

An alternative fund structure in Sweden

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Recent changes in the Swedish tax legislation have made it favourable to establish private equity funds based on a Swedish corporation. The fund structure is attractive for Swedish investors as well as non-Swedish investors. As all investors will commit themselves to invest in a Swedish corporation, it is expected that such single fund structure will be less costly to establish and maintain as compared to the traditional multiple limited partnership structures domiciled in different countries. Further, by introducing preference tracking shares and participating tracking loans as the means by which the investors will invest in the fund, there is a possibility to increase the liquidity of the interests in the fund by allowing the investors to sell specific portfolio companies instead of selling all or part of the investors' holding of all portfolio companies. In this article, Peter Alhanko and Ulf Rehnmark of Mannheimer Swartling, describe a simplified structure of a fund based on a Swedish corporation taking advantage of the changes in the tax regulations.

Investments in Swedish private equity funds have traditionally been made in limited partnerships based either in Sweden, the US, the UK or in the Channel Islands. Following recent changes in the Swedish tax legislation, there are now several reasons to consider using Swedish corporations (Sw. aktiebolag, "AB") instead of limited partnerships as private equity fund vehicles.

The purpose of this article is to make a brief description of a typical structure of a private equity fund making investments via a Swedish corporation ("Fund AB").

The background to this interesting opportunity to make private equity investments through a Fund AB is sought in changes in the Swedish tax legislation effective as of June 30, 2003 and January 1, 2004, respectively, resulting in a number of favourable participation exemption rules for capital gains and dividends.

The new rules provide that capital gains and dividends on unquoted (unlisted) shares are tax-exempt if held for business purposes by Swedish corporations. The rules apply regardless if the shares held by the Swedish corporation (i.e. Fund AB) are shares issued by Swedish or foreign portfolio companies.

Consequently, the new rules establish Sweden generally as an attractive location for holding companies. There is no requirement that a foreign corporation held by a Swedish holding company is subject to a certain level of taxation. However, if the foreign corporation has low-taxed profits, the Swedish rules regarding controlled foreign companies ("CFC")

may apply and the profits of the CFC may be taxed on a current basis in the hands of the Swedish shareholder(s). Normally, however, the CFC rules only apply to corporations resident in tax havens.

Fund AB structure

Company structure

Fund AB will be the investing vehicle making the investments in the portfolio companies. Fund AB will issue ordinary shares and different series of preference tracking shares. The ordinary shares will at all times represent more than 50% of the votes and the capital of Fund AB.

A corporation owned by the management of the fund ("Management AB") holds all the ordinary shares in Fund AB. The management of the fund will be employed by Fund AB.

Options to invest

All investors in the fund will have the option to invest in Fund AB by means of either preference tracking shares or participating tracking loans. Fund AB will issue one series of preference tracking shares and one series of participating tracking loans to the investors for each portfolio company.

Swedish investors will, due to tax reasons, most likely invest in Fund AB by means of preference tracking shares. Non-Swedish investors will, due to tax reasons, most likely mainly invest in Fund AB by means of participating tracking loans. There is nothing that prevents non-Swedish investors to invest in preference tracking shares, if that would be suitable in the individual case when considering the tax effects.

Management AB will invest in Fund AB by means of preference tracking shares of a particular series to which the carried interest is linked.

Investment agreement/shareholders' agreement

Each investor will enter into a separate investment/shareholders' agreement with Management AB containing the customary fund provisions, such as the investment policy, the investor's commitment, the management fee, cash calls, allocations and distributions. The provisions will be similar to those found in the limited partnership agreements and they will in principle be applied in the same manner as they are applied in private equity funds organised as limited partnerships.

Investments and exits

Investments

When making an investment in a new portfolio company, Fund AB will send cash call notices to the investors. Fund AB will issue a new series of preference tracking shares to the Swedish investors and Management AB pro rata to their

commitments. The non-Swedish investors will receive participating tracking loan notes issued by Fund AB. The amount under each non-Swedish investor's participating tracking loan will be equal, pro rata to their commitment, to the amount contributed by a Swedish investor by means of preference tracking shares.

Exits

When Fund AB has divested a portfolio company, the proceeds will be allocated and distributed pursuant to the "waterfall" provisions and other terms and conditions of the investment/shareholders' agreements.

Fund AB will repay an amount up to the face value of the participating tracking loans to the non-Swedish investors as a repayment of such participating tracking loan. Any excess amounts to be distributed pursuant to the terms and conditions of the investment agreements will be distributed as interest. The holders of preference tracking shares, i.e. the Swedish investors and Management AB, will receive the same amount at the same time as the non-Swedish investors with equal commitment.

