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LUXEMBOURG



# RAISING FINANCE FOR COMPANIES IN LUXEMBOURG

October 2006

According to a survey published by the European Private Equity and Venture Capital Association in May 2004, The Grand Duchy of Luxembourg was with the United Kingdom and Ireland, the country with the most favorable environment for the development of private equity and venture capital. Since that survey, the law on SICAR ("*Société d'investissement en capital à risque*") was passed so that Luxembourg is presently one of the most favorable jurisdiction in Europe for the development of the Private Equity industry.

The other usual sources of financing companies such as bank financing, business angels, shareholders equity, leasing, factoring, flotation and stock exchange are also used in Luxembourg.

Moreover, Luxembourg public aid for business and investment projects is available in many forms. Facilities are provided by the State and by the European Union and include the following incentives:

- building, equipment and plant may be subsidised by the State through a capital grant;
- major investments may be financed in whole or in part through a medium-or-long term loan from the SNCI (National Credit and Investment Corporation);
- start-up loans from the SNCI to small and medium enterprises allow them to finance investments at a fixed, reduced rate;
- the SNCI is authorized to take a minority shareholding in Luxembourg businesses whose legal form is public limited liability company (a *Société Anonyme* or *Société à Responsabilité limitée*);
- industrial land may be made available by local authorities and the government under a superficial rights contract;
- up to 50% of the cost of research and development projects may be financed by the government;
- government grants are available for organizational studies;
- various forms of tax relief are available as an incentive to new investment in Luxembourg;
- investments of capital at risk in the audiovisual production can benefit from a special tax scheme on base of audiovisual certificates of investment.

Applications are handled by the Ministry of Middle Classes and the Ministry of the Economy. In the limited space available for this article, we will focus on raising finance for companies by means of Private Equity and Venture Capital.

With its stable and flexible legal environment, Luxembourg has always proposed attractive vehicles and has become a major player in the European Private Equity and Venture Capital market. On top of the well-known Soparfi (i) and the regulated Venture Capital Investment Fund (ii), Luxembourg has recently welcomed the SICAR. Securitisation vehicles complete the panel of investment structures available for the Private Equity industry (iii).

# Unregulated fund vehicles

The Soparfi has always been used for its access to the well-established Luxembourg participation exemption regime as well as the EU Directives and the numerous double tax treaties concluded by Luxembourg which offer a flexible and efficient tax regime. Even if the Soparfis are subject to taxes, the vehicles would make it possible to manage a private equity investment without significant income and exit tax charges. The Soparfis are not specifically regulated by any supervisory authority.

The Company Act dated 10 August 1915 constitutes the general legal framework applicable to Luxembourg companies. A Soparfi is a Luxembourg commercial limited liability company which can be incorporated as a “*Société Anonyme*”(SA), a “*Société à responsabilité limitée*” (Sàrl) or a “*Société en Commandite par Actions*” (SCA.).

The management of those types of companies may be organizedorganised in ways that there are specific to private equity investments. In this respect, the choice of the form of the company between Sàrl, SA and SCA is crucial.

Regarding the tax issue, the Soparfi is subject to the general corporate tax regime. The company is thus subject to corporate income tax and municipal business tax at an aggregate rate at 29.63% for companies located in Luxembourg City. It is also subject to net wealth tax (at the rate of 0.5% of the unitary value of the company, computed on the basis of the balance sheet as of 31 December of the preceding year). Lastly, it is subject to a capital duty amounting to 1% of the subscribed capital (upon incorporation of the company and upon any subsequent share capital increase).

However, its tax charges may be reduced through holdings of shares and by its:

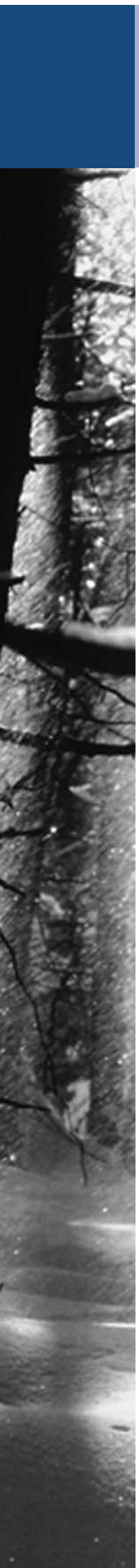
- fulfilling the conditions laid down in section 166 of the Income Tax Act (ITA) relating to participation exemption for both income through holdings and capital gains realizedrealised in connection with share transfers.

- fulfilling the conditions laid down in section 147 ITA concerning tax withholding on dividends paid.

