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Recent German Taxation Developments Regarding Management Equity Programs

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The taxation of an executive's participation in a management equity program (MEP) has quite recently become a major topic in several German tax audits dealing with MEPs. The discussions between taxpayers and the tax authorities are - according to market rumors - often based on the interpretation of two recent decisions by the Highest German Tax Court, which deal with the taxation principles of executive compensation programs.

From a German tax point of view, payments to the executive under an MEP, which are sourced from the disposal of the underlying shares, can either be qualified as employment income or as capital gain. To generate a tax benefit for the executive, MEPs are aiming to qualify such payments under an MEP as tax preferred capital gains. Capital gains and employment income are taxed differently: there is a spread in tax rates between 26.375% (flat) for capital gains (increased up to 28.5% if the participation in the underlying equity was above 1% within the last 5 years) and employment income of up to 47.5%. Moreover, employment income is subject to wage tax, which requires the employer to withhold taxes at source. If the employer fails to properly deduct wage taxes at source he becomes liable to pay these taxes to the tax authority. On the other hand, only employment income qualifies for a deductible business expense for the employer.

The fact that some terms and conditions of MEPs are tied up with the employment relationship may motivate tax authorities to re-qualify payments under the MEP as employment income and tax this income at higher rates. There are currently two typical approaches taken by the tax authorities to re-qualify capital gains as employment income: (i) the lack of economic ownership of the executive in the underlying equity participation and (ii) good and bad leaver provisions that influence the purchase price of the underlying shares upon exit or termination of the employment relationship.

(i) Economic ownership

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

In 2011, the Highest German Tax Court (BStBl II 2011, 923) ruled that shares issued by the parent entity of the employer under an equity participation program were not economically owned by the employee as long as the equity participation program legally restricts the transferability of the shares acquired by the employee (*dinglicheVerfügungsbeschränkung*). In the underlying case, the employee acquired so-called "restricted shares" under US law, i.e., shares that cannot be legally disposed of by the employee over a certain period. 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 economic owner of the shares during that period.

Based on this decision and according to market rumors, some tax authorities in tax audits now tend to reject the transfer of economic ownership if the articles of association require approval by the majority shareholder for the disposal of shares by the executive. If the executive has no economic ownership in the underlying shares, any payments under the MEP must be regarded as employment income and cannot qualify for tax preferred capital gains.

(ii) Good and bad leaver provisions

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

The Highest German Tax Court ruled in 2013 (DStR 2014, 258) on an MEP, which was based on participation rights (*Genussrechte*) issued by a German GmbH. Participation rights are a special form of equity participation but do not grant any shareholder rights nor do they participate in any loss. In the case at hand, 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 terms and conditions of the participation rights provided for good and bad leaver provisions. The price for the repurchase of the participation rights by the employer was subject to how the employment was terminated. If the employment was terminated without notice by the employer (*Kündigung aus wichtigem Grund*), the price to be paid by the employer to the employee was the original acquisition cost of the participation rights. If there was no termination without notice, the employee was entitled to a pre-agreed purchase price upon expiry of the employment contract.

From these terms and conditions, the Highest German Tax Court concluded that 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 such directly related to the conduct of the employee and therefore a reward for his services. However, the Highest German Tax Court did not re-qualify the capital gain as employment income in total but only insofar as the capital gain paid by the employer exceeded the value of the participation rights. If the participation rights can exist independently, detached from the employment relationship or are subject to an arm´s length valuation among third parties, only those exceeding consideration - and not the capital gain in total - constitute employment income.

Outlook

It is still unclear if and to what extent these decisions by the Highest German Tax Court can be applied in general to MEPs. Even if these decisions are currently discussed in German tax audits, there is no binding interpretation or any guidelines issued by the tax authorities on the application of these decisions to MEPs. Moreover, the approach taken by the tax authorities in tax audits has led to several dissenting views in German tax literature (among others recently Frey, DStR 2015, 1094). Even a judge at the Highest German Tax Court has published his opinion that German tax authorities would misinterpret the decision on economic ownership if the tax authorities apply this decision uniformly to MEPs (*Geserich*, DStR 2014, 1716).

And quite recently in May 2015, the Lower Tax Court Cologne (3 K 3253/11) ruled in favor of an executive that, regardless of good/bad leaver provisions and restrictions on the free transferability of the shares under the MEP, the executive receives tax preferred capital gains and not employment income if the executive has acquired the shares at arm's length and is subject to a potential risk of loss from his participation. The decision by the Tax Court Cologne is now on appeal at the Highest German Tax Court.

It should also be noted that only the overall picture of the terms and conditions of a MEP qualifies for employment income or capital gain. There is no "infection" by single terms and conditions of the MEP to the overall qualification if the other terms and conditions of the MEP clearly constitute a legal relationship separate from the employment contract.

The two decisions by the Highest German Tax Court were based on exceptional cases, which are not typical for common MEPs. The restriction on free transferability of the underlying shares applied to "restricted shares" under US law and should not apply if the shares are held not directly but – as is often the case – via a management holding LP. The decision regarding good and bad leaver provisions applied on *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.

However, the further development of the taxation of MEPs should be carefully reviewed. If German tax authorities successfully enforce their position, amendments to MEPs – or even the cancellation of good and bad leaver provisions – may be considered. By doing this assessment, the economic benefit from having good leaver provisions may still outweigh the potential higher tax rate of employment income. In case of a potential requalification of the capital gain as employment income, it should also be taken into account that employment income is tax deductible for the employer and capital gains are not.

Gibson, Dunn & Crutcher's lawyers are available to assist in addressing any questions you may have regarding these developments. Please contact the Gibson Dunn lawyer with whom you usually work, or the author, Hans Martin Schmid, in the firm's Munich office at +49 89 189 33-290 or mschmid@gibsondunn.com.