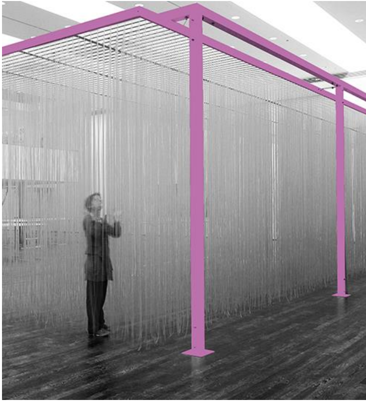

From our Hong Kong Office

October 2018

European Private Equity and Real Estate investments through Luxembourg, the Asian Connection

Executive Summary

This note summarizes the latest trends in relation to private equity and real estate investments by global and Asia-based asset managers, corporations, financial institutions and institutional investors and the manner in which they are using Luxembourg investment vehicles and platforms from both a fund raising and an investment perspectives.

For years, Luxembourg has positioned itself as the European jurisdiction of choice for global asset managers and investors accessing the European market for their private equity and real estate (PERE) investments.

Well-known Asia-based investors and managers have been using Luxembourg vehicles for their European investments and are increasing their presence and activities in the Grand Duchy by setting up investment platforms.

In this note, we will share with you the latest trends in relation to the above and focus in particular on two non-regulated investment vehicles specifically designed for PERE investments, namely, the special limited partnership (SLP), a structure inspired by Anglo-Saxon limited partnerships, as well as the reserved alternative investment fund (RAIF), an investment vehicle similar to well-established Luxembourg regulated alternative fund structures such as the specialized investment fund (SIF), although not regulated as such.

The Big Picture

During the course of 2016 Chinese outbound M&A deals hit a record high with USD 76.5 billion investments in Europe, spread on more than one hundred deals, including landmark take overs such as Syngenta AG and Pirelli SpA (ChemChina), Supercell (Tencent), Inter Milan (Suning Group), AC Milan (Sino Europe Sports Investment Management) – to name a few.

The list goes on with other major acquisitions by South Korean, Chinese and Hong Kong-based conglomerates such as Doosan Group, Fosun International and Hutchison Whampoa, which recently made the headlines throughout Europe.

European real estate and infrastructure markets also witnessed record inflows of Asian capital throughout 2016 and the first semester of 2017, with major players from China (China Investment Corporation), Singapore (Mapletree Group and Global Logistics Properties) and Korea (Korean Investment Corporation) securing acquisitions in France, Germany, Italy, Norway and the United Kingdom, amongst others.

A large number of those deals have one thing in common, which is the use of a Luxembourg investment platform.

As further outlined below, Luxembourg has become a hub for Asian investors and asset managers structuring private equity and real estate transactions with target assets located in Europe.

Besides the standard structuring of European M&A acquisitions, usually involving the set-up of Luxembourg special purposes vehicles, Asian

investors and asset managers are increasing their activities in the Grand-Duchy by setting up alternative investment funds and getting ready for capital raising from European investors, as described in the following sections.

Luxembourg as a hub to structure PERE investments in Europe

Traditionally, investors and asset managers throughout Asia have heavily relied on tax exempt offshore companies based in jurisdictions like the Cayman Islands or the British Virgin Islands for the structuring of their international investments. These vehicles have the advantage that they are well-known by investors, asset managers and their legal counsels (in particular in the Anglo-Saxon world), they are cheap, easy to establish and last but not least, tax exempt. Hence they became the default choice for Asian investors and managers for pooling the investors' interests and holding the PERE investment structure. They needed however to be used in conjunction with an intermediary company located in an onshore jurisdiction in order to gain access to double tax treaties and reduce potential withholding taxes in the source country – indeed, offshore companies, being tax exempt, do not benefit from double tax treaties.

However, the global tax environment changed in the aftermath of the 2008 financial crisis, with a major impact on tax structuring and transfer pricing. In particular, the base erosion and profit shifting ("**BEPS**") action plan developed by the Organization for Economic Co-operation and Development ("**OECD**") radically changed the way international investments may be structured, focusing on coherence, transparence and business substance. In particular, intermediary holding companies, whose sole purpose lies in getting access to a double tax treaty network, are no longer entitled to therefrom under action 6 (treaty abuse) and, if they are tax exempt, controlled foreign companies legislation (CFC) renders them tax transparent under action 2. The increased transparence under the country-by-country requested by action 13, as well as an enhanced exchange of information between tax authorities (foreseen by actions 5 and 12) should enable the tax authorities of the investors' residence state to effectively tax all income. Finally, new transfer pricing rules contained in actions 8 to 10 ensure that companies that do not (i) assume sufficient risks, (ii) perform sufficient functions and (iii) maintain sufficient business substance are no longer considered as the beneficial owner of the income derived from the investments, but as mere nominees or agents that may not claim treaty benefits for itself.

