Luxembourg Corporate - Foreign direct investment - Structuring the equity

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As one of the leading global jurisdictions for structuring foreign direct investment (**FDI**), Luxembourg has developed a sophisticated framework to enable the financing of such investments.

This briefing outlines the newly introduced foreign investment screening system and provides a detailed overview of equity structuring decisions (both within and outside the FDI framework), including choice of vehicles and tax considerations.

Financing decisions always need to be considered within the broader framework of the vehicles' overall financing structure.

The optimum balance of financing instruments in relation to any structure will vary according to its particular circumstances. These include the laws applicable to the investors, the laws of the jurisdiction of the assets into which investment is made, and commercial decisions about the appropriate mix of bank finance and own funds.

However, one factor that all Luxembourg domiciled FDI structures have in common is the requirement for an appropriate level of equity investment. While the level of equity investment will also vary according to the circumstances of the particular investment structure, noting in particular the requirements of applicable debt-equity ratios, the corporate structuring of that equity investment will be largely a matter of commercial choice for investors and fund managers.

Luxembourg's FDI screening law

Luxembourg has introduced a new screening law to supervise foreign direct investment in so-called critical sectors.

The new foreign investment control regime came into effect on 1 September 2023 (the **FDI Law**) and transactions from that date onward require notification if they fall under the scope of the new law. Read our briefing on the new law: Snapshot: Luxembourg's foreign direct investment screening law | Ogier.

Structuring FDI in Luxembourg (either under the FDI Law's framework or outside of it)

Vehicle selection

Luxembourg has a very wide range of corporate and limited partnership vehicles. In the context of FDI structuring, the vehicles most commonly encountered are as follows:

a. Société anonyme (**SA**)

b. Société à responsabilité limitée (**Sàrl**)

c. Société en commandite par actions (**SCA**)

d. Société en commandite spéciale (**SCSp**)

These vehicles may also be used as regulated investment funds or (except the SCSp) as securitisation vehicles. The characteristics arising from any applicable regulatory overlay are also relevant to the aggregate characteristics of a structure.

One of the most commonly used vehicles for non-regulated FDI structuring is the Sàrl. It is a private limited liability company, managed by a board of managers, for the benefit of its shareholders. It is characterised by a very high degree of flexibility and a very limited level of statutory prescriptions. It is thus easily tailored to the requirements of a single investor or joint venture private investment.

In contrast, the SA is a public limited liability company which is able (in contrast to a Sàrl) to make offers of shares to the public, to have a wider shareholder base and to provide a high level of confidentiality for its investors. As a public company, it does however operate in a more extensive statutory framework than a Sàrl.

The SCA is a corporate limited partnership with a share capital. This vehicle is frequently encountered in Luxembourg structures. Although a limited partnership (with one or more general partners and one or more limited partners) the SCA is also subject to the same, more extensive, statutory framework as the SA.

The SCSp is a transparent limited partnership without legal personality, specifically modelled on Anglo-American forms of investment limited partnerships.

Constituting the vehicle

As Luxembourg is a civil law jurisdiction, the SA, SCA and Sàrl must all be constituted by a formal deed, made before a Luxembourg notary. This notarial deed is the constitutional document of the vehicle, including a statement of all the characteristics of share classes.

In order to carry out incorporation, the initial economic contribution of the founding investors must be unconditionally held by the vehicle at the moment of its incorporation with a value at least equal to the minimum required by Luxembourg law. Where this initial contribution/subscription is made in cash, this cash sum, equal to at least €12,000 in the case of Sàrl and €30,000 in the case of SA or SCA, must be deposited with a Luxembourg account bank, in cleared funds, in advance of the incorporation.

The account bank then issues a certificate to the Luxembourg notary confirming the blocking of this sum, to the order of the vehicle to be incorporated. On incorporation by the notary, the latter issues a certificate unblocking those subscription monies which are then at the disposal of the vehicle.

The SCSp, as an exception to this rule, may be constituted either by a private, non-notarial instrument between its members, or by notarial act. No minimum capital requirements apply in the case of the SCSp.

