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US Credit Fund Managers Launching a Luxembourg Credit Fund (Sleeve): Legal, Tax, Regulatory and Commercial Aspects

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Luxembourg tops the shortlist for EU credit fund vehicles. US credit fund managers (USCFMs) turn to Luxembourg fund vehicles if they target EU-based prospective investors or an EU credit strategy or a combination of the two.

This article sets out the key considerations relevant for USCFMs when they turn to Luxembourg to organize their credit fund structures, following a Q&A format. It addresses commercial, regulatory, tax, structuring, and key operational aspects of Luxembourg credit funds.

Credit strategies come in all sorts and forms, but this article distinguishes, when relevant, between loan origination and the acquisition of loans in the secondary market. Luxembourg is also high on the shortlist for onboarding EU capital for US oriented credit strategies. Questions 17 through 19 are of relevance for such situations, but US credit strategies are beyond the scope of this article.

Structuring Considerations at Luxembourg Fund Level

1. Why Would a USCFM Need a Luxembourg Fund Vehicle to Onboard EU Investors?

EU investors demonstrate a general preference to invest in Luxembourg fund vehicles for a variety of reasons. Luxembourg is not considered "offshore" and it is not black or grey listed by any relevant body. A Luxembourg fund vehicle can be launched as an entity in the scope of the EU Alternative Investment Fund Managers Directive (**AIFMD**), which may give access to certain additional pockets of EU capital, may boost the USCFM's general credibility in the European Union and can come with an EU marketing passport which accommodates EU-wide distribution. Luxembourg provides for a solid anti-money laundering and counterterrorism financing (AML/CTF) framework, which secures the credibility of the investor pool onboarded in the Luxembourg fund and that comforts EU investors. EU investors generally are familiar with Luxembourg fund products and are comfortable with Luxembourg's matured and solid financial infrastructure. Hence, to secure a successful European capital raise, a Luxembourg fund vehicle is often a key condition.

2. Is a Luxembourg Fund Vehicle Needed to Get Access to Certain Pools of EU Borrowers?

For USCFMs that target European-wide loan origination, a Luxembourg fund qualifying as an alternative investment fund within the meaning of the AIFMD (**AIF**), which is managed by an authorized alternative investment fund manager (**AIFM**)

in Luxembourg or another EU Member State is typically a "must have." The AIFM usually is based in Luxembourg for a variety of reasons addressed in this article.

Due to regulatory lending restrictions applicable in certain EU Member States the Luxembourg AIFM and Luxembourg AIF set-up generally secures the most efficient access to prospective corporate borrowers in other EU Member States. USCFMs that do not avail of an in-house EU AIFM can contract with a Luxembourg "host" AIFM. The Luxembourg "host" AIFM will assume the risk and portfolio management functions and usually delegates the portfolio management function back to the USCFM.

Access to the secondary EU debt markets does not necessarily prompt the need for a Luxembourg AIF with a Luxembourg AIFM. However, if EU secondary deals are an important focus of the fund's strategy and the fund targets EU investors, it is very likely that the fund vehicle is organized as a Luxembourg AIF with a Luxembourg AIFM, as such set up may come for example with (withholding) tax benefits granted by the EU Member State where the borrowers are situated.

3. Is a Luxembourg Direct Lending Fund Regulated As a "Professional Lender" under Luxembourg's Banking Laws?

A Luxembourg AIF which is not set up under a specific regulatory fund regime (such as a SIF or a SICAR) may face regulation pursuant to Luxembourg banking law if it engages in loan origination. The banking law regulates professionals that perform lending operations aimed at the public. The Luxembourg regulator has clarified that a lending activity is not aimed at the public if the principal amount of the originated loans is not below EUR 3 million and the loans are granted exclusively to "professionals." The concept of professionals is very broad and *de facto* encompasses all borrowers except retail type of borrowers. A typical loan origination fund only lends to professionals for amounts that go well beyond EUR 3 million per loan and thus remains out of the scope of the banking law.

