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Luxembourg Provides Opportunities for Debt Investments

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Oliver Hoor of ATOZ Tax Advisers (Taxand Luxembourg) analyzes how debt investments may be efficiently made via Luxembourg investment vehicles or a combination of Luxembourg (and potentially foreign) investment vehicles.

Introduction

Debt investments gained massive traction following the last financial crisis in 2008 and 2009 when banks, hampered by post-crisis regulations, were unwilling to provide businesses and investors with sufficient loan financing. This created a need for private debt investments, filling the gap left by banks and offering investors promising yields and portfolio diversification.

The current economic situation, fueled by several crises since the beginning of this decade, will further boost the need and opportunities for private debt investments in 2023 and beyond. The recent failures of the First Republic Bank, Silicon Valley Bank, Signature Bank, and Silvergate Bank in the United States, and the rushed takeover of Credit Suisse by UBS in Switzerland further show weaknesses in the banking sector that may result in reduced bank lending.

The assets under management in debt by regulated Luxembourg funds such as Reserved Alternative Investment Funds (“RAIFs”) and Specialized Investment Funds (“SIFs”) exceeded EUR 260 billion in June 2022, representing a year-on-year growth of more than 45%. These impressive developments are indicative of the positive outlook for this asset class.

Business Case and Investment Strategies

Debt investments provide interesting opportunities for both investors and borrowers. Investors are presented with attractive investment opportunities that provide risk-adjusted returns. As such, debt investments have become a broadly accepted category of a diversified portfolio and is now part of many asset allocation strategies. Moreover, debt investments provide investors with access to markets that might otherwise be inaccessible to investors such as increased access to infrastructure debt that provide long-term stable returns.

Likewise, debt investments are beneficial for borrowers. At a time of quantitative tightening where banks are increasingly more hesitant to grant debt funding to businesses and investors, private debt investments may fill the gap. For example, when banks have a reduced appetite to finance investments such as real estate with previous debt levels, debt investments may close the gap between internal funding and bank funding. In addition, banks may have incentives to sell non-performing loans and distressed debt assets to debt funds with a view to take these risky positions off their balance sheets.

Debt investments may follow a wide range of investment strategies with varying risk/return profiles including, in particular:

1. **Direct lending strategies** primarily focus on providing loans to private mid-market companies. Regulations following the financial crisis of 2008/2009 reduced the capacity commercial banks had to lend to many of these businesses. As a result, non-bank lenders such as institutional private debt investors have helped to fill that gap.
2. **Distressed debt investing** (or investments into non-performing loans) refers to acquiring debt instruments of companies experiencing some financial or operational difficulties. Distressed debt investors often purchase debt instruments at a significant discount to face value, expecting to profit as a company goes through a bankruptcy or restructuring to improve long-term performance.
3. **Mezzanine lending** is a hybrid of debt and equity financing. Mezzanine lenders typically have the right to convert to an equity interest in the company in case of default (generally after senior lenders are paid).
4. **Real estate debt:** The most common strategy is direct lending for real estate acquisitions. This may include the buying and selling of securitized real estate loans in the secondary market. The risk profiles of these investments vary based on the underlying assets.
5. **Infrastructure debt:** Debt used for infrastructure development and investment in existing assets, generally with longer terms (30+ years) because of the extended useful lifetime of the assets.
6. **Special situations lenders** typically buy debt instruments well below par, looking to profit from a positive resolution to any issue(s) affecting the company. Some special situations may include litigation or bankruptcy.

Luxembourg Investment Vehicles

Overview

Luxembourg's legal framework provides for different fund regimes, securitization vehicles and companies that may be suitable for investments into debt. The choice of the optimal investment vehicle (or a combination of investment vehicles) must be determined on a case-by-case basis.

Debt investments further require an analysis from both a Luxembourg and local regulatory perspective. In particular, direct lending strategies may be subject to limitations that may be addressed through the investment via specific vehicles (for example, local securitization vehicles) or a fronting bank that grants the loan to the borrower and subsequently transfers the loan to the debt fund.

Fund Vehicles

Luxembourg's legal framework provides for a number of different fund regimes such as the SIF and the RAIF that can be established in corporate, partnership, or contractual form ("*fonds commun de placement", "*FCP").

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") that manages the RAIF. This makes the RAIF regime very beneficial in terms of time-tomarket.

A SIF or a RAIF may be established as an umbrella fund with several compartments where each compartment may have different investors and 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).

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 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 an unregulated (special) limited partnership ("SCS" or "SCSp") which qualifies as an alternative investment fund ("AIF") and must be managed by an AIFM. Here, the fund would neither be subject to CIT, MBT and NWT, nor to subscription tax.

While Luxembourg funds may directly invest into debt instruments, in practice, investments are commonly made via a Luxembourg company and/or Luxembourg or foreign securitization vehicle.

