. private vehicles that are simply issuing financial instruments whose value or yield is dependent on the performance of one or a number of portfolio assets
3. intermediate portfolio holding vehicles for non-EU funds holding debt or other receivables

Securitisable risks

Risks relating to all types of assets, whether movable or immovable, tangible or intangible, as well as those relating to obligations assumed by third parties or inherent in all or part of third-party activities, may be securitised. There are no portfolio diversification requirements, so that SVs are able to hold single asset portfolios where appropriate.

Securitisation may occur either through a true sale under which assets are assigned to or acquired by the SV or through a "synthetic" securitisation, where only the risk linked to the portfolio assets is transferred. Under the modernised Securitisation Law, it has been clarified that the acquisition of the assets to be securitised may now take place directly or indirectly by the SV (thereby confirming the possibility to structure acquisitions via subsidiaries).

Financing of the SV

Aside from the fact that an SV as a company will have share capital and corresponding issued equity, it will finance its securitisation operations through the issue of financial instruments (this term now replaces the previously used narrower and undefined term of "securities"). There is neither a legal definition nor any prescription as to the characteristics of such financial instruments, simply that their yield or value accretion must derive from the securitised risks. On this basis, the following is to be noted:

1. In general, financial instruments issued by Luxembourg SVs are debt securities (but shares are authorised too) and are often subject to foreign law
2. The financial instruments issued may be secured or unsecured, provided their value or yield is effectively ring-fenced to the performance of the underlying portfolio
3. An SV may also issue financial instruments whose value or yield is linked to specific compartments, assets or risks
4. The financial instruments may be listed in Luxembourg (the Luxembourg Stock Exchange operates two markets, (a) the Luxembourg Stock Exchange, a European regulated market offering European passport and (b) the Euro MTF, a Multilateral Trading Facility) or abroad

The modernised Securitisation Law has also significantly broadened the funding possibilities of SVs by providing that they may receive financing through borrowing or intra-group financing (previously, the financing by way of loans was possible under limited circumstances only). This now includes any form of indebtedness that gives rise to a repayment obligation from the SV.

Corporate / Structuring

Investors

There are no restrictions on eligible investors under Luxembourg law, however, the laws on financial instruments that may be applicable to investors in their own jurisdictions will need to be taken into account.

Corporate form

A Luxembourg SV can be constituted as:

1. a private limited liability company (SARL), a public limited company (SA), an incorporated limited partnership issuing shares (SCA), a co-operative company organised as a public limited company (société cooperative organisée comme une société anonyme), a general partnership (SNC), a simplified limited company (SAS) or as a tax transparent limited or special partnership (SCS or SCSp)
2. alternatively a (common) fund (fonds commun de titrisation), without legal personality and managed by a management company

The vast majority of Luxembourg SVs are structured as companies (although securitisation funds get some traction), and SVs set up as partnerships prove attractive for foreign investors already used to this legal form.

The Luxembourg companies law applies to SVs set up as companies, except in relation to a few limited instances where changes required by the Securitisation Law will apply.

Compartments

The Securitisation Law offers the possibility to have ring-fenced compartments within the SV, allowing a clear segregation of assets and liabilities between them. The rights/claims of investors/creditors relating to a specific compartment will be limited to the assets of that compartment, which will be exclusively available to satisfy such rights/claims. As between investors, each compartment shall be treated as a separate entity, except if otherwise provided for in the SV's constitutional documents. Compartments must be authorised in the SV's constitutional documents and are created by a simple decision of the management body of the SV.

A compartment may be liquidated separately to the other compartments of the SV.

In addition, the modernised Securitisation Law now offers the possibility for financial statements and profit distributions of an equity financed compartment to be approved solely by its shareholder(s).

Limited recourse, non-petition and subordination

There is statutory recognition of contractual limited recourse, non-petition and subordination (ie tranching) of the financial instruments issued by Luxembourg SVs, which offers a great means to achieve insolvency remoteness. It is not compulsory to issue different tranches of funding, it is merely enabled for those SVs whose business model is to do so.

A further welcome change brought by the modernised Securitisation Law is that the legal framework now provides for a comprehensive set of rules regarding the ranking of the financial instruments issued by the SV (units, shares or debt instruments, for example).

Supervision

Nearly all Luxembourg SVs are unregulated. Indeed, provided an SV does not (a) offer its financial instruments to the public and, cumulatively, (b) does not do so on a continuous basis, it does not need to be regulated under Luxembourg law. Conversely, if it were to both (a) offer financial instruments to the public and (b) do so on a continuous basis, it would need to be regulated by the CSSF.

Offer to the public

In relation to Luxembourg SVs, financial instruments issues are not considered to be offered to the public if they are issued either (a) only to professional clients, within the meaning of the Law of 5 April 1993 on the financial sector (the **1993 Luxembourg Banking Law**), or (b) on a private placement basis only. Similarly, financial instruments' issues whose denominations equal or exceed €100,000 are assumed not to be issues to the public.

A stock exchange listing does not in itself constitute an offer to the public. In determining whether an issuance constitutes an offer to the public, a look through basis will be applied in relation to any intermediate offering distribution/mechanism.

