

## German Supreme Tax Court Confirms Capital Income Qualification Under Management Equity Programs – Close to a Breakthrough, But ...

The German Supreme Tax Court has confirmed that a close to “market standard” Management Equity Program will be taxed on capital income principles. The decision (court number IX R 43/15) provides comfort with respect to most structural aspects of Management Equity Programs, but puts the spotlight on the entry valuation as most critical feature to get right. Structuring Management Equity Programs will need to focus even more on the accuracy of the entry valuation than in the past.

### Introduction

The German Supreme Tax Court (the Court) has issued its long awaited decision on the tax treatment of management equity programs (MEP) under German tax laws. The Court ruled that, in the case at hand (and taking all relevant facts into account), the income derived by the managers from the MEP qualified as capital income subject to preferential tax rates and not as (fully taxable) income from wages.

### Close to a breakthrough ...

The Court ruling is close to a break through as it confirms that most features of MEPs which are structured in line with market standards in German Private Equity transactions will not prohibit MEP proceeds from being treated as capital income. According to the decision, neither the fact that only certain selected managers had been offered the opportunity to invest in the MEP; nor the vesting and leaver provisions applicable to MEP participants in the case at hand, justified a requalification of income earned under the MEP from capital income into fully taxable income from wages. Furthermore, the fact that the managers investing through a pooling vehicle in the form of a partnership were excluded from management and representation of that partnership did not raise concerns with the Court.

### Selection of first and second tier management not relevant

The Court refused to share the view of the German tax authorities that investment in the MEP only being open to certain managers of the target group *automatically* produces fully taxable income from wages. Rather, it took the view that an investment into the employer group can be an independent source of income for each participating manager which, on an isolated basis, is not automatically triggered by their employment relationship.

## **Green light for vesting provisions**

On the vesting schedule and leaver provisions, the Court ruling provides very clear guidance: even an MEP with a five-year vesting schedule and no participation in the hidden reserves in the first two years was acceptable to the Court. A call option capable of exercise upon termination of the manager's employment "for cause" was not harmful to the analysis, either. The decision makes it clear that the existence of these vesting and leaver provisions alone should not lead to the MEP revenues being classified as income from wages.

## **Management of the pooling vehicle by the sponsor not harmful**

The Court did not raise concerns that the pooling vehicle used in connection with the MEP was solely managed and represented by an entity held by the PE Sponsor. Unlike the decision of the lower court ruling on this case, the Court did not even touch on this issue in its decision.

## **Debt financing of the investment not relevant**

Also, the fact that the participation of the managers in the MEP was predominantly financed by bank debt, did not (in contradiction to other court rulings) lead the Court to conclude that the MEP proceeds should be taxed as fully taxable income from wages. It should be noted that the debt was not guaranteed or otherwise backed or provided by the PE Sponsor.

## **Valuation at entry**

The Court made it clear that, to the extent that the managers have invested on arm's length terms, i.e. have paid fair market value for their investment at entry, there should be (i) no income tax from wages arising upon entry and (ii) no tainting of the entire income earned under the MEP as fully taxable income from wages. The chance to achieve a capital gain from the underlying investment should not be deemed to be based on the employment relationship and, furthermore, should be balanced by the risk of the manager losing the capital invested.

It should be noted that in this court case, the managers invested on the very same terms as the PE Sponsor. There was no indication that the PE Sponsor also held shareholder loans or preferred equity in parallel to the ordinary equity which was held by both the managers and the PE Sponsor.

## **Close to be a break through, but...**

The Court ruling will not be the end of the debate. It takes some of the most intensively debated items off the table, but not all. The critical issues left for the further debate are those not covered by the underlying facts of the Court ruling.

In particular, it appears that there was no "sweet equity" provided to Managers in the MEP considered in this Court case. Rather, the managers invested on a pure *pari passu* basis on similar terms as the PE Sponsor and entry valuation was confirmed by an auditor's opinion. Therefore, the Court was not forced to discuss whether the management strip deviating from the Sponsor strip could be viewed as income taxable upon grant or as tainting all income under the management strip as income from wages. So, the questions around structuring the sweet equity elements remains and likely will become even more important than in the past.

Furthermore, the Court did not really focus on the mechanics behind the leaver scheme. In the case at hand, and different from most market standard MEPs, the decision on whether to exercise the call option over a leaver's shares sat with the partnership pooling vehicle (and not with the PE Sponsor or a vehicle

designated by the PE Sponsor), in which certain other managers also held votes. The Court did not discuss the issue of legal or factual entitlement to exercise the call option which leaves some uncertainty as to its views.

Finally, the Court made it clear that this German Supreme Tax Court decision was based on an overall view of the case at hand and accepted certain findings of fact by the lower Tax court when determining how the tax provisions should apply. The German Supreme Tax Court had not carried out its own examination of the facts. In other words, the Court ruling was heavily dependent on the factual conclusion of the competent lower court.

## Outlook

The Court ruling allows more certainty in structuring MEPs and has provided certain comfort around the structuring of market standards programs. Furthermore, it is likely that on the basis of the Court ruling it should be feasible to receive binding rulings from the tax authorities on MEPs again, which in practice, in most parts of Germany had not been possible in the last 12 months.

It seems likely that entry valuation and the structural elements of the sweet equity component will get even more attention than in past and should carefully considered.

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If you have questions about this *Client Alert*, please contact any member of the German tax team of Latham or the Latham lawyer with whom you normally consult.

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