Luxembourg tax law lays down special rules for parent companies and subsidiaries, which is known as the “*Schachtelprivileg*”. Income from shareholdings is exempt if:

- (a) the distributing company is a fully taxable resident limited company, or a non-resident limited company that is fully liable to a tax corresponding to a corporation tax or a company that is resident in another member state of the European Union and is covered by article 2 of the EU Council Directive of 23 July 1990 on the common tax treatment applicable to parent companies and subsidiaries of different member states.

- (b) the receiving company is a limited company that is resident in Luxembourg and fully taxable or a Luxembourg domestic permanent establishment of a company that is resident in another state of the European Union, and is covered by article 2 of the EU Council Directive of 23 July 1990 on the common tax treatment applicable to parent companies and subsidiaries of different member



states, or a Luxembourg domestic permanent establishment of a limited company that is resident in a state with which Luxembourg has concluded a double taxation treaty.

(c) at the date on which the income is made available, the beneficiary holds or undertakes to hold the shares in question for an uninterrupted period of at least twelve months, and that during this period the holding rate does not fall below the threshold of 10%, or the acquisition price below €6,000,000.-EUR.

A shareholding held indirectly through a tax transparent entity (in compliance with the tax framework) is considered as a direct shareholding in proportion to the fraction held in the assets of this entity. If the Soparfi does not benefit from the full exemption on received dividends, it may still benefit from an exemption of 50% of this dividend income under certain conditions (in compliance with article 115.15 of the Luxembourg ITA).

A further benefit of the system by comparison with the one applicable in other countries is the ability to deduct expenses relating to dividends (e.g. interest charges incurred in financing the shares). Nevertheless, they may only be deducted insofar as they exceed the deductible charges for the year in question.

Exemption from withholding tax on dividends paid:

Section 147 ITA provides for an exemption from withholding tax on dividends paid and other share proceeds, on that condition that :

the distributing company is a fully taxable limited company under Luxembourg law  
the company receiving the dividends and other income is: a fully taxable resident limited company, or resident in a member state of the European Union and falls under article 2 of the EU Council Directive of 23 July 1990 on the common tax treatment applicable to parent companies and subsidiaries of different member states, or a domestic permanent establishment of a limited company resident in a other member of the European Union and falls under article 2 of foregoing Directive, or a domestic permanent establishment of a limited company resident in a state with which Luxembourg has concluded a double taxation treaty.

At the date on which the income is made available, the beneficiary holds or undertakes to hold directly for an uninterrupted period of at least twelve months a participation of at least 10%, or an acquisition price of at least €1,200,000.-EUR.

As Soparfis benefit from EC Directives and double tax treaties signed by Luxembourg, they are generally able to distribute dividends without any significant Luxembourg withholding tax cost.

Soparfis are used in many private equity deals such as primary or secondary Buy-Outs, refinancing or other types of transaction.

Pursuant to a Luxembourg Act dated 25 August 2006 introduced into the Luxembourg legal system, the minimum number of shareholders in public limited liability company (*société anonyme*) is reduced from two to one and the company may be managed by one director instead of a board of directors.



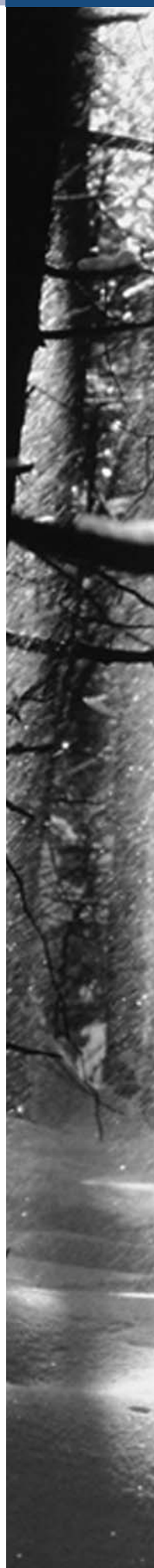
## Regulated fund vehicles

Undertaking for collective investment (UCI) which itself distinguishes between UCIs whose securities are distributed to the public or UCIs whose securities are reserved for institutional. The ones which offer their securities to the Public are subject to the so-called “Part II” of the law dated December 20, 2002. PE UCIs reserving their securities for Institutional Investors are regulated by the Law dated July 19, 1991. This Law shall be amended. The principal modifications would relate to broadening the range of eligible investors and increasing flexibility in the regime by amongst others: cancelling the need for a promoter, extending the asset classes eligible and reducing the minimum number of required NAV calculations per year.

They are subject to a common regulatory regime and subject to the supervision of the Luxembourg Regulator, the *Commission de Surveillance du Secteur Financier* (“CSSF”). In addition to the general rules applicable to any UCIs, the CSSF has issued from time to time a number of circulars that either specify certain legal provisions or that introduce elements of regulation. In particular, Chapter 1 Point I of the IML Circular 91/75 sets out specific rules and derogations applicable to private equity UCIs. The risk-spreading requirement is a key element to consider. In practice, the regulation requires that not one investment be larger than 20% of the total net asset value of the UCI. The risk-spreading requirement needs to be complied within 6 months of the fund’s incorporation.

