

Luxembourg's Position in the World Financial Industry

By Jamal Afakir

Based on a recent survey issued by Eurostat, the statistical office of the European Union (EU), Luxembourg was the largest EU investor outside the European territory in 2009, representing a 42% share of the EU member states in total. Luxembourg is also the first recipient within the EU of foreign direct investment (FDI) from investors located outside the EU, with its share representing 44% of the total EU FDI.

The predominant place given Luxembourg in capital flows attraction, for non-EU investors as well as EU investors, is mainly due to its position as the leading European investment fund centre ahead of France, the UK or Germany, as well as the worldwide leader for fund distribution. In addition, its central position within western Europe, its role as a founding member of the EU, the stability of its government and social environment may explain the ability of Luxembourg to gain such a leading position in the financial industry over the past 20 years.

Aside from collective investment funds and bond issuers, many financial parties have set up investment hubs in Luxembourg. This is particularly true for private equity firms and private equity real estate firms. A review of publicly available information highlights that out of the 30 largest private equity firms in the world, 26 invest through Luxembourg. The remaining four simply do not invest outside of the US. The figures are approximately the same regarding the 30 world's largest private equity real estate firms, out of which 80% invest through Luxembourg vehicles or platforms.

In addition to its leading position in the collective investment fund, private equity fund and private equity real estate fund industries, Luxembourg is positioning itself to become the major European center for Islamic finance funds and investors.

Positioning towards Islamic finance and GCC countries

According to Luxembourg for Finance, the first Shariah compliant insurance company ever set up in Europe chose Luxembourg as its domicile, back in 1983. In September 2009, 15 Sukuk were listed and traded on the Luxembourg Stock Exchange. Meanwhile, 39 Shariah compliant investment funds and sub-funds were established in Luxembourg. These figures do not take into consideration the large number of private Islamic finance deals structured through Luxembourg, either in the field of real estate (a majority of French or the UK prime real estate assets is held directly or indirectly by Luxembourg vehicles), or private equity.

Although a very simplistic shortcut, the active link between Luxembourg and Islamic finance investors may be highlighted by the fact that Luxembourg hosted the largest GCC investment in the EU in 2008, receiving EUR59.3 billion (US\$77.5 billion), and representing almost 93% of the GCC investments in the EU in 2008. In the meantime, Luxembourg was the leading EU investor in the GCC with EUR12.7 billion (US\$16.6 billion), investments, corresponding to 67% of the total EU investments in that region of the world in 2008.

Islamic finance package

Luxembourg undertook specific actions to increase its value proposition to Islamic finance investors with an Islamic finance package that includes (i) setting up a working group dedicated to making Luxembourg more attractive to Islamic finance, (ii) the issuance by the Lux-

embourg tax authorities of guidelines to ensure a favourable tax environment for Islamic finance transactions, (iii) an audit regarding the benefits for the government, or entities belonging to the government, in using Islamic finance instruments such as Sukuk as an alternative source of financing and (iv) an application by the Luxembourg Central Bank to become the first 'non-regional' associate member of the Islamic Financial Services Board (IFSB), the international regulator of Islamic financial markets.

The package has since been implemented. The admission of the Luxembourg Central Bank as the first member state of the European Union to become a member of the council of the IFSB was approved at the 15th meeting of the council of the IFSB held on the 23rd November 2009 in Kuala Lumpur. On the 12th January 2010, a Luxembourg delegation attended a working seminar in Dubai, "to explore opportunities for greater collaboration in financial services between the Grand Duchy and the MENA region" according to a Luxembourg for Finance report.

Luxembourg direct tax law

On the 12th January, 2009, the Luxembourg direct tax administration (LDTA) released a circular clarifying the tax treatment applicable to Murabahah and Sukuk under Luxembourg direct tax law. The circular also provides the LDTA with an understanding of the main characteristics of Islamic finance and so-called Islamic finance investment instruments.

The circular states that under a Murabahah transaction, profit derived by the Islamic financing party will be recognised for Luxembourg direct tax purposes on a linear basis during all the Murabahah payment price deferral period, notwithstanding the effective instalment payments (hereafter the 'Luxembourg tax spreading'), subject to conditions.

The circular assimilates Sukuk to conventional finance debt instruments for Luxembourg direct tax purposes. Yield on Sukuk is similarly qualified as interest and treated as tax deductible if incurred in the interest of the issuer. The circular also indicates that the Sukuk yield should not be considered as a dividend distribution for Luxembourg tax purposes and confirms that it is not subject to Luxembourg withholding tax.

Registration duty and VAT treatment

On the 17th June 2010, the Luxembourg indirect tax authorities issued a second circular which provides guidelines clarifying the Luxembourg VAT and registration duty treatment applicable to Ijarah and Murabahah transactions and structures.

In essence, registration duty is only due once in the case of Murabahah transactions, provided that certain conditions are met, and is based on the initial purchase price paid by the intermediary Murabahah seller. The mark-up profit is not subject to Luxembourg registration duty under the same conditions. Additionally, this second circular provides that special purpose vehicles (SPVs) entering into Murabahah or Ijarah transactions qualify as VAT taxable persons. This offers advantageous VAT options in the context of Murabahah and Ijarah transactions where the underlying asset is a real estate property.

