tax notes international

Volume 53, Number 13 ■ March 30, 2009

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Reprinted from *Tax Notes Int'l*, March 30, 2009, p. 1217

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by Philippe Neefs and Oliver Hoor

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This article covers Luxembourg's rapid ascent as a global hub for Islamic finance, and the breadth of available business opportunities. The malleability and tax efficiency of the investment vehicles and seminal government regulations provide a huge potential for the expansion of Islamic offerings on the Luxembourg market.

Because media coverage of Luxembourg as a prime platform for Islamic finance transactions is scarce, this article reviews Luxembourg's position as an international tax and financial center.

I. Introduction

Contemporary Islamic finance is a burgeoning segment of international finance, and Luxembourg aims to become a center point. Although no conclusive data are yet available — a fact reflective of the industry's youth — many observers estimate the global Islamic finance industry has up to US $700 billion in managed assets[1] and a growth rate of 10 percent to 15 percent per annum.[2] Arguably, the resilience of Islamic finance amid the current economic downturn demonstrates its potential for growth in the future.

Over the last few years the Islamic finance movement has been given a major boost with the rise of Islamic finance hubs and Western governments' willingness to give their Muslim communities access to financial services consistent with their religious beliefs.

Crucially, Luxembourg preempted the growth in Islamic finance by making available a wide array of tax-efficient *sharia*-compliant instruments, well before other Western governments. Today, Luxembourg is seen by many firms, both Islamic and non-Islamic, as an increasingly important global center for Islamic finance.

Government support and a favorable regulatory environment encourage Islamic companies and financial institutions to set up operations in Luxembourg. The Luxembourg Stock Exchange was the first European stock market to launch *sukuk* (asset-backed securities), and the Luxembourg Financial Services Authority (Commission de Surveillance du Secteur Financier, or CSSF) has witnessed a significant increase in Islamic equity investment funds. A business-oriented environment, a proactive CSSF, and a flexible and secure framework permit Luxembourg to maximize the tax efficiency of its *sharia*-compliant products and to spearhead global Islamic transactions.

Luxembourg tax advisers have continuously sought to improve the efficiency of their Islamic products and instruments. This article gives a tax perspective by covering two main areas: the fundamentals and techniques of Islamic finance, and the widespread *sharia*-compliant opportunities that Luxembourg offers, boasting unrivaled flexibility and exceedingly low levels of effective taxation.

II. Fundamentals of Islamic Finance

A. Main Principles

Islamic finance is finance under Islamic law (*sharia*) principles. The basic sources of *sharia* are the *Quran* and the *Sunnah*, which are followed by a consensus of the jurists and interpreters of Islamic law.

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[1] *See* ''Savings and Souls,'' *The Economist*, Sept. 4, 2008, *available at* http://www.economist.com/world/mideast-africa/displaystory.cfm?STORY_ID=12052687.

[2] Rahail Ali (ed.), *Islamic Finance: A Practical Guide* (Global Law and Business, 2008).

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All contracts in the framework of Islamic finance must comply with the rules of the *sharia*, which notably ban interest and speculation and stipulate that income must be the fruit of shared business risk rather than guaranteed return. A contract is deemed *sharia* compliant if its terms and conditions do not violate the prohibitions of Islamic law.

The main principles of Islamic finance include:

- **The prohibition of the payment and receipt of interest (*riba*).** The structure of Islamic finance revolves around the prohibition of all fixed returns derived from a debt instrument (*riba*) and the lawfulness of profit deriving from investments. An Islamic finance investment must be part of ''real activity'' and not a financial or monetary transaction through which the mere transfer of funds is sought. Any predetermined fixed rate return on a debt instrument, be it substantial or not, tied to its maturity, and whose principal amount is guaranteed regardless of the performance of the investment, is considered *riba* and prohibited by the *Quran*. Islam requires, however, that the lender — should he wish to take a share in the profit — also participate in possible losses proportionate to his capital in the business.
- **The prohibition on uncertainty (*gharar*) about the subject matter and terms of contract.** *Gharar* relates to the mere uncertainty in the quantity, quality, or existence of the subject matter of a contract, and not to the risk as used in commercial terminology. Uncertainty and entitlement to profit in business go hand in hand in Islamic law. Contracts must therefore be drafted as clearly as possible so as to avoid *gharar*. In many cases, *gharar* can be effectively eliminated from a contract by carefully stating its object and price.
- **The prohibition on transactions involving speculation and gambling (*masir*).** Attached to the prohibition on uncertainty is the prohibition on transactions involving *masir* that involve asymmetric information, excessive uncertainty, risk, and lack of control. Incidentally, by prohibiting *gharar*, the *sharia* also forbids trading *gharar*. Consequently, the current practices of conventional financial institutions and insurance companies in the futures and options markets are not compliant with the *sharia* because of, for example, the features of *gharar*, interest, and gambling. Gambling may be construed as a form of *gharar* since the gambler who puts his money at stake is not in control of its result. Gambling is involved in many financial transactions and conventional banks' schemes and products, which Islamic companies and financial institutions are to avoid.
- **The prohibition on investments in undesirable businesses.** Irrespective of the form of investment used, investments in businesses dealing with activities that the *sharia* considers unlawful are deemed prohibited, such as:
  - — alcoholic beverages and tobacco products;
  - — grocery stores dealing with *haram* goods;
  - — restaurants, casinos, and hotels with bars for prohibited activities;
  - — amusement and recreational services likely to involve indecent activities;
  - — conventional financial institutions (primarily because of *riba* and/or *gharar* associated therewith); and
  - — pornography.
- **Earnings through profit-sharing investments.** Islamic finance techniques are asset-based and involve real economic activity undertaking responsibility and liability. When loans are granted for business purposes, the lender — should he want to be entitled to a legitimate gain under the *sharia* — should take part in the risk.
- **Asset-based principle.** Of all the rules that govern the structure of Islamic finance instruments, the rule that transactions must be based on real assets is the most striking.

