Luxembourg Puts Reverse Hybrid Doubts to Rest with New Tax Circular

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Circular L.I.R. n°168quater/2 clarifies the CIV carve-out, bringing long-awaited certainty to RAIFs, SIFs and other Luxembourg funds.

Janus and the Double Face of Transparency

The Roman god Janus, guardian of transitions and thresholds, is traditionally depicted with two faces: one turned toward the past, the other toward the future. His ambivalence embodies the complexity of beginnings and endings, of openness and closure. The same image has haunted the reverse hybrid rule since its introduction under Luxembourg tax law and entry into force in 2022: depending on the angle of analysis, an entity could appear tax transparent under domestic law yet tax opaque under the perspective of a foreign jurisdiction. This duality risked creating potential situations of double non-taxation, precisely the outcome targeted by the OECD's Base Erosion and Profit Shifting (**BEPS**) project and the EU's second Anti-Tax Avoidance Directive (Council Directive (EU) 2017/952, **ATAD 2**).

For a fund caught by the reverse hybrid rule, the portion of its income attributable to "bad" ATAD 2 investors could be taxed in Luxembourg directly at fund level, rather than flowing through in a tax-neutral fashion to investors.

On 22 August 2025, the Luxembourg tax authorities issued Circular L.I.R. n°168quater/2 (dated 12 August 2025) (the "**Circular**"), finally offering the clarity that Janus never could. By shedding light on how the collective investment vehicle ("**CIV**") carve-out should apply in practice, this tax circular gives Luxembourg's funds industry something it has long lacked: the ability to look forward with legal certainty, no longer torn between two irreconcilable perspectives.

Origins of the Reverse Hybrid Rule

The reverse hybrid provisions trace their origins to Action 2 of the OECD's BEPS project, which targeted hybrid mismatch arrangements. ATAD 2 translated these concepts into EU law, requiring Member States to neutralize mismatches arising from differences in legal characterization of entities or instruments. Luxembourg implemented this Directive, introducing the reverse hybrid rule in Article 168quater of the Income Tax Law (*Loi concernant l'impôt sur le revenu*, "**LITL**"). This rule took effect on January 1, 2022, following the law of December 20, 2019, which was later amended by the law of December 23, 2022.

A "reverse hybrid" arises when an entity is regarded as tax transparent by its country of establishment (e.g. Luxembourg for partnerships such as the *société en commandite simple* (**SCS**), *société en commandite spéciale* (**SCSp**) or *fonds commun de placement* (**FCP**)) but as tax opaque by one or more foreign jurisdictions where its associated investors are located. If 50% or more of the voting rights, capital, or profit entitlement of the Luxembourg entity is held by such investors - alone or "acting together" - the entity's net income, otherwise untaxed, becomes subject to Luxembourg corporate income tax at 17% plus the 7% employment fund surcharge (17.12% in 2025).

Luxembourg lawmakers, following ATAD 2, exempted CIVs from the scope of the rule if they were (i) widely held, (ii) invested in a diversified portfolio of securities, and (iii) subject to investor-protection regulation. Yet these statutory conditions lacked precise interpretation. Although Luxembourg's parliamentary works suggested that specialised investment funds (**SIFs**, under the law of 13 February 2007) and reserved alternative investment funds (**RAIFs**, under the law of 23 July 2016) were intended to fall within the carve-out, neither the Directive itself nor the Luxembourg transposition provided definitive confirmation.

As a result, key questions remained: at what point, and under what circumstances, could a CIV be considered widely held? Should "diversification" be tested formally or by reference to economic exposure? And could the concept of "significant influence" be stretched to broaden the scope of associated enterprises?

This uncertainty had tangible effects. Some managers resorted to using corporate, tax-opaque vehicles - corporate RAIFs or SIFs - to sidestep reverse hybrid concerns, despite a strategic preference for more flexible and cost-efficient transparent (unregulated) partnerships.

The Circular's Long-Awaited Clarification

The new Circular addresses these concerns head-on. Three clarifications stand out.

UCITS, Part II UCIs, SIFs and RAIFs Automatically Treated as CIVs

The Circular confirms that UCITS and Part II UCIs under the law of 17 December 2010, SIFs under the 2007 law, and RAIFs under the 2016 law all qualify automatically as CIVs. These vehicles are therefore outside the scope of Article 168quater LITL without needing to demonstrate compliance with the "widely held", "diversification", or "investor protection" conditions.

What It Means to Be "Widely Held"

For other fund types, such as unregulated partnerships, the Circular devotes significant attention to the "widely held" condition. The core requirement is that the fund be marketed to multiple unrelated investors. Only once this is established does the presumption introduced by the Circular apply: the condition is presumed satisfied where no individual ultimately owns or controls more than 25% of the fund's capital or voting rights. This presumption seems secondary and rebuttable. It cannot override the primary test: that a fund must genuinely be marketed to, and held by, a plurality of unrelated investors.