4. What Is the Typical Legal Form of a Luxembourg Credit Fund?

A Luxembourg AIF typically is organized as a Luxembourg special limited partnership (*société en commandite spéciale*; SCSp). An SCSp AIF can conduct credit strategies including loan origination, which follows explicitly from the recently adopted changes to the AIFMD. Furthermore, an SCSp AIF can essentially accommodate all features and governance aspects that can be accommodated by non-Luxembourg limited partnerships traditionally used by USCFMs. USCFMs familiar with Cayman or Delaware limited partnerships require little guidance to become familiar with the fund governance and fund terms of an SCSp AIF. Limited partners of an SCSp benefit from limited liability (they are not liable for the debts of the SCSp) unless they carry out acts of management towards third parties.

5. What About Investor Confidentiality?

Information on limited partners (LPs) in an SCSp is recorded in an LP register held by the general partner (GP). LPs have access to the register, but access rights usually are restricted to their own information. LP information is not published with the Luxembourg Business Register (LBR). The SCSp must disclose certain details of its ultimate beneficial owners (UBOs) in an UBO register (UBOR) held by the LBR. The typical example of an UBO is an individual that ultimately owns more than 25 percent of the SCSp. As the LPs of a private fund vehicle are seldom individuals, LPs seldom qualify as UBOs. The individuals ultimately owning the LPs may however qualify as UBOs, provided they meet the more than 25 percent threshold. In a private fund context it is highly unusual that such individuals are identified. Even if a UBO would be identified in the LP chain, it is noted that the UBOR is not accessible by the general public, but by national authorities, professionals that are subject to anti-money

laundering (AML) obligations and certain journalists. Information on LPs in an SCSp generally is reported to the Luxembourg tax authorities (LTA) pursuant to different reporting frameworks such as the SCSp's income tax filings, the FATCA and CRS reporting frameworks, and, in specific cases, the so-called DAC 6 reporting rules. Such information is generally subject to exchange with foreign tax authorities. DAC 6 requires certain parties to disclose information on particular arrangements with an EU link that have a tax avoidance potential. If the arrangement encompasses an SCSp, the reporting may include LP details. However, SCSp structures launched to raise EU capital typically do not have such tax avoidance potential. Like in a Delaware or Cayman LP, the confidentiality of the side letter process can be secured if an SCSp is used. The exchange of side letter terms only defines the terms, but not the LPs that benefit from them. As per fund documentation, GPs are permitted to exchange LP information with different actors in the fund structure subject to confidentiality and/or data privacy conditions.

The confidentiality of LPs in a private fund organized as an SCSp is well guaranteed. LP information is not published in the LBR and is usually not published in the UBO register. The LTA collects LP information and may share it with foreign tax authorities. Any exchanges of LP information among actors in the fund structure is subject to confidentiality and/or privacy conditions.

6. Should the SCSp Adopt the RAIF Regime?

The SCSp AIF can choose to adopt the Luxembourg reserved alterative investment fund regime (RAIF SCSp) if the USCFM wishes, for instance, to accommodate umbrella structures with segregated compartments in an, at fund level, unregulated environment. Such compartments can conduct different (credit) strategies (for example, closed and open-ended) tailored to the investment appetite of different investors. If RAIF status is adopted, an EU (host) AIFM must be appointed (*see also* Question 15). A RAIF SCSp cannot be managed by a non-EU AIFM. A RAIF is not subject to authorization and supervision by the Luxembourg financial regulator (CSSF) but is subject to a 30 percent diversification cap on a compartment basis and a minimum capital of EUR 1,250,000 is to be reached within two years.

If a USCFM intends to conduct different credit strategies for different pools of investors, a RAIF with segregated compartments can accommodate that. Such an umbrella RAIF may lead to a reduction of maintenance costs compared to setting up a range of separate vehicles for each strategy/investor pool. It also benefits from the possibility of a one-off service provider onboarding process. That onboarding process generally is perceived as sticky by USCFM, so a one-off process for the different compartments in an umbrella, is a benefit. The RAIF status may also be considered for branding reasons towards European investors because the use of a RAIF generally is perceived as a sign of long-term commitment by the USCFM to the European Union.

A potential drawback of a RAIF with segregated compartments is that all compartments form part of the same legal entity (usually an SCSp). Accordingly, there is only one Luxembourg general partner entity for all the compartments and certain reserved matters (for example, a GP removal) require a majority vote of all the investors in the SCSp across the compartments. It is also noted that US check-the-box election may only be possible for the entity as a whole and not on a compartment basis.