A promoter is required by the CSSF. This is not a legal requirement but an administrative practice of the CSSF. The promoter is an entity which takes ultimate responsibility in case of damages caused to investors. The promoter has to be an institutional active in the financial sector with sufficient financial surface and adequate reputation. Moreover, a custodian bank and a central administration being Luxembourg professionals of the financial sector submitted to the CSSF prudential supervision are required. The minimum subscription of €12,500.-EUR per investor is needed. Lastly, the net asset value of the fund will be produced on a frequency depending on the redemption/subscription frequency and the fund needs to prepare a semi-annual and an annual report.

With regard to the tax framework, Luxembourg investments funds (UCITS and non-UCITS) are not subject to income/capital gains taxes in Luxembourg. Withholding tax levied at source on income received by a Luxembourg UCI is technically non-refundable. However, UCIs formed as investment companies (SICAVs) may benefit from certain double taxation treaties signed by Luxembourg.





## SICAR

On 15 June 2004, Luxembourg passed a Act creating a specific legal framework for venture capital investment vehicles, the *Société d'Investissement en Capital à Risque* (SICAR). This Act illustrates the increasing strategic importance of this type of investment to the Grand Duchy and to Europe as a whole. The SICAR offers competitive solutions to sophisticated Private Equity and Venture Capital Market players. The SICAR is designed to be sufficiently flexible to take into account the particular needs of a variety of promoters and targeted investors called “qualifying investor” including not only institutional and professional investors but also private individuals fulfilling certain conditions such as a €125,000.-EUR minimum investment and a written acknowledgement of risk awareness. Five different legal forms are available under the new legislation: the limited partnership “*Société en Commandite Simple*” (SCS), alternatively the SICAR can take one of four non-transparent forms as SA, SCA and co-operative company organized/organised as a public limited company (SCSA).

The minimum share capital of €1 million Euros must be reached within 12 months of the incorporation of the SICAR. Only 5% of capital needs to be paid up on subscription, (share capital). Share capital may be fixed or variable.

As a regulated vehicle the SICAR must be approved by and thereafter supervised by the CSSF. Neither the promoter nor the asset manager needs approval by the CSSF, enabling specialist investment teams to create a SICAR.

The incorporation documents such as the articles of association of the SICAR, the prospectus (Private Placement Memorandum), main contractual agreements (custody, domiciliation, administration etc), articles of association of the General Partner etc), the documentation needed to assess the experience and reputation of the SICAR managers/directors as well as the identification of the fund initiator, the information on the anticipated distribution/sale of the SICAR shares, the names of the custodian bank and the auditor, have to be reviewed by the CSSF, which will ensure that the proposed CSSF meets the requirement of the Law.

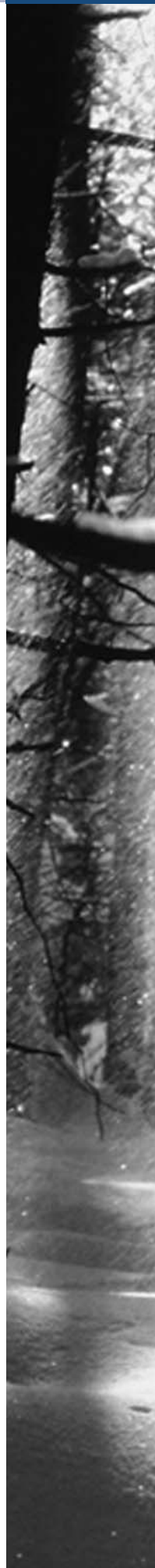
There is no minimum financial requirement for the asset manager of the promoter. CSSF circular 06/241 describes the notion of risk capital as well as the CSSF approach in reviewing the application files. Basically it is up to the sponsor to demonstrate that its project qualifies as a SICAR. The circular has also clarified the eligibility of certain types of investments: real estate investments for a SICAR on the condition that they are considered as risk capital and are indirectly made through real estate companies. The SICAR may invest in units, shares or other form investments funds as long as they have adopted a venture capital /private equity investment strategy.

Unlike UCI's rules, the SICAR does not have to comply with risk diversification requirements, meaning that a SICAR may, in principle, invest 100% of its assets in only one target investment. The central administration does not need to be a regulated entity submitted to CSFF. Circulars applying to UCIs do not apply to SICARs. Thus, there is

no legal requirement for a semi-annual report in addition to the audited annual report.

