Building a better working world

Luxembourg fund series – Chapter One

Understanding Luxembourg fund in 10 minutes

With the increasing need for investor protection and transparency, change in international tax environment, European investors' interest in allocating assets to emerging markets including Mainland China which is matched by managers' desire to source limited partners from Europe, we have seen an increasing interest in fund managers in Asia (including those based in Mainland China) to raise onshore Luxembourg funds. On 18 February 2020, the European Union (EU) added the Cayman Islands to its list of non-cooperative jurisdictions for tax purposes. Even though the direct consequences are limited at present as the EU has not developed comprehensive sanctions, this recent development further draws attention of Asian fund managers to review their current and future fund structures in Cayman Islands and other offshore financial centers, especially those having underlying investments in Europe. In other words, choosing a regulated and recognized fund jurisdiction which provides tax certainty and sustainability has become more important. Luxembourg is one of the locations which possesses the above advantages.

In this first article of the Luxembourg fund series, we aim to give a brief introduction on the Luxembourg fund regime, benefits and necessity to establish a Luxembourg fund for both commercial and tax purposes, and considerations that fund manager should be aware of when setting up a Luxembourg fund.

Q1 What is the market scale and ecosystem of the investment fund industry in Luxembourg?

- Second largest investment fund center after the US, and is a worldwide leader in cross-border fund distribution.
- As of December 2019, there are more than 14,800 Luxembourg-domiciled funds with over €4.7 trillion in assets[1], which are distributed in more than 70 jurisdictions.
- Stable political and social environment, with a national competent authority with strong fund industry focus.
- Favorable regulatory and tax rules, while adherence to the international standards.
- High concentration of investment fund experts specialized in all aspects of product development, administration and distribution.

Q2 Why more and more fund managers are choosing Luxembourg as the fund domicile?

- Luxembourg fund solutions are tested and well-understood by international investors.
- Due to the corporate governance or internal polices of the EU institutional investors, they would prefer (or only be allowed) to invest in an EU-domiciled fund which is regulated by its respective competent authority. The long established outstanding international financial services reputation of Luxembourg has increased the confidence of investors.
- Luxembourg funds – Undertaking of Collective Investment in Transferrable Securities (UCITS) and Alternative Investment Funds (AIFs) – benefit from a "Product" passport enabling them to be distributed to investors in the EU and Economic European Area (EEA), following a notification procedure. Non-European funds / Luxembourg funds which do not benefit from a "Product" passport would need to rely on the targeted country's distribution regulations.
- Under the prevailing international tax environment, tax authorities around the globe are targeting structures / arrangements established for tax avoidance purpose. Luxembourg is one of the ideal jurisdictions where it would be commercially feasible to establish fund holding and management structures supported by reasonable commercial purpose and substance.
- Luxembourg has a wide treaty network and a favorable domestic tax regime which is compliant with the EU Directive. The use of Luxembourg fund platform would not increase investors' tax burden but may reduce tax leakage. Qualified management fees received by Luxembourg based managers are exempt from Value-Added Tax.

1. Source: https://www.alfi.lu/

Q3 What is the difference of Undertaking of Collective Investment in Transferrable Securities Directive (UCITS) and Alternative Investment Fund Managers Directive (AIFMD)?

UCITS and AIFMD are regulatory frameworks introduced in the EU aiming to offer high levels of investor protection appropriate for retail investors and professional investors, respectively. UCITS are open-ended funds investing in transferable securities such as shares and bonds which are subject to a harmonized EU regulatory regime. Investment funds that fulfill the requirements of UCITS benefit from a "passport" permitting them to be freely marketed throughout the EU.

Investment in real estate, private equity, venture capital, hedge funds and debt funds fall outside the scope of UCITS but is subject to AIFMD, which regulates managers of such non-UCITS investment funds (i.e., alternative investment funds or AIFs). Authorized managers of AIFs benefit from a "passport", allowing them to market to professional investors through the EU.

Luxembourg was the first EU member state to transpose UCITS into national law; and one of the first EU member states to implement AIFMD. These first mover effects contribute to the success of Luxembourg's investment fund industry.

Q4 What are the available fund regimes in Luxembourg for AIFs?

Below investment vehicles are available for the setting up of AIFs in Luxembourg:

Regulated investment funds which are subject to direct supervision of the Commission de Surveillance du Secteur Financier (CSSF)

- Part II Undertakings for Collective Investment (Part II UCI)
- Specialised Investment Fund (SIF)
- Investment Company in Risk Capital (SICAR)

Unregulated investment funds which do not require prior approval by CSSF for the fund formation

- Reserved Alternative Investment Fund (RAIF) indirectly regulated by the competent authority of its alternative investment fund manager (AIFM), i.e., in Luxembourg it is CSSF
- Financial participation company (SOPARFI) and unregulated partnerships

Based on the investment strategy, targeted investors and marketing strategy of the proposed fund, we can advise an appropriate investment fund regime, the legal form of the fund vehicle (e.g., common fund or corporate form), requirements on the fund manager and third-party service providers, as well as fund governance, tax, accounting and other regulatory requirements. We can assist in the implementation of the selected Luxembourg fund holding and management structure, with the objective to complying with the AIFMD and achieving operational and tax efficiency.

Q5 What are the factors that fund manager should consider when setting up a Luxembourg fund?

- Investor base and fund size
- Investment strategy, type and location of assets
- Marketing / distribution strategy
- Regulatory environment and compliance requirements
- Initial set up costs and ongoing maintenance costs
- Speed required in setting up the fund vehicle and management structures
- Choices between regulated versus unregulated structures
- Risk diversification
- Choice between standalone or umbrella structure
- Flexibility in corporate structure and governance
- Potential tax advantages
- Ecosystem of the fund industry

Q6 A non-EU / non- EEA manager would consider raising and marketing an unregulated Luxembourg-domiciled to investors in EU and Asia. Would it be possible?