Describing the Islamic financial system as merely interest free would be wholly inaccurate. The promotion of entrepreneurship, preservation of property rights, transparency, and the sanctity of contractual obligations, crucial to any sound financial system, are the cornerstones of Islamic finance.

One distinct feature of the modern Islamic finance movement is the role of the *sharia* board, which monitors the operations of the Islamic banking institution and plays a central role in transactions, notably in clarifying elements that are doubtful from a *sharia* perspective in the form of legal opinions (*fatwa*). The *sharia* is open to interpretation and *sharia* boards often have divergent views even on key *sharia* issues. In this regard, there is no practical guide except for the general guiding principles outlined above. Any particular Islamic finance transaction therefore needs to be vetted by Islamic scholars to ensure compliance with *sharia* concepts. While a specific instrument may be accepted by one *sharia* board, it may be rejected by another.

B. Islamic Finance Techniques

The Islamic economic system has a set of interest-free core models that serve as a basis for the design of more sophisticated and complex financial instruments. The most relevant Islamic modes of financing may be categorized into equity- and debt-related techniques.

1. Equity-Related Techniques

***Mudaraba* (profit-sharing agreement).** The *mudaraba* is a profit-sharing arrangement with one party providing capital and the other party (*mudarib*) providing entrepreneurial skills. While losses accrued are borne by

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the provider of capital, profits are shared by both parties in accordance with a predetermined ratio.

***Musharaka* (joint venture).** The *musharaka* is a partnership between two parties that provide capital in agreed measures. The partnership clearly sets out arrangements for the sharing of both profits and losses in the venture.

Diminishing *musharaka* (declining balance partnership). The diminishing *musharaka* involves the shared ownership of an asset that one party gradually buys from the other, thus incrementally increasing its share until the full ownership of the asset is transferred to one party. This variant is only feasible regarding fixed assets or other assets that can be leased or given for use to the other party.

2. Debt-Related Techniques

***Murabaha* (forward sale).** The *murabaha* involves a contract between two parties for the sale of goods at a price that includes an agreed profit margin. It results in debt amounting to the cost, plus a profit margin. The debt must be paid back irrespective of the profit or loss incurred by the purchaser (client). Modern *murabaha* transactions generally take the form of *murabaha* to purchase order, characterized by the bank purchasing an asset from a third party at the client's request, and selling it to the client on a deferred payment basis.

Commodity *murabaha* (or *tawarruq*). The commodity *murabaha* avoids *riba* and involves a contract in which a commodity (for example, gold or platinum) is purchased on credit and immediately sold at spot value with the objective of receiving cash. The commodity as such is not required by the buyer; rather, the buyer simply needs liquidity that he receives via the purchase of a commodity on credit and its immediate sale against cash.

***Salam* (spot sale).** *Salam* involves a forward sales contract, which enables a commodity to be bought with immediate payment but future delivery. This type of contract exemplifies the concept of the time value of money through the pricing of goods. The fundamental element of *salam* is that the price paid in advance is lower than the cash-and-carry price at the time of delivery. *Salam* provides the buyer with a hedge against possible future price increases, and the seller with immediate cash injection.

***Istisna'a* (commissioned manufacture).** Whereas the principle of *gharar* prevents the sale of an asset one does not own, the techniques of *istisna'a* and *salam* have been developed as exceptions to this. *Istisna'a* is a sales contract applicable to assets to be manufactured (for example, a real estate development project) that are identified by specifications and not by designation. This contract is valid only for those assets that must be manufactured or built. Both unique and homogeneous assets are covered under *istisna'a*, provided their specifications are agreed on at the time of the agreement.