Securitization Vehicles

General

Securitization vehicles may be established in the form of a securitization company, fund, or partnership. However, most securitization vehicles are most commonly established in the form of a securitization company that can create several compartments for different investors with different investment policies.

A securitization company is generally subject to CIT and MBT at an aggregate rate of 24.94% (in the municipality of Luxembourg City). While securitization companies are not subject to transfer pricing rules, their taxable income should not be negative (after deduction of operational costs and interest expenses). A securitization company is further subject to Luxembourg minimum NWT.

When it comes to CIT and MBT, the interest limitation rules must be considered that may limit the deductibility of interest expenses incurred by the securitization company when the latter incurs exceeding borrowing costs (i.e., when the interest expenses exceed the interest income and economically equivalent revenues).

When the underlying assets are interest bearing debt instruments, the interest limitation rules should not result in the non-deductibility of interest expenses as the interest income should exceed (or at least correspond to) the amount of interest expenses incurred in relation to debt instruments issued to the investors.

However, when a Luxembourg securitization company incurs “exceeding borrowing costs,” the deductibility of such exceeding borrowing costs is generally limited to 30% of the earnings before interest, taxes, depreciation, and amortization (“EBITDA”). The term “exceeding borrowing costs” is defined as the excess of borrowing costs over interest income and other economically equivalent taxable revenues. Notably, the interest limitation rules provide for a EUR 3m safe harbor up to which exceeding borrowing costs are deductible without limitation.

Alternatively, securitization vehicles established as a securitization fund in FCP are managed by a management company. These funds are not subject to CIT, MBT, or NWT, and are exempt from subscription tax.

Securitization vehicles that are established as a (special) limited partnership are characterised by significant legal flexibility. From a tax perspective, these securitization vehicles are not subject to CIT, MBT, NWT, or subscription tax.

Excursus: Securitization Companies, Interest Limitation Rules and Standalone Entity Exception

When a securitization company invests in distressed debt assets (or non-performing loans), the interest limitation rules may limit the deductibility of interest expenses. Broadly speaking, distressed debt investments rely on the acquisition of debt instruments at a price below par value on the secondary market. Thereafter, the idea is to realize a return upon the disposal or repayment of the debt instrument once the financial situation of the debtor improves.

When the income realized in relation to assets cannot be classified as interest income (or economically equivalent revenues) the securitization company would incur exceeding borrowing costs (in relation to the debt instruments issued to the investors) which may not be fully deductible in accordance with the interest limitation rules.

However, the interest limitation rules 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 (“PE”).

Securitization transactions are often organized via so-called “orphan” vehicles where the shares of the Luxembourg securitization company (often a minimum participation of EUR 12,000) are held by a third party disconnected from both the originator of the securitization and the investors. These orphan arrangements are industry standard in many parts of the securitization sector and respond to commercial and regulatory imperatives (independence of governance and deconsolidation for regulatory purposes, notably).

The third parties holding the Luxembourg securitization company shares are often charitable trusts or foundations such as Dutch Stichtings. The question then arises as to whether securitization companies held in such orphan structures may fall within the scope of the standalone entity exception. In substance, it may seem obvious that they should be within the scope of the exception as the fundamental purpose of orphan arrangements is to create a vehicle that is a standalone for a host of non-tax reasons.

The securitization company issues notes or other debt instruments to the investors and uses the funds received to acquire a portfolio of assets such as distressed debt. The interest paid under the debt instruments issued by the securitization company generally corresponds to the income derived from the investments (minus the costs incurred by the securitization vehicle).

Given that the income derived from the underlying assets is largely transferred to the investors (for example, in the form of interest paid under notes), the only payments made by the securitization company to the charitable trust are (limited) profit distributions and capital repayments at the end of the lifetime of the investment period.

Securitization companies in orphan structures are generally not part of a consolidated group for financial accounting purposes, nor do they have a PE in another jurisdiction. Therefore, the standalone entity exception should apply (i.e., the interest limitation rules should not apply) as long as the securitization company has no associated enterprise, be it an individual or an entity, that own a participation of 25% or more in terms of voting rights, capital ownership or profit entitlement.

Thus, in the context of an orphan structure, whether the securitization company has any shareholder that owns a participation of 25% or more must be analyzed. A trust is a three-party fiduciary relationship in which the trustor or settlor transfers assets to the trustee for the benefit of a third party (i.e., one or more beneficiaries). In the case of an orphan structure, the beneficiaries of a trust may be charities or the trust itself may be a charity with a defined class of beneficiaries. Thus, the legal ownership rests with the trust, whereas the beneficial or economic ownership belongs to the beneficiaries.

