Luxembourg Private Credit Funds: Market Analysis and Outlook

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Pursuant to a well-known proverb, "interest on debts grows without rain". Whether this is cautionary advice for borrowers or an encouragement for lenders can be left to individual interpretation. Fact is, however, that both worldwide and in the Luxembourg investment funds industry the private credit market is a popular and quickly growing market segment. The present article aims to shed some light on current trends and developments, based on recent empirical data pulled from surveys.

Before going into further detail, it appears useful to briefly mention which assets are referred to when talking about "private credit". The term "private" in this context means that the relevant loans are not traded on public markets, as opposed to corporate bonds which have been a very common asset class for a long time. They are rather negotiated individually and not distributed through a stock exchange, and can form part of a portfolio of an investment fund. The underlying loans can relate to the (re-)financing of any sector of the economy, such as a company in general terms (referred to as a corporate loan), a real estate or infrastructure project or also consumer loans such as credit card debts.

The private credit market has grown substantially over the last decade, which is generally explained by a growing reticence of banks, due to regulatory pressure (in particular capital ratios), to remain engaged in this segment, and the possibility for private credit funds to act quicker and often with more market knowledge and pragmatism. Pursuant to a recent survey by the Alternative Credit Council[1], it is estimated that the size of the global private credit market now amounts to around US$ 3 trillion, with strong and stable growth rates despite a number of economical challenges over the past years.

The largest segment in this market with close to 60% of market share is the direct financing of companies (corporate lending), but with an increasing tendency towards real estate, infrastructure and asset backed lending. The trend towards the financing of so-called real assets is expected to accelerate, due to government policies with a focus on energy and infrastructure investments.

The development in Luxembourg mirrors this development, where the assets under management of private credit funds are now estimated at EUR 510 billion, with rather spectacular growth rates of 21.5% in the last six months of 2023 only. While private credit funds are, admittedly, a more recent asset class, their growth trajectory over the past years with upwards of 40% p.a. confirms the view observed more generally that, at least in the recent years, the dynamic of the alternative asset sector in Luxembourg surpasses that of the traditional UCITS segment.

Another clear trend that emerges from a recent survey performed by the Luxembourg fund association ALFI and KPMG[2] concerns the choice of investment vehicle: The structures that are under the direct supervision of the CSSF and therefore require an approval process before becoming operational – with a negative impact on their time to market – are in a steep decline, which is a tendency shared with the entire private assets sector in general. While the market share of specialised investment funds (SIF) decreases (from 49% to 32% of funds subject to a dedicated product law), that of the reserved alternative investment fund (RAIF) rises to 62%.

Both are, however, eclipsed by alternative investment funds in the form of partnerships (special limited partnerships – SCSp – especially): Almost two thirds of all Luxembourg private credit funds opt for this form (63%, up from 45% just a year earlier), while RAIFs and SIFs together only amount to 37%. Such tendency is likely the result of a preference of anglo-saxon fund initiators for a corporate type that they are very familiar with, combined with the additional flexibility in terms of the content of the partnership agreement and the absence of a subscription tax to be paid.

The main advantage of the RAIF, which is the possibility to structure it as an umbrella entity with several compartments, does not appear to be a strong argument in many cases, as the majority of private credit funds are single compartment structures.

Another interesting aspect is that the vast majority of private credit funds (74%) are closed-ended, and therefore do not provide an exit possibility for investors during their term. This is also in line with the preference stated in the amended AIFM Directive[3] concerning loan-originating funds. It means, however, that all those rather complicated rules on liquidity management that have been included in the newly amended text will only apply to a small portion of loan-originating funds.

An attentive analysis of the survey data reveals another salient point in this context: In terms of the investment strategy of private credit funds, there is an almost even split between those funds that can grant loans themselves, and those that invest into already existing debt on the secondary market. Consequently, about half of all private credit funds will not be in scope of the new rules set out in the AIFM Directive, as these only apply to loan-originating funds and not to debt participating funds. That appears to quite clearly confirm the argument of the industry, raised during the negotiations about these new rules, that they are unnecessary and have very little added value for investors in practice. Did not a well-known Italian banker recently mention something about avoiding to create unnecessary complexity and bureaucracy?

Speaking of investors, those that invest into Luxembourg private credit funds are almost exclusively institutional or professional investors. Only 6% are retail investors, and that segment is actually shrinking. At least for the moment there is therefore no discernible trend for a retailization of any significance. This can change, however, and the fairly recent publication of the guidelines (RTS) for ELTIF structures has the potential to fuel a stronger development of this product aimed at retail investors over the next years.

