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Clarification on the tax treatment of management packages: the Conseil d'Etat "punishes" shareholding managers

Management packages have developed with the rise of LBO deals. They serve as an incentive to managers – keys persons to the success of a LBO deal – by enabling them to have a stake in the capital and, therefore, to benefit from an exit capital gain, in conditions that are generally relatively favorable.

For a long time, common practice considered the exit capital gain as a capital gain on securities, as opposed to a salary, until the French Tax Authorities (the "FTA"), through a Tax Instruction initially published in 1995, updated since then and still in effect today, made it clear that taxable gains earned under schemes providing access to capital other than those schemes specifically provided for by the French legislator (stock options, nowadays free shares, etc.) would likely be subject to re-characterization.

Yet, the first tax inspections were carried out only later, i.e. at the beginning of the 2000's.

In a decision issued on September 26, 2014, the Conseil d'Etat (French Supreme Administrative Court) ruled – for the first time to

our knowledge – on the nature of the taxable gain.

Since the 1995 Tax Instruction and the conduct of the first tax investigations, legal practitioners have tried to define the criteria that should be applied to differentiate the capital gains and the salary. The general approach was that the characterization as a capital gain would remain effective if the managers take a financial risk in the deal. This approach was more business-oriented than legally-oriented.

In practice, this led to the implementation of the following precautions:

- Managers would pay, right from the outset, a price (called indemnité d'immobilisation) corresponding to the value of the options offered to them, as determined pursuant to valuations performed by experts,
- Managers would not receive any guarantee whatsoever with respect to any future gains/losses.

The Conseil d'Etat seems to sweep these precautions away as it upheld the primarily legal rationale applied by an administrative court of appeals that issued the judgment appealed against by the taxpayer, even though the court of appeals had also mentioned that the size of the investment was also a factor to be taken into account.

Facts of the case

We believe the facts are representative of the most common method of structuring management packages. The taxpayer had been granted an option to buy a certain number of shares – such number being dependent on the internal profitability rate of the investment – in return for the payment of an indemnité d'immobilisation. This indemnité d'immobilisation was relatively small as far as can be ascertained in light of the elements provided by the judge. The strike price had of course been set from the outset and turned out to be much lower than the final value of the share.

As per a contractual arrangement, the right to exercise the options was conditioned upon the beneficiary holding a position as manager within the group for at least five years.

The solution adopted by the Conseil d'Etat

The Conseil d'Etat approved the reasoning of the administrative court of appeals that had primarily noted that the grant of the option to purchase shares was related to the appointment of the taxpayer as manager of the group, and that the exercise of the option was conditioned upon the latter's presence within the group for five years.

Because of this simple finding, tax court judges can consider that the capital gain originates from the financial conditions governing the allocation of the shares and that such conditions themselves originate from the appointment of the beneficiary as manager of the group.

In addition, the Conseil d'Etat also upheld two other interesting findings of the administrative court of appeals:

- Firstly, the Conseil d'Etat specified that the court of appeals had provided adequate reasoning for its

judgment by ruling that the paid indemnité d'immobilisation, i.e. 1% of the final gain, was modest.

The innovative aspect of this finding compared to the current practice lies in the fact that the judge referred to the value of the shares at the date of sale, not at the date of grant, which de facto generates a significant delta.

This position appears to be open to criticism since, in the business world, the possibility to acquire options is offered to shareholders who do not have a subordination relationship with the company in which they invest. The determination of the value of the option is then carried out through methods that are well-known to experts. It is the option mechanism in itself that generates a gain in value that may be high.

- Secondly, the Conseil d'Etat set aside, with little consideration, the fact that the taxpayer had made representations and warranties in the framework of the deal.

This position is also open to criticism as a salary is, by essence, an accrued item that may not be taken back, unlike a capital gain when representations and warranties have been provided.

Further, the Conseil d'Etat's approach does not take into account the fact that capital gain is uncertain, as opposed to the salary which stems from a contractual obligation.

This decision poses a significant risk to existing management packages since, based on our experience, virtually all the methods implemented in practice to structure management packages are flawed by the two shortcomings pointed out by the Conseil d'Etat :

- The exercise of the options is conditioned upon the presence of the managers within the company/group,
- Some indemnités d'immobilisation are insufficient if they must be assessed in light of the exit price.

It could be expected that the Conseil d'Etat will be requested to confirm this solution in cases where managers have invested more important sums in the company. Yet, as it based its decision primarily on the analysis of the legal ground concerning the advantageous grant of options, we believe that this decision should be viewed as a landmark decision.

It seems difficult to propose an alternative to deal with this unfavorable decision. Yet:

- more than ever, the use of share savings plans must be set aside for management packages shares (in any way, simple options are excluded, just like share purchase warrants and preference shares since January 1, 2014), as any irregularity can result in a 80% fine, it being specified that negotiations with the FTA are limited to the remission of this penalty and, de facto, frustrate any attempt to bring the matter before a court for a decision on the merits,
- Managers will probably need to take risks that they did not take so far, possibly by investing from the outset a large amount in shares, where appropriate, with options,

- Lastly, it seems difficult to maintain clauses similar to “bad leaver” clauses, which is highly problematic if we consider that management packages are supposed to serve as an incentive. In this context, tax and legal advisers will have to be even more creative.