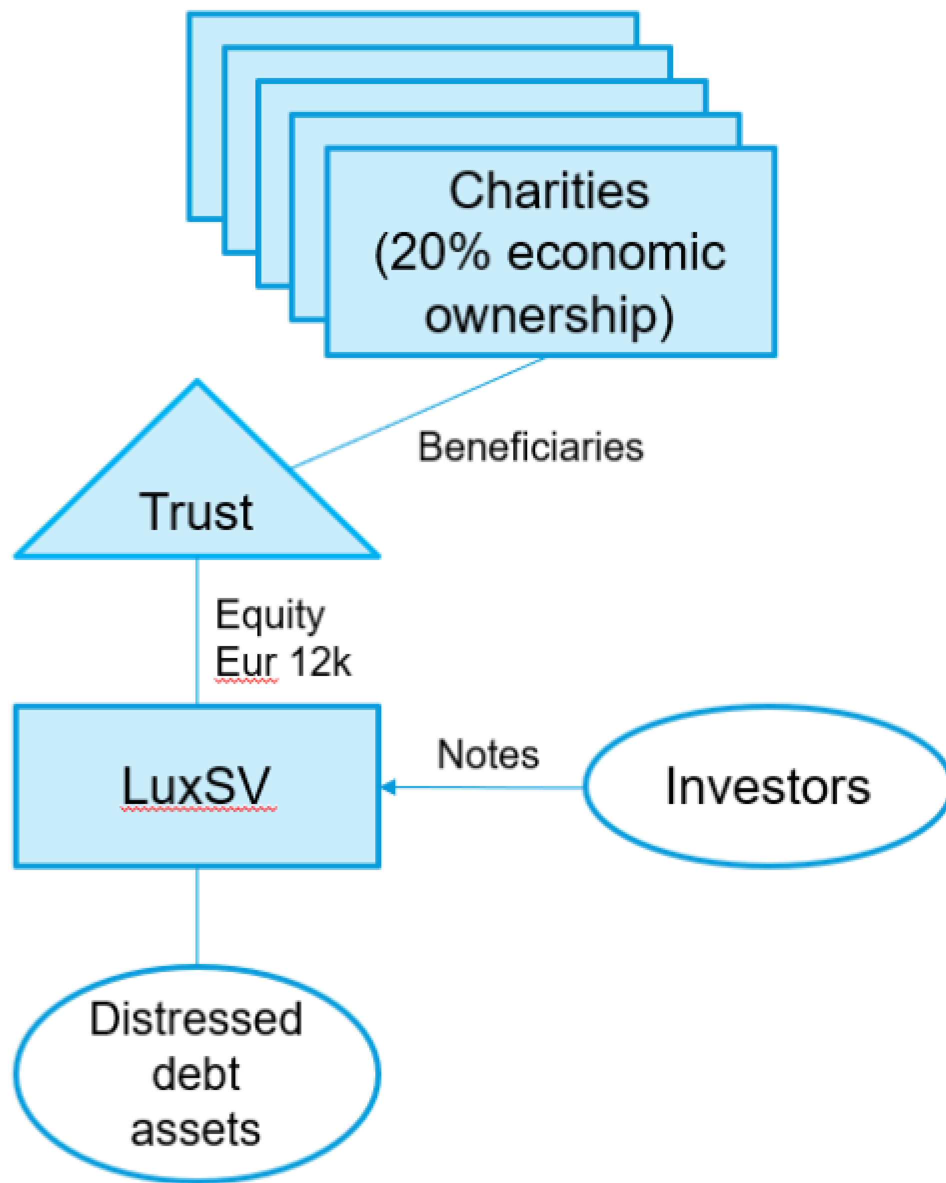
As already mentioned above, in many cases, Luxembourg securitization companies are held by foundations such as a Dutch Stichting. Here, a case-by-case basis analysis will determine whether the foundation is an entity within the meaning of Article 159 or 160 of the Luxembourg Income Tax Law ("LITL") (corporate taxpayer) or Article 175 of the LITL (transparent entity). This requires a detailed analysis of the precise constitution and operating rules of the foundation.

However, regardless of the classification of a trust or a foundation, the ownership of the shares in the Luxembourg securitization company must be attributed in accordance with the concept of economic ownership. This concept is an expression of the economic approach (that is broadly speaking, substance over form) according to which the economic reality should take precedence over the mere legal form. With regard to the ownership of assets for tax purposes, economic ownership takes precedence over legal ownership when the legal owner and the economic owner are not the same person.

Section 11 of the Tax Adaptation Law provides for some examples as to how the concept of economic ownership applies in practice. Paragraph 2 and 3 of Section 11 of the Tax Adaptation Law provide that assets held in a fiduciary relationship should be attributed to the beneficiary thereof (depending on the circumstances, either the founder or the beneficiaries). While the typical fiduciary relationship referred to in section 11 is a civil law concept slightly different from that of the typical common law trust, it is generally acknowledged that Section 11 of the Tax Adaptation Law also applies to common law trusts.

As a consequence, the individual beneficiaries of a charitable trust should be considered the owners of the shares in the securitization vehicle from a Luxembourg tax perspective and, provided that these beneficiaries do not constitute an associated enterprise (having a right to 25% or more in terms of voting rights, capital ownership or profit entitlement), the securitization company should not have an associated enterprise within the meaning of Article 164ter (2) of the LITL. If the immediate owner of the shares were a trust with other trusts as beneficiaries, then the same analysis would apply, effectively looking through to the ultimate beneficiaries of these other trusts.

