**The RAIF in an alternative investment context**

September 27, 2016

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Luxembourg's Reserved Alternative Investment Fund, established by legislation that took effect in July, is the latest addition to the 'toolbox' available to the country's investment industry. Built on the new regulatory approach introduced in 2013 by the European Union's Alternative Investment Fund Managers Directive, it differs from other Luxembourg fund regimes by eschewing direct regulation of the fund product.

The RAIF was the focus of a breakfast seminar on September 27, 2016, at which Linklaters Luxembourg partners Hermann Beythan, Nicolas Gauzès and Olivier Van Ermengem examined regulatory and tax issues associated with the RAIF and its potential use in various investment contexts.

In a global environment in which regulatory oversight of the financial industry remains a key public policy priority in most countries and in which tax avoidance is subject to intense public scrutiny and, increasingly restrictions, they emphasise that the RAIF can be used for multiple purposes.

**What is a RAIF – and what is it not?**

A RAIF is not a UCITS, nor a SIF, nor a SICAR, notes Mr Beythan – all vehicles subject to direct product regulation, in line with Luxembourg's traditional approach to financial regulation. The RAIF is not regulated, but nor is it the same kind of structure as an unregulated limited partnership, a financial participation company or Soparfi, nor a securitisation company, given that it must have an authorised and regulated alternative investment fund manager.

As such, the RAIF occupies a place in the Luxembourg investment toolbox that hitherto has been empty – offering speed to market, thanks to the lack of a requirement for prior regulatory authorisation. However, it is subject to requirements: to make investments, to have an investment policy, to be open to several investors in order to qualify as an alternative investment fund under the AIFMD, and it must have central administration agent in Luxembourg.

"The RAIF itself is not regulated, nor the investor, nor the investment," Mr Beythan says. "However, there is a regulated part of the structure consisting of players that are supervised: the fund's AIFM, depositary, central administration agent and auditor, as well as to a certain extent the investment manager and any investment adviser to which investment management or advice functions are delegated."

Thus despite the absence of direct regulation, investors in a RAIF nevertheless enjoy a high degree of protection, including the depositary's oversight and safekeeping duties, and administrative functions including record-keeping, NAV calculation, registry and transfer agency carried out by a regulated Luxembourg service provider.

**AIFMD passporting – or private placement**

A RAIF's AIFM can be in Luxembourg or another European Union country – and perhaps soon outside, once the AIFMD passport allowing AIFs to be marketed to professional investors throughout the EU is extended to third countries. This should increase the appeal of the Grand Duchy as a domicile for alternative fund products to managers based in the US or Asia because of its secure regulatory environment and a required local footprint that is meaningful without being excessively onerous.

In addition to being eligible for marketing to professional investors under the AIFMD passport, the legislation allows RAIFs to be sold to well-informed investors (including under certain circumstances high net worth individuals) in the EU or in other countries where local private placement rules permit this.

A RAIF, notes Mr Beythan, may invest in all types of asset classes, traditional or alternative. If it invests in risk assets, like the existing SICAR vehicle, it can benefit from the specific risk capital tax regime, and is not subject to diversification rules similar to those applicable to Specialised Investment Funds. Like other AIFs, it can be established in the form of contractual funds (FCPs), partnerships or investment companies (SICAVs) using any available corporate form.

The RAIF offers particular potential because of its flexibility in terms of capital and distribution. It can have fixed or variable capital, divided into shares, units or interests, and redemptions, distributions and capital call requirements are solely as determined in the fund's constitutive documents. In addition, it is unique in the non-regulated world (other than securitisation) as a corporate vehicle with legally separate compartments. There is also flexibility regarding governance between manager(s) or a general partner.

**Choice of tax regimes**

The tax regime applicable to the RAIF is not new, being inspired by existing fund vehicles, but legislation builds in some flexibility, Mr Van Ermengem says. The general regime applicable to a RAIF is like that of a SIF, which is not subject to corporate income tax or net worth tax, just to a 1 basis point subscription tax on assets measured at the end of each quarter.

