Investments into distressed debt:

Taking a look at suitable investment vehicles

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Over the past 20 years, private debt investments have become increasingly popular. A sub-category of private debt investments are investments into distressed debt, which are an important niche market which soared over the last decade, contributing to the Grand Duchy's success as a prime location for Alternative Investments.

Broadly speaking, investments into distressed debt rely on the acquisition of non-performing loans or other distressed debt instruments at a price below par value. Thereafter, the idea is to realize capital gains upon the disposal or repayment of the debt instrument once the financial situation of the debtor improves.

Investments into distressed debt may be made via different investment vehicles including, in particular, Luxembourg companies, securitization vehicles and funds, or a combination thereof. In some cases, investments may also involve foreign investment vehicles (for example, a local securitization company). The choice of the optimal investment platform may depend on a number of factors such as the preferences of the investors, requirements from the perspective of the investment jurisdiction(s), constraints from a regulatory perspective and the magnitude of the investment.

Fund vehicles

The Luxembourg legal framework provides for a number of different fund regimes such as the Specialized Investment Fund ("SIF"), the Reserved Alternative Investment Fund ("RAIF") that can be established in contractual form (mutual fund, *fonds commun de placement*, "FCP"), as a limited partnership ("SCS" or "SCSp") or in corporate form. While the SIF is a regulated vehicle that benefits from a light regulatory regime, the RAIF is only indirectly regulated via the regulation of the Alternative Investment Fund Manager ("AIFM"). Therefore, the RAIF regime is very beneficial when it comes to time to market.

A SIF or a RAIF may be established as an umbrella fund with several compartments (each compartment may follow a different investment strategy). The SIF law does not provide for any specific investment restrictions but refers to the concept of risk-spreading (i.e. a SIF may not invest more than 30% of its assets or commitments to subscribe in securities of the same nature issued by the same issuer). The same risk-spreading requirement should apply in case of a RAIF that adheres to the SIF regime.

While funds established in corporate form are exempt from Luxembourg corporate income tax ("CIT"), municipal business tax ("MBT") and net wealth tax ("NWT"), funds established in contractual form or as a limited partnership are not even subject to CIT, MBT or NWT. Distributions made by a Luxembourg fund are not subject to Luxembourg withholding tax. Likewise, capital gains realized by non-resident investors upon disposal of fund units are not taxable in Luxembourg. However, a SIF or a RAIF is subject to an annual subscription tax ("taxe d'abonnement") of 0.01% calculated on the fund's net asset value.

Investments may further be made via a (special) limited partnership ("SCS", "SCSp") which qualifies as an alternative investment fund ("AIF") and has to be managed by an AIFM. Here, the fund would neither be subject to CIT, MBT and NWT, nor to a subscription tax.

Securitization Vehicles

Securitisation is the process whereby illiquid assets or rights are pooled and transformed into tradable and interest-bearing financial instruments that are sold to capital market investors. Investments in distressed debt assets may be organised through a securitization company or a securitization fund (even though the former is much more common than the latter). Securitization companies may create several compartments for different investors with a different investment policy.

A securitization company is generally subject to CIT and MBT at an aggregate rate of 24,94% (in the municipality of Luxembourg-City). Securitization companies are not subject to transfer pricing rules but their taxable income should not be negative (after deduction of operational and other costs)

The interest limitation rules may limit the deductibility of interest expenses incurred by the securitization company when the latter incurs exceeding borrowing costs (i.e. when the entity incurs more interest expenses or economically equivalent expenses than interest income and economically equivalent revenues).

When income derived from the investment can be classified as interest income (under Luxembourg GAAP, income up to the amount of the original reasonable expectation may under certain conditions be classified as interest income), the interest limitation rules should not be relevant as the company would not incur exceeding borrowing costs. Should the securitization company incur exceeding borrowing costs, the deductibility of interest expenses would be limited to 30% of the EBITDA with a EUR 3m safe harbour.

The interest limitation rules also provide for a carve-out for standalone entities which are entities that (i) are not part of a consolidated group for financial accounting purposes and (ii) have no associated enterprise or permanent establishment. Securitization companies are generally not part of a consolidated group for financial accounting purposes and have no permanent establishment abroad. Thus, if it can be established that the securitization company has no associated enterprise that owns a participation of 25% or more in terms of voting rights, capital ownership or profit entitlement, the standalone entity exception should apply.

Investments may also be organised via a securitization fund established in the legal form of a FCP which is managed by a management company. Securitization funds are no subject to CIT, MBT and NWT and exempt from subscription tax.

Last but not least, according to a bill of law that is meant to modernise the securitization law, securitization will become accessible to new legal forms including the (special) limited partnership ("SCS", "SCSp") that are characterised by significant legal flexibility. From a tax perspective, securitization vehicles established in the legal form of a partnership are not subject to CIT, MBT and NWT.

Luxembourg Companies

Luxembourg companies are generally subject to corporate income tax and municipal business tax at an aggregate rate of 24.94% (in the municipality of Luxembourg). Income derived from distressed debt investments (interest income and capital gains) are taxable as part of the company's worldwide income.

