The New Luxembourg Circular on the Tax Treatment of Limited Partnerships (SCS/SCSp)

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On 9 January 2015, the Luxembourg tax authorities released a circular (Circular L.I.R. No. 14/4, the "Circular") which provides guidance on the tax treatment of income derived by Luxembourg limited partnerships (SCS/SCSp). The Circular further confirms the municipal business tax ("MBT") treatment of Alternative Investment Funds ("AIFs"), Specialized Investment Funds ("SIF"), Investment Companies in Risk Capital (SICARs) and SICAV Part II Funds established in the form of a Luxembourg limited partnership. This article analyses the tax treatment of Luxembourg limited partnerships and outlines the guidance provided in the Circular.

I. Introduction

On 12 July 2013, the Luxembourg legislator transposed the EU Alternative Investment Fund Managers Directive ("AIFMD") into domestic law and used this opportunity to reform the limited partnership regime from a corporate and tax perspective with a view to elevate Luxembourg to a domicile of choice for funds.

More precisely, the legal framework applicable to the société en commandite simple (i.e. the standard Limited Partnership, "SCS") has been significantly improved and a new form of limited partnership has been introduced (i.e. the special limited partnership, société en commandite special, "SCSp"). Following the modernization of the limited partnership regime based on the model of Anglo-Saxon limited partnerships, the Luxembourg limited partnership is specifically tailored for the structuring of Alternative Investments (private equity, real estate and hedge funds, etc.).

From a Luxembourg tax perspective, the SCS and SCSp are deemed to be transparent and therefore not subject to corporate income tax.[1] Instead, the income derived by the partnership is attributed to the partners that are subject to (corporate) income tax with their respective share in the profits.[2] Non-resident partners are only subject to tax in Luxembourg if the SCS or SCSp carries out a commercial activity through a permanent establishment[3] in Luxembourg.[4]

Luxembourg Limited Partnerships (SCS/SCSp) are, however, subject to Luxembourg MBT if they carry out a commercial activity in Luxembourg.[5] Moreover, even in the absence of a commercial activity (for example, when a Luxembourg limited partnership exclusively performs private wealth management activities), a Luxembourg limited partnership is subject to MBT if the general partner is a Luxembourg company or a Luxembourg permanent establishment ("PE") of a foreign company that owns a partnership interest of at least 5%.[6]

II. Commercial activity within the meaning of Article 14 (1) LITL

The carrying out of a commercial activity requires cumulatively (i) an independent activity (ii) of permanent character, (iii) that is carried out with the intent to realize profits and (iv) participation in the general economic life (positive criteria). Furthermore, the activity must not qualify as an activity in the area of (v) agriculture and forestry[7], (vi) independent services within the meaning of Article 91 of the LITL (for example, liberal professions) or (vii) private wealth management (negative criteria). The Circular provides guidance on the interpretation of these criteria and makes reference to German and Luxembourg case law as well as parliamentary briefing documents.

(i) Independent activity

The criterion independent activity assumes an activity that is carried out by the taxpayer in its own name and on its own behalf.[8] The taxpayer further needs to be able to exercise business initiative and bear the risk of the activity which includes that the profits or losses deriving from the activity are directly allocated to the taxpayer.[9] In case of a partnership, this test should frequently be satisfied as it is a separate legal entity.

ii) Permanent character

The notion of "permanence" is meant to distinguish commercial activity from onetime transactions and wealth management. An activity has frequently a permanent character if, as from the beginning, there is an intention to carry out a lasting activity that should result in a source of income.[10] Permanence does not, however, require a minimum period or an activity that is performed without interruptions; a temporary or recurring activity may suffice. Nonetheless, onetime transactions do not amount to a permanent activity.[11] The presence of substance (for example, premises, own staff) may hint at whether this criterion is fulfilled at the level of a partnership.