The minimum share capital of €12,000 applicable to the Sàrl must be fully subscribed and paid up as at the incorporation. In the case of the SA and SCA, the minimum required capital of €30,000 must be fully subscribed at the incorporation and paid up at least as to 25%.

Structuring the investment

(a) Contributing the equity

Equity may be contributed to a Sàrl, SA or SCA in cash or, by way of a contribution in kind. In relation to contribution in kind, almost any tangible or intangible assets may be contributed, provided that such assets are capable of credible and reliable valuation. Eligible intangible assets include securities, debt claims, goodwill in a specific business and intellectual property rights.

Where shares in an SA or SCA are issued partly paid up in consideration of an undertaking to make a contribution in kind, the assets to be contributed must be fully transferred to the vehicle within five years.

In relation to an SA or SCA, the valuation of an equity contribution of assets must be supported by an up-to-date valuation report from an independent Luxembourg auditor. This auditor report requirement does not apply in relation to a Sàrl but the valuation of the assets must be certified to the notary incorporating the company. Furthermore, no report is required when the contribution in kind consists in a receivable held by the holder of a debt instrument (the contributor) against the company (the contributee).

Equity may also be contributed in the form of share premium either attaching to specific shares or not, or in the form of capital surplus contribution (ie capital contribution without the issuance of shares, as further detailed below), with a great level of flexibility. Any share premium or capital surplus contribution shall be fully subscribed for and paid up.

Sweet equity contributions ("apports en industrie") can also be made to the extent that the shares issued in consideration are not considered as share capital from an accounting perspective and are not transferable. Such shares will benefit from governance and/or economic rights as set out in the articles of association.

(b) Equity contribution without issuing shares (capital surplus)

An alternative way of making or increasing equity contributions to a Luxembourg company is by means of an "account 115 contribution" (capital surplus contribution). This involves a contribution of value to the vehicle which is recorded to a special account/reserve in the company's books and records which is characterised as equity, but which does not involve the issuance of shares.

The absence of share issuance removes the requirement that otherwise often applies to make such transactions by way of notarial deed. This mechanism therefore provides a highly flexible way of ensuring a company's equity that can be actively managed so as to ensure on-going compliance with required debt-equity ratios and can therefore facilitate active portfolio management.

The corporate requirements to make such contributions are: enabling provisions in the articles, an ordinary, non-notarial shareholders' resolution, and implementation by the directors/managers. A short form contribution agreement may also be required depending on the nature of the contribution.

(c) Financing instruments

(i) Asset-tracking shares

Where a vehicle makes multiple investments with a commercial requirement for asset-correlated investment returns to different classes of investors, then asset-tracking classes of shares and "account 115" equity contributions are entirely acceptable. Such asset-tracking mechanisms are contractually binding absent insolvency.

Insolvency-proof compartments have statutory recognition in the case of Luxembourg securitisation vehicles or specialised investment funds. In relation to unregulated, investment holding vehicles, insolvency-proof compartmentalisation is not statutorily recognised. If differential, asset-specific leverage is envisaged then structural asset ring-fencing may be advisable.

(ii) Alphabet shares

Also frequently encountered in the Luxembourg market is the use of alphabet shares. This technique involves the issuance of several classes of shares whose economic rights are not correlated to only certain portfolio assets, but rather apply to a pool of assets as a whole and/or to specific investment periods.

The use of a number of classes of alphabet shares of this nature allows the vehicle to redeem individual classes of those shares at appropriate points in time so as to effect transfers of value, by means of redemption payments to shareholders, following the receipt of value from the underlying asset pool. Such redemption payments will be treated as a partial liquidation and do not attract a withholding tax under Luxembourg law, if properly structured.

(iii) Preferred shares

Preferred shares carry the preferential right to receive a fixed percentage of profits before others. In some cases, they also offer the preferential right to capital distribution before other classes. As a result, they often carry no voting rights.