Another option available to an SCSp AIF is to opt in for the specialized investment fund (SIF) regime or the specialized investment company in risk capital (SICAR). The SIF and SICAR regimes, which are subject to authorization and supervision by the CSSF, are however rarely used for credit funds and are therefore not further discussed here.

7. How Is the Luxembourg SCSp Taxed?

As discussed in more detail under Questions 7.1 and 7.2 below, an SCSp is in principle tax neutral, subject to (a) the SCSp not conducting an actual or

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deemed business (otherwise, Luxembourg municipal business tax (MBT) at a rate of 6.75 percent rate may apply), and (b) the possible application of so-called reverse hybrid rules, which would tax the SCSp on certain income at a rate of 18.19 percent.

7.1 Municipal Business Tax: Is There an Actual or a Deemed Business?

In case the GP of an SCSp (whether it is an AIF or not) holds an interest of 5 percent or more in the SCSp, such SCSp will automatically be deemed to conduct a business for MBT purposes and will thus be subject to MBT at 6.75 percent. The 5 percent threshold is assessed based on the GP's capital commitment, but to be on the safe side (and to avoid that the carried is taxed at GP level) it generally is preferable that the GP is not entitled to carried pursuant to the fund's waterfall. Otherwise, the MBT rules would arguably be triggered at the moment the fund enters the "catch up phase" and a distribution of at least 5 percent of the profit is made to the GP. The remainder of this Question 7.1 concerns the situation wherein the 5 percent threshold is not met by the GP.[1]

Pursuant to a specific circular of the Luxembourg tax authorities (LTA) an SCSp that qualifies as an AIF is deemed not to conduct a business and is therefore not subject to MBT. Loan origination and secondary credit strategies should not invalidate AIF status. The latter is explicitly confirmed by AIFMD 2, which was recently adopted and will be effective early 2026. Hence, a credit fund organized as an SCSp-AIF should be protected against MBT by the circular.

An SCSp that does not qualify as an AIF, for example certain types of separate managed accounts, co-investment vehicles, aggregators, carried collectors and structuring vehicles (for example, holding vehicles or hedging vehicles), should carefully monitor that they remain sufficiently passive. For that purpose, such SCSps should carefully consider their object clause, investment strategy and their activities in general.

MBT does not apply to SCSps that opt for the RAIF regime. An SCSp-RAIF arguably also is not subject to the reverse hybrid rules (*see* Question 7.2 below). An SCSp-RAIF, however, is subject to an annual subscription tax of 0.01 percent on its AUM, to be paid quarterly.

7.2 Reverse Hybrid Rules

A Luxembourg SCSp can become subject to Luxembourg tax (18.19 percent) on all or part of its income if it has 50 percent or more of "bad" investors that are "associated" to the SCSp. For this purpose, an investor is an individual or an entity that is opaque for Luxembourg tax purposes (for example, if the direct investor in the SCSp is a limited partnership, which is transparent for Luxembourg tax purposes, the tax opaque partners in that limited partnership are relevant). Bad investors are those located in a jurisdiction that treats the SCSp as opaque from a tax perspective. Tax exempt investors (for example, sovereign wealth funds, endowments, pensions funds, and investors located in zero tax jurisdictions) should not qualify as bad investors. Bad investors count towards the 50 percent threshold if they are "associated" to the SCSp. Such association requires a 50 percent interest. It is obviously rare for an investor to hold 50 percent in a fund, but this threshold is assessed on the basis of an "acting together" concept. If that concept applies, each acting-together-investor is deemed to hold the aggregate stake of all the investors that are treated as acting together. Although we deem it generally unlikely, it cannot be fully excluded that LPs in a SCSp may be treated as acting together. However, Luxembourg law provides that investors in an AIF are presumed not to act together if it holds less than 10 percent. To clarify, the rules apply to AIFs only. If the reverse hybrid rules are triggered, Luxembourg tax is due on the portion of certain types of the Luxembourg SCSp's cash income "that is not taxed elsewhere" unless this is due to the tax-exempt status of the investor.