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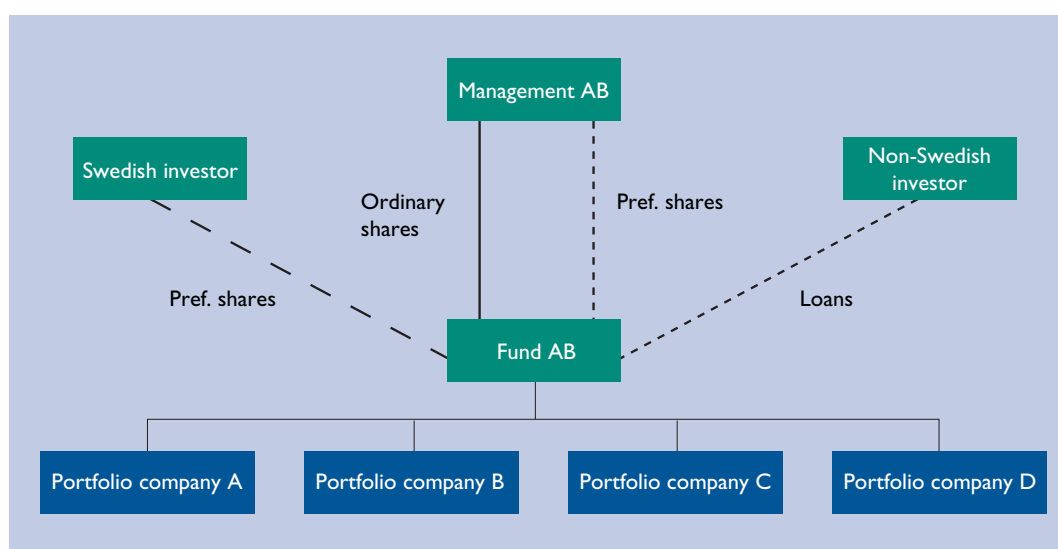
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Figure 1: Proposed Fund AB structure



Tax

Taxation of Fund AB

Capital gains on shares in unquoted companies realised by Fund AB are exempt from tax. Should an exit in relation to a portfolio company be carried out through an IPO, Fund AB may get a step up in its tax basis. This means that future capital gains of the listed shares may be calculated based on the market value of the portfolio company at the time of the listing instead of their historical acquisition costs.

Fund AB is a taxable person in Sweden. Therefore, there is generally no risk that the foreign investors will get a permanent establishment in Sweden as a result of the investment in Fund AB.

Repatriation of profits from Fund AB

The structure makes it possible to make a tailor made and tax efficient profit repatriation system adapted to the particular needs of each investor. The profit repatriation system can also be made tax efficient for investors making their investments in Fund AB through entities located in tax havens.

Swedish corporate investors will be exempt from tax on capital gains and dividends and therefore they will generally invest in Fund AB through preference tracking shares.

The same applies to non-Swedish investors that are exempt from capital gains and dividends in their respective jurisdictions; provided, however, that they qualify for exemption from Swedish withholding tax on dividends. Such exemption is in general available for foreign entities that are treated as “foreign companies” as such term is defined in the Swedish Income Tax Code.

Swedish withholding tax would generally be due

on dividends to non-Swedish investors located in tax havens and to non-Swedish institutional investors that are exempt from tax in their home jurisdictions. Therefore, such investors will prefer to receive interest payments from Fund AB and will, thus, most likely invest through participating tracking loans. There is no Swedish withholding tax on interest payments.

VAT

In the current Swedish limited partnership structures, there is some risk that carried interest paid to the management company could be reclassified as a service fee and, thus, be subject to VAT. In the proposed structure, Management AB will receive an amount corresponding to the carried interest by virtue of their holding of the particular series of preference shares. Further, management will be employed directly by Fund AB, which means that their services will not be invoiced by another entity. Thus, there is no basis on which VAT can be levied.

Other advantages with the Fund AB structure

Having already said that Fund AB will have significant tax advantages for both Swedish and non-Swedish investors, there are also other advantages with having a structure based on a Fund AB.

A single structure

There will be one single fund structure for all investors; i.e. all investors will invest in Fund AB. A simple structure like this will lower the costs considerably for both establishing and maintaining funds, since there is no need for parallel investing structures where the investing vehicles are domiciled in different countries.

Increased transferability

There is an increased flexibility in transferring the investors' investment in the fund since different series of preference tracking shares and different series of participating tracking loans are used, together with separate investment/shareholders' agreements. Consequently, an investor may have the possibility to transfer its preference tracking shares and participating tracking loans linked to a certain portfolio company but remain holder of the other preference tracking shares and participating tracking loans.

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