Issue on a continuous basis

As now clarified in the Securitisation Law itself, an offer will be deemed to be made on a "continuous" basis if more than three issues of financial instruments are made per year (taking into account the total number of issues of all compartments).

For unregulated SVs, no application to the CSSF is required. Furthermore, there is no regulatory requirement to appoint a regulated administrator, manager or custodian, nor is there any regulatory oversight of the SV's documents or approval of the SV’s board members.

It is not necessary for an unregulated Luxembourg SV to issue any form of private placement memorandum, prospectus, or offer document, provided the issue of financial instruments falls within one of the exemptions under the Luxembourg Prospectus Law implementing the EU Prospectus Directive (which for an unregulated SV, would often overlap closely with the Securitisation Law's approach to offers to the public in any event).

Asset management and disposal

An SV can now securitise risk portfolios actively managed by the vehicle itself or a third party (collateralised loan or debt obligations for instance) on the condition that its financial instruments are issued through a private placement. This is a key change compared to the previously applicable passive management approach, paving the way for further CLOs and CDOs structuring in Luxembourg.

An SV may manage its assets itself or entrust such management to third parties (including the assignor or originator of the assets) and/or appoint a third-party servicer, without the need for such parties to apply for a license under the 1993 Luxembourg Banking Law.

Granting of security

Under the previous regime, an SV could only grant security over its assets either (i) for the purpose of securing its own obligations in connection with the securitisation of those assets, or (ii) in favour of its investors, and any security granted in violation of this rule was to be declared null and void.

The Securitisation Law now provides for a more flexible regime by allowing an SV to give security for obligations relating to the securitisation operation, opening up the possibility to have security interests granted over the securitised portfolio to parties that are not direct creditors of the SV and/or for the indebtedness of its subsidiaries.

Main service providers

A Luxembourg domiciliation agent (providing a registered office and other services such as accounting, tax compliance etc) will generally be appointed by an SV. All SVs (including unregulated ones) must also appoint a CSSF-approved independent auditor, who will audit the annual accounts of the SV. Once a year, such accounts must be approved by the SV shareholder(s) and published.

Regulated SVs must entrust the custody of their liquid assets and securities to a credit institution that is established in or has its registered office in Luxembourg.

Certain reporting and other obligations

Luxembourg SVs are subject to certain reporting obligations set out in (i) Regulation ECB/2013/40 of the European Central Bank (the **ECB**) of 18 October 2013 concerning statistics on the assets and liabilities of financial vehicle corporations engaged in securitisation transactions (the **ECB/2013/40 Regulation**) and (ii) circular 2014/236 of the Luxembourg Central Bank dated 25 April 2014 on statistical data collection for securitisation vehicles. In addition, they will be subject to the EMIR (EU Regulation No 648/2012) reporting and other obligations under certain circumstances (ie the entering into derivative contracts).

SVs may also be subject to certain reporting and other obligations under the European Market Infrastructure Regulation (**EMIR**) when entering into derivatives contracts.

New and existing securitisation funds also now have to register with the Luxembourg Trade and Companies Register.

AIFMD

Entities whose sole purpose is to carry out one or more securitisation operations within the meaning of article 1(2) of the ECB/2013/40 Regulation (the **Securitisation Special Purpose Entities**) fall as a principle outside of the scope of the Directive 2011/61/EU of 8 June 2011 on Alternative Investment Fund Managers (the **AIFMD**) and the implementing Luxembourg law of 12 July 2013 (the **AIFM Law**).

However, (i) primary lenders (ie entities whose main business is to originate new loans) and (ii) SVs issuing structured products that primarily offer a synthetic exposure to assets other than loans (non-credit-related assets) and where the credit risk transfer is only ancillary are not considered as Securitisation Special Purpose Entities and are therefore not exempt from the scope of the AIFM Law.

Nevertheless, irrespective of the fact of whether SVs qualify as Securitisation Special Purpose Entities under the AIFM Law, they do not qualify as Alternative Investment Funds (**AIFs**) if:

1. they issue only debt instruments
2. they are not managed in accordance within a "defined investment policy" (within the meaning of the AIFM Law)

EU Securitisation Regulation

The Regulation (EU) 2017/2402 was entered into force on 17 January 2018 and has been applicable to securitisation transactions since 1 January 2019. Particular attention will therefore need to be paid on a case by case basis to the definition of "securitisation" under the Regulation, although in practice many securitisation transactions carried out by Luxembourg SVs will be out of scope, since the definition of securitisation under the Securitisation Law is broader than in the Regulation.

Tax perspective

As indicated above, an SV can be incorporated either as a company (generally a tax opaque entity) or as a (common) fund (*fonds commun de titrisation* – that is to say, a tax transparent entity).

SV companies

An SV constituted as a company should, as a rule, be fully subject to Luxembourg corporate income taxes. For the fiscal year 2024, an SV company would be liable on its worldwide income to the corporate income tax (**CIT**) at a rate of 18.19%, including the 7% solidarity surcharge, and to the municipal business tax (together with CIT the **Income Tax**) at a rate of 6.75%, resulting in an aggregate rate of 24.94%.