Monitoring the SCSp's investor base is key. Practice shows that the reverse hybrid rules rarely

kick in, but it is an important aspect of fund due diligence processes when new investors come in. When investors cannot be provided with evidence that an accurate monitoring process is in place, they may shy away. Monitoring is done through questions in the subscription documents. We have seen that the answers given are not always complete and accurate. Hence, it is important that the answers are reviewed prior to onboarding as it is very challenging to ask investors to correct or complete the answers to the questions at a later stage.

In certain cases, we see that the investor base of an SCSp after the first closing consists of associated bad investors for more than 50 percent. Technically, such SCSp is subject to the reverse hybrid rules until those bad investors get sufficiently diluted after one or more subsequent closings. Note that the reverse hybrid rules only kick in when the SCSp generates certain categories of cash income. Hence, if there is a clear expectation that those bad investors will be diluted below 50 percent by good investors, there should be no issue. If the sponsor does not want to incur any risk, bad investor on-boarding could be pushed back to later closings as to secure that the 50 percent bad investor threshold is not met.

8. Must an SCSp Have a Luxembourg GP?

Pursuant to Luxembourg corporate law (specifically, the real seat theory), only entities that have their central administration in Luxembourg are subject to Luxembourg company law. The central administration of a company usually coincides with its place of effective management; the place where the key decisions are taken. As the governing body of an SCSp is its general partner, the general partner of an SCSp should have its central administration in Luxembourg to ensure that the SCSp is recognized under Luxembourg law.

If the GP and the SCSp do not have a (sufficient) Luxembourg footprint it would push the SCSp into unexplored territory in terms of applicable legal framework and potentially the enforceability of the limited partnership agreement. Perhaps merely academic, but it may technically even endanger the eligibility to an EU marketing passport especially if the footprint is present beyond EU borders.

9. What Is the Luxembourg Footprint Needed to Secure the Central Administration in Luxembourg?

As to secure that the place of central administration of a GP is in Luxembourg, the Luxembourg GP should be able to demonstrate that it avails of Luxembourg footprint when it comes to its key decisions. The key decisions of the GP are, for example, the appointment of an (EU) AIFM to conduct the investment management functions (risk and portfolio management), the appointment of service providers (for example, a depositary and a central administration agent), capital calls, cash distributions, investor onboarding and in some cases even the marketing function. Hence, such key decisions should be taken in Luxembourg which can be substantiated by the composition of the GP's board (market standard is to have a board with a majority of Luxembourg (professional) residents and a representation clause which requires the signature of at least one Luxembourg resident) and the fact that board meetings are regularly (every quarter is usual) initiated out of Luxembourg. To secure day-to-day control by the USCFM over the GP the non-Luxembourg board member is part of the USCFM's organization. Decisions by the GP require the positive vote of that board member. It is common practice that any non-Luxembourg board members attend these meetings at least once a year. Other meetings can be attended by video call.

In addition, it is arguably relevant that the SCSp's administrative functions are conducted in Luxembourg, such as the preparation of the annual accounts and the NAV calculations. These functions usually are outsourced and should, with the required Luxembourg footprint in mind, preferably rest with the Luxembourg-based fund administrators. The Luxembourg fund administrator can delegate or seek support from the USCFM when it comes to those functions.

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10. How To Design the Management Fee Flow (Commercial and Tax Considerations)?

Luxembourg transfer pricing rules require that the functions conducted by the Luxembourg GP are remunerated in line with what a third party, conducting similar functions, would derive. Tax lawyers refer to it as the arm's length principle. As GP functions typically are limited, the arm's length remuneration of the GP is seldom material and typically results in tax leakage not exceeding USD 25k annually. If a GP also conducts additional functions such as, for example fund marketing or central administration of the fund, such GP should derive a higher remuneration and therefore its tax leakage would be higher.

The remuneration of the GP can be generated in basically three different ways: (i) the SCSp pays a separate remuneration to the GP and the management fee paid by the SCSp to the USCFM is reduced with the amount paid to the GP; (ii) the SCSp pays the management fee to the GP and the GP on pays the management fee to the USCFM, but retains an arm's length remuneration; or (iii) the SCSp pays the management fee to the USCFM and the USCFM pays a remuneration to the GP out of the fee it receives. The USCFM (and not the LPs in the SCSp) bears the cost of the GP remuneration under all three of those models.