Luxembourg private credit funds invest predominantly (60%) in Europe, be it the European Union or other European countries, and most invest in several countries. On a global level, investments into the United States dominate the private credit market and account for roughly half of all investments into this market segment, while for Luxembourg funds the figure only rises to 16% of their investments. Part of an explanation for this may be that the asset class is less mature in Europe than in the U.S., and that cross-border lending (or credit activities for alternative investment funds as such) has not been possible in all European states due to a disparate legal environment for such activity. A positive aspect of the amendments to the AIFM Directive relating to loan-originating funds should consist in that it can be expected to simplify and harmonise the activity of private credit funds within the EU. Another consequence hoped for is that private credit funds should grow in size, as today they are fairly small: 87% of them have a capitalisation below EUR 1 billion.

Another much debated topic, sustainable finance, is at least so far rather absent in the private credit market. Outside the EU it is, if at all mentioned, seen more as a reporting topic and it is unlikely that this will change fundamentally over the next years, considering the priorities that can be expected of the new U.S. government. Among Luxembourg debt funds, more than three quarters are so-called art. 6 funds that have no particular aspirations in terms of ESG strategy. While the portion of so-called art. 8 funds with some level of ESG integration has slightly grown (by 2%), most of that will most likely be a re-categorisation of the more ambitious art. 9 funds as a result of tighter regulatory scrutiny of these products. From the feedback received from private credit funds initiators through the survey, it does not appear as if for them (or rather their investors) ESG is currently a priority.

In summary it can be observed that the private credit market as such and debt funds in particular play an increasing role in a sector that was traditionally occupied by banks, and that it has become a vital part of the financing of what is sometimes referred to as the "real economy". Luxembourg's wide array of choices in terms of investment vehicles and early embrace of private credit activity for alternative investment funds gives it a competitive advantage in this fast-growing sector. The upcoming rules for loan-originating funds in the amended AIFM Directive should not change this, albeit increase the compliance burden for market participants.

* *https://www.vdblaw.com/*

1) *https://www.aima.org/compass/insights/private-credit/financing-the-economy-2024.html*
2) *https://www.alfi.lu/en-gb/news/kpmg-alfi-private-debt-funds-survey-2024*
3) The amendments to the AIFM Directive were published in March 2024 and will need to be implemented into national law by April 2026.

Navigating taxation and structuring of Digital Assets Funds in Luxembourg

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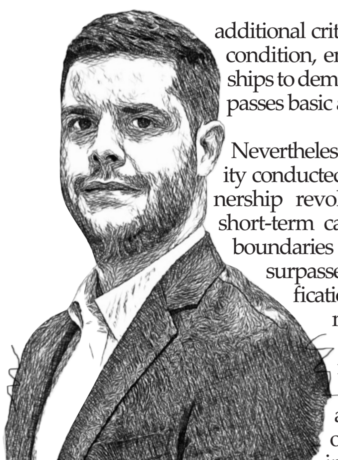

With the continuous rise of digital assets, the digital asset world is emerging as a new industry. While first movers have positioned themselves as strong players in this market, more and more crypto-focused funds are now appearing. In this context, Luxembourg is witnessing a growing number of incorporations of digital assets funds. This trend is not surprising. For decades, Luxembourg has offered a robust regulatory framework and recognized expertise in the financial domain, making it an attractive choice for fund managers seeking to explore the opportunities presented by this new class of assets. It is thus only logical that Luxembourg has emerged as a preferred host country for asset managers willing to establish their investment vehicle.

In the realm of digital assets, the investment model closely mirrors that of the alternative fund industry, particularly through the use of Special Limited Partnerships (SCSps) as investment vehicles. This model has gained traction due to its flexibility, cost efficiency, and adaptability, making it a preferred choice for major asset managers. The SCSp's structure allows fund managers to tailor their approach to meet the diverse needs of investors while efficiently managing investments. This flexibility has led to its widespread adoption, providing an advantageous framework for both asset managers and investors. Alternative Investment Funds (AIFs) investing in digital assets are subject to different levels of supervision based on their size. This regulatory framework ensures appropriate oversight and compliance, aligning with Luxembourg's robust financial regulatory environment.

To qualify as an AIF[1], the SCSp must meet certain criteria, such as raising capital from a number of investors with the aim of investing it in accordance with a defined policy. The AIF status offers several benefits for both investors and the fund itself. Focusing on the tax aspects, an SCSp is regarded, from a Luxembourg tax perspective, as a transparent entity and, therefore, not liable for corporate income tax (nor subject to net wealth tax).[2] However, the SCSp could potentially be subject to municipal business tax in case it carries out a commercial activity.[3] Consequently, fund managers must identify the activity(ies) performed by the SCSps to determine which tax regime applies to it. The mischaracterization of its activity could result in unexpected tax implications.