The tax authorities may consult the Register of Beneficial Ownership (*Registre des Bénéficiaires Effectifs*, **RBE**) to verify the absence of a controlling investor. Yet this is a delicate approach. The RBE was created for anti-money laundering purposes under the law of 13 January 2019, not as a tax enforcement tool. Moreover, in practice, RBE entries often designate managers rather than actual investors, raising questions about whether "control by other means" can really be inferred.

The Circular also introduces tolerances during a fund's lifecycle: a 36-month launching phase, during which a temporary concentration of investors is permitted, and the liquidation phase. Both tolerances remain subject to Luxembourg's general anti-abuse rule (Article 6 of the Tax Adaptation Law, *Steueranpassungsgesetz*, of 16 October 1934, as amended).

The Luxembourg tax authorities may also cross-check Form 205 filings, which disclose all direct stakeholders of the partnership and, where relevant, indirect investors through transparent vehicles.

Defining a "Diversified Portfolio" - Loans Included

The Circular interprets "diversified portfolio of securities" broadly. Securities include equity instruments, beneficiary shares, bonds, fund units, deposits, derivatives - and loans. The explicit inclusion of loans is particularly notable. While it reflects the economic reality of private credit funds and is consistent with diversification principles under CSSF Circular 07/309 for SIFs, it raises questions under the SICAR tax regime, which has traditionally excluded pure debt from the category of eligible securities. Although the Circular states that its definitions apply only to Article 168quater, its reasoning could invite questions about the scope of other tax regimes in the future.

Practically, the Circular adopts the 30% concentration rule familiar from the SIF framework: a fund is not considered diversified if more than 30% of its assets or commitments are invested in securities of a single issuer, unless justified. For private equity, this allows concentrated holdings where properly documented. For debt funds, the explicit recognition of loans provides welcome certainty, though repeated bilateral loans to a single borrower may challenge the cap. Real estate and infrastructure funds face more ambiguity: direct property is not a security, but a look-through approach to project companies or REIT-like structures could bring such assets within scope. The Circular stops short of clarifying this.

Investor Protection: Supervision and Substance Over Form

Finally, the Circular confirms that the investor-protection condition is satisfied where funds are supervised by the CSSF or managed by an authorized AIFM under the AIFM Directive (Directive 2011/61/EU).

Market Impact - How Reverse Hybrid Uncertainty Shaped Fund Structures

Statistics from the CSSF and the Association of the Luxembourg Fund Industry (**ALFI**) illustrate how reverse hybrid uncertainty has shaped behaviour. The number of Luxembourg-domiciled funds - whether FCPs, SICAVs, SICARs, or other UCIs - increased from around 4,000 in 2015 to more than 5,900 in 2024. RAIFs alone grew exponentially, from only a few dozen at their launch in 2016 to nearly 3,000 today.

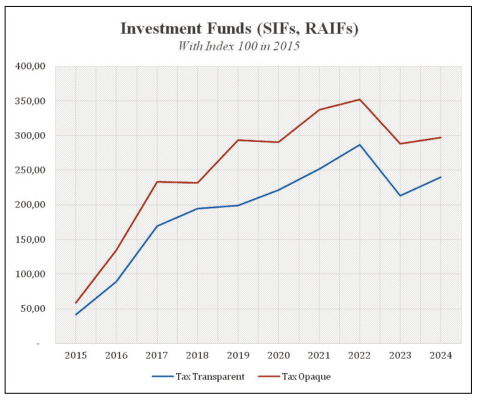
When considering unregulated partnerships alongside RAIFs and SIFs, most of these vehicles traditionally adopted tax-transparent forms such as the SCS or SCSp. Yet focusing specifically on RAIFs and SIFs, the CSSF's official lists indicate that tax-opaque corporate forms have consistently maintained a slight numerical advantage over transparent partnerships, albeit with only a modest gap in earlier years. That gap, however, has steadily widened. Key inflection points appear in 2017 (the year ATAD 2 was adopted at the EU level, introducing the reverse hybrid concept), in 2019 (its formal transposition into Luxembourg law), and in 2022 (the year the reverse hybrid rule entered into force).

The timing suggests more than coincidence: lingering uncertainties around the interpretation and scope of the reverse hybrid provisions clearly shaped sponsors' conduct. Many opted for tax opaque corporate RAIFs (or SIFs) to shield themselves from potential reclassification risk - even if that choice meant foregoing the relative cost-efficiency and flexibility of lighter, partnership-style regulation. In some cases, managers appear to have accepted higher compliance costs as the price of legal certainty.