A non-EU / non-EEA manager must register with the local competent authority of the relevant EU member states in which the fund would be marketed according to the respective national private placement rules. This would cause the fund to be subject to ongoing supervision by the competent authority in each jurisdiction, increasing the compliance costs. If the non-EU / non-EEA manager desires to obtain a "passport" for marketing its AIF in EU, it may apply for authorization as an AIFM with a competent authority in an EU member state (e.g., Luxembourg). This would require the manager to comply with the AIFMD rules as an EU-manager.

Some may choose to engage a third party AIFM which would delegate part of the portfolio management / investment function to the non-EU / non-EEA manager while keeping risk management functions. This would allow the passporting of AIF throughout EU while managing the compliance cost via engaging third party AIFM.

The marketing of Luxembourg fund in Asia would be subject to the distribution rules imposed by the competent authority in the relevant Asian jurisdiction provided that such jurisdiction is open for cross-border fund distribution.

Q7 Can a Luxembourg fund be marketed to Asian and US investors?

It should be possible for both Asian and US investors to invest in a Luxembourg fund vehicle. That said, considering the tax burden of these non-EU investors in their home jurisdiction, fund managers may consider if it is advisable to establish a parallel fund in the US, e.g., Delaware, alongside the Luxembourg fund; or a feeder fund into the Luxembourg fund to optimize the fund structure.

Marketing of UCITS and AIF outside the EU / EEA is subject to each country's national regime.

Q8 What is the initial formation cost and maintenance cost of a Luxembourg fund?

Despite of the sophisticated nature of the fund regime, the initial formation and maintenance costs of a Luxembourg fund are not significantly higher than (actually approximate) that of a fund vehicle established in an offshore jurisdiction. We set out below an example of the costs of setting up a Luxembourg-domiciled fund vehicle under the SIF and RAIF regime.

Initial formation cost (one-off)	Maintenance cost (annual)
Notary fee: €2,000 - €5,000 **CSSF initial authorization fee*:** ▶ Single compartment €4,000 ▶ Multiple compartment €8,000 **Legal fees:** ▶ SIF: €50,000 - €60,000 ▶ RAIF: €40,000- €50,000 **Other costs:** advisory fees, printing of prospectus or offering document	**CSSF annual fee*:** ▶ Single compartment €4,000 ▶ Multiple compartment from €8,000 **Portfolio management or investment advisory service fees:** generally ranging from 0.05% to 2% of net assets. Minimum amounts and reduced fee rates for certain asset levels may apply. In addition, a performance fee, usually ranging from 5% to 20%, may also apply. **Management fee:** the range varies according to strategy, size, targeted market, etc. and generally it is 0.03% to 0.12% of net assets for AIFM. **Depositary:** generally 0.05% - 0.1% of net asset value. Minimum amounts and reduced fee rates for certain asset levels may apply. **Administrator:** generally 0.1% - 0.3% of net asset value. Minimum amounts and reduced fee rates for certain asset levels may apply. **Audit fee:** depending on the size and complexity of the fund **Other costs:** directors' fees, legal fees, cross-border registration application, authorization, and maintenance fees, etc.

** Not applicable for RAIF*

The Luxembourg fund vehicles are considered to be a sustainable model given their adherence to international standards. As the Luxembourg regulatory regime is becoming more flexible and creative to cater for the commercial needs of fund managers and international investors, we are seeing that the use of Luxembourg fund vehicles is gaining momentum.

EY supports asset managers, traditional and alternative investment fund houses through the choice of fund vehicles, the analysis of target markets, the definition of an efficient operating and tax model and distribution strategy, and the selection of service providers. **If you would consider setting up your next fund or redomicile your fund to Luxembourg, please feel free to contact us. Our Luxembourg fund team would be happy to further discuss with you.**

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please contact us for specific advice.

Your key contacts

Loretta So
Financial Services Tax Partner
Ernst & Young (China) Advisory Limited
+86 21 2228 2882
loretta.so@cn.ey.com

Joyce Xu
Wealth and Asset Management Partner
Ernst & Young Hua Ming LLP Shanghai Branch
+86 21 2228 2392
joyce.xu@cn.ey.com

Amanda Yeung
EMEIA Chinese Business Services
China Overseas Investment Network Director
Ernst & Young Services S.A.
+352 42 124 8686
amanda.yeung@lu.ey.com

Alain Kinsch
Luxembourg Country Managing Partner
EMEIA Private Equity Fund Leader
Ernst & Young S.A.
+352 42 124 8355
alain.kinsch@lu.ey.com

Michel Feider
Luxembourg Financial Services Assurance Partner
Ernst & Young S.A.
+352 42 124 8797
michel.feider@lu.ey.com

Bart Van Droogenbroek
Luxembourg Tax Leader
Ernst & Young Tax Advisory Services S.à.R.L
+352 42 124 7456
bart.van.droogenbroek@lu.ey.com

Other Luxembourg team members:

Vincent Remy
Luxembourg Wealth and Asset Management Tax Leader**
+352 42 124 7611
vincent.remy@lu.ey.com

Dietmar Klos
Luxembourg Real Estate Leader**
+352 42 124 7282
dietmar.klos@lu.ey.com

Olivier Bertrand
Luxembourg Tax Partner**
+352 42 124 7657
olivier.bertrand@lu.ey.com

Stephen d'Errico
Luxembourg Corporate Services Partner**
+352 42 124 7188
stephen.derrico@lu.ey.com

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