These measures directly impact the above-mentioned traditional offshore investment model that may be easily challenged by tax authorities and may result at the end in an inefficient tax structure.

The Asian PERE industry seems to take into account this change of paradigm by adopting new practices and revising their legal and tax engineering. As a result, onshore jurisdictions such as Luxembourg emerge as a natural alternative for international PERE investments from Asia into Europe.

This may be explained by the wide range of Luxembourg vehicles, regulated and unregulated, that are available and the stable legal and tax environment. Also, the Luxembourg double tax treaty network of more than 70 active double tax treaties (including amongst others the People's Republic of China, Hong Kong, Japan, Singapore and South Korea) are key in this respect. Combined with an attractive domestic tax regime for PERE investments, the treaties usually allow for a minimum tax leakage throughout the investment structure. Hence a large number of recent deals involving the acquisition of European assets by Asian investors are thus performed by Luxembourg entities, either in the form of a company or of a partnership, depending on the features of the deal.

It has nevertheless to be noted that under action 6 of the BEPS action plan, a Luxembourg or other company may only claims the benefits of a double tax treaty if it able to evidence that there is no treaty abuse. To this effect, different provisions may by introduced into existing tax treaties through the multilateral instrument provided by action 15 of the BEPS action plan, such as a principal purpose test or a limitation of benefits test or even a combination of both. Under the principal purpose test (which is mostly implemented by EU jurisdictions), the company must evidence that its main purpose is not to benefit from a treaty but that is has been established in its jurisdiction for genuine business purposes. A similar general anti-avoidance rule is meanwhile also included in the EU Parent Subsidiary Directive, on which European parent companies typically rely in order to exempt dividends derived from the EU subsidiaries. In addition, actions 8 to 10 of the BEPS action plan require that the company performs sufficient functions, assumes sufficient risks and hence maintains an adequate business substance, including an adequate capital, in order to be able to perform these functions and assume these risks.

In practice, this means that such company must first be in a position to evidence bona fide

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business reasons for its existence and its establishment in a given jurisdiction. It is noteworthy to mention that it will most likely be very difficult to justify multiple layers of companies situated in various jurisdictions for reasons other than pure tax reasons. Hence, a concentration of companies, preferably under a common platform in the same jurisdiction is preferred. In addition, the company must perform certain functions in that jurisdiction and assume the risks thereunder. Depending on the nature and the scale of the investments, this requires that human and technical infrastructure is maintained by that company. Generally, certain administrative functions (e.g. accounting, HR) are outsourced to it and appropriate equity funding is provided to it, in addition to a robust local effective management structure.

Investors and managers hence often chose Luxembourg as their hub for their EU investments: an EU resident holding company is in any event mostly needed and the international dimension of Luxembourg's financial center (languages, know-how, geographic location, presence of the necessary financial institutions and service providers also) may generally justify the establishment of the company in Luxembourg primarily for commercial reasons. The group functions transferred to the Luxembourg company may easily be performed from Luxembourg and maintaining the necessary business substance is usually not an obstacle given the variety of solutions made available. The structure may be rendered even more robust if the fund that pools the investor's interest is also established in Luxembourg (see below). Needless to say that the cost-benefit of such a platform, consisting of the fund and one or more investment companies, increases the more investments are performed by it.

In light of the above, investors and managers around the world are reconsidering the use of standalone (offshore) investment vehicles which are usually lacking of the required degree of economic substance to justify large scale operations in tax neutral or tax exempt environments, and relocate their vehicles in onshore tax neutral jurisdiction based on non-tax reasons.

From the perspective of Asian asset managers and investors which traditionally relied on standalone offshore investment vehicles, the attention has thus turned to new alternatives, such as a Luxembourg platform, ensuring flexibility and tax neutrality in an onshore environment and providing a long term robust structure for their European investments.

Alternative investments funds, a raising sector in Luxembourg, AIFMD compliance and the AIFMD Passport

Another reason of the success of the Grand-Duchy of Luxembourg with Asia-based managers is that, in addition to providing robust investment vehicles, it provides solutions for the distribution and capital rising with European investors.

The European rules on alternative investment funds, in particular, the Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers (the "**AIFMD**") has indeed increased the need for onshore investment vehicles and managers, for all market participants willing to offer alternative investment products to professional investors based in Europe. The AIFMD laid down for the first time European common requirements to be met by managers for the purposes of ensuring investors' protection and reducing certain systemic risks exposed by the 2008 financial crisis. Most importantly, from a marketing perspective, it also provided for a minimum set of rules to comply with in order to make use of national private placement rules ("**NPPRs**"), where available, AIFMD reporting requirements, as well as a passport enabling managers to market their funds throughout the European Union (the "**AIFMD Passport**").