***Qard hasan* (interest-free loan).** The *qard hasan* is a loan agreement characterized by a guarantee for repayment in full by the end of a predetermined period without any further return (or share in the profit or loss of the business) to the creditor. A modest service charge is permissible, however.

***Ijara* (leasing).** The *ijara* involves the lease of particular assets for a period of time in exchange for predetermined rental payments. Following the finalization of the agreement, the lessor cannot increase the rent unilaterally. However, in the case of a lease with a long duration, the increase of rental payments may be based on any agreed benchmark during the lease period (for example, the inflation rate or an interest-based rate such as the EURIBOR). For the period the asset is leased, the lessor remains the owner of the asset and bears its ownership risks. All liabilities emerging from the ownership are borne by the lessor, but the liabilities relating to the use of the property are borne by the lessee.

***Sukuk* (asset-backed securities).** *Sukuk* represent the proportional ownership of the holders in underlying assets that may be issued by governments or private companies. While *riba* is prohibited, the *sharia* accepts the validity of financial assets that derive their return from the performance of a real asset. *Sukuk* may be based on all *sharia*-compliant financing. However, most *sukuk* currently issued are based on underlying *ijara* transactions[3] whereby the stream of income generated from the sale and leaseback of real property assets (for example, airports, buildings, schools, or hospitals) funds the payment to the *sukuk* holders.

But for those elements deemed undesirable and prohibited by the *sharia*, debt plays a vital role in Islamic finance. Islamic financial institutions regularly create debt by providing financial facilities in trading activities. Thus, *sharia* compliance certainly does not revolve around putting debt and equity in opposition, but rather emphasizing equity and subjecting debt to the principle that once created, it should not increase on a conventional opportunity cost basis.

III. Opportunities in Luxembourg

A. Structuring Islamic Finance Investments

1. Overview

The advent of Luxembourg as a prime platform for business has provided the financial industry with global opportunities. As one of the most prominent investment management centers and a pivotal holding location, Luxembourg is perfectly equipped to address the dynamic needs of Islamic finance investments in and through Europe. The Luxembourg financial center has

[3]Natalie Schoon, *Islamic Banking and Finance* (Spiramus Press, 2008), p. 47.

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many strengths, including the flexibility of policymakers, the proactive attitude of industry leaders, banking confidentiality, and the possibility to obtain certainty and security in advance from the Luxembourg tax authorities on a case-by-case basis.

Luxembourg is perfectly equipped to address the dynamic needs of Islamic finance investments in and through Europe.

While Islamic finance structuring in non-Islamic jurisdictions must abide by all of the traditional limitations of *sharia* law, it generally faces the additional challenge of operating in legal and regulatory environments unaccustomed to Islamic finance techniques.

The compatibility of the Luxembourg legal framework with Islamic finance requirements for the implementation of *sharia*-compliant products is of immeasurable importance. Islamic modes of finance such as *mudaraba*, *musharaka*, and diminishing *musharaka* on one hand, and *sharia*-compliant debt push down via *ijara*, *qard hasan*, *murabaha*, or commodity *murabaha* on the other, may be realized in an extremely tax-efficient manner.

Different types of investors necessitate an endless variety of legal, financial, and tax advice. Luxembourg has recognized this and seeks to provide the most efficient investment vehicle or structure to each investor. Luxembourg offers a wide choice of:

- regulated investment vehicles (undertakings for collective investments — UCI, parts I and II; for example, *société d'investissement à capital variable* (SICAV), *société d'investissement à capital fixe* (SICAF), or *fonds commun de placement* (FCP));
- semiregulated investments vehicles (for example, *société d'investissement en capital à risqué* (SICAR) or specialized investment fund (SIF)); and
- unregulated holding companies (for example, *société de participation financière* (SOPARFI) or *société de gestion de patrimoine familial* (SPF)).

Importantly, the internationally recognized Luxembourg Stock Exchange boasts an attractive international listing marketplace for shares and a wide range of securities including asset-backed securities, equity securities, and global depositary receipts. Fourteen *sukuk* with a combined value of US $5.5 billion were listed and traded on the Luxembourg Stock Exchange as of September 2008,[4] the first European stock exchange to list *sukuk*.

Key to Islamic investors, Luxembourg boasts a wide investment treaty network of 79 countries[5] (including Kuwait, Saudi Arabia, the United Arab Emirates, Kazakhstan, Uzbekistan, Malaysia, Turkey, and India) that provides maximum investment protection. Investment treaties with Azerbaijan, Sudan, and Pakistan are awaiting ratification, and a treaty is being negotiated with Bahrain.