The following chart depicts a securitization investment structure that relies on the standalone entity exception:



Luxembourg Companies

General

Debt investments may further be made via a Luxembourg company that is generally subject to CIT and MBT on the company's worldwide income at an aggregate rate of 24.94% (in the municipality of Luxembourg City). Luxembourg companies are further subject to an annual NWT of 0.5% applied on the company's unitary value (that is a modified net asset value). Luxembourg companies may benefit from EU Directives and tax treaties concluded by Luxembourg.

Interest income (and potentially capital gains) realized in relation to debt investments are taxable for CIT and MBT purposes. Expenses incurred by the Luxembourg company (interest expenses, operational expenses, etc.) should be deductible for tax purposes.

When the income derived from the investment is classified as interest income under Luxembourg GAAP, the interest limitation rules should not be relevant (as the company would not incur exceeding borrowing costs). Otherwise, when the company incurs exceeding borrowing costs, the interest limitation rules would limit the deductibility of interest expenses to 30% of the EBITDA, with a safe harbor of EUR 3m up to which exceeding borrowing costs would remain deductible without limitation.

A Luxembourg company investing into debt must realize an arm's length remuneration. While a Luxembourg company investing into (third party) debt should not fall within the scope of the Luxembourg tax circular applicable to companies performing (intra-group) financing activities, it should be possible to rely on the same remuneration model when determining an arm's length remuneration given the similarities of the functional and risk profile of these activities.

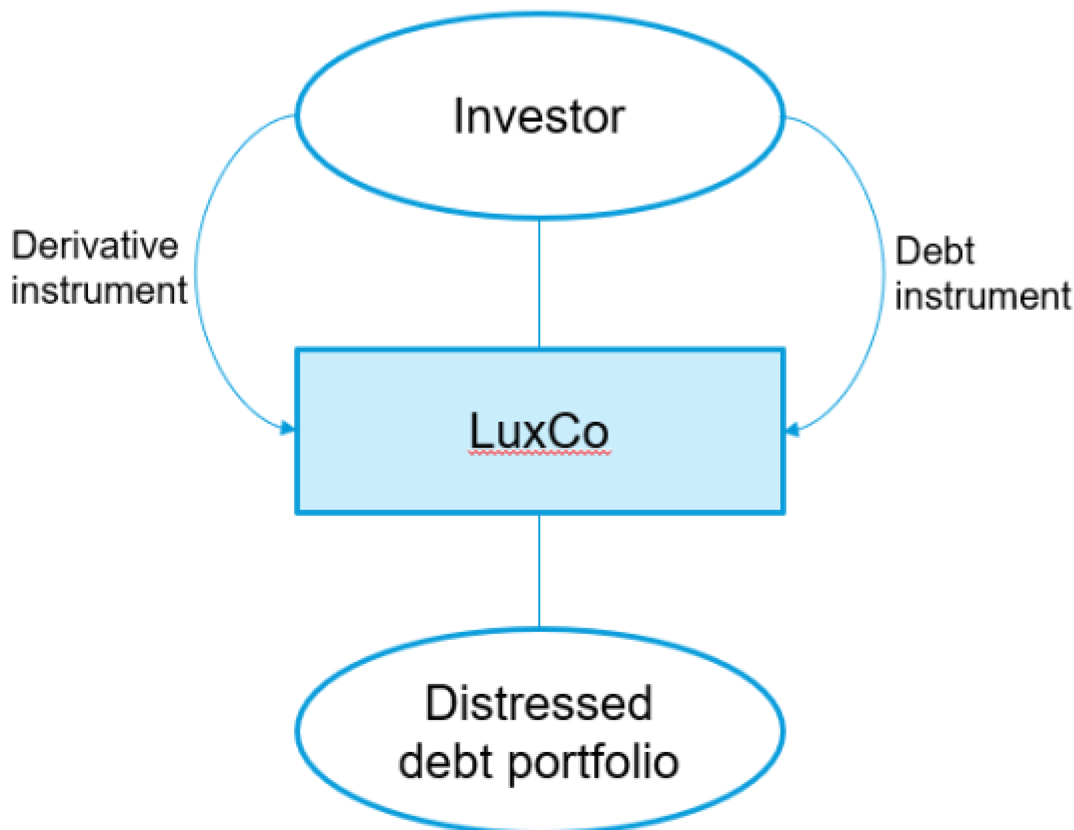
Excursus: Luxembourg Companies Investing Into Distressed Debt

When a Luxembourg company invests into distressed debt assets (or non-performing loans), the income derived from the portfolio may often be classified as capital gains rather than interest income (or revenues which are economically equivalent to interest). In these circumstances, the interest limitation rules may result in the non-deductibility of part of the interest expenses incurred in relation to the financing of the distressed debt portfolio (as the company would incur exceeding borrowing costs).

