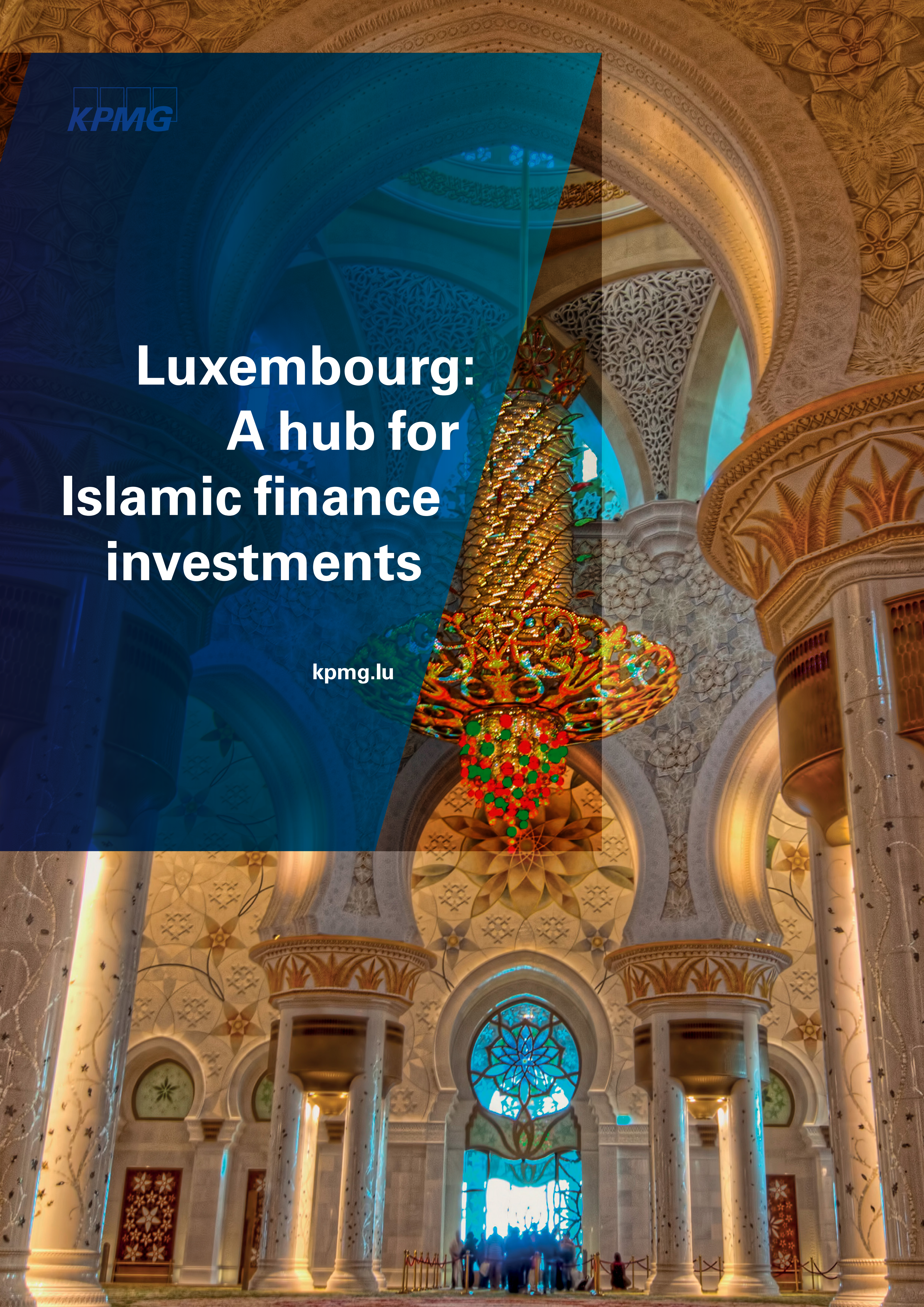
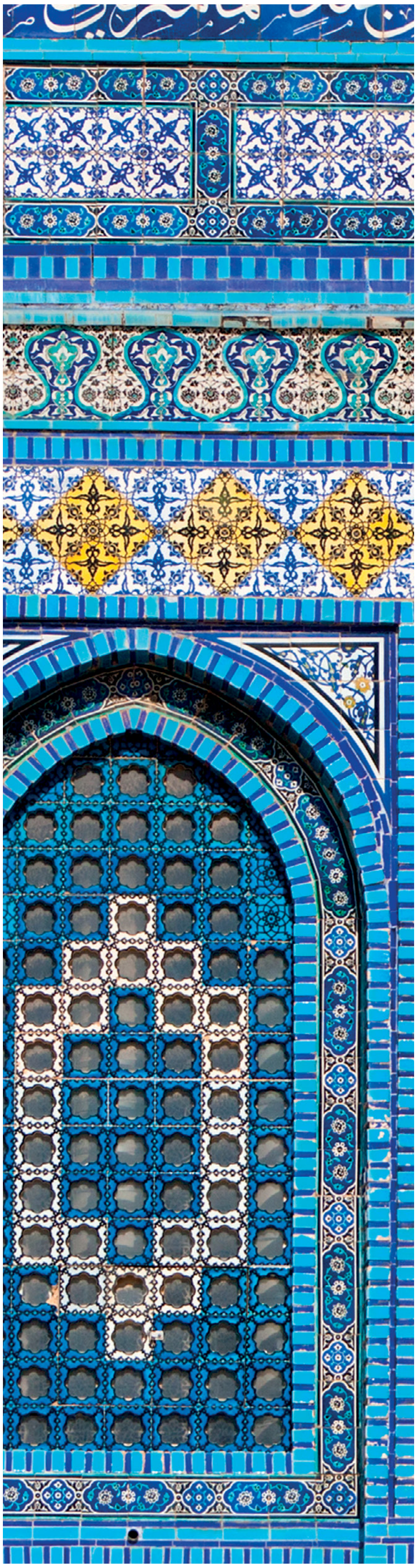
KPMG