2. Domestic Tax Law

In applying the 2009 tax reform,[6] Luxembourg companies are subject to corporate income tax and municipal business tax at an aggregate standard rate of 28.59 percent (companies established in the city of Luxembourg) on their worldwide income. This rate has been decreased from 29.63 percent in 2008 and should progressively be reduced to 25.5 percent. Moreover, Luxembourg companies are subject to a net wealth tax levied on the company's unitary value (a modified net asset value) as of January 1 of a given year at a rate of 0.5 percent. Luxembourg also offers the lowest standard VAT rate within the European Union (15 percent).

Considering the importance of equity financing in Islamic finance transactions, the abolishment of the Luxembourg 0.5 percent capital duty (previously levied on the fair market value of contributions) significantly enhances Luxembourg's Islamic investor-friendly tax environment.

In an effort to become the partner of choice for Europe's envisioned knowledge-based economy, since January 1, 2008, Luxembourg has applied a tax regime that provides for an exceedingly low effective tax rate on some types of IP income earned by Luxembourg taxpayers. The hallmark of the new regime is an 80 percent tax exemption on royalties and capital gains derived from a broad range of IP rights, including trademarks, patents, domain names, and know-how. For companies benefiting from the new regime, this would result in a Luxembourg effective income tax rate of 5.7 percent on qualifying net IP income (that is, 28.59 percent aggregate tax rate applied on 20 percent taxable IP income). The law also provides for an 80 percent deemed income deduction applicable to the use

[4]For more information, see http://www.bourse.lu.

[5]Agreements on the Reciprocal Promotion and Protection of Investment play a crucial role in the strengthening and developing of economic relations on a regular basis. These agreements aim at promoting and protecting investments of the nationals and enterprises of one contracting party in the territory of the other by providing an appropriate legislative environment to promote and stimulate investment.

[6]The Luxembourg parliament gave assent to Bill 5913 on Dec. 16, 2008.

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of self-developed patents. A full net wealth tax exemption is applicable to qualifying IP rights beginning January 1, 2009.

Regarding corporate shareholders resident of the EU or — beginning January 1, 2009 — of a country with which Luxembourg has signed an income tax treaty, Luxembourg domestic tax law provides for an exemption from the 15 percent withholding tax on dividends if some conditions are met. As a rule, no withholding tax is levied on royalties (with some exceptions), interest, and liquidation proceeds.

The fiscally unrivalled nature of the repatriation mechanism of Luxembourg's *sharia*-compliant financing instruments cannot be overstated. For example, financing instruments may be structured with a direct link to a particular asset or investment portfolio, bearing variable yield depending on the income deriving from the asset and participating in the business risk of the borrower as required by the *sharia*. Unlike some other jurisdictions, yield paid on pure income participating financing instruments may be deductible for Luxembourg tax purposes and not subject to Luxembourg withholding tax, irrespective of the status or residence of the recipient.

Alternatively, financing instruments may be convertible, bearing no fixed yield but providing for redemption at their fair market value. The fair market value increases because of the conversion feature attached to the company's value. The loss realized by Luxembourg companies on the redemption of such instruments may be tax deductible and paid free of Luxembourg withholding tax.

The Luxembourg tax treatment of business transactions is based less on their legal characteristics than on their economic reality (the substance-over-form principle).

To promote foreign investments, Luxembourg also provides for a wide range of incentives including investment tax credits, rollover of capital gains, and attractive special tax regimes such as the Luxembourg shipping company regime.

3. International Tax Law

As a founding member of the EU, Luxembourg has incorporated the EU parent-subsidiary, interest and royalty, and merger directives into domestic legislation. These directives have great significance for international groups. Indeed, the parent-subsidiary directive generally eliminates withholding tax on profits distributed by the subsidiary for substantial shareholdings and removes potential double taxation on those profits. The merger directive ensures that pan-European group reorganizations such as mergers, demergers, and share-for-share transactions may be structured in a tax-neutral manner.

Luxembourg's wide double tax treaty network is ever-expanding and currently numbers 51, including Indonesia, Malaysia, Turkey, and Uzbekistan, enabling significant tax-efficient structures for the avoidance of double taxation. Tax treaties with the United Arab Emirates, Qatar, Kuwait, Azerbaijan, Kazakhstan, and Kyrgyzstan are awaiting ratification, while tax treaties with Bahrain and Pakistan are in negotiation.

The Luxembourg tax law provides for neither controlled foreign corporation rules nor detailed transfer pricing rules. However, as an OECD member country, Luxembourg adheres to the OECD transfer pricing guidelines requiring that all transactions between related parties comply with the arm's-length principle.

B. Luxembourg Holding Companies

Luxembourg tax law provides for three different holding tax regimes: the SOPARFI, the SPF, and the 1929 holding company regime; the latter is mainly of historic interest (its expiration is set for December 31, 2010).

