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Luxembourg: Introducing the RAIF and major BEPS developments relevant to funds

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The Reserved Alternative Investment Fund

A year ago, the Luxembourg fund industry welcomed the Reserved Alternative Investment Fund (RAIF). The RAIF is governed by the law of 23 July 2016 (the RAIF Law) and more than 100 RAIFs have been set up since the law was passed. Moreover, in July 2017, the Luxembourg stock exchange listed a RAIF for the first time.

The RAIF: A Newcomer to the Luxembourg Alternative Investment Fund Industry

The longstanding approach of the Luxembourg government has been, to create sound regulation around the fund products (so-called 'product laws') on the one hand, while on the other hand imposing somewhat burdensome licensing requirements on financial service firms active in the production and distribution of such fund products (e.g. managers, depositary banks, fund administrators, IT support, distributors and advisors).

This regulated environment has been beneficial to the development of Luxembourg's role as a global fund domicile by creating a brand for its fund products (UCITS and SIFs) and a label of quality. The downside, however, has undoubtedly been costs, entry barriers and slowness in the regulatory process.

The entry into law in July 2013 of the Alternative Investment Fund Managers (AIFM) Law, implementing in the Grand-Duchy of Luxembourg the Alternative Investment Fund Managers Directive (AIFMD) has had an unforeseen and undesirable effect on the funds industry by introducing an additional layer of supervision – at the level of the alternative investment fund (AIF) itself under the products law, and at the level of its alternative investment fund manager

(AIFM), which may be based in a different country from where the AIF is established.

This dual layer of supervision has created a competitive disadvantage for Luxembourg compared to its traditional competitors (both onshore and offshore) and has accelerated the modernisation and emergence of unregulated vehicles such as a common limited partnership or a special limited partnership appointing an authorized AIFM, giving them access to the European marketing passport.

The international fund promoters' strong appetite for these unregulated vehicles, attested since their implementation in Luxembourg simultaneously with the AIFM Law, is evidence that the funds industry no longer perceived the product laws as a key and essential factor. Instead, reducing administrative burdens and costs, and above all, cutting time-to-market are key motivations for initiators.

The enactment of the RAIF Law demonstrates the willingness and continuing commitment of the Luxembourg government to improve the Luxembourg funds-structuring toolbox in line with market expectations and to widen the marketability of Luxembourg investment funds, thus contributing to the development and success of the European investment fund industry.

The RAIF Law has introduced the possibility of setting up unregulated AIFs, using a variety of corporate and contractual forms, having the same features as our well-known and tested regulated investment vehicles (typically the specialised investment funds – SIF, as well as the investment companies in risk capital – SICAR) but without the regulatory approval and prudential supervision of the Commission de Surveillance du Secteur Financier (CSSF).

The Criteria and Main Features of RAIFs

Pursuant to the RAIF Law, the RAIF must meet the criteria of an AIF in the sense of the AIF Law and appoint a fully authorized AIFM established in Luxembourg or in another EU Member State.

Management and supervision of the RAIF will, therefore, be ensured through the regulated AIFM's supervisory oversight, making sure the RAIF complies with the AIFMD. Thus, the RAIF will benefit from the EU marketing passport available to its AIFM.

RAIFs are exclusively reserved to well-informed investors and subject to a minimum aggregate investment amount of €1,250,000 (including share premiums or value of the partnership interests) that must be reached within 12 months following its set-up.

Similar to existing regulated AIFs, such as SIFs and SICARs, RAIFs may be set up in the forms set out here:

i. partnership limited by shares (société en commandite par actions (SCA), common limited partnership (société en commandite simple (SCS) and special limited partnership (société en commandite spéciale (SCSp));

ii. public limited liability company (société anonyme (SA), private limited liability company (société à responsabilité limitée (SARL), cooperative company in the form of a public limited liability company (société coopérative sous forme de société anonyme (SCOSA)); or

ii. common fund (fonds commun de placement privé (FCP)).

RAIFs may also adopt a variable capital structure by taking the form of an investment company with variable capital (SICAV) or a fixed capital structure under the form of an investment company (SICAF).

The set-up of a RAIF will have to be recorded by a notarial deed in front of a Luxembourg notary, who will ensure that the RAIF is registered on a list held by the Luxembourg trade and companies register within 10 days following its creation.

All other features and requirements of the RAIF regime are similar to those of SIFs and SICARs, including the terms of investment policy and eligible assets.

Such features include, amongst others, the possibility for the RAIF to be organised with segregated compartments and/or multiple class structures, flexible capital calls and redemption mechanics, no legal constraints in respect of dividend distributions, reserves, etc.

In addition, RAIFs will have to appoint a Luxembourg-based administration agent, a Luxembourg depositary bank (or a Luxembourg branch of depositary bank registered in the EU) and an external auditor. Depending upon its investment policy, the RAIF will follow SIF or SICAR risk-spreading requirements and tax regimes.

