Update on German Taxation Developments Regarding Management Equity Programs

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The German Federal Fiscal Court confirmed in a decision published on January 25, 2017 that payments under a management equity program qualify as tax preferred capital gains and not as employment income, provided,

- the management participation is purchased and sold at market price and
- the participation is subject to a potential risk of loss.

Leaver and vesting schemes do not hinder such a qualification as capital gain.

Taxation of MEPs – End of Legal Uncertainty?

In recent years, the taxation of an executive's participation in a management equity program (MEP) has been 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 has caused German tax authorities to requalify payments under MEPs as employment income rather than capital gains. The reasons for this approach by the tax authorities are different tax rates: capital gains are taxed at 26.4% (and up to 28.5% if the participation in the underlying equity was above 1% within the past five years) whereas employment income is taxable up to 47.5% depending on the amount of income [*for further details please refer to our alert of September 2, 2015*].

German tax authorities often try to requalify capital gains paid under MEPs as employment income on the grounds of "good and bad leaver provisions" that influence the purchase price of the underlying shares upon termination of the employment relationship. According to the view of the tax authorities, good and bad leaver provisions are directly related to the professional conduct of the manager, and, therefore, payments under the MEP are a reward for services rather than capital gains.

The requalification by the tax authorities of payments under MEPs as employment income was basically based on the interpretation of two older decisions by the Federal Tax Court, which did not deal with typical MEPs but rather with taxation principles of employee incentive programs. Court decisions on equity participations in commonly structured MEPs did not exist until May 2015.

In May 2015, the Lower Tax Court of Cologne ruled in favor of the management and qualified the MEP payments as tax preferred capital gains – making this the first German tax court decision dealing with the tax consequences resulting from equity participations in commonly structured MEPs in Germany. The tax authorities appealed this decision to the Federal Fiscal Court. In its decision of October 4, 2016, which was published on January 25, 2017, the Federal Fiscal Court finally confirmed the decision of the Lower Tax Court of Cologne and acknowledged the qualification of MEP payments as tax preferred capital gains.

Facts of the Underlying Case

The MEP the Federal Fiscal Court had to decide upon was "classically" structured with leaver and vesting provisions. The MEP in the underlying case had standard *bad bad leaver*, *bad leaver* and *good leaver* provisions. If the employment was terminated without notice being issued by the employer (bad bad leaver), the price to be paid to the manager was the equity participations' original acquisition cost. If the manager terminated the employment or the MEP (bad leaver), the original acquisition cost was repaid with a five percent interest. If there was no termination without notice for any other reason (good leaver), the manager was entitled to a variable payment based on market price but at least the original acquisition cost plus a five percent interest. The vesting period for the good leaver was spread over five years, with a full repayment of the capital contribution plus interest at the beginning and an increasing share of the payment based on market price over the vesting period.

The equity participations were acquired at fair market value, granted shareholder rights and a participation in profit, loss and liquidation proceeds.

Key Reasons given by the Federal Fiscal Court

The Federal Fiscal Court confirmed that an equity participation in the company of the employer can constitute a legal relationship between the manager and the employer that is separate from the employment contract (*Sonderrechtsbeziehung*). The manager uses capital as a source of income independent from the employment relationship; any yields from this capital source qualify as capital income and not as income from employment. It is also not employment income only because the participation in the MEP is restricted to employed managers. Exclusion and termination provisions, as is the case with the leaver and vesting provisions, are a consequence of the manager participation and do not as such justify the assumption that payments under the MEP can qualify as employment income. If the manager has acquired the shares at arm's length and is subject to a potential risk of loss participation, the equity participation can qualify for a legal relationship between manager and employer separate from the employment, with the result that the manager receives tax preferred capital gains and not employment income.

Conclusion

This decision long-awaited for by the industry dealing with management incentives hopefully should bring current disputes with the tax authorities to an end, at least with respect to those MEPs that are similar in structure to the MEP in the underlying case. The Lower Tax Court of Cologne and the Federal Fiscal Court required for a tax preferred capital gains taxation that the management participation is purchased and sold at market price and the manager is subject to a potential risk of loss with the participation in the employer's equity.

But the decision cannot be taken as a free pass for always qualifying payments under an MEP as tax preferred capital gains. Each MEP is still subject to an overall assessment of the underlying facts and caution should, inter alia, be exercised where the terms of the MEP restrict shareholder rights or emphasize performance-based variables for payments under the MEP. It should also be noted that a decision by the Federal Fiscal Court only becomes binding to the tax authorities if the decision is published by the Federal Ministry of Finance in the respective Federal Tax Gazette (Bundessteuerblatt) – and this has not happened yet.

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, Dr. Hans Martin Schmid, Partner, Tax, Munich, mschmid@gibsondunn.com.