As the first cross-border funds center in the world only second to the United States in terms of assets under management, Luxembourg has attracted traditional and alternative investment fund managers for decades. The Luxembourg legislator fully embraced the spirit of the AIFMD and made the strategic decision to modernize its alternative funds structuring toolbox by introducing new investment vehicles as further described below.

Managers used to the flexibility and effective time-to-launch of offshore structures can find substantially equivalent unregulated investment vehicles in Luxembourg, in an onshore and AIFMD compliant environment. This proved to be a key factor in attracting Asian fund managers traditionally dealing with lightly regulated offshore funds, as they expand their activities globally and widen their portfolios of investors by focusing on European institutional investors.

In this respect, Luxembourg vehicles such as the specialized investment fund ("**SIF**"), the investment company in risk capital ("**SICAR**"), the reserved alternative investment fund ("**RAIF**") or the special limited partnership ("**SLP**"), to name the most important ones, are suitable to fulfill the requirements of the AIFMD in order to sell in

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Europe on the basis of NPPRs, where available, and enjoy the benefit of the AIFMD Passport through the appointment of a duly licensed AIFM.
In this respect, one willing to rely on NPPRs should be aware that (i) a number of core requirements of the AIFMD regarding in particular reporting, control and asset-stripping will have to be met at the level of the fund, (ii) the fund, its AIFM and delegates will have to be in jurisdictions having signed and AIFMD memorandum of understandings ("**MoUs**") with the country of distribution and (iii) notification or authorization procedures in the country of distribution will have to be complied with.

As indicated above, the AIFMD grants duly authorized alternative investment fund managers (**AIFMs**) the right to distribute the funds they manage to non-retail investors within the entire European Economic Area under a simplified notification process, the AIFMD Passport. Currently available to European managers and EU-domiciled funds only, the AIFMD Passport has proved to be a decisive factor for the attractiveness of Luxembourg as alternative fund's hub as well. A number of managers have indeed, to cope with AIFMD requirements as well as to a certain extent external factors like Brexit, chosen Luxembourg not only to domicile their funds, but their AIFM, and therefore enjoy the advantages of the AIFMD Passport since 2013.

To summarize, AIFMs located outside the EU, such as Asian managers, which may not yet by themselves benefit of the AIFMD Passport and those willing to access to the European market have therefore two solutions, either (i) they rely on NPPRs or (ii) setup their fund in Europe and create their own, or appoint a third party, duly licensed EU AIFM.

One model often used by Asia-based managers consist in setting up their investment vehicle in Luxembourg and appoint a local third party service provider as their EU-AIFM, which in turns delegates the portfolio management to the Asia-based manager. Should the home jurisdiction of the Asian manager and the EU country of distribution not have entered into an AIFMD MoU, then the Asian manager may be appointed as investment adviser to the AIFM (but not as investment manager). This is currently a standard set-up that is adopted in relation to Mainland Chinese promoters.

In the preceding paragraphs, we have highlighted how as a result of the change in the tax paradigm worldwide as well as the trend towards more regulation in the EU regarding alternative fund distribution, Luxembourg has become the jurisdiction of choice where to build the substance and setup an investment platform for European investments. In the following paragraphs, we will highlight how certain Luxembourg investment fund structures have become closer to anglo-saxon investment vehicles with the SLP and the RAIF structures.

The Luxembourg Special Limited Partnership, the onshore alternative to Cayman funds

Within the context of the AIFMD implementation in Luxembourg in 2013, the legislator revisited the existing Luxembourg limited partnership regime. The purpose of the Luxembourg law maker was to modernize the limited partnership as well as strengthen Luxembourg's position in the alternative investment sector with managers used to anglo-saxon types of vehicles willing to find an alternative to Cayman and similar offshore vehicles.

Legislative changes resulted into a comprehensive overhaul of the legal framework regarding common limited partnerships ("**CLP**") as well as the introduction of new special limited partnership vehicles ("**SLP**"). Whilst the modernization of CLPs largely responded to the needs of the investment fund industry for more flexibility, the actual game changer for fund initiators and asset managers alike was the introduction of SLPs – offering new structuring solutions for (regulated/unregulated) alternative investment funds, joint venture and special purpose vehicles.

The main advantage of the SLP is that it combines legal features largely inspired by Common Law type of partnerships with the fact that it is located in an onshore context and may thus fit in the European legal framework of the AIFMD.