(iv) Beneficiary shares

In addition to shares, Luxembourg company law allows the issue of participation certificates, also called founder shares ("titres ou parts bénéficiaires") which do not form part of the share capital. The articles of association determine the rights that are attached to such beneficiary shares. These rights could conceivably be voting rights and/or dividend rights or rights to participate in the liquidation or a combination thereof.

It is possible to issue beneficiary shares with or without the right to participate in profits or with or without voting rights. These beneficiary shares can be issued for a consideration in cash or kind, but can also be issued without consideration.

Pre-emption rights on share transfer

In relation to transfers of existing shares, the quasi-partnership character of the Sàrl requires that transfers to non-members can only be made with the approval of existing shareholders, in a general meeting, holding at least 75% (the majority can, however, be lower-down to 50%) of the issued share capital.

In contrast, in relation to the SA and SCA, free transferability of shares applies at law subject to any contractual rights of pre-emption on share transfers or requirements for approval (eg by the board or general partner, as applicable) of the transferee in the articles of association, provided that such clauses do not have the effect of rendering transferability in practice impossible.

Capital increase and preferential subscription rights

To increase the share capital of a Sàrl, an amendment of its articles of association will be required. Such amendment is passed before a Luxembourg notary and requires a majority of shareholders holding at least 75% (the majority can however be lowered down to 50%) of the share capital in issue. Any new investors (not being existing shareholders) must also be approved (as indicated above under "pre-emption rights") by existing shareholders holding at least 75% (or 50% as the case may be) of the issued share capital.

As an alternative, Luxembourg companies, may also state an authorised share capital in their respective articles of association authorising the board of managers/directors or the general partner to determine the terms of further share issuance within certain limits and to carry it out. Such authorisation may be valid for a period of a maximum of 5 years and is renewable. In such case, the board of managers/ directors or the general partner may also be authorised in the articles to remove or limit the preferential subscription rights of the shareholders.

Where, in relation to an SA or an SCA, an increase of issued or authorised share capital requires the articles to be amended which requires a majority of 66.67% of shareholder votes (present or represented at the meeting) with a quorum of shareholders representing at least 50% of the issued share capital.

Increases of share capital by an SA/SCA for cash subscription (but not by way of asset contribution) will generally be subject to statutory, preferential subscription rights. No such statutory, preferential subscription rights exist in relation to a Sàrl although equivalent contractual rights may be included in its articles.

The SA/SCA statutory, preferential subscription rights may be waived by the shareholders individually. The shareholder's meeting may also vote to reduce or cancel these preferential subscription rights, applying the same requirements as for amendment to the articles, which also requires a detailed report of the reasons for limiting the preferential subscription rights to be presented to the shareholders meeting by the board of directors.

Redemption of shares

(a) Share buy-back

Whilst subscription by an SA or SCA for its own shares is not permitted, it is permitted for these vehicles (and for a Sàrl) to buy back their own shares which are then either cancelled or held in treasury (under certain conditions). For a Sàrl, the ability to buy-back the shares must be set out in its articles of association, the company must have sufficient funds to do so and transfers into treasury require a shareholder approval as set out above under "pre-emption rights" but is otherwise largely a matter of contract.

In relation to an SA/SCA, an additional, generally applicable statutory framework also requires authorisation to the board of directors (or the general partner, as applicable), by a general shareholder(s) meeting approving the terms and conditions, the maximum number of shares, the period of validity for the authorisation of up to five years and the maximum and minimum consideration to be paid, and a summary in the annual management report.

Shares bought back must be fully paid up and the buy-back must not have the effect of reducing the vehicle's net assets below the value of its subscribed share capital plus undistributable reserves.

In relation to a SA/SCA/Sàrl, the general civil law principle of equal treatment of shareholders will require that any share buy-back needs to be proposed equally to each shareholder in the same situation.

Buy-back of limited interests in the case of a SCSp can be freely determined in the partnership agreement.

(b) Redeemable shares

Redeemable shares may be issued, subject to the following statutory requirements: redemption is authorised in the articles of association prior to issue of the redeemable shares, shares to be redeemed must be fully paid up, and redemption can only be funded from distributable profits and reserves or the proceeds of a new issuance of shares made for the purposes of the redemption.