The first model requires a specific clause in the LPA and a reduction of the management fee by the GP remuneration to ensure that investors do not face a double fee. Commercially, that model generally is not seen as preferrable because it tends to raise investors' eyebrows due to (unjustified) concerns that they somehow pay double. In addition, the GP remuneration clauses generally are perceived as "ugly" and not in line with usual LPA aesthetics. The second model is dominant. In the second model it is key that the fee on-paid by the GP to the USCFM can shelter the management fee received by the GP from the SCSp from Luxembourg taxation. However, the deduction of that on-paid fee in the hands of the GP is not always clear-cut due to the anti-hybrid tax rules, especially when the GP is disregarded from a US tax perspective. The third model has gained traction due to the anti-hybrid rules, but sometimes also because USCFMs do not want to run an important part of their earnings model (the management fee) through an entity that has unlimited liability for debts for the SCSp.

For Luxembourg VAT purposes, fund management services are deemed to take place in Luxembourg as the SCSp qualifies as a VAT taxable person. However, those services do not attract Luxembourg VAT because an exemption applies. Other services, such as marketing, fund administration and investment advisory can also benefit from a VAT exemption.

11. How to Design the Carried Interest?

The driver behind the structuring of the carried interest typically is the tax position of the USCFM's principals and their residence. The principals usually are not based in Luxembourg. There are, however, also certain Luxembourg tax aspects to be mindful of when structuring the carried.

If the carried is held by the Luxembourg GP and that GP is organized as a limited liability company, the carried revenues would be taxed at GP level at a rate of 24.94 percent. In addition, as discussed under Question 7.1 above, there is a potential risk that the carried may taint the SCSp as a municipal business taxpayer (6.75 percent on the SCSp's profits). To avoid the aforementioned issues, the entity entitled to the carried typically is not the GP but an LP organized as a non-Luxembourg entity or a Luxembourg SCSp).

Raising Capital in the European Union

12. Raising Capital: Is There Still Room for Reverse Solicitation in the European Union?

If EU investors are onboarded on the basis of reverse solicitation, EU marketing fees and regulatory reporting requirements generally are not triggered.

USCFMs have traditionally relied on reverse solicitation to accept commitments of a limited number and specific EU based investors with which they had longstanding relationships. On that basis the EU country-specific national private placement rules (NPPR) were arguably not triggered, or marketing prohibitions arguably did not apply. In some cases, there was genuine own initiative from the side of the prospective investor. In other cases, the "own initiative" concept was more stretched and was in fact a direct consequence of certain pre-marketing efforts, for example, prospective investors were approached in an earlier stage with pre-marketing materials (for example, term sheets and pitch decks) and reached out later on, on that basis, for final fund documents. In certain EU countries this more stretched approach generally was accepted in practice, while this triggered the NPPR (if any) in some other EU countries.

With the implementation of the European Union Cross Border Distribution Directive, the stretched use of reverse solicitation came to an end. A formal pre-marketing framework was introduced through the formalization of a dividing line between pre-marketing and marketing. Presenting "sign on the dotted line" fund documents to prospective investors constitutes marketing. On the other hand, most of what happens prior thereto, for example, sharing pitch decks, is pre-marketing. Efforts that precede the pre-marketing phase, such as basic introductions by the USCFMs to EU investors, should not qualify as pre-marketing.

If an USCFM has pre-marketed a fund to a prospective investor in a particular country and that prospect (or any other prospect in that country) reaches out for final fund documents within 18 months, there is no possibility to onboard such investor through reverse solicitation. Rather, the marketing rules of the EU Member States have to be complied with.

The door to reverse solicitation is technically still slightly ajar in the European Union. A response to an "out of the blue" outreach by a prospective investor or an outreach by a prospective investor that is a consequence of general introductions on the USCFM rather than a specific product may qualify as reverse solicitation, but in practice such situations are rare. If a USCFM intends to rely on a reverse solicitation, it is key that relevant proof is gathered (for example, a reverse solicitation letter) substantiating that the initiative came from the LP.