Features of the SLP are almost exclusively determined by its limited partnership agreement, with statutory provisions kept to a minimum. A high degree of contractual freedom and flexibility is therefore ensured in terms of internal management, allocation of voting rights and profits amongst partners, issuance of partnership interest (in the form of securities or capital accounts), debt financing, returns of capital contributions and dissolution of the partnership, to list a few. In terms of flexibility, from certain angles the Luxembourg SLP goes even beyond equivalent offshore vehicles. SLPs are for example established upon signature of the limited partnership agreement - the subsequent registration with the Luxembourg Trade and Companies Register only being a formality filings requirements with the local trade register tend to be lighter in Luxembourg, as in the case of annual

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returns filings – not required for SLPs but still applying to Cayman and Guernsey limited partnerships. The absence of restrictions regarding distributions is another distinctive feature of Luxembourg SLPs. Distributions by Cayman exempted limited partnerships to their limited partners can be, for instance, subject to claw-back rules for a period of six months commencing on the date of the relevant payment or release, in the event that the entity was insolvent when the distribution was made and the limited partner knew the insolvency of the ELP. These restrictions are not imposed to SLPs.

In terms of confidentiality, the names and outstanding subscriptions by the limited partners are not disclosed to the public, to the extent that the partnerships' constitutive documents may also be filed with the Luxembourg Trade and Companies Register in excerpt form.

SLPs are further characterized by a look through approach by the Luxembourg tax administration and most Beijing tax authorities, resulting into general tax transparency. Capital accounting, which are necessary to cope with complex financings can also be applied in the context of SLPs as the law leaves freedom to the creation of capital and/or loan accounts for each partner in lieu of issuance of securities to them.

It is worthwhile noting that an SLP is as such regarded as an EU AIF which can be sold throughout the EU under NPPRs and can offer an immediate access to the AIFMD Passport by the appointment by the general partner of an AIFMD compliant AIFM (which can also be the general partner itself). The fact the SLP structure may give access to the AIFMD Passport when the manager deems it appropriate or necessary is an important advantage of the SLP compared to traditional offshore vehicles.

A bridge between Civil Law and Common Law legal systems, SLPs are the onshore alternative to offshore limited partnerships which have been historically popular among Asian investors and managers.

The Reserved Alternative Investment Fund, the Luxembourg non-regulated alternative investment platform

As we indicated above, the AIFMD introduced a harmonized manager regulation across Europe, *de facto* creating a new European investment funds order whereby alternative investment funds can be subject to either regulation both at product and manager level, or only through the regulation of the AIFM. Although other regulated investment funds solutions such as SIFs or SICARs are perfectly suitable and widely used by international investors and managers, the Luxembourg legislator realized that market participants no longer perceived product supervision as a must, thus shifting from its traditional double tier supervisory model, supervising both the manager and the fund, to a single tier model only focusing on the AIFM and no longer on the fund.

As a consequence, a new investment vehicle has been introduced in the Luxembourg funds market place in the fall of 2016: the reserved alternative investment fund ("**RAIF**").

One of the key features of the RAIF framework is its flexibility, *i.e.* the possibility to create a fund in all aspects similar to a SIF or a SICAR, comprising fully ring-fenced sub-funds with an upfront AIFMD compliance and access to the AIFMD Passport without being having the fund subject to CSSF supervision. RAIFs thus benefit from a streamlined time-to-market for new fund launches. To benefit from the RAIF legal framework, RAIFs must appoint a duly licensed AIFM. This means that unlike SLPs, which as described above, may appoint a duly license AIFM and become AIFMD compliant with access to the AIFMD Passport, RAIFs must appoint an AIFM, for the time being in the EU and when the benefit of the AIFMD will be extended to non-EU countries to managers in those countries.

It is worthwhile mentioning that all Luxembourg corporate, partnership and contractual legal forms are available to set up RAIFs, including in terms of choosing between a variable (open ended) or fixed capital (closed ended) structure. RAIFs can be setup using the SLP as described above and benefit from the flexibility of the SLP regime.

From a tax perspective, RAIFs may choose between the regime applying to SIFs, (i.e. an annual subscription tax at a rate of 0.01% of their net asset value) or to be fully subject to tax save for qualifying risk capital income and gains – pursuant to the rules governing SICARs.

Similarly to the considerations made for SLPs, RAIFs stands as strong onshore alternative to traditional offshore funds established in the Cayman Islands or the British Virgin Islands, with marketing advantages resulting from the AIFM Passport and the enhanced cross-border marketability of Luxembourg funds among European and institutional investors.

Outlook for Asian managers structuring European investments or distribution

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Asia-based asset managers, in particular, those focusing on alternative investments, are increasingly launching projects outside their traditional domestic / regional markets to achieve portfolio diversification and higher returns.

The European market is considered as a key market within the strategy of Asian players going global with Luxembourg often considered as the ideal bridge jurisdiction to implement such a strategy.

The corollary to this is the appetite of European investors for products focusing and/or managed from Asia which has been growing steadily, in particular, since the opening up of the Chinese economy to foreign investment and the increasing recognition and reputation on the market of Asian asset managers.

Luxembourg stands on both side of the spectrum by providing the investment structures and platforms to those investors and managers and we believe that this trend towards onshore structures and substance building will continue and benefit directly to Luxembourg as a PERE centre of excellence.

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