When investments are financed by debt instruments, expenses incurred by the Luxembourg company (for example, interest expenses) should generally be deductible for tax purposes. The Luxembourg company has, however, to realize an arm's length remuneration in regard to its investment activity.

The interest limitation rules may limit the deductibility of interest expenses incurred by the company when the latter incurs exceeding borrowing costs. As long as the income derived from the investment can be classified as interest income under Luxembourg GAAP, the interest limitation rules should not be relevant (as the company would not incur exceeding borrowing costs).

Should the company incur exceeding borrowing costs, the deductibility of interest expenses would be limited to 30% of the EBITDA with a EUR 3m safe harbour. However, payments under derivative instruments that are not interest expenses or economically equivalent expenses do not fall within the scope of the interest limitation rules.

Combinations of investment vehicles

Overview

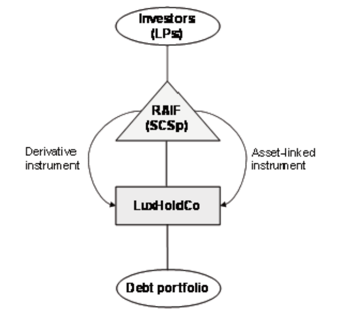
Investments into distressed debt may in practice involve more than one entity. The reason for that may, for example, be a requirement or a limitation from a regulatory perspective, or a preference on the part of the investors. One example involves a Luxembourg fund that invests via a Luxembourg company that functions as an investment platform. In some jurisdictions, investments may be made via local securitization vehicles because direct investments might not be feasible or uncommon. The investments may also be driven by investor preferences. As one example, some German institutional investors may have a preference for an investment into securities issued by a securitization company rather than investing into fund units as such an investment falls within a different investment category (i.e. investments must not exceed certain quotas).

Luxembourg fund with an investment platform

A Luxembourg fund (here, a Reserved Alternative Investment Fund, "RAIF") may invest via a Luxembourg company ("LuxHoldCo") into distressed debt. LuxHoldCo may, for example, be financed by an asset-linked debt instrument that bears variable interest depending on the performance of the underlying investments. Crucially, LuxCo has to realize an arm's length remuneration that will be subject to CIT and MBT.

As a variation, LuxHoldCo may be financed with an asset-linked instrument that tracks the interest income derived from the investment portfolio minus an arm's length remuneration. In addition, LuxHoldCo may enter into a derivative instrument with the RAIF that would largely transfer the downside risk and upside potential of the investment to the RAIF (i.e. capital gains and losses). Payments under such derivative instrument may not fall within the scope of the interest limitation rules.

The following chart depicts a potential investment structure.

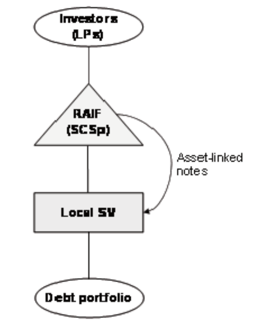


Luxembourg fund with local securitization vehicle

A Luxembourg fund (here, a Reserved Alternative Investment Fund, "RAIF") may invest via a local securitization vehicle ("Local SV") into distressed debt owed by borrowers resident in the residence state of the Local SV. Local SV may issue asset-linked notes to the RAIF that track the performance of the Local SV's investment portfolio.

The following chart depicts a potential investment structure.

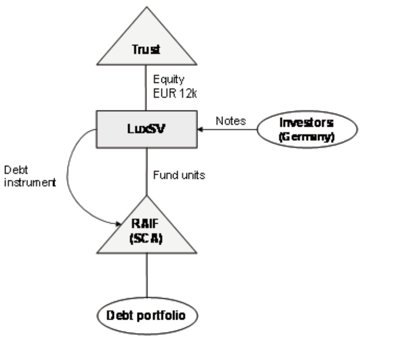
Securitization vehicles are generally not taxable or, when the entity is taxable, payments under the notes should be deductible for tax purposes. The RAIF established in the legal form of a special limited partnership ("SCSp") is not subject to CIT, MBT and NWT.



Securitization of fund units

A Luxembourg securitization vehicle ("LuxSV") issues notes to its German institutional investors. LuxSV invests into fund units issued by a Luxembourg Reserved Alternative Investment Fund ("RAIF") that invests into distressed debt assets. The RAIF is further financed by a debt instrument that bears variable yield linked to the performance of the underlying investments.

The following chart depicts a potential investment structure:



The income derived by the RAIF should be exempt from CIT, MBT and NWT. Payments made by the RAIF to LuxSV should not be subject to Luxembourg withholding tax. At the level of LuxSV, the income derived from the RAIF should be fully taxable. However, interest expenses incurred in relation to the notes should be deductible for Luxembourg tax purposes.

Conclusion

Luxembourg's diverse and flexible legal, regulatory and tax environment provides for various opportunities to organise investments into distressed debt in a tailor-made fashion.

Given the current economic environment, it can be expected that investments into distressed debt will soar in the months and years to come and provide investors with interesting investment opportunities.

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