13. Testing Appetite with EU Prospective Investors: How to Do It?

Before organizing a Luxembourg fund vehicle, a USCFM prefers to be sure that it is worth the cost and effort. Hence, the USCFM typically prefers to get a grip on EU investor appetite in a cost-efficient manner and thus without launching the Luxembourg fund first. This is usually done through pre-marketing efforts. Those efforts give access to EU prospective investors without the need for setting up the fund or having a final conclusion on how the fund structure will be designed. Under the pre-marketing rules it is technically the future fund's strategy that is pre-marketed and not a specific borrower-facing entity.

Pre-marketing efforts can be conducted in each EU Member State separately, relying on the NPPR of those countries (if any), or on the basis of a pre-marketing passport. To secure a pre-marketing passport the USCFM would need to team up with a European Union host AIFM. The host AIFM would front the USCFM's pre-marketing efforts and may seek the support of, for example, a European Union placement agent.

Passported pre-marketing and NPPR pre-marketing require a notification with the regulator within two weeks from the moment the efforts have begun. During the pre-marketing phase the USCFM can only share materials on the basis of which a prospective investor cannot make an informed investment decision. Under most NPPR rules and under the passporting rules, pre-marketing for a fund in a specific EU Member State closes the door for 18 months to reverse solicitation for such fund in that same EU Member State for the fund.

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The rule of thumb is that NPPR pre-marketing strategies are only used if the (pre) marketing focuses on certain specific EU Member States only. Otherwise, a pre-marketing passport is used considering the pre-marketing limitations that apply under the NPPR of certain EU Member States and the relatively light cost and administrative burden to conduct pre-marketing under a passport. If the pre-marketing has proven to be successful and prospective investors have confirmed the preference for a Luxembourg borrower-facing vehicle, the fund can be launched.

14. There Is Investor Appetite: What Is the Timing for the Fund Launch?

When the USCFM has encountered prospective EU investors during its pre-marketing rounds, the fund structure can be launched. It takes normally five to six months before the Luxembourg structure is ready to go to market. This time lapse is mainly caused by: (1) onboarding the Luxembourg-based fund service providers (for example, the administrative agent and EU host AIFM) which have to perform due diligence and anti-money laundering checks on the USCFM); (2) the opening of a bank account for the Luxembourg GP; and (3) the process to register the fund for marketing. The drafting of the fund documents runs simultaneously. As there are techniques to establish a Luxembourg GP without a bank account, the delay caused by item (2) and more importantly any frustration in respect of that process can be largely avoided.

15. Launching with or without an EU Host AIFM?

As discussed under question 2, a Luxembourg fund vehicle with a Luxembourg host AIFM is a must-have for an EU loan origination strategy. For other strategies the need for a Host AIFM is largely driven by the marketing strategy. If the marketing efforts target an EU-wide potential investor pool, a host AIFM typically is opted for as this comes with an EU marketing passport. If the marketing only targets certain EU Member States that provide for efficient NPPR rules for marketing, there is no obvious need to engage with a host AIFM.

It is in any case key to understand that the pre-marketing strategy (whether NPPR or pre-marketing passport) should not dictate the marketing strategy. In other words, if pre-marketing was conducted under a pre-marketing passport, the USCFM should be free to opt for marketing under NPPR or a passport and vice versa. In practice, USCFMs often proceed on the basis of a marketing passport and engage with a host AIFM in such a scenario. The choice to launch with or without a host AIFM deserves ample consideration, whereby the key factors are: EU investor access, costs, control, branding and perhaps most importantly the familiarization process of the USCFM with the Luxembourg host AIFM model. The appointment of an EU AIFM will trigger AIFMD 2, which will be in force as from early 2026. AIFMD 2 imposes diversification, risk retention and leverage caps for credit funds, but these are not perceived as relevant impediments for credit strategies by the industry.

16. Host AIFM Model: Interactions Among the USCFM, the Host AIFM and the Depositary

A Luxembourg host AIFM is a third-party fund management service provider appointed by the Luxembourg fund. The EU host AIFM assumes the risk and portfolio management functions and often delegates the portfolio management back to the USCFM. If the USCFM is not subject to regulatory oversight, the USCFM can in principle only act as advisor to the host AIFM. In the delegation alternative, the GP of the SCSp provides a power of attorney to the USCFM enabling it to enter into transactions.

