No Gains, Just Pain: Increasingly Uncomfortable Taxation Environment for Private Equity Executives' Compensation

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Arguing that their compensation should count as capital gains — since it derives from the appreciation in value of portfolio companies — private equity executives in Europe generally have been taxed under the more favorable capital gains principles, rather than employment or other income principles. However, this fundamental proposition is now being challenged by European tax authorities and courts, which are increasingly tightening the rules and thereby shrinking the boundaries within which compensation can remain safely taxed as capital gains. In some cases, European jurisdictions are developing severe penalties for what they deem to be abuse of law in this area, or even a criminal treatment — and sometimes where the arrangements are not particularly artificial. This article highlights recent developments in France, Germany and the United Kingdom.

France

In 2013, France more closely realigned tax rates for income derived from capital gains and ordinary employment. Despite that realignment, compensation income remains generally more heavily taxed than gains derived from the sale of equity instruments. Social security charges, which apply only to employment income (as opposed to capital gains), further accentuate this difference in treatment. As a result, parties in leveraged buyouts (LBOs) and in the corporate world more generally have still pursued equity -based incentives, but are utilizing increasingly sophisticated instruments.

In return, French tax authorities have begun actively investigating management packages, applying the abuse of law theory (which carries an 80 percent penalty) in order to challenge taxpayers' characterization of certain income. Such challenges have become so routine that managers in successful LBOs can almost always expect a tax audit. In cases deemed particularly egregious, the tax authorities also have brought criminal charges against the parties involved. While the abuse of law committee (the administrative body that reviews cases in which the tax authorities apply the abuse of law theory) and courts of first instance and appeals generally have been split on the treatment of management packages, the first case to reach the Supreme Court (Conseil d'Etat, September 26, 2014, no. 365573, Mr. and Mrs. Gaillochet) was decided in the tax authorities' favor. While the ruling was limited to the particular facts and circumstances at issue, most practitioners have interpreted the decision as a clear warning that management packages will be scrutinized under the abuse of law theory, and many will not pass muster. In April 2015, the tax authorities signaled as much, publishing a notice classifying management packages generally as "abusive schemes."

Private equity houses, managers and their advisers will need to review their options. One approach is to structure incentive packages in the form of ordinary shares, to which managers subscribe at market value. The Macron Law, which relaxed a number of regulations in France in August 2015 (including reducing the mandatory vesting and holding periods for restricted stock units), has renewed interest in qualified restricted stock unit plans. Discussions are underway between professional organizations and the government to set a clearly defined legal framework for stock-based incentives for management compensation plans. Given their courtroom victory, it remains to be seen whether the tax authorities will be amenable to such a compromise.

Germany

The tax treatment of management equity programs (MEPs) has recently become a major topic in German tax audits. Generally, payments under an MEP could be treated as employment income or capital gains income, which have significantly different tax rates (47.5 percent for employment income, 26.375 or 28.5 percent for capital gains depending on shares owned). Employment income also is subject to the wage withholding tax and

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social security contributions. The tax authorities recently introduced special task forces to analyze and challenge MEPs in tax audits.

The tax authorities tend to classify payments received under an MEP as employment income, even if such payments were received as part of a purchase price for the shares held by managers. Their argument is threefold:

1. The managers' benefits under an MEP are predominantly employment-based, as evidenced by specific clauses for departure (so-called good leaver/bad leaver provisions), downside protection for equity investments and vesting periods.
2. The managers are not the beneficial owners of the shares in the company. Their shareholder rights are limited and, apart from the participation in the sales proceeds, economically irrelevant.
3. Based on the abuse of law theory, the MEPs constitute employment income.

Case law does not provide clear guidance, since the underlying cases relate to fairly egregious structures that deviate from the common setup in which managers, through a partnership, directly or indirectly hold shares in the company for which they work. Case law suggests that a capital gains treatment could be established if the managers bear a relevant downside risk and if the acquisition and sale of the MEP shares comply with third-party standards and do not include any preferential treatment for the managers.

These issues come into play especially during acquisitions and takeovers. In the acquisition of a company with an MEP, it is important that the parties agree on the treatment of the payments to the managers resulting from the sale. Any employment income leads to a wage withholding tax and a reporting obligation for the company, and contractual arrangements typically allocate any such tax risk to the seller.

For new MEPs, whether to provide a relevant downside risk for management and to track third-party terms are often considered. Such elements do mitigate the risk of a reclassification as employment income. Usually, these MEPs maintain any vesting periods or good leaver/bad leaver provisions.

For existing MEPs, new case law should be monitored. It remains to be seen whether the Federal Fiscal Court will confirm the view taken by the tax authorities that MEPs constitute employment income or will recognize MEPs as a vehicle of co-investment, making them taxable as capital gains.

United Kingdom

In 2015, fund manager executives encountered three unfavorable changes to their taxation treatment:

1. In April, the "disguised investment management fee" rules eliminated certain structures seeking to turn management fee income into capital gains. The rules spawned the concept of a statutorily defined "carried interest," which could enable private equity executives to navigate the new rules by using market standard carry structures.
2. In July, after a successful Conservative Party election result, a new set of rules on carried interest came into force, with immediate effect. Importantly, the new rules eliminated the ability of U.K. resident nondomiciliaries receiving carried interest to argue that compensation paid from investment vehicles outside the U.K. should be exempt from U.K. taxation on the grounds that it was non-U.K. situs gains.
3. In December, the government confirmed that carried interest must relate to fund assets, the average holding life of which must be at least four years, before it can receive capital treatment.

Therefore, circumstances under which fund managers can obtain capital gains treatment are diminishing. Additionally, HM Revenue & Customs (HMRC), the U.K.'s tax and customs authority, is pressing through the courts a growing number of cases based on specific schemes that seek to structure executives' gains outside the scope of employment income.

In parallel, the government has announced that in 2016, it will press ahead with new rules that make it a criminal offense for a taxpayer not to declare income or gains above a certain threshold (where the taxation loss is greater than £25,000), even if the omission is inadvertent and does not involve negligence. The government also would criminalize an organization's failure to take steps to prevent its agents or employees from evading taxes. Important questions arise over whether it is appropriate to group strict liability offenses with instances of undeliberate underdeclaration of income. For example, if a person files a tax return genuinely believing he or she is a nondomiciled U.K. resident, or that he or she is in receipt of carried interest as defined, should that person potentially face prison time under the new rules if the judgment is made wrongly? Each of the new carried interest rules poses interpretation challenges for even experienced tax practitioners.

Conclusion

European tax authorities and courts are increasingly enforcing the view that compensation cannot be taxed as capital gains except in the most straightforward and publicly approved contexts. We expect 2016 to be a year when the PE industry considers its options in light of the new landscape, and fewer compensation arrangements will pursue the goal of capital gains taxation for its executives.