In addition, an SV company should be subject to a minimum net wealth tax, in practice generally amounting to €4,815 (although such tax may vary depending on the balance sheet composition of the SV company).

Although an SV company is subject to Income Tax at the aggregate rate provided its assets are appropriately structured, it should be able to achieve tax neutrality given that all interest, dividends and other distributions commitments made to its shareholders or creditors constitute deductible items for Income Tax purposes.

Furthermore, as a Luxembourg fully taxable entity, an SV company is deemed tax resident in Luxembourg for domestic tax purposes. So, as a rule, it should be entitled to double tax treaties (**DTT**) and EU Directives' benefits.

However, due to their passive activities, specific tax regime and economic conduit nature, the Luxembourg tax authorities (**LTA**) generally do not consider Luxembourg SV companies as being the beneficial owners of the income they derive from their investments. In practice, the LTA are therefore usually reluctant to issue tax residence certificates for the purpose of benefitting from either DTT or EU Directives, such certificates being generally requested by foreign tax authorities to grant local withholding tax reduction or reliefs. This situation should be analysed on a case-by-case basis to determine whether an SV company may benefit from a relevant DTT/ EU Directive and consider appropriate tax structuring possibilities.

Luxembourg SVs are, in principle, subject to transfer pricing rules. However, due to Luxembourg's specific legal and regulatory requirements, an SV company cannot bear material risks. As such, the Luxembourg transfer pricing circular n° 56/1 – 56bis/1 on intra-group financing activities cannot be fully satisfied and should not apply to SV companies as they generally own third-party assets

In the context of an SV company, attention should also be paid to the recent developments in the field of the Base Erosion and Profit Shifting **(BEPS)** project conducted by the Organisation for Economic Co-operation and Development (**OECD**) and in particular to the two anti-tax avoidance EU Directives that have been transposed into Luxembourg income tax law and are in force respectively since 1 January 2020 and 1 January 2022 –the Anti-Tax Avoidance Directive I (**ATAD 1)** and the Anti-Tax Avoidance Directive II (**ATAD II)**.

ATAD I focuses on the setting-out of controlled foreign company rules, interest deduction limitation rules (**IDLR**), anti-hybrid rules, exit taxation rules and general anti-avoidance rules. ATAD II has expanded the scope of the hybrid mismatch provisions foreseen by ATAD I and has also implemented the anti-reverse hybrid rules.

SV companies being fully subject to Income Tax, the applications of the IDLR are of particular relevance as they could jeopardise the tax neutrality of the SV company in certain circumstances, depending especially on the legal and tax nature of its assets. In particular, if a SV company realises income other than (i) interest income and (ii) taxable income that is economically equivalent to interest, it would, in principle, be affected by these rules. The corresponding tax deductions of payments and commitments would then be capped at the higher of 30% of earnings before interest, taxes, depreciation, and amortization (**EBITDA**) or €3 million; and may lead to Income Tax leakage.

Although more remote in practice, an SV company may also be impacted by the anti-hybrid rules in case of a difference in the tax qualification of the financial instrument or entity between

Luxembourg and the jurisdiction of the investor.

Finally, Luxembourg SV companies could be impacted by the proposal published by the Council of the European Union on 22 December 2021 to prevent the misuse of so-called shell entities for tax purposes, the Anti-Tax Avoidance Directive III (**ATAD III**) . Discussions around ATAD III seem to have marked a pause at EU level so it is not possible to confirm at this stage whether the adoption of ATAD III in its current form will be pursued or if more substantial changes will be made to it. Similarly it is not possible to predict timing for implementation under the current circumstances.

SV funds

An SV constituted as a fund should be considered as a transparent vehicle for Luxembourg tax purposes and therefore not subject to Luxembourg Income Tax, and out of the scope of application of the IDLR. SV funds are also not subject to minimum net wealth tax. The taxation of income generated by SV funds does in principle not take place at the level of the SV fund itself but rather at the level of its investors on a look-through and prorate basis.

SV funds are typically not entitled to benefit from DTT or EU Directives due to their tax transparent status. Whether a look through approach is available between the investors in the SV fund and the countries of its investments to enable DTT or EU Directives access has to be reviewed from a local perspective as well.

Key tax takeaways

- Luxembourg SVs – both companies and funds – should not be subject to withholding tax in Luxembourg with respect to payments made to their investors
- Luxembourg SVs should be considered as entrepreneurs for VAT purposes. Management services provided to a Luxembourg SV benefit from a VAT exemption in Luxembourg. If they are specific and essential to the management of the SV, collateral management fees and investment advisory fees may also be VAT exempt
- Luxembourg SVs are designed to achieve tax neutrality whether set up as a company or as a fund depending of the structuring constraints at investor and investment levels. It is nevertheless strongly recommended to seek professional advice when establishing and operating a Luxembourg SV vehicle to navigate the intricacies of the rapid evolving tax landscape effectively

Local and Luxembourg tax advice should in particular be sought for all the investments performed by both Luxembourg SVs to undertake proper and careful tax structuring to possibly mitigate local tax leakages.

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