Regarding the taxation aspect, the SICAR offers an attractive regime. For SICARs established as an non-transparent entity, there is no corporate income tax on revenues or capital gains from securities and no wealth tax. In addition, there is no Luxembourg withholding tax on dividend distributions, no capital gains tax in Luxembourg for non-resident investors, no *taxe d'abonnement* (*Luxembourg subscription tax*), a maximum capital duty of €1,250.-EUR and double taxation treaties apply.

As of the date of printing this article, there is a draft bill in preparation which would introduce some modifications to the SICAR Law.







## Securitisation

Securitisation is a flexible and efficient way of raising capital consisting in grouping together assets with predictable cash flows or rights to future income streams such as mortgages, loans, Trade receivables and turning them into bond-style securities that are then sold to investors.

The assets are transferred to a specific entity “a special purpose vehicle” than then issues debt backed solely by the assets “collateral) transferred and payments derived from those assets.

Securitisation is accessible to everyone and to all types of investors (corporate, private or institutional). It provides a number of benefits for each party involved as securities are relatively stable, offer a good return on investment and are often guaranteed by a third party. Securitisation can therefore make sense whether a company has substantial capital needs, is seeking to improve its financial performance measures, finds itself constrained by its credit rating or want to transfer non-core risks to third parties.

The Securitisation Act was enacted by Luxembourg Parliament on 9 March 2004, and passed on 22 March 2004. It is based on the concept of the fiduciary estate recently introduced into Luxembourg Law. The definition of “securitisation” is very broad. It encompasses all transactions by which a securitization vehicle acquires or assumes directly or indirectly any risk relating to claims, other assets, or obligations assumed by third parties or inherent to all or part of the activities of third parties. The securitization vehicle is financed by issuing transferable securities “shares, bonds or other securities whose value or yields depends on such risks. Securitisation vehicles must specifically state in their articles of incorporation or management regulations (for funds), that they are governed by the Law.

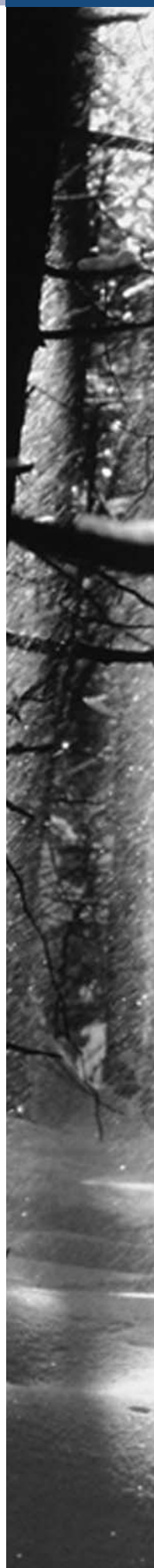
The Law includes all transactions by which a securitization vehicle acquires or assumes a risk linked to an asset. Financing of transactions is achieved by issuing shares, bonds or any other types of security (certificates, EMTNs or subordinated loans).

The Law allows a wide range of assets such as trade receivables, mortgage loans, shares and essentially any tangible or intangible asset or activity with a reasonable ascertainable value of predictable future stream of revenue to be securitised. Securitisation can be achieved through a transfer of the legal ownership of the asset (“true sale”) or through a transfer of credit risks linked to assets (“synthetic”). The accounting rules applicable on securitisation vehicles vary according their form. Securitisation companies must comply with the accounting regulations of the Act of 10 August 1915 on commercial companies. On the other hand, securitisation funds are subject to the accounting and tax regulations applicable to investment funds provides for by the Laws of 30 March 1988 and 20 December 2002 on investment funds. Hence, the valuation of securitizationsecuritisation funds is based on the mark-to-

mark principle. Both forms of securitizationsecuritisation vehicles must be audited by an independent auditor, in the case of regulated securitisation vehicles, the independent auditor must be authorizedauthorised by the CSSF.

The Act provides a high degree of flexibility in terms of tax neutrality, securitisation vehicles, regulation of securitisation vehicles, classes of assets, forms of securitizationsecuritisation transactions and compartment segregation. In addition, the Law provides high investor protection via the bankruptcy remoteness, a fiduciary representative and a custodian.

The fiduciary representative is the professional of the financial sector who can be entrusted with the safeguarding of the interests of the investors and certain creditors. The fiduciary representatives must be authorizes by the Ministry of Finance and have their registered office in Luxembourg. They may not exercise any activities other than the principal activity except an accessory and ancillary basis. The authorization for exercising the activity of a fiduciary representative can only be granted to stock companies having a capital and owns funds of at least EUR €400,000.-. In order to guarantee that assets in the form of cash or transferable securities held by a securitisation vehicle are kept under the best security conditions to the investor, the Law requires regulated securitisation vehicles to deposit such assets with a Luxembourg credit institution. Lastly, the Luxembourg Act achieved complete tax neutrality.







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