1. SOPARFI — Participation Exemption Regime

The SOPARFI is a fully taxable Luxembourg company whose primary activity is holding and financing. The SOPARFI benefits from an extensive and flexible participation exemption regime from both Luxembourg's tax treaty network and EU directives. Importantly, the SOPARFI is not subject to any prudential control.

The Luxembourg participation exemption regime provides that dividends, capital gains, and liquidation proceeds relating to participations in Luxembourg and foreign companies (that is, EU companies listed in the appendix to article 2 of the parent-subsidiary directive and other companies that are subject to corporate income tax at a minimum rate of 10.5 percent) may be tax exempt under some conditions. The participation exemption regime includes a further exemption from the 0.5 percent annual net wealth tax.

Regarding the financing of Luxembourg companies, no detailed thin capitalization rules are defined in Luxembourg domestic tax law. However, under the current Luxembourg administrative practice, compliance with an 85-15 debt-equity ratio is essential when financing participations to avoid a recast of yield payments into hidden dividend distributions; the latter is not tax deductible and in principle is subject to Luxembourg withholding tax. However, since debt instruments that do not bear any fixed return (as required by Islamic law) qualify as equity for debt-equity ratio purposes, participations may be financed up to 99 percent with asset-linked income participating or convertible financing instruments.

For participations qualifying for the participation exemption regime, yield paid on asset-linked and convertible financing instruments should not be tax deductible but free of Luxembourg withholding tax. Should a participation held by a Luxembourg SOPARFI not be covered by the participation exemption regime, yield paid on these financing instruments

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would also be tax deductible leading to a minimum taxable basis. Thus, investments in non-EU resident companies that are not subject to corporate income tax at a minimum rate of 10.5 percent may be structured in a tax efficient manner via Luxembourg.

Luxembourg holding structures may be further optimized using *sharia*-compliant financing techniques tailored to each case. To achieve *sharia*-compliant status, conventional debt may be restructured using sophisticated financing structures, including the classic Islamic modes of finance such as the *murabaha*, commodity *murabaha*, and *ijara* (for example, the sale and leaseback of assets belonging to the subsidiary).

2. SPF — The Family Wealth Management Vehicle

With the SPF, the Luxembourg government has introduced a new investment vehicle with a privileged tax regime targeting individuals for the purpose of passively holding shares or other investments. The SPF is poised to replace the 1929 holding company and is undoubtedly the ideal investment vehicle for wealthy Islamic individuals willing to pool their European-based investments in an extremely tax-efficient manner.

The SPF takes the legal form of a Luxembourg company but may only perform private wealth management activities, including holding, management, and disposal of financial assets. The SPF may hold any kind of financial instruments, be it shares in companies and undertakings in collective investments, or bonds and asset-linked instruments such as *sukuk*. Real estate may only be held indirectly through a Luxembourg company.

Due to its private nature, the number of investors in an SPF should be limited and may, for instance, comprise members of a family, an investor club, or any other group of individuals willing to manage all or part of their private wealth in common. Shares issued by an SPF may not be publicly traded or listed on a stock exchange.

The SPF is exempt from corporate income tax, municipal business tax, and net worth tax. Also, it is exempt from Luxembourg withholding tax on distributions. The SPF is nevertheless subject to an insignificant subscription tax of 0.25 percent on its net asset value capped at €125,000 per annum. Because of its particular tax regime, the SPF is out of the scope of double tax treaty benefits and cannot benefit from the EU parent-subsidiary directive. The directive may, however, be circumvented via the interposal of an SOPARFI that could be financed in a tax-efficient manner with *sharia*-compliant asset-linked financing instruments. Capital gains and liquidation proceeds connected to an SPF and received by nonresident investors are tax exempt in Luxembourg even if they are short-term gains or proceeds.

An SPF loses its tax-exempt status, however, if it receives more than 5 percent of its dividends from nonresident, nonlisted companies that are not subject to an income tax similar to Luxembourg corporate income tax (that is, at least 10.5 percent on a comparable taxable basis). Companies listed in the EU parent-subsidiary directive are deemed to be subject to comparable taxation.

C. Luxembourg Investment Funds

As Europe's largest center for investment funds, Luxembourg remains the undisputed leader in cross-border sales of investment funds and provides an ever-expanding range of tax-efficient opportunities for investment structuring.

1. UCITS

A UCI is a collective investment of funds raised from the public for the purpose of investing these funds according to the principle of risk diversification. Luxembourg UCITS (Undertakings for Collective Investments in Transferable Securities) is a subcategory of funds that fulfill EU regulation requirements and may therefore be offered to (Islamic) investors throughout the EU on the basis of a single authorization from one member state.

Under Luxembourg law, investment funds may be set up as mutual funds (FCP), or corporations with either fixed (SICAF) or variable (SICAV) capital. Also, these legal structures may take the form of a single fund or an umbrella fund. All Luxembourg UCIs must obtain prior authorization from the CSSF.