iii) Carried out with the intent to realize profits

The activity must be undertaken with the intent to realize profits. Whether or not losses are realized in the start-up phase or during certain periods is irrelevant. Instead, it is decisive that the taxpayer intends to realize an overall profit during the period the activity is carried out.[12] As partnerships are deemed to have a profit motive, this criterion should frequently be met.

iv) Participation in the general economic life

This criterion partly overlaps with the criteria of permanence and the intent to realize profits and is meant to distinguish commercial activities from wealth management. The commercial activity must be part of the general economic life or in other words, the enterprise must take part in the provision of goods or services to the market and its activity must be visible to the general public. In this regard, the existence of a certain organization, physical substance and publicity may be indications. Whether or not the activity is limited to a limited circle of customers is irrelevant; in the extreme, it may suffice to have only one customer. In a company group context, it may suffice that a partnership is only doing business with affiliates.

v – vii) Negative criteria

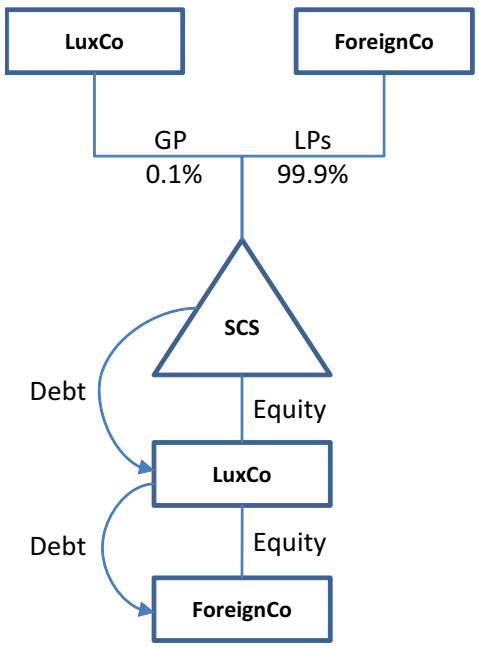
In addition to the positive criteria that characterize a commercial activity, there are three negative criteria that need to be fulfilled. According to Article 14 (1) of the LITL, the activity must not be an activity in the area of agriculture and forestry[13] or independent services within the meaning of Article 91 of the LITL. Otherwise, the classification of income into one of these income categories takes precedence over the classification of the income as commercial income.

The activities of a partnership must further exceed the scope of wealth management (Vermögensverwaltung) in order to qualify as a commercial enterprise. In accordance with relevant case law, wealth management assumes an activity that focuses on the generation of ongoing income from assets with a long-term strategy (for example, dividend income, interest income or rental income). Wealth management also includes the acquisition and disposal of part or, in the extreme, all of the assets. The realization of capital gains does not compromise the classification as wealth management even if such capital gains are realized within a short period of time.

Nevertheless, where the focus of the activity is on the realization of rather short-term capital gains, the limits of wealth management would be exceeded and the partnership should be classified as commercial enterprise. Whether or not the activities of a Luxembourg limited partnership fall within the scope of private wealth management has to be assessed on a case-by-case basis in view of the overall picture (including a review of the overall set-up, the investment strategy and the conduct).[14]

It should be noted that income deriving from wealth management will generally not be classified as commercial income even if the positive criteria of a commercial activity are fulfilled.[15] Where the activities of a partnership do not exceed wealth management activities, the related income should in principle be classified as income from capital[16], rental income[17] or other income[18] (for example, certain capital gains) which is allocated to the partners in accordance with Luxembourg company law or a diverging arrangement defined in the partnership agreement.

