Further guidance welcome

Recent German taxation: developments regarding management equity programs

By Dr. Hans Martin Schmid

In private equity transactions, a management equity program (MEP) combines the interests of management with the financial objectives of the private equity investor. The investor wants management to participate in the equity of the company to ensure that management is both retained and incentivized to achieve the exit the investor desires. And management, which is subject to challenging performance targets set by the investor, stands to have a meaningful share in the corresponding growth in the company's value. The tax consequences of equity participations as the incentive element of the compensation package play an essential role for the company's management – and those tax consequences are currently disputed in German tax audits and tax court procedures.

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German tax principles

From a German tax point of view, payments to management under an MEP, which are sourced from the disposal of the underlying shares upon exit or termination, can either be qualified as employment income or capital gains. To generate a tax benefit for the executive, MEPs aim to qualify such payments as tax preferred capital gains.

Capital gains and employment income are taxed differently: There is a spread in tax rates of between 26.4% (flat) for capital gains (and up to 28.5% if the participation in the underlying equity was above 1% within the past five years) and up to 47.5% for employment income. Moreover, employment income is subject to wage tax, which the employer must withhold at the source. If the employer fails to properly do this, he or she becomes liable for paying these taxes to the tax authority. On the other hand, only employment income qualifies as a deductible business expense for the employer.

The taxation of an executive's participation in an MEP has quite recently become a major topic in German tax audits dealing with these programs. The fact that some MEP terms and conditions are tied up with the employment relationship motivates German tax authorities to requalify payments under MEPs as employment income and tax them at higher rates.

Based on the interpretation of two decisions by the highest German tax court, the Federal Fiscal Court (*Bundesfinanzhof*), which do not deal with typical MEPs but rather with the taxation principles of employee incentive programs, German tax authorities try to requalify capital gains paid under MEPs as employment income on two grounds: (a) the executive's lack of economic ownership in the underlying equity participation, and (b) "good and bad leaver provisions" that influence the purchase price of the underlying shares upon termination of the employment relationship. →

Economic ownership

To generate a capital gain, the executive must be the economic owner of the underlying shares.

In 2011, the Federal Fiscal Court ruled that shares issued by the parent entity of the employer under an employee incentive program were not economically owned by the employee since the program legally restricted the transferability of the shares that the employee acquired. In the underlying case, the employee acquired so-called „restricted shares“ under US law – that is, shares that cannot be legally disposed of by the employee during a certain period of time. The court ruled that holding or vesting periods normally do not hinder the transfer of economic ownership in the underlying shares to the employee. However, if the disposal of the shares is legally restricted over a certain period, the employee cannot be regarded as their economic owner during that period.

Based on this decision, tax authorities auditing MEPs try to reject the transfer of economic ownership if the articles of association require approval by the majority shareholder for the executive's disposal of shares. The tax authorities argue that any payments under the MEP are employment income and cannot qualify for tax preferred capital gains since the executive has no economic ownership in the underlying shares.

Good and bad leaver provisions

To generate a capital gain, and thus capital gains rather than employment income tax treatment, the issuance of shares must qualify for a legal relationship between the executive and the employer that is separate from the employment contract (*Sonderrechtsbeziehung*).

The Federal Fiscal Court ruled in 2013 on an incentive program that was based on participation rights (*Genussrechte*) issued by a German GmbH to selected executives. Participation rights are a special form of equity participation but do not grant any shareholder rights. Nor do they participate in any loss. In that case, the participation rights provided for an interest payment of 10% per year as well as a participation in the increase in value of the GmbH. The rights' terms and conditions provided for good and bad leaver provisions, and the employer's participation rights' repurchase price was subject to the manner in which the employment was terminated. If this happened without notice being issued by the employer (bad leaver), the price the employer was to pay to the employee was the participation rights' original acquisition cost. If there was no termination without notice (good leaver), the executive was entitled to a pre-agreed purchase price upon expiry of the employment contract.

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The Court did not requalify the capital gains as employment income only because the participation rights were granted to selected executives with the intention to motivate and incentivize management to stay with the GmbH. However, from the terms and conditions of the participation rights, the Court concluded the participation rights did not qualify for a legal relationship between executive and employer separate from the employment contract. The capital gains were subject to good and bad leaver provisions as directly related to the conduct of the executive and therefore a reward for his services.

Based on this decision, tax authorities argue that for payments under an MEP, employment income is paid if the purchase price for the shares upon early employment termination depends on whether the executive is a good or bad leaver. If the purchase price can vary due to professional conduct, the issuance of shares under an MEP does not provide for a relationship separate from the employment contract and any gains from shares' disposal do not qualify for preferred capital gains taxation. This is true even if there is no early termination at all but the MEP provides for such good and bad leaver provisions.

Outlook

These two decisions by the Federal Fiscal Court were based on exceptional cases not typical for common MEPs. The decision on the free transferability of shares applied to directly held „restricted shares“ under US law, whereas MEPs are often structured as equity participations through management holding partnerships. The decision regarding good and bad leaver provisions applied to Genussrechte that – contrary to most equity participations in MEPs – did not grant shareholder rights, did not share a loss and had an unusually high interest rate.

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Binding interpretations or any guidelines from the Federal Tax Administration on the application of these decisions to MEPs in general do not exist. However, further guidance by the Federal Fiscal Court can be expected in the near future:

In May 2015, the Lower Tax Court of Cologne ruled on the tax consequences resulting from payments under an MEP that was structured as an equity participation in the company through a management holding partnership – making this the first German tax court decision dealing with the tax consequences resulting from equity participations in commonly structured MEPs in Germany. The Court ruled in favor of management and qualified the MEP payments as tax preferred capital gains.

The Court had no doubt about management's economic ownership in the underlying shares, even though there were restrictions on the free transferability at the management holding vehicle level. And, according to the Court, a vesting and leaver scheme is also not contrary to capital gains qualification. If the executive has acquired the shares at arm's length and is subject to a potential risk of loss participation, the executive receives tax preferred capital gains and not employment income regardless of good and bad leaver provisions in the MEP's terms and conditions. Not surprisingly, the tax authorities appealed this decision to the Federal Fiscal Court and the outcome is still open.

Further developments regarding taxation of MEPs should be carefully reviewed. If German tax authorities successfully enforce their position, amendments to MEPs may be considered. However, an assessment may reveal that the economic benefit from having approval rights and good and bad leaver provisions still outweighs the potential higher employment income tax rate. Given the potential requalification of the capital gains as employment income, it should also be taken into account that employment income is tax deductible for the employer whereas capital gains are not. ←

Dr. Hans Martin Schmid,
Partner, Tax,
Gibson, Dunn & Crutcher LLP,
Munich

mschmid@gibsondunn.com

www.gibsondunn.com