In an Islamic equity fund, amounts raised from investors are invested in shares in listed companies or real estate entities, provided that such companies operate in a *sharia*-compliant manner. The main issues include:

- the area of activity for companies whose shares are the target for Islamic equity funds;
- the interest element in the companies' income; and
- the companies' debt-equity ratio.

The compliance of a company with the *sharia*, and therefore the permissibility of its shares as an investment for the fund, will be verified by the respective fund's *sharia* board; regular *sharia* auditing is usually conducted to ensure the fund's continued compliance with the requirements of the *sharia*. As of September 2008, there were 31 *sharia*-compliant investment funds in Luxembourg, and several more in the process of being launched.[7]

Luxembourg investment funds are exempt from corporate income tax, municipal business tax, and net worth tax. There is no withholding tax on dividends paid by a Luxembourg UCI, except for a possible application of the EU savings directive, which does not

[7]Commission de Surveillance du Secteur Financier, the Luxembourg Financial Supervisory Authority.

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apply to Islamic equity funds. An insignificant annual subscription tax (*taxe d'abonnement*) of 0.01 percent or 0.05 percent of the company's net worth is, however, payable. The rate at which the subscription tax is levied depends on the form of the investment funds.

Since only 24 of Luxembourg's tax treaties are applicable to Luxembourg SICAVs or SICAFs, those investment funds may invest through a fully taxable company financed with asset-linked instruments to benefit from Luxembourg's wide tax treaty network.

2. SIF

The SIF (specialized investment fund) is designed as a classic investment fund collecting funds from a closed circle of experienced investors. While its tax regime is similar to any other Luxembourg investment fund, its regulation by the Luxembourg Financial Services Authority is much lighter. The SIF can be implemented in contractual form (FCP) or in corporate form (SICAV or SICAF), and structured either as a single fund or an umbrella fund.

An SIF is reserved to well-informed investors. As such, investor protection is downgraded and the SIF enjoys far more flexibility than other regulated funds. The SIF may also invest in any type of asset and therefore be used for any type of funds, such as:

- transferable security funds investing in *sharia*-compliant assets;
- real estate funds investing in participations in real estate companies or other interests related to long-term real estate (for example, right to ground rents or long-term *sharia*-compliant leases);
- private equity funds;
- venture capital funds investing in high-risk companies; and
- funds of funds.

Considering the endless possibilities offered by the SIF and the flexibility of its legal framework, it is an ideal vehicle for structuring *sharia*-compliant investments in a very tax-efficient manner.

As with any other UCI, the SIF will be required to diversify its investments. However, no quantitative limits are set by law. Thus, the SIF's founders will set appropriate diversification rules that will later be approved by the CSSF.

The SIF is exempt from corporate income tax, municipal business tax, and net worth tax. There is no withholding tax on dividends paid by a Luxembourg UCI but for possible application of the EU savings directive. An insignificant annual subscription tax of 0.01 percent of the company's net worth is payable, however.

Similar to other corporate investment funds, the SIF in its corporate form only benefits from 24 of Luxembourg's tax treaties. However, it may invest through a fully taxable Luxembourg company financed with asset-linked instruments to benefit from Luxembourg's wide tax treaty network.

D. Special Investment Vehicles

1. SV — The Luxembourg Securitization Vehicle

The Luxembourg SV may be used to acquire or assume, directly or indirectly, risks attached to claims, other assets (for example, commodities), or commitments that were assumed by third parties. Considering its exceedingly broad scope, the Luxembourg SV is compatible with many *sharia*-compliant securitization transactions and may be listed on the Luxembourg Stock Exchange.

The Luxembourg SV is financed with the issuance of securities backing its assets (collateral) and the income generated by those assets. The purpose of the Luxembourg SV is to facilitate capital market transactions, intragroup transactions, and a combination of the two. The law governing the Luxembourg SV is a well-balanced compromise between maximum flexibility and high investor protection, while providing for a neutral tax environment. Of note, only those securitization vehicles engaged in the regular issuance of securities to the public are subject to prior authorization and regulation of the CSSF.

The Luxembourg SV's regulatory framework allows the implementation of securitization vehicles either in the form of a company or as a fund (the latter must be managed by a management company). Both securitization companies and securitization funds may be set up using an umbrella structure, that is, a structure comprised of compartments with segregated classes of assets and liabilities. It is therefore possible to make distinct transactions with one vehicle. Between investors, each compartment is treated as a separate entity; the rights of investors and creditors are limited to the risks on the assets of a given compartment. Each compartment can be liquidated separately, without triggering the liquidation of, or otherwise affecting, the other compartments. Moreover, the Luxembourg SV or any compartment thereof may issue several securities, each of which relates to different collaterals bearing different terms and conditions.