Example: An SCS owns a participation in and grants several loans to a Luxembourg company. The general partner ("GP") of the SCS is a Luxembourg company that has a partnership interest of 0.1%. The limited partner ("LP") of the SCS is a foreign company that owns an interest of 99.9% in the partnership. Given the long-term character of the investments owned by the SCS aiming at the realization of ongoing income, the activities performed by the SCS should fall within the scope of private wealth management. Thus, the SCS should not be subject to Luxembourg MBT.[19]



III. The concept of commercial tainting (Geprägetheorie)

Even where a Luxembourg SCS or SCSp does not perform a commercial activity within the meaning of Article 14 (1) LITL, it will be deemed to perform a commercial activity if the general partner is a Luxembourg company, or a Luxembourg PE of a foreign company, that owns a partnership interest of at least 5% (so-called "commercial tainting").[20] In these circumstances, a SCS or SCSp is subject to MBT. Foreign resident companies may, however, not trigger the commercial tainting.[21]

The 5% threshold has been introduced in 2013 as part of the reform of the limited partnership regime. Before this amendment, the commercial tainting was depending on the mere fact that the general partner of a SCS was a Luxembourg company. The introduction of the 5% threshold is very positive since it provides legal certainty for taxpayers and ensures that a Luxembourg limited partnership can be implemented in a tax neutral manner (for example, when structuring private equity and real estate investments).

IV. Clarifications regarding regulated vehicles

The Circular further covers the following cases where a SCS or SCSp is under the supervision of the Commission de Surveillance du Secteur Financier (CSSF):

Alternative Investment Funds ("AIFs")

The Circular clarifies that limited partnerships falling within the definition of AIFs as determined in the law of 12 July 2013 (the "AIFM Law") are considered not to perform a commercial activity. Indeed, AIFs follow an investment policy compliant with the AIFM Law and do not have a commercial purpose. Hence, AIFs established as a SCS or SCSp should not be subject to Luxembourg MBT unless their general partner is a Luxembourg company or a Luxembourg PE of a foreign company that owns a partnership interest of at least 5%.[22] Although the Circular covers the tax treatment of limited partnerships in general, the main purpose of the Circular is to clarify that the activities of an AIF are as such not classified as commercial activities for Luxembourg tax purposes.

Furthermore, an AIF established outside the territory of Luxembourg but having its centre of effective management or its central administration in Luxembourg by means of a Luxembourg AIFM[23] is not subject to MBT.[24]

SICAV - Part II Fund

Where a Luxembourg limited partnership has the status of a SICAV Part II Fund, Article 173 of the law of 17 December 2010 determines that the Fund is not subject to any tax other than subscription tax (taxe d'abonnement).[25] Accordingly, a SCS or SCSp adopting the status of a SICAV Part II will never be subject to MBT.[26]

Specialized Investment Fund (SIF)

According to Article 66 (1) of the law of 13 February 2007 (the "SIF law"), a SIF is not subject to any tax other than subscription tax[27] (taxe d'abonnement). Hence, a SIF established in the form of a Luxembourg limited partnership is by definition not subject to MBT.[28]

SICAR (Société d'investissement en capital à risque)

Article 14 (1) of the LITL determines that SICARs (falling within the law of 15 June 2004) taking the legal form of a SCS or SCSp are not considered to perform a commercial activity. Moreover, the rules regarding the commercial tainting of a Luxembourg limited partnership (Article 14 (4) of the LITL) are not applicable.[29] Thus, a SICAR in the form of a Luxembourg limited partnership is not subject to MBT.

V. Conclusion

The Circular provides useful guidance on the meaning of a commercial activity within the meaning of Article 14 (1) LITL, the scope of private wealth management and the concept of commercial tainting, which is in line with longstanding jurisprudence and doctrine. It follows that the Circular does not introduce new rules or concepts.

Notably, the main purpose of the Circular is to clarify that the activities performed by a Luxembourg AIF established in the form of a limited partnership are not of a commercial nature. Thus, the Circular provides legal certainty in regard to the classification of income derived via a Luxembourg SCS or SCSp – in particular, in the context of Alternative Investments.

Moreover, the Circular reiterates that foreign AIFs (having their centre of effective management or their central administration in Luxembourg) and Luxembourg SIFs, SICARs and SICAV Part II funds established in the legal form of a SCS or SCSp are deemed to not carry out a commercial activity irrespective of whether the general partner is a Luxembourg company, or a Luxembourg permanent establishment of a foreign company, that owns a partnership interest of 5% or more.