Luxembourg: A hub for Islamic finance investments

kpmg.lu



Introduction to Luxembourg



The advent of Luxembourg as a prime platform for business has provided the financial industry with opportunities across the globe. As one of the most prominent investment management centres and pivotal holding locations, Luxembourg is perfectly equipped to address the dynamic needs of Islamic finance investments throughout Europe.

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

Government support and a favourable regulatory environment together encourage Islamic companies and financial institutions to set up operations in Luxembourg. Combined with a business-oriented environment and the proactive CSSF (the Luxembourg Financial Services Authority), a flexible and secure framework is created, permitting Luxembourg to maximise the tax efficiency of its Sharia-compliant products, and spearhead Islamic transactions globally.

Crucially, the compatibility of the Luxembourg legal framework with Islamic finance requirements for the implementation of *Sharia*-compliant products is of immeasurable importance.

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

Importantly, the internationally recognised Luxembourg Stock Exchange (www.bourse.lu) boasts an attractive international listing marketplace for shares and a wide range of securities. Luxembourg is the second largest fund domicile in the world and is already the third largest domicile for Islamic funds worldwide, behind Malaysia and Saudi Arabia. These three countries cover more than 70% of the Islamic fund market. The number of regulated and unregulated Islamic funds in Luxembourg has increased to 111 funds in 2013. The assets under management amount to EUR 5bn. In addition 16 Sukuk are listed on the Luxembourg Stock Exchange.

Source: Luxembourg for Finance, Luxembourg Stock Exchange, zawya.com Thomson Reuters Global Islamic Asset Management Report 2014

As a founding member of the EU, Luxembourg has notably incorporated relevant EU tax Directives into domestic legislation. These have great significance for international groups. The EU Parent-Subsidiary Directive generally eliminates withholding tax on profits distributed by the subsidiary for substantial shareholdings and removes potential double taxation on those profits. The EU Merger Directive ensures that pan-European group reorganisations such as mergers, de-mergers and share-for-share transactions may be structured in a tax neutral manner.

Luxembourg tax law provides for neither controlled foreign companies (CFC) rules nor detailed transfer pricing rules.

Luxembourg's extensive tax treaty network is ever-expanding and currently numbers 70 including the most important hubs of Islamic finance: Azerbaijan, Bahrain, Egypt, Indonesia, Malaysia, Oman, Pakistan, Qatar, Saudi Arabia, Turkey and the United Arab Emirates.

