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GERMAN FEDERAL TAX COURT ON MANAGEMENT PARTICIPATION: TAXATION AS A CAPITAL GAIN CONFIRMED

In a ruling dated 4 October 2016 (reference number IX R 43/15), the German Federal Tax Court commented on the general tax treatment of management participations in Germany. In this ruling, the Court held that the profit generated upon selling a management participation unit is taxed as a capital gain. Previously, the financial authorities had tried to tax such income as income from employment which implicates severe tax disadvantages for the managers.

In the case at hand, a manager indirectly made an investment in his employer's capital by investing in a non-commercial partnership that held shares of the employer's holding company. The manager acquired the shares for an arm's length market value consideration. The partnership agreement provided for a leave-scheme, predetermining the compensation conditions for certain events when the shareholders had to return their shares. One year after acquisition, the manager sold his shares with a significant gain.

The tax authorities considered this gain as income from employment arguing that the offer to invest in the employer's capital was only made to very few high-level employees. Moreover, the management's participation was connected with an obligation to return the shares at the end of the employment contract. Besides, because of his inside knowledge the authorities claimed the manager had no real risk of losing his money. As a result, from the authorities' perspective, the gain was so closely related to the employment relationship that it had to be considered as income from employment.

However, the German Federal Tax Court contradicted this notion. A capital gain from selling a management participation does not constitute employment income for the mere fact that the investment opportunity was offered only to a small number of employees. This is rather an immanent part of any management participation scheme. In the view of the Court, a manager's participation is a special legal relationship that can stand autonomously next to an employment relationship. The Court also rejected the argument that the manager had minimized his risk because of his inside knowledge.

The Court thereby established decisive criteria classifying management participation gains as capital gains. The manager's shares must be acquired at market value and the manager must bear a real risk of loss. However, the agreement on certain leaver rules alone does not lead to income from employment. Although the Court pointed out that every decision has to be made on a case-by-case basis, the judgement is of key importance for the tax practice as management participation schemes are commonly used to motivate high-level employees.

It is therefore expected that this ruling is highly appreciated by managers who can generate capital gains which are no longer taxed on a full employment-income basis. Companies and funds, who intend to incentivise key personnel, will also welcome the ruling. From a legal advisory point of view the ruling is to be supported because of providing legal certainty and manageable criteria for a commonly used legal structure.

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