The EU AIFM and the SCSp's GP will monitor the activities of the portfolio manager on a post-trade basis. The risk management function, which rests with the host AIFM, typically requires some

pre-trade involvement because the host AIFM must be able to report to the SCSp that a deal proposed by the portfolio manager fits the fund's risk profile. The host AIFM's involvement should generally not delay or frustrate the deal process. The relationship between the USCFM and the host AIFM in general, and also specifically the involvement of the host AIFM in the deal process, should be carefully discussed beforehand so that both parties know what to expect in terms of information exchange.

Engaging with a host AIFM means that the SCSp will have to onboard a depositary. The depositary is a third party responsible for cashflow management and ownership verification of assets. A depositary is essentially a watchdog to verify on behalf of the investors that the SCSp's assets exist and that cash is used for the benefit of the SCSp's affairs. A depositary generally does not require pre-deal involvement.

Structuring European Credit Assets Through Luxembourg Borrower-Facing Vehicles

17. What Is the Typical Design of the Entity That Faces EU Borrowers?

It is generally not the investor-facing SCSp that originates or acquires the loans. Rather, the SCSp usually makes investment through a taxable Luxembourg entity. Such entity should potentially have access to reduced rates of interest withholding or capital gains tax in the source countries pursuant to tax treaties and/or EU tax directives. This may, however, be subject to anti-abuse tests such as substance, beneficial ownership test or principal purpose tests. Source country requirements should be closely monitored in that respect. Source taxation is often not the driving force for the use of a tax opaque Luxembourg borrower-facing entity. Rather, such Luxembourg entity is often used to push any applicable tax filing requirements imposed by source countries away from the investors and down to the Luxembourg entity. A Luxembourg entity is also often used to accommodate third-party leverage and the accompanying security package.

18. How Is the Luxembourg Borrower-Facing Entity Financed?

The loan portfolio held by a Luxembourg taxable borrower-facing entity typically is funded with a proportion of equity injected by the borrower-facing SCSp and for the remainder with one or more loans granted by such SCSp.[2] Those loans carry a fixed or floating yield that mirrors the yield derived from the loan portfolio, reduced by an arm's length margin.

It is key that the yield under those loans is tax deductible and thus sets off the taxable income derived from the loan portfolio, otherwise a substantial tax drag would arise in the structure which would push the fund's performance south. Arm's length interest paid to the SCSp should be tax deductible, subject to earning stripping and anti-hybrid rules.

Earning stripping rules are often of little concern in case of loan origination, as these rules do not apply if an entity earns interest and interest-equivalent income. Direct lending strategies typically generate, apart from interest income, other income such as origination fees, guarantee fees, commitment fees and original issue discount. Such type of income should normally qualify as interest-like income for purposes of the earning stripping rules.

Extra care should be taken if the fund targets discounted or distressed loan in the secondary market. In view of the current interest rate environment, secondary credit deals usually trade at a discount. If debt is bought at a discount and is redeemed or sold above its purchase price the gain may not qualify as interest-like income for purposes of the earning stripping rules. If such gain exceeds EUR three million per annum the earning stripping rule is effective. This means that interest is only deductible for an amount equal to the higher of EUR three million and 30 percent of the non-interest-like income is annually allowed for deduction to

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offset the gain. Importantly, if the expenses do not qualify interest or interest-like, they should be fully deductible. However, if the borrower-facing entity qualifies as an AIF, the earning stripping rules are switched off. In the typically Luxembourg master-feeder structure, the borrower-facing Luxembourg entity usually qualifies as an AIF or is financed with instruments that should give rise to non-interest like deductions (for example, convertible loans or warrants) and thus the earning stripping rules should not be a concern.

The tax deduction of interest due under the loans granted by the SCSp to its Luxembourg borrower-facing tax opaque subsidiary can also be denied pursuant to anti-hybrid rules. The question whether those rules apply depends on a range of factors but predominantly on the ultimate investor base, which is obviously hard to anticipate, but should be carefully monitored. In general, the rules are mainly triggered by taxable investors that consider the SCSp AIF as tax opaque or consider the borrower facing entity as tax transparent and that hold a stake of at least 10 percent in the SCSp AIF. Investors holding a less than 10 percent stake are protected by a specific presumption that only applies if they invest in an AIF.