Corporate securitization vehicles are subject to tax in Luxembourg at the standard corporate tax rate (28.59 percent in 2009 for the city of Luxembourg), but exempt from net wealth tax. Most importantly for Islamic investors, commitments to investors — even in the form of pure variable yield on asset-linked financing instruments or dividends — are fully deductible from the tax basis of the securitization company and not subject to Luxembourg withholding tax. As a result, it is possible to reduce the company's taxable income to close to zero. By virtue of their special purpose, securitization companies are not subject to any thin capitalization rules and therefore are able to issue securities in any form.

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The Luxembourg corporate SV should also be entitled to benefit from the income tax treaties concluded by Luxembourg and EU tax directives.

The Luxembourg securitization fund is considered transparent for Luxembourg tax purposes, and its income is taxed at the level of its investors. Since the net assets are deemed to be directly owned by its shareholders, the Luxembourg SV is not subject to net wealth tax, nor is it subject to subscription tax. The securitization fund does not benefit from EU directives or Luxembourg's income tax treaty network.

2. SICAR — The Luxembourg Venture Capital Vehicle

The SICAR is a semiregulated venture capital investment vehicle with the principal object of investing in risk-bearing assets issued by domestic and foreign enterprises.

With the *sharia* encouraging risk taking and prohibiting interest, unleveraged venture capital funds are ideal tools for making investments in a manner adhering to Islamic principles. In view of the simplified application of company law, limited regulatory supervision, and favorable tax rules (such as tax exemption of qualifying income and the dividend withholding tax exemption), the SICAR is tailored for Islamic finance investments in and through Luxembourg.

The SICAR may be established either as a Luxembourg company or a limited partnership. Both SICAR companies and SICAR limited partnerships may be set up using an umbrella structure. The SICAR is supervised by the CSSF and subject to prior authorization by it.

The SICAR is tailored for Islamic finance investments in and through Luxembourg.

Securities issued by a SICAR should, however, be reserved to well-informed investors; that is, institutional investors, professional investors, and any other investor having confirmed in writing that he adheres to the status of a well-informed investor investing a minimum of €125,000 in the company. Alternatively, the latter may obtain confirmation from a financial institution that he has sufficient experience to understand the risks involved and take adequate investment decisions. As investors are assumed to be aware of the risks of their investments and to accept from the outset the fund's proposed investment policy, the SICAR boasts maximum flexibility regarding its investments. It may, for instance, invest all of its funds or acquire the majority of voting power in a single company.

The SICAR benefits from a very attractive tax regime that depends on the legal form under which it has been incorporated. Should the SICAR take the legal form of a Luxembourg company, it will be treated as not tax transparent (that is, liable to corporate income tax). In such a case, its income should be subject to tax in Luxembourg at the standard rate (28.59 percent in 2009 for the city of Luxembourg). However, the SICAR benefits from a tax exemption regarding current income arising from transferable securities (including shares and *sukuk*) as well as on income arising from the sale, contribution, or liquidation of these assets. No debt-equity ratio applies in relation to investments of a SICAR. Losses and deductions relating to tax-exempt income may not be offset against taxable income. The corporate SICAR is also exempt from net wealth tax.

In principle, the corporate SICAR benefits from the relevant EU directives and the extensive Luxembourg income tax treaty network.

Dividends distributed by a corporate SICAR are exempt from Luxembourg withholding tax, irrespective of the residence and tax status of its shareholders. Moreover, nonresidents will be exempt from Luxembourg income tax on capital gains realized on the disposal of shares of a SICAR.

A SICAR incorporated under the form of a limited partnership will be considered a transparent entity for tax purposes and therefore will be taxed at the level of its investors. A SICAR is not considered exercising a commercial activity and consequently not subject to municipal business tax, even if the unlimited partner or the majority of the limited partners are share capital companies. The SICAR in the form of a limited partnership is not subject to net wealth tax, as it is considered a transparent entity whose net assets are deemed to be directly owned by its shareholders.

3. Luxembourg Real Estate Companies

Of particular interest to Islamic investors is that significant tax benefits may be generated via the ownership of property through a Luxembourg special purpose vehicle established in the form of a fully taxable company, rather than via the ownership of real estate directly.

While tax benefits may be available in the country where the real estate is located, capital gains may be generated in a tax-neutral manner through the disposal of the Luxembourg or additional foreign special purpose vehicle rather than the disposal of the real estate itself.

Luxembourg real estate companies may be financed with *sharia*-compliant asset-linked financing instruments whose yield merely depends on the income derived from a specific investment or investment portfolio. The yield paid on that instrument may allow the repatriation of the majority of the profits free of the

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Luxembourg withholding tax. As a result, a Luxembourg real estate structure may raise tax benefits in the country where the real estate is located without adding significant tax costs in Luxembourg.

