

## **NEWSFLASH – LUXEMBOURG'S CARRIED INTEREST REFORM: A NEW CHAPTER IN EUROPEAN TAX COMPETITIVENESS.**

On July 24, 2025, the Luxembourg government submitted Draft Law No. 8590 to the Parliament, by announcing a bold reform of the country's carried interest tax regime. With the will to boost its competitiveness in the European financial landscape, the proposed framework is designed to attract top-tier fund managers, reinforce Luxembourg's role as a global investment hub, and deliver clarity and certainty in a field marked by legal grey zones.

### **Understanding Carried Interest: The Engine Behind Fund Performance**

Carried interest is a cornerstone of private equity and alternative investment compensation. It typically refers to the share of profits (usually 15–20%) received by fund managers once a pre-agreed return threshold, commonly 8% per annum, known as the "hurdle rate", has been delivered to investors. This mechanism ensures that fund managers are closely aligned with the interests of their investors: more performance, more reward.

Until now, Luxembourg taxed carried interest as miscellaneous income, often subject to a marginal rate of up to 45.78%, although exempt from social security contributions. The rules were relatively narrow in scope and applied mainly to salaried employees of AIFMs. A temporary regime launched in 2013 offered a reduced tax rate for inpatriates but ceased accepting new entrants in 2018. These limitations have reduced Luxembourg's ability to compete with jurisdictions like the UK and France, which offer preferential tax treatment to carried interest beneficiaries.

### **The Reform: Two Tailored Regimes, One Clear Objective**

Draft Law No. 8590 introduces two distinct and permanent tax regimes for carried interest, addressing both the diversity of market practices and the call for broader eligibility.

#### **1. The Contractual Carried Interest Regime**

This regime applies when the right to carried interest is granted via contract, without requiring the beneficiary to invest in the fund. In such cases:

- Taxation is capped at one-quarter of the applicable personal income tax rate, reducing the maximum effective rate to approximately 11.45%.
- No time limit applies to the regime, replacing the previous 10-year window available only to inpatriates.
- The scope is expanded to include non-employees such as independent directors, external advisors, or board members contributing to fund performance.
- Deal-by-deal structures are now covered, even if carried interest is distributed before full investor repayment.

#### **2. The Participation-Based Carried Interest Regime**

This applies where the beneficiary also holds a stake, directly or indirectly, in the fund or a related vehicle:

- If held for more than six months, carried interest derived from this participation is fully tax-exempt, provided the holding is below 10% of the fund's capital.
- Returns on this investment not linked to carried interest remain taxable under standard capital gains rules.
- The reform neutralizes the legal form of the fund vehicle (e.g., SCSp, FCP), preventing transparency rules from complicating tax treatment.

These changes harmonize Luxembourg's tax framework with real-world fund structures, increase flexibility, and provide a decisive competitive advantage.

### **Legal Clarity and Anti-Abuse Measures**

The reform includes a comprehensive statutory definition of carried interest, covering both capital gains and performance-related income. Importantly, it closes loopholes by excluding disguised bonuses and ensures that artificially granted carry rights are scrutinized for substance and alignment with market standards.

Additionally, the legislation explicitly addresses previous legal uncertainties. For instance, carried interest paid before the full return of capital to investors (deal-by-deal carry) is now officially eligible, acknowledging Anglo-Saxon practices. The treatment of carried interest distributed via transparent vehicles has also been clarified, guaranteeing consistent tax results whatever the structure.

### **Strategic Positioning in a Shifting European Landscape**

As other jurisdictions reassess their carried interest regimes, such as the UK (moving towards reclassification as trading income), Spain (imposing holding periods of five years), and Italy (applying a flat rate of 26%), Luxembourg's proposal offers a markedly more attractive environment. A dual-path regime offering either a capped 11.45% tax rate or full exemption stands out in sharp contrast.

For a country already managing over 5,780 billion euros in assets and hosting more than half of Europe's private equity funds, this reform signals an ambition to not just house the back office but to host the decision-makers themselves. By encouraging the relocation of front-office functions, Luxembourg is betting on substance over structure, and brains over boxes.

### **Implementation Timeline and Next Steps**

Assuming parliamentary approval, which seems likely given the coalition's backing, the new regime would take effect in fiscal year 2026. Industry stakeholders are already urged to:

- Review fund documentation (e.g., LPA, waterfall mechanics)
- Track holding periods meticulously
- Adapt existing structures to comply with the new regime's technical conditions

### **Conclusion: A Calculated Leap Forward**

Luxembourg's carried interest reform is not just a tax change; it's a strategic move designed to recalibrate the country's position in the battle for fund management talent and capital. With simplicity, clarity, and fiscal appeal at its core, Draft Law No. 8590 has the potential to turn Luxembourg into Europe's most tax-efficient jurisdiction for carried interest, redefining its financial identity in the process.