Key to Islamic investors, Luxembourg boasts a broad investment treaty network including Azerbaijan, Egypt, India, Kuwait, Malaysia, Saudia Arabia, Turkey and the United Arab Emirates that provides maximum investment protection. Investment treaties with Bahrain and Qatar are awaiting entry into force.

Principles of Islamic finance

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

All contracts in the framework of Islamic finance have to comply with the rules of the Sharia that notably ban interest and speculation, and stipulate that income must be the fruit of shared business risk rather than guaranteed return. A contract is deemed Sharia-compliant if its terms and conditions are free of all prohibition.

The main principles of Islamic finance include:

- The prohibition of payment and receipt of interest (*Riba*),
- The prohibition of uncertainty (or *Gharar*) about the subject-matter and terms of contract,
- The prohibition of transactions involving speculation and gambling (or *masir*),
- The prohibition of investments in undesirable businesses,
- Earnings through profit-sharing investments,
- Asset-backing principle.

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

Islamic finance techniques

The Islamic economic system has a set of interest-free core models that serve as a basis for the design of more sophisticated and complex financial instruments.

The most relevant Islamic modes of financing may be categorised into equity- and debt-related techniques:

Equity-related techniques

- Mudaraba (Profit sharing agreement)
- Musharaka (Joint-venture)
- Diminishing Musharaka (Declining balance partnership)

Debt-related techniques

- Murabaha (Forward sale)
- Commodity Murabaha (or "Tawarruq")
- Salam (Spot sale)
- Istisna'a (Commissioned manufacture)
- Qard Hasan (Interest-free loan)
- Ijara (Leasing)
- Sukuk (Asset-backed securities)

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

Sharia - Compliant investments via Luxembourg

Different types of investors imply an endless variety of legal, financial and tax advice. Luxembourg has recognised this and seeks to provide the most efficient investment vehicle or structure to each investor.

Luxembourg holding companies

Luxembourg tax law provides for two different holding tax regimes, namely the SOPARFI and the SPF.

SOPARFI – Luxembourg participation exemption

The SOPARFI ("*société de participation financière*") is a fully taxable Luxembourg company whose primary activity is holding and/or financing. The SOPARFI benefits from an extensive and flexible participation exemption regime from both Luxembourg's tax treaty network and EU Directives. The SOPARFI is not subject to prudential control.

SPF – The Family Wealth Management vehicle

The SPF ("*société de gestion de patrimoine familial*") offers a privileged tax regime aimed at individuals for the purpose of passively holding shares or other investments. The SPF has replaced the 1929 holding company and is undoubtedly the ideal investment vehicle for wealthy Islamic individuals willing to pool their European based investments in a tax-efficient manner.

Luxembourg investments funds

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

UCITS – Undertakings for Collective Investments in Transferable Securities

A UCI is a collective investment of funds raised from the public for the purpose of investing these funds according to the principle of risk diversification. Luxembourg UCITS are a sub-category of funds that fulfil EU regulation requirements and may therefore be offered to investors throughout the EU on the basis of a single authorisation from one Member State.

Besides the EU regulations have been extended by the AIFM Directive. Authorized Alternative Investment Fund Managers (AIFM) are empowered to distribute AIFs in the entire EU with one single authorization.

SIF – Special Investment Funds

The SIF is designed as a classic investment fund collecting funds from a closed circle of experienced investors. Whilst its tax regime is similar to any other Luxembourg investment fund, its regulation by the CSSF is much lighter and consequently less onerous. As such, investor protection regulations do not apply to the same extent as for retail funds and the SIF enjoys far more flexibility than other regulated funds. The SIF may also invest in any type of asset and therefore be used for any type of fund.

Special investment vehicles

SV – The Luxembourg Securitization vehicle

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

SICAR – The Luxembourg Venture Capital vehicle

The SICAR ("société d'investissement en capital à risqué") is a semi-regulated venture capital investment vehicle with the principal object of investing in risk-bearing assets issued by domestic and foreign enterprises.

With the *Sharia* encouraging risk-taking and prohibiting interest, un-leveraged venture capital funds are ideal tools for making investments in an Islamic manner. In view of the simplified application of company law, limited regulatory supervision and favourable tax rules (such as tax exemption of qualifying income and dividend withholding tax exemption), the SICAR is tailored for Islamic finance investments in and via Luxembourg.

