Luxembourg for alternatives: Structures, regulation and trends explored

What is it about Luxembourg that makes it attractive for establishing Private Equity (PE) funds, from a legal, tax and regulatory perspective?

Without question, Luxembourg's position as the largest European fund domicile and second largest in the world has a lot to do with the competitiveness of its legal, tax and regulatory environment. The kind of characteristics or advantages that a PE manager would typically look for in a domicile, such as a pragmatic approach to regulation, an extensive double tax treaties framework, confidentiality, and a robust legal framework including strong investor protection laws didn't just fall into place post Alternative Investment Fund Managers Directive (AIFMD), they've evolved over time. In fact, Luxembourg has been a major player in the global funds industry for over two decades.

That said, there's no doubt that Luxembourg has seized the initiative in the wake of the AIFMD, with "game changing" legislation such as, the laws introducing the Special Limited Partnership regime in 2013 or the Reserved Alternative Investment Fund (RAIF) regime in 2016 to name a few, so there's no sign that Luxembourg is about to rest on its laurels. Fund managers who choose the Grand Duchy as a domicile can be confident that this is a jurisdiction that will innovate and adapt to industry developments and client demands.

Following the transposition of the AIFMD in the Luxembourg legal framework, the Special Limited Partnership regime was introduced.

What was the significance of that? What does the regime mean in practice?

The Special Limited Partnership regime offered fund managers a new tool in the already well-stocked Luxembourg toolbox: the Société en Commandite Spéciale, or SCSp. This vehicle was a significant development for Luxembourg because it provided fund managers with a genuine alternative to the Anglo-Saxon limited partnership, which, historically, had always been the first choice for those looking for a (non-) regulated, tax transparent fund vehicle with limited liability.

What really stood out about the SCSp, though, was just how flexible it was and, of course, still is. It's a creature of private contract, allowing investors and fund managers to structure their relationship in a fashion that works for them. There's also significant flexibility with regard to their regulatory status and use – they can be regulated or unregulated vehicles and can be deployed as fund vehicles, feeders, co-investment vehicles and carry vehicles.

Looking at Luxembourg today, how does it compare with other European fund domiciles?

Luxembourg remains a compelling choice in terms of regulatory and legislative developments such as the RAIF regime, together with tried and tested regimes like the Specialised Investment Fund (SIF) and Société d'investissement en capital à risque (SICAR), which have certainly played their part in cementing the Grand Duchy's status as Europe's leading fund domicile.

An often overlooked point in Luxembourg's favour is the extension of depositary license to the specialised professionals of the financial sector – i.e. you don't need to be a credit institution, such as a bank or similar, to act as an AIFMD depositary. This opened up the depositary market, giving PE firms the opportunity to deal with independent players, renowned for their nimbleness and pragmatism, for their entire fund structuring requirements.

Overall, though, very few of the traditional fund domiciles are standing still, with Ireland, Guernsey, Jersey and the UK among those to have introduced regulatory changes over the last couple of years to enhance their attractiveness to PE firms. However, there's no question that it's becoming an increasingly competitive market between the traditional domiciles and that can only be a good thing for the future of private equity – PE managers need a domicile that accommodates them and the fast-paced industry in which they operate.

There has been talk of UK-based GPs showing interest in Luxembourg in light of Brexit to maintain passporting rights to access the single market for fundraising purposes. Is this something that you are seeing?

Given the current uncertainty brought by Brexit and the Base Erosion and Profit Shifting (BEPS) initiative, we are seeing some of the big managers, banks and insurance companies already moving to Luxembourg to build up substance through strengthening their local presence and to assure they maintain access to the European markets for fundraising purposes. Likewise, we've seen those who already have a presence in Luxembourg relocate some of their staff from other jurisdictions to the Grand Duchy. We still don't really have any clarity on where the UK stands post-Brexit, but, of course, if the UK does ultimately lose its passporting rights, we may well see other general partners (GPs) mobilise. Luxembourg is obviously well placed to capitalize should that be the outcome.

The Organisation for Economic Co-operation and Development (OECD) is putting pressure on businesses under its BEPS initiative. What are the implications for Luxembourg as a PE fund domicile in light of BEPS?

BEPS wasn't really intended to catch PE funds, but rather multinational trading companies using offshore and onshore jurisdictions to artificially reduce their taxable profit or artificially move profits to more tax favorable jurisdictions. In contrast, a PE fund is just a co-investment platform that tries to achieve tax neutrality for its investors – the investor should not be taxed more than it would have been if it owned the investment directly. It's an important distinction.

Luxembourg signed into the BEPS multilateral instrument to implement BEPS on

7 June this year, under which the signatory countries agreed to respect the minimum standards set out in BEPS. This underlines Luxembourg's commitment to move towards a BEPS compliant environment although it's worth noting that Luxembourg has also been pragmatic in terms of its adoption of "non-minimum" standards.

What are the initial steps that need to be taken to structure a fund in Luxembourg?

If you're looking to outsource your fund administration and interested in Luxembourg as a potential jurisdiction to structure, please contact Hana, who will be more than happy to walk you through the process alongside our expert team of qualified accountants, administrators and in-house support teams.