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Implementation of private Islamic finance transactions

The Luxembourg practice towards Islamic finance covered both retail investors through the set up of Luxembourg undertakings for collective investments in transferable securities in the one hand, as well as investment banking and asset management in the other, especially in the fields of private equity and real estate.

Investments funds

The head of asset management at European Finance House recently commented: "We have selected Luxembourg as the home for our first mutual fund range due to its strong regulatory framework, excellent investor protection and high recognition across multiple jurisdictions."

Luxembourg offers a wide range of mutual investment vehicles offering different levels of regulations and investor protection, as well as different investment strategy opportunities. Such flexibility allows Islamic finance asset managers to target various types of investors, being mutual funds, high net worth, corporations or individuals, being resident in the EU or not. An increasing number of Luxembourg mutual funds are set up under the regulations of the Luxembourg specialised investment fund (SIF). The SIF can be set up under the form of a company, generally with variable capital or or co-ownership.

Compared to other available Luxembourg investment funds, the SIF offers greater flexibility in terms of investment policy as well as a more relaxed regulatory regime. These characteristics are justified by the will of the lawmaker to design a specific investment fund that would be marketed towards institutional and professional investors, as well as well informed investors, such as investors who confirm in writing that they adhere to the status of 'well-informed' investors and who either (i) invest a minimum of EUR125,000 (US\$163,000) or (ii) have been assessed by a credit institution, an investment firm or a management company which certifies the investors' ability to understand the risks associated with investing in the SIF.

From a Luxembourg tax perspective, SIFs are exempted from Luxembourg corporate income and net worth tax. They are subject to an annual subscription tax at a rate of 0.01% assessed on their net asset value. Profits repatriated in whatsoever form from the SIF to its investors are not subject to Luxembourg withholding tax.

SIFs have recently been used as umbrella funds through which non-EU investors, such as GCC resident high net worth individuals, US investors and offshore funds, have invested in private equity investments or real estate investments.

Private equity and real estate investments

Being a founding member state of the EU, Luxembourg enjoys all the benefits of EU rules and regulations, especially in the context of corporate taxation. In particular, the implementation of the EU parent subsidiary directive by the EU member states should generally lead those states to be exempt from withholding tax dividends paid by their resident companies to a Luxembourg company, under specific holding percentage and holding period requirements.

At the level of the Luxembourg recipient of the dividends, such dividends, as well as capital gains derived from the sale of such shareholdings, should be exempt from Luxembourg corporate income tax under specific holding percentage/acquisition costs and holding

period requirements. This exemption, also known as the Luxembourg participation exemption regime, is total, meaning there is no minimum corporate tax to be left in Luxembourg.

Luxembourg private equity and real estate investments would generally be structured through the set up of SPVs, taking often the form of public companies, limited liability companies or partnership limited by shares. The interposition of SPVs is usually driven by the need for general partners and investors to ensure that risk is ring fenced - distressed assets should not adversely impact other assets held by the investors through Luxembourg.

In the case of private equity and in some instances in the case of real estate investments, Luxembourg SPVs acquire or set up local holding companies in the jurisdiction where the target is located. Such holding company enters into financing agreements (Murabahah in the case of real estate transaction or instance) and applies to the local group tax consolidation regime, to allow for the offsetting of operating income realized at the level of local operating subsidiaries against financial expenses incurred at the level of the local holding company.

Luxembourg SPVs are in principle fully subject to Luxembourg corporate income tax but given the nature of the assets which is qualifying participations, the income and gains generally derived by the Luxembourg SPV should be 100% tax exempt under the Luxembourg participation exemption regime, if certain conditions are met. Alternatively, SPVs may hold local assets directly from Luxembourg. This was particularly true for French real estate assets prior to 2009, and is still the case for German and UK real estate assets. The double tax treaties concluded between Luxembourg and those jurisdictions provide, under conditions, for specific exemption in the jurisdictions where the real estate asset is located, either in case of a share deal (Germany), or an asset deal (the UK).

Conclusion

Despite the efforts of the UK and France to promote an attractive framework for Islamic finance investors and professionals, Luxembourg benefits from its historical prominent position in investment structuring and Islamic finance structuring, especially taking into consideration the new tax framework implemented during the first semester of 2010.

Challenge consists now in informing and educating Islamic finance professionals and investors about the competitive advantage of Luxembourg compared to other jurisdictions, especially offshore centres such as the Channel Islands and Cayman, Bermudas and the British Virgin Islands. The fact that EU direct investments made by investments funds located in those jurisdictions would bear significant tax burden upon repatriation of profits should in itself be a key argument to promote Luxembourg as an EU onshore alternative. More promisingly, Luxembourg's flexible investment funding, legal and regulatory framework should become a major decision factor for Islamic fund promoters and investors in the coming months. ⁽⁹⁾

Jamal Afakir

Director

ATOZ Tax Advisers

Email: jamal.afakir@atoz.lu

Jamal advises on Islamic tax structures.