

# NEW CARRIED INTEREST REGIME POTENTIAL NON TAXATION

On 24 July, the Luxembourg government approved and deposited a draft law amending the Luxembourg carried interest regime. The proposed changes aim at further reinforcing Luxembourg's attractiveness for the alternative investment sector.

## Key highlights

The draft law introduces a differentiation between two types of carried interest:

- ▶ Purely contractual carried interest, i.e. not linked to any form of investment  
Such carried interest, which is currently taxed at a rate of up to 45.78% (+1.4% dependence insurance contribution) will in the future be taxed at  $\frac{1}{4}$  of the beneficiary's global tax rate, i.e. a maximum of 11.45% (+1.4% dependence insurance contribution)
- ▶ Carried interest linked to an investment  
The latter will be taxed according to regular capital gains rules, i.e. not taxable if held for more than 6 months and the beneficiary does not hold a substantial participation (more than 10% of the shares/quota of the underlying vehicle)

Furthermore, the proposed wording enables the inclusion of a wider scope of AIF such as debt funds. It also no longer requires investors to be repaid first and will thus include deal-by-deal arrangements.

The draft law also significantly extends the scope of beneficiaries that is no longer restricted to employees of the AIFM or management company, but can include external individuals, such as directors, advisors or employees of related entities.

## Detailed discussion

- ▶ Tax qualification of carried interest

The new regime confirms that, under Luxembourg tax law, carried interest should be considered as speculative capital gains (and not as employment income or trading income). Given such qualification, the regime will apply to Luxembourg tax residents only. Contrary to the previous carried interest regime, this new version will not be limited to individuals newly establishing their tax residence in Luxembourg.

It is worth noting that the commentaries to this draft law are clear that the capital gains qualification applies whatever the conditions attached to the carried interest, i.e. vesting conditions, good or bad leavers provisions shall not give rise to any requalification risk.

Also, the draft law indicates that the capital gain qualification will be applicable even in case the distributing entity is transparent for tax purposes, e.g. SCSp, FCP, thus the regular look through principles will not apply to such a carried interest distribution. As a result, taxation of the carried interest should also only take place upon receipt.

► Eligible beneficiaries

The proposed regime extends the scope of beneficiaries and will be available to any natural person managing AIFs or, directly or indirectly, performing services to the benefit of an AIFM, a management company of an AIF or a related entity, whatever their capacity (employee, non-executive director, independent advisor...). The draft law as currently proposed seems not to include any form of restriction with respect to the beneficiaries as far as carried linked to an investment is concerned.

► Recognition of two types of carried interest

The draft law and its commentaries clarify the definition of carried interest as being a share of the outperformance (above the hurdle rate<sup>1</sup>) of an AIF distributed to the eligible beneficiaries.

The legislation in place so far included a requirement that investors are fully repaid before payout can be made to carry holders. Such requirement was seen as preventing payout on a deal-by-deal basis. This requirement is therefore repealed in the draft law, making the new regime more widely applicable.

The proposed regime treats carried interest differently depending on whether the beneficiary is required to make an investment in order to benefit from carried interest or not.

<sup>1</sup> The hurdle rate has to correspond to market practice and not be too low, otherwise abuse of law provisions may apply

► Contractual carried interest (no form of investment required)

In cases where carried interest is granted to the beneficiary without any form of investment being required, upon payout, the gain is to be considered as extraordinary income, taxable at  $\frac{1}{4}$  of the individual's tax rate, i.e. a maximum of 11.45%. The gain will also be subject to dependence insurance due at a rate of 1.4%. The overall maximum rate would therefore be below 13%. Differently from the previous legislation in place, the taxation at  $\frac{1}{4}$  of the individual's tax rate is not limited in time. One of the objectives of this new legislation is indeed to introduce a permanently favorable mechanism.

If beyond the contractual carried interest granted without any investment requirement, the individual would also voluntarily invest, the return on such investment would be treated as described below.

► Carried interest linked to an investment from the beneficiary

When carried interest is granted under the condition that the beneficiary makes an investment, directly or indirectly, whatever the form, in the AIF or in a dedicated vehicle, regular capital gains rules will apply. In such case, both the capital gains on the investment realised by the beneficiary upon a disposal of the investment and the carried interest income itself will be subject to capital gains rules. Regular return (distributions) received by the beneficiary from the investment - which are to be looked at separately from the carried interest - will be subject to standard movable income taxation rules.

**Those rules provide that, should the investment have been held for more than 6 months, and the holder did not hold a substantial participation<sup>2</sup>, the gain is not taxable.**

The commentaries to the draft law also indicate that the qualification of the payout as capital gains as described above does not prevent the recognition of a benefit in kind at the time of subscription, should the investment be acquired for no consideration or for a consideration lower than the fair market value.

The proposed new rules are expected to be applicable starting from 2026. They are very welcome as they bring clarity and legal certainty around a topic which is complex by nature. It is worth noting that, for those individuals in the alternatives sector moving from abroad and considering Luxembourg as a destination, this new regime can be combined with the revamped expatriate tax regime, which allows for a 50% tax exemption on salary (up to EUR 400,000) for 8 years.

<sup>2</sup> A participation is considered as substantial if alone or together with his spouse or partner and minor children, the individual has directly or indirectly held more than 10% of the share capital at any time during the five preceding years

## INTERESTED?

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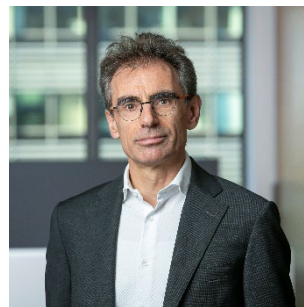


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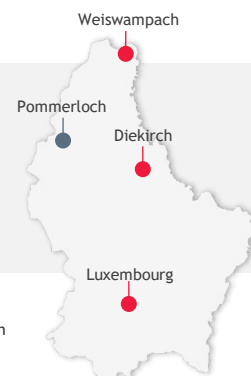
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