If the RAIF elects to adopt the SIF model, it will be subject to an annual subscription tax of 0.01 per cent on its net assets (with certain exemptions available) and will be exempt from municipal business tax, corporate income tax and net wealth tax. If adopting the SICAR model, the RAIF will be fiscally treated as a SICAR: it will be fully subject to tax but any income arising from qualifying investments in risk capital is exempt and it should benefit from double tax treaties (unless established under the form of an SCS or SCSp, in which case, being a tax transparent entity, it will benefit from a tax neutral regime). Finally, management services provided to a RAIF, whether set up as a SIF or a SICAR, will be exempt from VAT.

New Transfer Pricing Circular Letter

On 27 December 2016, the Luxembourg direct tax authorities issued a new circular letter on intra-group financing transactions (circular letter LIR n° 56/1 56bis/1 – the Circular) which replaces the previous one from 2011. The Circular has been approved by the European Commission and complies with the measures set forward by Actions 13-15 of the OECD BEPS project. Although effective since 1 January 2017, concerned companies have until the end of 2017 to comply with the provisions laid down in the Circular, which applies the full principles of the OECD Transfer Pricing (TP) Guidelines

(i.e. the at-arm's-length principle, comparability, substance over form/economic reality).

Following the Circular, companies engaged in intra-group financing transactions should have sufficient substance in terms of the ability to assess and control the risk related to such activity (organizational substance), as well as to bear such risk (economic substance).

Organizational Substance

Organizational substance refers to the functions performed by the Luxembourg company. Should the latter be considered as the beneficial owner of the interest received, the functional profile of the company should be different to that of a mere agent or nominee. It would be of utmost importance that the board/employees of the Luxembourg company are involved in the decision-making process and have full access to all information needed to make such decisions. The decision-making process should therefore be reflected in the board minutes.

Companies that do not comply with the above substance requirements may be subject to an impromptu exchange of information by the Luxembourg tax authorities. Even though the company would still be considered a Luxembourg tax resident, the latter may, following such exchange, not be viewed as the beneficial owner by the foreign tax authorities which could have an impact on the access to double tax treaties and result in withholding tax issues.

Economic Substance

Apart from organizational substance, the company should have an adequate amount of equity to assume the risk that is associated with the investments owned by the Luxembourg company, in particular the risk of credit default. A minimum level of equity will therefore be determined through the use of appropriate TP methods and will constitute the basis of the at-arm's-length remuneration of the company. Hence the adequate level of equity needs to be determined on a case-by-case basis, and not on a lump sum basis as used to be the case under the old circular (1 per cent of the assets, capped at the amount of €2,000,000).

The most common method used to quantify the risk of a Luxembourg company (which should be considered as the beneficial owner of the interest received), is the expected loss model approach, which the Luxembourg tax authorities expressed as being their preferred method.

It should, however, be noted that the risk may not totally be allocated to the Luxembourg company but shared with other parties in the structure, especially in fund structures. Such a risk-sharing model being the economic reality, the latter should be reflected in the pricing, whilst the portion of risk remaining in Luxembourg needs to satisfy the beneficial ownership.

The Multilateral Instrument

The multilateral instrument (MLI) aims for the swift implementation (by more than 100 jurisdictions, including Luxembourg) of tax treaty measures set forward by Actions 2, 6, 7 and 14 of

the BEPS project. Luxembourg has adopted a restrictive approach and one of the key features is the introduction of the principal purpose test (PPT) in double tax treaties in order to avoid treaty shopping (Action 6 of the BEPS Project). The PPT clause aims to deny treaty benefits to taxpayers where there is clear evidence that a given arrangement or transaction was set up for the principal purpose of obtaining that benefit.

In early 2017, the OECD published a discussion draft on 'Non-CIV Examples'. Non-CIV is a term widely used by the OECD BEPS Project to refer to the broad variety of, amongst others, private equity and AIF vehicles that do not meet the OECD strict criteria for collective fund vehicles (i.e. widely held, holding a diversified portfolio of securities, themselves regulated – in brief 'UCITS-type' funds).

The purpose of the discussion draft is to provide for positive examples of Non-CIVs, i.e. where the benefits of a treaty should not be denied. This is important given that fund structures should be tax neutral in order to be efficient, i.e. the tax treatment of the investors should not be more detrimental than if the latter were holding the investments directly.

The conclusion of the draft is that private equity funds should be able to retain tax treaty benefiting structures in the post-BEPS environment, provided that the arrangements made have strong commercial drivers supporting them. In addition, platforms, SPVs or holding companies will be required to have the high level of substance needed to satisfy one of the main goals of the BEPS project, which is to have income flows much more closely aligned with the economic activity that generates that income.

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