Indexing 2015 as 100, transparent vehicles climbed to an index of about 290 by 2022, but opaque vehicles rose faster, reaching nearly 350. Both categories dipped after 2022 amid global economic uncertainty, but by 2024 opaque structures - particularly corporate RAIFs - still outpaced partnerships, indexed at about 295 compared with 250. This suggests the turn to opacity was not accidental but a deliberate defensive strategy to pre-empt reverse hybrid exposure.

The Circular may now rebalance the field. By explicitly confirming that RAIFs and SIFs qualify for the CIV carve-out and by clarifying the "widely held", "diversified portfolio", and "investor protection" conditions for other funds, it reduces the compliance risk that has driven opacity. If applied consistently, it may encourage managers to return to transparent partnerships, reassured that structuring decisions will not be destabilized by interpretative uncertainty.

Indexed growth of tax-opaque vs. tax-transparent RAIF/SIF vehicles, 2015–2024 (Index 100 = 2015). Source: CSSF Statistics



Conclusion - Janus Faces the Future

Like Janus, Luxembourg's reverse hybrid rule once forced funds to look in two directions at once: transparent at home, potentially opaque abroad. The Circular resolves this duality, providing the market with the clarity to face forward.

For sponsors, the message is clear: Luxembourg remains committed to international standards while preserving its position as Europe's pre-eminent fund domicile. Janus could never escape the backward glance. Thanks to this Circular, Luxembourg funds can now face the future with confidence.

Luxembourg REIFs evolve to meet a changing market

Luxembourg continues to solidify its position as a leading hub for real estate investment funds (REIFs), according to the latest edition of the ALFI Real Estate Investment Funds Survey. The survey provides insights into how the market is adapting to shifting investor demands, regulatory evolution and broader macroeconomic trends.

Key takeaways from the 2024 survey include:

Lighter structures gaining ground

The survey confirms a strong shift toward lightly regulated fund structures. RAIFs, manager-regulated AIFs and non-regulated vehicles now represent 69.5% of the market — with the significant evolution from just one RAIF in 2016 to 226 in 2024. The SCS/SCSp legal form continues to dominate, used by 59% of surveyed funds, reflecting preferences for tax transparency and structural simplicity.

Institutional focus with broad strategies

REIFs remain primarily institutional with an EU base of investors: 80.4% of investors come from Europe, and 83% of funds serve 25 or fewer investors. Multi-sector strategies are now the norm, followed by targeted allocations to residential, office and retail. This diversification reflects growing demand for flexibility and stability.

Resilience under pressure

Despite market headwinds, Luxembourg REIFs showed notable resilience. Over 80% of funds chose to hold their investments during challenging conditions rather than liquidating or reinvesting. The use of liquidity management tools such as redemption gates remains limited, underscoring the long-term nature of the strategies employed. Only 4.5% of funds suspended redemptions, while 16% processed redemptions in kind, indicating that most managers rely on strong governance rather than reactive measures.

Commenting on the findings, Christophe Masset, Partner at Deloitte, Cross-Border Tax stated: "The latest ALFI survey highlights the rising importance of liquidity management for Luxembourg real estate funds amid market stress driven by geopolitical shifts and monetary policy changes. Among funds using liquidity management tools, nearly 5% have suspended redemptions. As regulators finalise AIFMD and UCITS standards, Luxembourg remains at the forefront, providing a robust framework for managers to navigate these challenges".

This cautious but steady approach reflects the long-term nature of REIF strategies and underlines investor confidence, even during volatile conditions.

Trends in size, fees and leverage

Smaller funds continue to make up the bulk of the market, but larger vehicles are gaining ground. Fee structures remain largely based on NAV, while performance fees are in decline. Use of leverage is becoming more conservative, aligned with a cautious view on debt in a higher-rate environment.

The survey confirms Luxembourg's continued relevance as a jurisdiction of choice for global real estate strategies. The adoption of ELTIF 2.0 and growing openness to retail participation point to a sector that is not only evolving, but expanding.

"ELTIF 2.0 tackles several challenges raised under ELTIF 1.0, through both enhanced product design and improved distribution," said Britta Borneff, ALFI CMO. In this context, the design of current and future product launches should carefully consider all key elements, including liquidity management programmes, distribution capacity, and the deployment of appropriate transfer agent technology, among others. Despite these complexities, the rapid growth of ELTIF 2.0 may well position it as a strong future counterpart to UCITS or AIFs."

Concluding, she added "with its flexibility, experience, and international reach, Luxembourg remains a reliable platform for real estate fund managers to innovate and grow."

Survey: https://lc.cx/N_nBXt