According to the Luxembourg Income Tax Law, a commercial activity is defined by several key criterias: (i) it must be conducted independently, (ii) pursued with the aim of generating profit, (iii) maintained on an ongoing basis, and (iv) constitute participation in the broader economy.[4] If an activity fulfills these conditions, it falls under the classification of a "commercial activity" subject to municipal business tax.

In 2015, the Luxembourg Tax Authorities issued a circular, commonly referred to as the "Circular,"[5] providing comprehensive guidance on the tax treatment of income derived by Luxembourg limited partnerships, including SCS and SCSp structures. Furthermore, based on the Circular and its references it has been established that the activity of a partnership must extend beyond the scope of asset management to be considered as engaging in commercial activities. This additional criterion, commonly called negative condition, emphasizes the need for partnerships to demonstrate a level of activity that surpasses basic asset management functions.

Nevertheless, if the primary focus of the activity conducted by a Luxembourg limited partnership revolves around the realization of short-term capital gains, it is likely that the boundaries of wealth management would be surpassed, thereby resulting in the qualification of a commercial activity. Determining whether the activity falls within the scope of private wealth management necessitates a case-by-case assessment, taking into account the comprehensive view of the partnership's overall setup, investment strategy and conduct.

In a significant number of case laws reviewed by the Administrative Court, a recurring theme revolves around the timing of the sale of immovable properties.[6] Specifically, the rapid succession of purchases and sales within a short timeframe has been scrutinized as a potential indicator of commercial activity. When transactions occur swiftly and with notable frequency, it raises questions about the commercial intent behind the transactions.

It seems that the Administrative Court has often regarded such rapid transactions as indicative of a commercial venture rather than mere investment activity. In this respect, the activity must be carried on with the intent of repeating it and constituting a source of income based on repeated operations (as opposed to isolated transactions carried on within the context of the taxpayer's private wealth management). In the context of a digital asset fund, an example would be to trade crypto-assets actively (algo-trading, spot and leveraged trading on a regular basis).

That being said, when tax authorities assess the commercial nature of an activity, the burden of proof falls upon the taxpayer to demonstrate the veracity of its non-commercial nature for tax purposes with the company's social object and supporting document to substantiate the nature of the activity in question.

To maintain the tax neutrality of the AIF, fund managers must ensure that the fund does not engage in commercial activities, such as trading or active management. We typically see the use of Luxembourg Special Purpose Vehicles (SPVs) in the market to hold the assets of funds. This approach has the main advantage of protecting investors by interposing a legal entity between the assets and the fund. The interposition of SPVs is also often used to segregate investments across various entities ensuring clarity and alignment with e.g. tracking elements implemented at fund level.

Finally, it helps manage and optimize potential tax considerations at fund level (including, among others, the elements described above regarding commercial activity).

Another underrated point of attention is the impact of the reverse hybrid mismatch rules. In a nutshell, according to the Luxembourg income tax law, an SCSp could become subject to corporate income tax if 50% or more of its limited partners (on a standalone basis or on an acting together basis) consider the SCSp as opaque in their country of residence.[7] However, if the fund qualifies as a Collective Investment Vehicle, as expressly defined by the hybrid mismatch rules, it should not fall within the scope of those rules[8]. A proper characterization is crucial as it can influence tax considerations, prompting asset managers to proactively address unexpected outcomes. Key actions could include: i) assessing the potential impact based on the jurisdiction of residence of their LPs (bearing in mind that some EU jurisdictions see SCSp as opaque), and ii) adapting their prospectus and subscription documents to address this point.

Undoubtedly, the Luxembourg structure for digital assets funds does present considerable advantages. However, it is imperative to understand the overall tax framework surrounding investment funds and structures in Luxembourg to maintain the expected tax neutrality for investors. Asset managers should consider exploring more nuanced and complex but potentially safer options for structuring their funds.

1) *This article focuses on under-threshold AIFs according to the AIFMD and does not consider AIFs established in the form of a RAIF, SIFs or SICARs.*
2) *Article 175 LITL.*
3) *Under certain circumstances, limited partners in the SCSp could also be subject to corporate income tax and net wealth tax in Luxembourg.*
4) *Article 14 (1) LITL.*
5) *Circular L.I.R. No. 14/4.*
6) *TA 4 janvier 20 I 0 n°25664 and 25666.*
7) *article 168 quater (1) LITL*
8) article 168 (2) LITL