When the Luxembourg company enters into a derivative instrument through which the downside risk and the upside potential of the distressed debt portfolio (that is hedging) is transferred to another party (for example, the investor), related payments should not be classified as interest expenses or interest income. As a result, the Luxembourg company would exchange potentially high gains and losses for a stable arm's length remuneration. Both risk-return profiles (high risks/high returns vs. low risks/stable return) are equally legitimate from a transfer pricing perspective.

The expenses incurred under the derivative instrument (in case capital gains are realized on the investments) should not be classified as borrowing costs. Thus, these payments should not fall within the scope of the interest limitation rules.

The following chart depicts a Luxembourg company ("LuxCo") financing investments into distressed debt via a debt instrument granted by the investor. In addition, LuxCo entered into a derivative instrument with the investor:



What a Luxembourg Investment Platform Might Look Like

Overview

A Luxembourg investment platform must be tailored to the type of investment (for example, loan origination vs. investment into distressed debt assets), the magnitude of the investment activity, the investment jurisdiction(s), the preference of the investors and requirements (or constraints) from a regulatory perspective in Luxembourg and the investment jurisdiction(s).

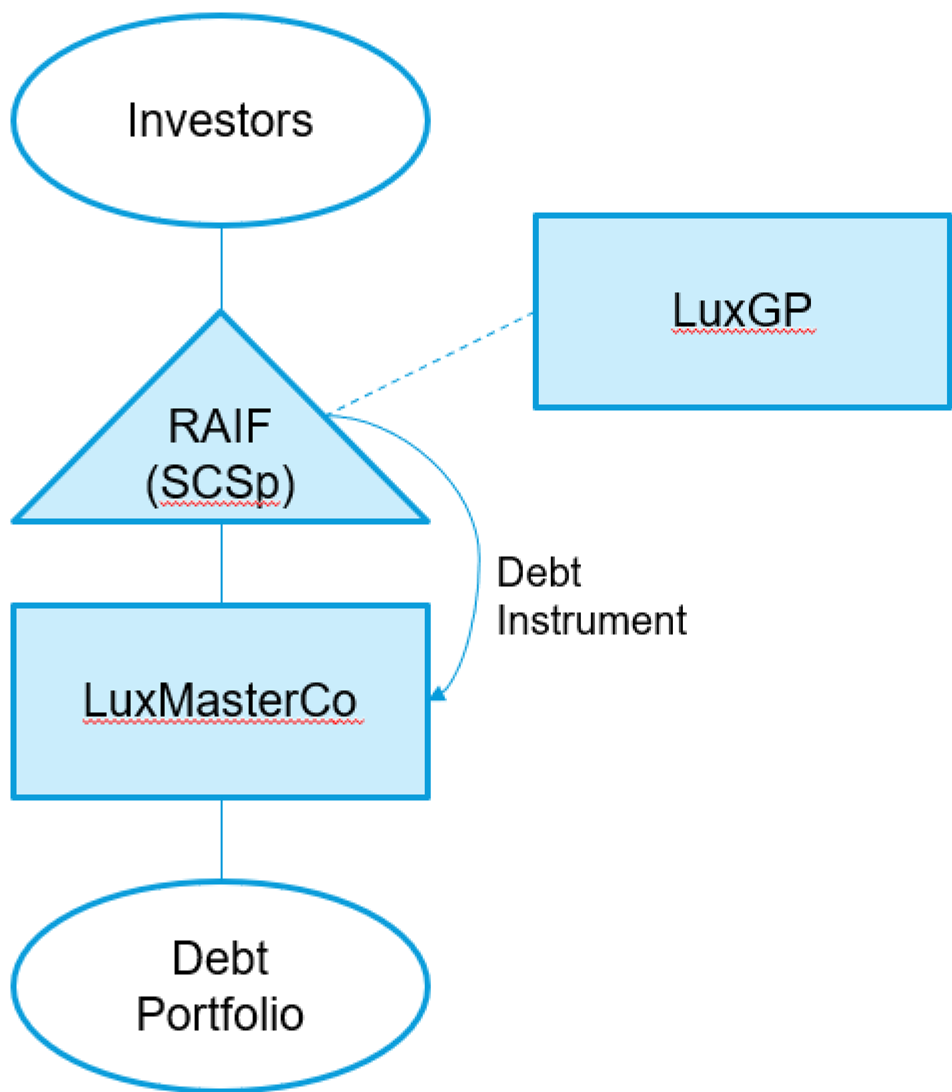
Therefore, an investment platform may often involve more than one entity, including local securitization vehicles that may facilitate investments from a foreign regulatory perspective and accommodate market practice in a jurisdiction.

This section provides several examples as to how an investment platform may be designed in practice.