If the RAIF invests in risk capital, it may opt for the SICAR regime and become subject to ordinary corporate income tax, although it will benefit from a significant exemption on income and gains from securities, including dividends, interest and capital gains. The option for risk capital investment must be incorporated in the corporate purpose of the vehicle, and verified annually by the fund's auditor. A RAIF must opt for one regime or the other – one compartment cannot choose the SIF tax regime and another the SICAR tax regime.

RAIF-SIFs have limited access to double taxation treaties, although a few of Luxembourg's treaties offer benefits to SIFs. A RAIF-SICAR subject to normal corporate income tax should in principle be able to invoke double tax treaty benefits. RAIFs enjoy a VAT exemption for management services, as with other AIFs. There is no obligation to draft consolidated accounts, so there should be no country-by-country reporting at RAIF level. Finally, no tax consolidation is possible with other Luxembourg entities.

**Coming to terms with BEPS**

The OECD's initiative on Base Erosion and Profit Shifting has brought a new factor to cross-border investment structures. "In Luxembourg there is one buzzword – people see substance as the safest reaction to the challenges that BEPS poses," Mr Van Ermengem says. "Whether a RAIF can help depends on the various aspects of substance: the transaction, the organisation, but also the framework and setting of your operations. Using a RAIF to pool investments and bringing in projects in their own compartments with their own investors, can create more substance in Luxembourg than an SPV in terms of employees and local activity."

He notes that discussions are still in progress at the OECD as to what extent collective investment vehicles, and intermediary vehicles that are not classified as CIVs in the private equity and real estate sector, should be able to benefit from treaty access. However, one can see in that meeting the limitation on benefits tests and principal purpose tests should probably be easier using a RAIF, because it probably will be widely held, it will have substance, and it will be able to demonstrate it is not using Luxembourg solely for tax purposes.

In addition, a vehicle funded with equity is more likely to avoid the discussion on beneficial ownership of its income or the fact it is a pass-through entity, along with most transfer pricing questions.

Finally, the tax regimes available for RAIFs are unlikely to attract examination under state aid rules since they are longstanding and the SICAR rules have been reviewed by the European Commission, without any negative response, so there's no reason to doubt that they will pass the state aid test.

**An alternative for SIFs and SICARs…**

The primary area in which a RAIF offers opportunities is as a fund vehicle for various types of investment. It is unlikely to replace the UCITS structure, which benefits from an EEA passport for retail investors, but it represents an alternative to either a SIF or a SICAR, being comparable for all purposes except CSSF supervision. Says Mr Beythan: "There are not many jurisdictions or investors that do need product regulation. For instance, German institutional investors, a big market, can live perfectly well with a RAIF."

He notes that non-regulated unsupervised limited partnerships remain popular in private equity for club deals or similar, but they suffer from lack of certainty: "The RAIF is helpful because it provides a safe harbour – you increase slightly compliance costs and pay some taxes, but you are certain to be clean for regulatory purposes."

**…As well as for Masterluxcos**

The RAIF also represents potentially an alternative to the Masterluxco structure using a Soparfi as an investment platform. Masterluxco structures can exist either as part of a structure with a single fund and the same investors as well as for a large-scale investment platform involving different investors for each investment. This type of investment structure entails various features, such as a topco, profit participating loans or debt, so as not to incur liability for Luxembourg withholding tax. In the case of a complex Masterluxco, there will also be tracking shares to deliver income from certain investments to the appropriate investors.

However, the structure brings regulatory and tax complications, such as the debt-equity ratio of the Masterluxco, transfer pricing and possibly beneficial ownership and look-through issues regarding back-to-back debt financing. Says Mr Van Ermengem: “These structures rely on instruments that are increasingly under attack.

“There are also corporate financial disadvantages, such as cash trap, where the impairment of one investment will impact the distributable reserves on the other investments. There are methods to deal with this, but the risk remains of cross-contamination of losses, and vulnerability to the views of tax authorities on certain financial instruments.”

Using a variable-capital RAIF, the structure becomes much simpler. Even where the RAIF is financed by equity, withholding tax is no longer an issue, so very often there will be no need for hybrid debt instruments or classes of shares, or for tracking shares, and there is usually no taxable income. Nor are there transfer pricing issues, because the RAIF is fully equity-financed. A RAIF structure also benefits from the VAT exemption on management fees, unlike Masterluxco, where it can represent a significant cost.