4. Luxembourg Fiduciary Structure

A fiduciary contract (loosely equivalent to the common-law concept of a trust) allows the owner of an asset to transfer its legal ownership to a trustworthy person, the fiduciary, who in turn assumes responsibility for managing the asset. On termination, the legal title of the assets reverts to the principal or third-party designees. The types of assets that may be placed in a fiduciary agreement are widely defined and include real estate, intangible rights, shareholdings, and any other assets that fulfill the requirements of the *sharia*.

The fiduciary contract generally provides that all income and gains including the return of all investments are for the benefit of the principal or such third parties as are designated in the fiduciary contract. Under such an arrangement, the principal or third party remains the beneficial owner while the fiduciary holds legal title.

According to Luxembourg tax law, assets transferred to a fiduciary from a principal remain attributable to the principal for tax purposes. As such, the principal or the beneficiaries designated by the third party are considered the economic beneficiaries of the income derived from these assets for tax purposes.

If the principal or third-party beneficiary is not a Luxembourg resident, income and capital gains derived from the assets held by the fiduciary are generally not taxable in Luxembourg. Limited exceptions include some short-term capital gains on Luxembourg company shares, and rent or gains derived from Luxembourg real estate. However, these exceptions may be further reduced with the application of a tax treaty. Indirect taxes are generally not levied on transfers to a fiduciary unless otherwise required by Luxembourg domestic law (for example, transfers of Luxembourg real estate).

E. Luxembourg Investment Vehicles

The main features of the different Luxembourg investment vehicles are summarized in the table.

IV. Conclusion

The potential for the growth of Islamic finance in Luxembourg is arguably immeasurable. Luxembourg's emerging role as a hub for Islamic finance is underpinned by the factors outlined in this article, and the tax efficiency offered by the many *sharia*-compliant instruments and vehicles available is second to none. At the same time, the Luxembourg government's tax and legislative framework has established a level playing field for a myriad of Islamic products such as *sukuk*, Islamic equity funds, and *sharia*-compliant financing instruments. The flexibility, security, and stability that Luxembourg offers permit the availability of products bearing exceedingly low effective taxation, the expansion of Islamic transactions, and the further development of *sukuk*. ◆

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Main Features of Luxembourg Investment Vehicles

	Holding Companies		Investment Funds		Special Investment Vehicles	
Key Topics	**SOPARFI**	**SPF**	**UCI Parts I and II**	**SIF**	**SICAR**	**SV**
Legal form	Corporation	Corporation	Corporation (SICAV/SICAF) — no specific requirement	Corporation (SICAV/SICAF) or mutual fund (FCP)	Corporation or partnership	Corporation or partnership
Minimum share capital or net assets	S.A.: €31,000 S.C.A. €31,000 S.à r.l.: €12,500	S.A.: €31,000 S.C.A.: €31,000 S.à r.l.: €12,500	€1,250,000	€1,250,000	€1,000,000	S.A.: €31,000 S.C.A.: €31,000 S.à r.l.: €12,500
Regulatory supervision	No	No	Yes	Semiregulated	Semiregulated	Semiregulated
Investors profile	No specific requirement.	No specific requirement.	No specific requirement.	Institutional and professional or well-informed investors.	Institutional and professional or well-informed investors.	No specific requirement.
Net wealth tax	0.5% p.a. on the unitary value — participation exemption may apply.	No	No	No	No	No
Subscription tax	No	No	0.01% or 0.05% p.a. on net assets	0.01% p.a. on net assets	No	No
Corporate income taxation (worldwide base, unless DTT applies)	28.59% (2009) — participation exemption may apply.	No	No	No	Yes — if corporate SICAR (28.595%) — tax-exempt income from transferable securities (equity and debt). No — if tax-transparent SICAR.	Yes — if corporate SV (28.59%) — deduction of commitments (including dividends) from taxable basis. No — if tax-transparent SV.
WHT on dividends	15% WHT — participation exemption may apply (under DTT or Luxembourg domestic tax law).	No	No	No	No	No
WHT on interest and royalties	No	No	No	No	No	No
WHT on liquidation proceeds	No	No	No	No	No	No
Benefit from the EU parent-subsidiary directive	Yes	No	No	No	Yes — if corporate SICAR. No — if tax-transparent SICAR.	Yes — if corporate SV. No — if tax-transparent SV.
Benefit from the EU interest and royalty directive	Yes	No	No	No	Yes — if corporate SICAR. No — if tax-transparent SICAR.	Yes — if corporate SV. No — if tax-transparent SICAR.
Double tax treaty protection	Yes	No	Possible — if SICAF/SICAF (under certain DTTs).	Possible — if SICAV/SICAF (under certain DTTs).	Yes — if corporate SICAR. No — if tax-transparent SICAR.	Yes — if corporate SV. No — if tax-transparent SV.

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