Luxembourg Fund with a Luxembourg Company

A Luxembourg fund (RAIF) invests via a Luxembourg company ("LuxMasterCo") into a portfolio of real estate loans owed by borrowers in different EU countries. The RAIF finances LuxMasterCo with a debt instrument that bears variable interest corresponding to the interest income derived by LuxMasterCo from the debt portfolio minus an arm's length remuneration.

The following chart depicts the investment platform:



LuxMasterCo has to realize an arm's length remuneration for its investment activities that is subject to CIT and MBT at an aggregate rate of 24.94% (in the municipality of Luxembourg City). Given that LuxMasterCo should realize more interest income than it incurs interest expenses, LuxMasterCo should not incur exceeding borrowing costs and, therefore, the interest limitation rules should not apply.

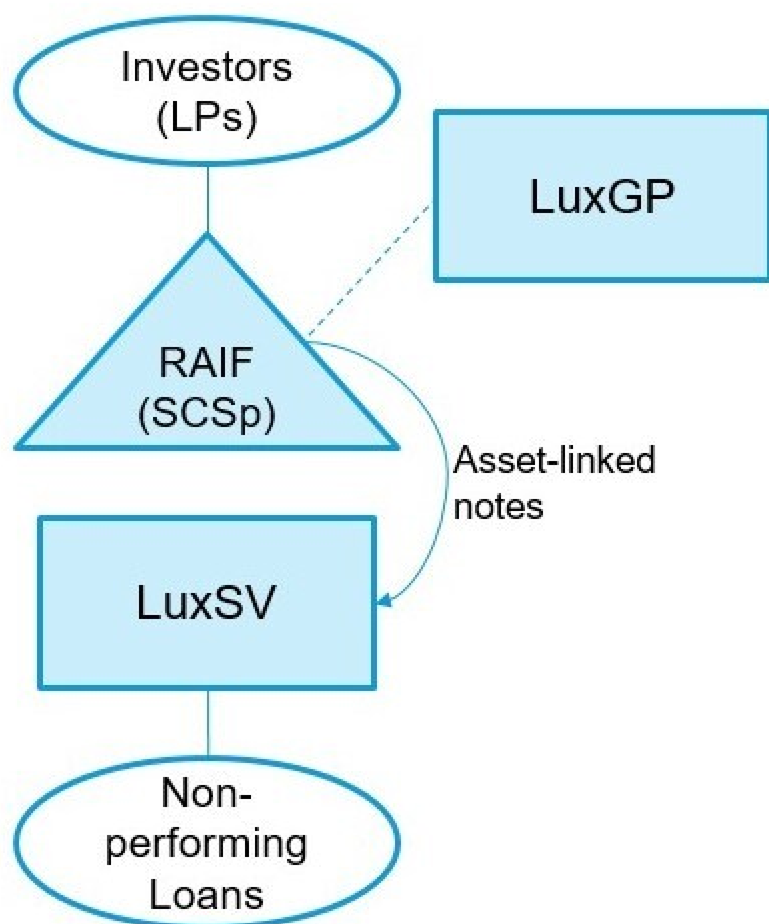
Arm's length interest payments made by LuxMasterCo to the RAIF are not subject to Luxembourg withholding tax. The RAIF established in the legal form of a SCSp is not subject to CIT, MBT or NWT. However, the RAIF is subject to an annual subscription tax of 1bps on its net asset value. Dividend distributions by the RAIF to the investors are not subject to Luxembourg withholding tax.

Luxembourg Fund with a Luxembourg Securitization Vehicle

A RAIF invests via a Luxembourg securitization company ("LuxSV") in a portfolio of non-performing loans. LuxSV is financed by asset-linked notes that track the performance of the underlying investments made by LuxSV (minus operational costs).

It is assumed that the shares of LuxSV (EUR 12,000) are held by a Dutch Stichting (i.e., the legal owner) that appointed five separate charities with equal rights as beneficial owners of these shares and the related income (i.e., the economic ownership of the participation in LuxSV rests with the five charities).

The following chart depicts the investment platform:



LuxSV is generally subject to CIT and MBT at an aggregate rate of 24.94% (in municipality of Luxembourg City). However, LuxSV is not subject to transfer pricing rules and, therefore, not required to realize an arm's length remuneration. Accordingly, LuxSV may realize a low or zero profit margin after deduction of operational costs and variable yield accrued under the asset-linked notes issued by LuxSV.