**RAIFs as co-investment vehicles**

Another potential use for the RAIF may be for co-investment structures, Mr Gauzès says. Currently this is usually structured using single SPVs for each new investment, but this raises a number of concerns. There is the cost of one structure per investment, because they may not have the same co-investors. With probably more than one Luxco for each, it will probably use a partnership as an SPV for the manager to control the companies, which will require a general partner on top of the structure.

With this structure, a further complication regards capital calls on investors, which could raise regulatory issues if this is interpreted as fundraising activity. In addition, a separate shareholders’ agreement must be negotiated for each of the vehicles. Finally, in addition to the company that must be created for each investment, the build-up process may require a separate SCA vehicle, which implies substantial costs.

Establishing a RAIF has its own costs, but it also brings advantages, not least that a single vehicle can be used to hold multiple investments with different investors thanks to the compartment structure. By contrast with other fund vehicles such as SIFs or SICARs, there is no requirement for regulatory approval before establishing a new compartment, thereby improving time to market significantly.

In addition, the RAIF can be marketed as a co-investment vehicle – in any country covered by the AIFMD passport – and capital calls no longer need to be structured, but can be a simple request to investors to send the money. Similarly, the distribution capability prevents trapped cash problems, and the compartment structure avoids the risk of cross-contamination of losses between different investments.

**Tax and regulation with a RAIF**

Using a RAIF does come with some constraints, including the requirement to appoint an AIFM. Mr Gauzès says a third-party AIFM may be the best solution from both a regulatory and a cost viewpoint. The asset-stripping rules could make a RAIF less attractive because of the bar on conducting a distribution or capital reduction from the target company within the first two years following the investment, and which would require structuring at the point of acquisition.

There are also tax considerations to take into account. If the RAIF adopts the SIF tax regime, it does not benefit from double taxation treaties, and there can also be a withholding tax issue with the distribution of dividends from domestic companies to the RAIF. Since the RAIF would not be subject to corporate income tax, it would also not benefit from the EU parent-subsidiary directive exemption for withholding tax on dividends from within the EU – an extremely important exemption for private equity.

As a replacement for a Masterluxco or as a co-investment vehicle, a RAIF is more likely to come under the SICAR regime, which would limit investments by the RAIF to so-called “risk” assets. There is no issue with private equity, which plainly involves risk assets, while for property under the CSSF guidelines from 2006 it would be difficult to consider investment in core real estate as risk assets. However, if there is development, such as opportunistic real estate, it should probably qualify, as would infrastructure projects.

Similarly, investment in treasury bonds would not qualify, but distressed debt or active management of a debt portfolio to enhance the return should qualify for the SICAR regime. However, this would have to be examined on a case-by-case basis and possibly discussed with the auditor, which will have to confirm compliance with the SICAR investment rules in the tax return at year-end.

**A bright future?**

“The RAIF was designed as a compliance tool, it fits perfectly with the AIFMD philosophy of regulation of the manager rather than of the product, so it is not a tax avoidance scheme,” Mr Gauzès says. “I see a bright future for the RAIF. It is a response to new challenges in terms of increased regulation and public scrutiny of investment and holding structures.”

“However, it will also be more attractive to people who are not interested in entering the regulated world, such as financial sponsors or alternative investors who have an interest in using a vehicle that allows them to be compliant but with less of a regulatory burden. Tomorrow's world will be a regulated one, but this is a positive approach to compliance.”

He notes that the RAIF also fits with global expectations in terms of tax evolution, which mean that Luxembourg is no longer seeking to market itself as a beneficial tax

jurisdiction. Instead it is the ability to establish an entire investment platform and the availability of the full structuring toolbox is the new key to success for the country's fund industry.

Says Mr Gauzès: "The RAIF is regulation at its best. In fact we like clear rules. If you're responsible advisers to your clients or responsible investors, and you know what compliance means, you don't necessarily need the CSSF looking over your shoulder. With the RAIF, you take the risk of defining the investment policy, making the investment and ensuring that the structure is compliant."

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