When funded from distributable reserves/profits, a figure equal to the redemption price must be recorded in a non-distributable reserve in the accounts of the company. Any redemption premium may only be paid where it will not cause the company's net asset value (as set out in its most recent annual accounts) to fall below its subscribed share capital plus non-distributable reserves.

Reductions of capital

Reductions of capital may be carried out in relation to SA, SCA and Sàrl by shareholders' resolution (with the same quorum and majority requirements as for the amendment of the articles of association). If the reduction involves a repayment to shareholders or waiver of an obligation to pay up shares, creditor protection principles apply in relation to SA and SCA which allow any creditor whose claims predate the publication in the Luxembourg official gazette (RESA – Recueil Electronique des Sociétés et Associations) of the shareholders' capital reduction resolution, to apply to the court for a protective order within 30 days following such publication.

That application must be for an order for the provision of security for the creditor's claim and the court may only reject such application if it considers the creditor already has adequate protection or if such security is unnecessary in view of the net asset value of the company. No payment may be made by the company to the shareholders following a capital reduction within this 30-day period, or until any objecting creditor applying to the court has had its claim settled or the court dismisses the application.

Unlike the case in certain other jurisdictions, creditor protection enables application by objecting creditors to the court. It does not require the positive application by the company itself for the court's approval of the proposed reduction.

No specific creditor protection provisions apply in relation to reductions of share capital of Sàrl or SCSp.

Distribution to investors

(a) Dividends

After payment or provision for relevant debt obligations (including any intra-group debt financing), all Luxembourg companies (to the exception of the SCSp) are obliged to allocate to a non-distributable reserve an amount equal to 5% of the company's net profit per annum. This obligation continues until the reserve has accrued to a figure equal to 10% of the company's share capital.

After payment or provision for debt liabilities and allocation to this non-distributable reserve, the company may then declare and pay annual and interim dividends.

In relation to standard, unregulated companies (not constituting an investment fund) annual dividends are declared by the shareholders at their annual general meeting approving the company's annual accounts, provided that those accounts demonstrate that the proposed final, annual dividend would not cause the company's net asset value to fall below the level its subscribed share capital plus distributable reserves. The amount of the final, annual dividend may not exceed distributable profits, reserves (and carried forward profits) net of any current or carried-forward losses and allocations required to the non-distributable reserve(s).

Interim dividends may also be declared in relation to a Sàrl/SA/SCA by the board of managers/directors (or the general partner, as applicable), provided that authority to do so is set out in the articles and that the proposed distribution does not exceed the profits of the company in the current year (plus net profits carried-forward) net of any current or carried-forward losses and any sums required to be allocated to non-distributable reserve(s).

In declaring any interim dividend, the managers/directors must prepare a balance sheet showing the net funds available for distribution and the decision to distribute must be taken within two months of that balance sheet. At the time the annual accounts are to be approved, the statutory auditor (if any) must confirm to the board (or the general partner, as applicable) whether or not these conditions are met.

Dividend payments attract Luxembourg withholding tax but such withholding tax may be reduced or exempt in certain circumstances.

(b) Share premium and capital surplus repayment

Under Luxembourg law, share premium and capital surplus is typically considered as a part of the company's equity, similar to its share capital. However, unlike share capital, share premium and capital surplus is more flexible in terms of repayment or distribution to shareholders. It requires a resolution of the general meeting of shareholders, typically based on the board's proposal. Companies must ensure that, after such a distribution, they remain solvent and that their net assets do not become negative.

Tax considerations for a Luxembourg FDI structure

The Luxembourg and foreign tax position of any FDI structure will be entirely dependent on its particular facts.

Frequently encountered questions include:

a. whether certain transfers of value will be subject to withholding tax

b. whether obligations to pay certain sums are deductible against the Luxembourg vehicle's domestic taxable base

In each case, the outcome will be determined by the combination of the following: type of vehicle, type of security and its characteristics, jurisdiction of the relevant investor, amount and nature of the investor's interest in the vehicle, and characteristics of the investor itself.

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