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1) Article 175 LITL, Paragraph 11bis of the Tax Adaptation Law (Steueranpassungsgesetz).
2) Article 14 (1) LITL.
3) See Oliver R. Hoor, "The Concept of Permanent Establishments", European Taxation, IBFD, April 2014, p. 119; see Oliver R. Hoor, "The Tax Treatment of Permanent Establishments", European Taxation, IBFD, July 2014, p. 287.
4) Article 2 (3) LITL (individuals) or Article 160 (1) LITL in connection with Article 156 No. 1 LITL.
5) Paragraph 2 (1), (2) of the MBTL.
6) Article 14 (4) LITL.
7) Article 61 of the LITL.
8) BFH, Decision of 17.1.1973, BStBl II 1973, p. 260.
9) BFH, Decision of 13.2.1980, BStBl II 1980, p. 303 ; BFH, Decision of 31.7.1990, BStBl II 1991, p. 66 ; BFH, Decision of 24.9.1991, BStBl II 1992, p. 330.
10) BFH, Decision of 21.8.1985, BStBl II 1986, p. 88; BFH, Decision of 19.11.1985, BStBl II 1986, p. 424; BFH, Decision of 13.12.1995, BStBl II 1996, p. 232; BFH, Decision of 10.12.1998, BStBl II 1999, p. 390; BFH, Decision of 19.2.2009, BStBl II 2009, p. 533.
11) BFH, Decision of 15.12.1971, BStBl II 1972, p. 291; a onetime transaction may, however, have a permanent character if there is an intention to repeat the activity in case an opportunity arises ; BFH, Decision of 14.11.1963, BStBl III 1964, p. 139.
12) BFH, Decision of 25.6.1986, BStBl II 1984, p. 751.
13) Article 61 of the LITL.
14) See Section 2 of the Circular; Hubert Dostert, "Le benefice commercial", Études fiscales, No. 109-111, 1997, p. 15; Luxembourg Administrative Court of First Instance: Decision of 20.6.2012, No. 28814; Decision of 8.3.2012, No. 28295; Decision of 25 March 2010, No. 25466; Decision of 4.1.2010, No. 25664 and 25666; Luxembourg Administrative Court of First Instance: Decision of 13.5.2014; No. 33835C, 33836C and 33837C; Decision of 15.3.2012, No. 29541C; Decision of 10.9.2008, No. 23434; BFH, Decision of 18.1.1989, BStBl II 90, p. 1051; BFH, Decision of 29.3.1973, BStBl II 1973, p. 661 ; BFH, Decision of 8.7.1982, BStBl II 1982, p. 700 ; BFH, Decision of 10.12.2001, BStBl II 2002, p. 291; according to Paragraph 7(4) of the Decree of 16 December 1941 on execution of paragraphs 17-19 of the StAnpG an activity is regularly classified as wealth management that involves the use of wealth, for example, when cash is invested to generate interest income or real properties are rented out.
15) BFH, Decision of 17.1.1973, BStBl II 1973, p. 260; a partnership may, however, be commercially tainted in accordance with Article 14 (4) of the LITL and, thus, be deemed to be a commercial enterprise.
16) Article 97 of the LITL.
17) Article 98 of the LITL.
18) Article 99 of the LITL.
19) Should the general partner of the SCS (i.e. LuxCo) own a partnership interest of more than 5%, the SCS would be commercially tainted and deemed to perform a commercial activity; see section III. Below.
20) Article 14 (4) LITL; see Section 3 of the Circular.
21) See commentaries to the bill of law of 21 December 2001.
22) See Section 4 of the Circular.
23) Alternative Investment Fund Manager.
24) See Section 5 of the Circular.
25) Articles 174 to 176 of that law of 17 December 2010.
26) See Section 6 of the Circular.
27) Article 68 of the law of 13 February 2007.
28) See Section 7 of the Circular.
29) See Section 8 of the Circular.