Real estate companies

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

Fiduciary agreements

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

How we can help you

As Islamic finance continues its expansion and diversification, our dedicated team of tax, advisory and audit professionals would be happy to assist you in structuring Islamic investments and advising on all Luxembourg aspects of *Sharia*-compliant structures.

KPMG Luxembourg and our Islamic Finance specialists are part of KPMG's global network of Islamic Finance professionals. Within this network we share our expertise and experience to allocate the best solutions and experts to your needs.

We can work in conjunction with trustworthy Luxembourg law firms and trust companies.

KPMG is one of the world's leading professional services organisations. With over 135,000 people worldwide, KPMG member firms provide assurance, tax, financial advisory and consulting services from more than 750 cities in 155 countries.

PRE SET-UP STAGE

- Market Research
- Market Entry Studies
- Regulatory Assessment
- Market Positioning
- Taxation Advice
- Conversion Advisory

SET-UP STAGE

- Business Strategy
- Business / Financial Plan
- Governance Structure
- Risk Management
- Business Processes Defining and Implementation
- Islamic Finance Learning
- Executive Search and Selection

OPERATIONAL STAGE

- Audit and Accounting
- Feasibility Studies
- Economic Management
- Performance Management
- Regulatory Advice
- Assessment of Shariah Compliance
- IT Risk Management
- Risk Management Review
- Training on Islamic Finance

TRANSFORMATION STAGE

- Business Transformation
- Forensics
- Business Model Review
- Governance and Risk Management Review

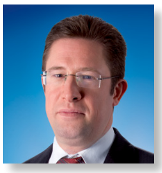
Our competence team for Islamic Finance

Pascal Denis
Partner
Management Consulting
E: pascal.denis@kpmg.lu
T: +352 22 51 51 - 7213

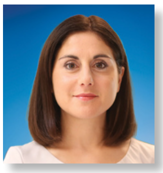
Philippe Neefs
Partner
Tax
E: philippe.neefs@kpmg.lu
T: +352 22 51 51 - 5531

Zia Hossen
Partner
Restructuring
E: zia.hossen@kpmg.lu
T: +352 22 51 51 - 7238

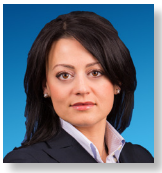
Anne-Sophie Minaldo
Partner
Regulatory Services
E: anne-sophie.minaldo@kpmg.lu
T: +352 22 51 51 - 7909



Pierre Kreemer
Partner
Audit
E: pierre.kreemer@kpmg.lu
T: +352 22 51 51 - 5502

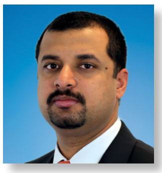


Lutfije Aktan
Partner
Audit
E: lutfije.aktan@kpmg.lu
T: +352 22 51 51 - 6609

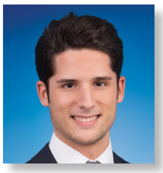


Sonia Dribek
Senior Manager
Management Consulting
E: sonia.dribek@kpmg.lu
T: +352 22 51 51 - 7246

Bertrand Segui
Senior Manager
Financial Risk Management
E: bertrand.segui@kpmg.lu
T: +352 22 51 51 - 7992



Muhammad Tahir Khan
Manager
Audit
E: muhammadtahir.khan@kpmg.lu
T: +352 22 51 51 - 6513



Daniel Meyer
Senior Adviser
Regulatory Services
E: daniel.meyer@kpmg.lu
T: +352 22 51 51 - 7335

KPMG Global – Network

KPMG Luxembourg and our Islamic Finance specialists are part of KPMG's global network of Islamic Finance professionals. In this network we share our expertise and experience to allocate the best solutions and experts to your needs.

EUROMONEY ISLAMIC FINANCE AWARDS 2010
EUROMONEY ISLAMIC FINANCE AWARDS 2011
EUROMONEY ISLAMIC FINANCE AWARDS 2012
EUROMONEY ISLAMIC FINANCE AWARDS 2013

Visit 39 Kennedy Avenue on blog.kpmg.lu and follow us on

www.kpmg.lu