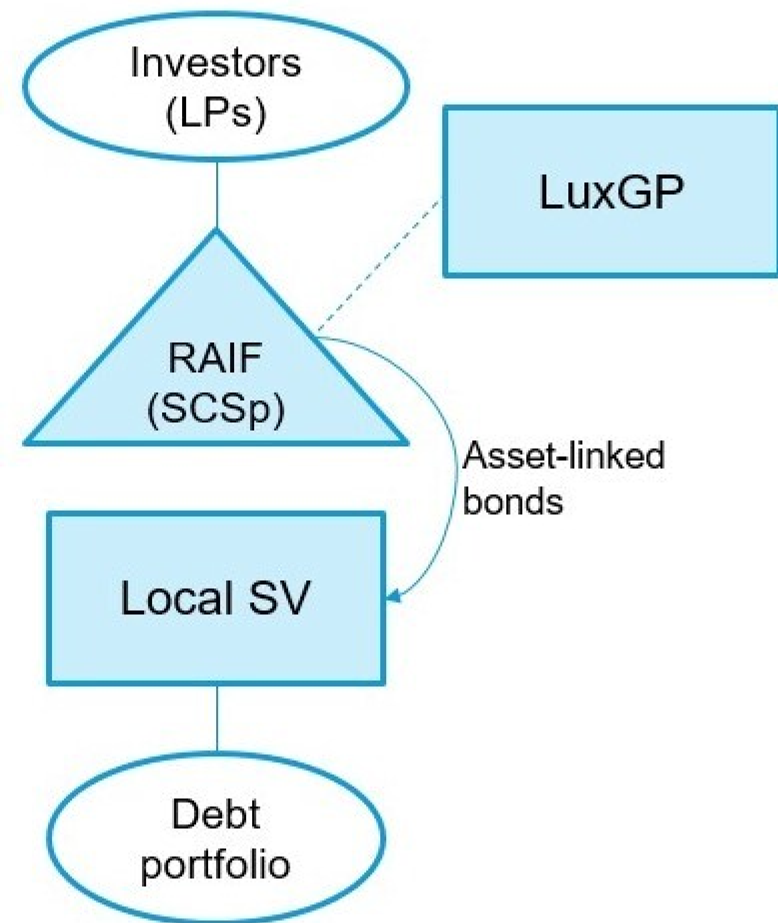
Given the ownership structure of LuxSV's shares, LuxSV should fall within the scope of the standalone entity exception under the interest limitation rules. Accordingly, the interest limitation rules should not apply and the variable yield accrued and paid under the asset-linked notes should be deductible for Luxembourg tax purposes.

Interest paid by LuxSV to the RAIF are not subject to Luxembourg withholding tax. The RAIF in the legal form of a SCSp is not subject to CIT, MBT, or NWT. However, the RAIF is subject to an annual subscription tax of 1bps on its net asset value. Dividend distributions by the RAIF to the investors are not subject to Luxembourg withholding tax.

Luxembourg Fund with a Local Securitization Vehicle

A Luxembourg RAIF invests into a local securitization vehicle ("Local SV") that engages in a direct lending strategy with borrowers resident in its state of residence. Local SV issues asset-linked bonds to the RAIF that track the performance of the underlying loan portfolio.

The following chart depicts the investment platform:



Local SV may take the legal form of a corporation, a partnership or have a FCP. Local SVs are generally not subject to income taxation or may deduct interest expenses incurred in relation to debt instruments issued to the investor (here, the RAIF). Interest payments made under the debt instrument issued by the Local SV are in most jurisdictions not subject to foreign withholding tax. Local SV's may be beneficial from a regulatory perspective as some securitization regimes benefit from a lighter regime when it comes to direct lending strategies.

The RAIF in the legal form of a SCSp is not subject to CIT, MBT or NWT. However, the RAIF is subject to an annual subscription tax of 1bps on its net asset value. Dividend distributions by the RAIF to the investors are not subject to Luxembourg withholding tax.