19. Managing Currency Exposure and Luxembourg Tax Leakage on Currency Results

A commitment to a credit fund may come with currency exposure for investors. The investor commits in currency A but the fund may invest in loans in currency B. If the portfolio appreciates 5 percent in currency B, but currency B falls 5 percent as compared to currency A, the investor has not made any profit unless the currency exposure is hedged.

Currency exchange results, results of currency hedges and currency conversion results may trigger Luxembourg tax exposure in the fund structure, causing a drag on the fund's performance. The different layers of currency exchange exposure must be carefully managed.

19.1. Currency Exposure Mitigated by Currency Hedges

Investors that commit to credit funds seek exposure to a credit portfolio rather than to currency. As discussed above, currency exposure may arise if the base currency of the investors (currency A) differs from the base currency of the assets (currency B). The relevant currency exposure is usually managed by the USCFM through full or partial hedge arrangements. In the scenario of a perfect currency hedge (currency A vs. B), the exit proceeds derived from the assets in currency B are returned to the investor in currency A, at the same exchange rate as the one that applies at the moment the investment were made.

19.2 At Which Level in the Fund Structure Should the Currency Hedges Be Concluded?

Currency hedge agreements can be entered into at the level of the SCSp or at the level of the Luxembourg borrower-facing entity. Any results under the hedge reported at SCSp level should be tax neutral in Luxembourg, but may trigger certain reporting, clearing and/or margin constraints pursuant to an EU regulation (EMIR) aiming to create transparency on, and mitigate risk in respect of, over the counter (OTC) derivate contracts. The details of this regulation go beyond the scope of this article, but is noted that the constraint can generally be mitigated if the hedges are concluded at the level of the borrower-facing entity provided that this entity is not an AIF. However, the results realized on the hedges at the level of a Luxembourg borrower-facing entity may trigger Luxembourg tax exposure.

19.3 Tax Exposure on Currency Results

The functional currency for financial and tax reporting purposes of Luxembourg borrower-facing entities is normally the same currency as the SCSp's currency (currency A). If the borrower-facing entity owns assets in another currency (currency B), an exchange difference between

currencies A and gives rise to currency results in the (financial and tax) accounts of the borrower-facing entity if those are denominated in currency A. At that level it is thus key to ensure that the currency results are managed. This can be done by denominating the loan that the borrower-facing entity obtains from the SCSp in currency B. The result is a "natural hedge" (currency profits on the assets are sheltered by currency losses on the loan and vice versa).

19.4 Functional Currency Tax Reporting

If a Luxembourg borrower-facing entity prepares its financial statements in the non-EUR currency of its assets, such financial statements will not reflect any currency exchange result in respect of the assets. However, tax exposure on currency results could still arise if the entity's tax reporting currency of that entity is EUR. By default, Luxembourg companies must file their tax returns in EUR. Such EUR tax filings would require a conversion of the entity's asset and liabilities at the beginning and end of the year from the entity's non-EUR financial reporting currency to EUR. That conversion at different year-end and year-beginning rates may trigger taxable currency results. As to avoid such tax leakage, the entity should request the LTA to perform its tax filings in its base currency rather than in EUR. Such a request should in principle be filed three months before the end of the year.

Summary

Private lending is a booming business. An ever-increasing number of USCFMs raise capital through Luxembourg SCSps for different types of credit strategies. European credit strategies are typically conducted through specific Luxembourg borrower-facing structures, which often are organized in a two-tier structure. The exact design of these structures is driven by a multitude of commercial, tax and regulatory factors that all deserve ample consideration.

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NOTES

1 The foreign LPs in an SCSp that conducts a deemed business should not be subject to Luxembourg taxation for that deemed business income. Luxembourg is generally only allowed to tax business income of foreign LPs if the general income from an actual business (conducted through the SCSp) in Luxembourg, provided that that actual business income is allocable to a permanent establishment in Luxembourg.

2 In specific cases, the borrower-facing entity subjects itself to the Luxembourg securitization law, which would reduce the Luxembourg tax leakage compared to a regularly taxed SCA but may jeopardize the treaty and EU tax directive entitlement. As the potential benefits of such entitlement normally outweighs the benefits of the reduced Luxembourg tax leakage, using a Luxembourg securitization vehicle is certainly not the default solution.

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