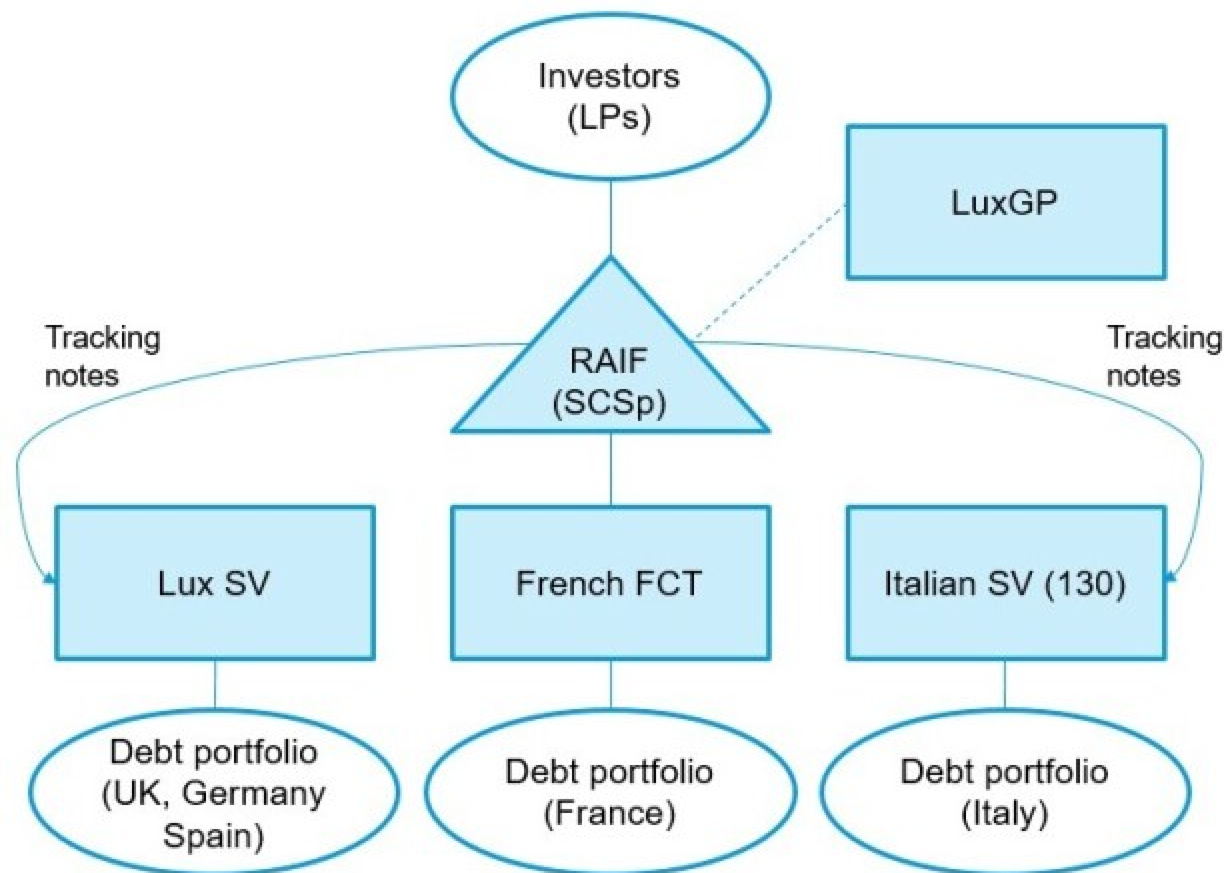
Luxembourg Fund with Pan-European Investments

A RAIF plans to invest into pan-European debt assets that may follow different strategies (direct lending, real estate, distressed debt, ...). The main investment jurisdictions are the United Kingdom, the Federal Republic of Germany, Spain, France and Italy. While investments in the United Kingdom, the Federal Republic of Germany and Spain are planned to be made via a Luxembourg securitization company ("Lux SV"), investments in France and Italy should be made via a local securitization vehicle (respectively "French SV" and "Italian SV").

Lux SV and Italian SV are financed by asset-linked bonds, whereas the French SV (*fonds commun de titrisation*, "FCT") is a collective investment fund that is financed by contributions.

It is assumed that the shares of Lux SV (EUR 12,000) are held by a Dutch Stichting (i.e. the legal owner) that appointed five separate charities with equal rights as beneficial owners of these shares and the related income (i.e. the economic ownership of the participation in Lux SV rests with the five charities).

The following chart depicts the European investment platform:



Lux SV is subject to CIT and MBT at an aggregate rate of 24.94% (in the municipality of Luxembourg City). However, Lux SV is not subject to transfer pricing rules and, therefore, not required to realize an arm's length remuneration. Accordingly, Lux SV may realize a low or zero profit margin after deduction of operational costs and variable yield accrued under the tracking notes issued by Lux SV to the RAIF.

Given the ownership structure of Lux SV's shares, Lux SV should fall within the scope of the standalone entity exception under the interest limitation rules regardless of how the income is classified for tax purposes. Accordingly, the interest limitation rules should not apply and the variable yield accrued and paid under the tracking notes should be deductible for Luxembourg tax purposes. Interest paid by Lux SV to the RAIF are not subject to Luxembourg withholding tax.

The French SV (i.e., the FCT) should be transparent for French tax purposes and is as such not subject to tax in France on its profits. Under French domestic law, there should be no requirement to withhold tax on distributions from the French SV.

The Italian SV should not be subject to the interest limitation rules and interest payments should not be subject to Italian withholding tax.

The RAIF in the legal form of a SCSp is not subject to CIT, MBT or NWT. However, the RAIF is subject to an annual subscription tax of 1bps on its net asset value. Dividend distributions by the RAIF to the investors are not subject to Luxembourg withholding tax.

Implications

Luxembourg's diverse and flexible legal, regulatory, and tax framework provides for various opportunities to organize debt investments in a tailor-made fashion, accommodating requirements from a legal and regulatory perspective as well as investor preferences.

Depending on the investment jurisdictions, a Luxembourg investment platform may involve several Luxembourg vehicles and local (securitization) vehicles for investments in specific jurisdictions.

Ultimately, the demand for financing remains high as banks are reducing their lending activities for various reasons. Therefore, it can be expected that investments of debt funds will continue to grow considerably over the coming years, following the trend witnessed over the last years, providing investors with interesting investment opportunities.

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