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Taxation of Management Participations for Advisory Board Members and Advisors

Management participations are a component of almost every private equity investment. Often, advisors and advisory board members also have the opportunity to invest on the same or similar terms as the management. While there are already some court rulings on taxation of employed managers with such equity participations, until now there have not yet been any such rulings for the taxation of advisory board members and advisors. The Fiscal Court of Baden-Württemberg made the first ruling on 26 June 2017 (judgment of the Fiscal Court of Baden-Württemberg of 26 June 2017 – 8 K 4018/14).

In principle, proceeds from management equity participations are subject to taxation as capital assets and thereby to the reduced flat rate tax and, in cases of investments of 1% or more, they are actually subject to the so-called partial income procedure. Under certain conditions, taxation at the normal income tax rate may also be a possibility, if the proceeds are imputed as income from employment to the employment relationship of the manager. Compared to taxation as income from capital assets, this is connected with an additional tax burden of approx. 20% (highest income tax rate 45% versus flat rate tax of 25%).

Court rulings have not yet settled the question of whether and, if so, under what conditions advisory board members or advisors as investors in management participations must anticipate that their proceeds are imputed to income from self-employment pursuant to Sec. 18 German Income Tax Act (EStG). In audit practice, the fiscal authorities sometimes do not differentiate between managers and advisory board members. Thereby, other conditions apply for the qualification of income from self-employment than for income from employment. In addition, income from employment is taxable upon accrual, while income from self-employment is determined by reference to profits (Sec. 2, para. 2 Income Tax Act).

Taxation of management participations

According to the opinion of the German Federal Fiscal Court, not every exchange of goods and services with a de facto proximity to the employment relationship can be automatically imputed to income from employment. Rather, one must examine in each individual case on the basis of all significant circumstances whether the relevant exchange of goods and services is induced by the employment relationship, or whether due to an independent privileged legal relationship it is to be imputed to another type of income or is not taxable at all. The German Federal Fiscal Court expressly qualifies such an independent privileged legal relationship as the equity participation of an employee in his employer.[1] If the employee uses his capital to invest in his employer's company, there is thus in principle an independent source of income that is not dependent on the employment relationship.

If a causal connection to the corporate relationship and to the employment relationship can be established, it must be determined in the sense of an "evaluative classification" of which of these is formative for the exchange of goods and services according to the circumstances of the particular case.[2] Whether such requalification occurs, according to German Federal Fiscal Court case law, can only be determined by an appraisal of all significant circumstances of the particular case (overall view).[3] There is a lack of instigation through the employment relationship if the privileged legal relationship exists independently of the employment relationship and represents the entire exchange of goods and services between the parties, without there also being significant services pursuant to income tax regulations that can be attributed to the employment relationship.[4]

1 BFH of 17 June 2009, VI R 69/06, German Federal Tax Gazette II 2010, 69 with additional references; recently BFH of 4 October 2016, IX R 43/15, German Federal Tax Gazette II 2017, 790.
2 BFH of 27 March 2013, I R 14/12, BFH/NV 2013, 1768, margin no. 31.
3 Cf. BFH of 17 June 2009, VI R 69/06, German Federal Tax Gazette II 2010, 69; of 7 May 2014, VI R 73/12, BFH/NV 2014, 1291; recently BFH of 4 October 2016, IX R 43/15, German Federal Tax Gazette II 2017, 790.
4 Cf. BFH of 5 November 2013, VIII R 20/11, German Federal Tax Gazette II 2014, 275.

On the basis of the court rulings that exist on this topic up to this point, for a requalification it does not suffice[5] that

- the participation is only offered for purchase to executive employees,
- the participation cannot be freely transferred to third parties, and
- upon resignation of the participant from the employment relationship, the equity participation can be terminated with extraordinary notice.

The German Federal Fiscal Court recently confirmed this in its decision of 4 October 2016, in which it dealt with a typical private equity management participation for the first time.[6] Accordingly, for the equity participation to be recognized as a privileged legal relationship, it depends on whether

- the management participation is purchased and sold at current market value and
- the manager bears an effective risk of loss from the participation.

Evidence of a connection to the employment relationship is holding conditions that are tied to the employment relationship. This can be a so-called leaver scheme that provides for different buy-back prices for so-called good and bad leavers. In its own right, a leaver scheme does not yet suffice for the requalification of capital gains to remuneration.[7]

Function and duties of advisory board members and advisors in private equity investments[8]

Advisory board members and advisors do not have an employment relationship with the investors' target company. Generally, they work on the basis of an advisory agreement that is concluded with the target company or one of the

[5] BFH of 17 June 2009, VI R 69/06, German Federal Tax Gazette II 2010, 69.
[6] BFH of 4 October 2016, IX R 43/15, German Federal Tax Gazette II 2017, 790.
[7] BFH of 4 October 2016, IX R 43/15, German Federal Tax Gazette II 2017, 790.
[8] See also Schneider, Der Beirat als Steuerungsgremium bei Private Equity-Beteiligungen, FYB 2018, pg. 65 et seq.

holding companies. Advisory board members may work in an advisory or supervisory capacity. The advisory board and its duties are generally incorporated and defined in the articles of association of the particular company. An advisory board may also be merely set up in an advisory capacity on the holding company level of the investor (advisory committee), without this being incorporated in the articles of association. An advisor without an advisory board function is often not so closely linked to the company and the investor and is consulted for issues limited in time and purpose.

Advisory board members and advisors support the private equity investor in the further development of the target company. They have industry know-how and often also have operational experience as managing directors or executive board members. Advisory board members and advisors generally do not assume operational duties, unless they step in as interim managing director by way of exception. However, they are sparring partners for the operational management and help with strategic planning and orientation of the company. Partly, they are already active in the choice of the target company and in the acquisition process and partly, they first supervene after conclusion of the acquisition process.

Facts on the decision of the Fiscal Court of Baden-Württemberg

In the case to be decided by the Fiscal Court of Baden-Württemberg, the advisor was already acting in an advisory capacity for the investors during the tendering procedure for the acquisition of the corporate group. It was actually submitted to the court that the investors would not have made the investment if they could not have had access to the contacts and industry knowledge of the plaintiff, a former managing director of a competitor. The advisor also acted as trustee for the investors in the preparation of the acquisition structure. The advisory agreement was first concluded after the conclusion of the transaction. According to this, the advisor's duty was to provide strategic advice to the holding company on all relevant areas of operational management and the development of the holding company and the companies connected thereto. For this purpose, the advisor was to take over the position of a managing director and an advisory board member in the holding company and the position of supervisory board member in the subsidiary. The advisor received an advisory fee for working 70 days per calendar year, as well as a flat-rate reimbursement of expenses and a fixed fee for each additional day of advisory. In fact, the advisor was actually the managing director of the operational subsidiary for a period of five months in one year and for almost two years until the sale of the group. Upon the later assumption of the position as managing director of the subsidiary, the advisory contract was adjusted to the effect that the scope of the remuneration was specified to be at least 200 advisory days and the fixed advisory fee was increased.

In connection with the execution of the sales agreement, the advisor acquired a participation in the holding company. However, this participation only applied to the direct nominal capital and the so-called Capital Reserve I. The investors also provided contributions to the Capital Reserves II and III and supplied a significant amount as shareholder loans. The distribution of proceeds was to occur such that first the shareholder loans, including interest in the amount of 1.25%, were to be repaid, then the Capital Reserve II, plus interest in the amount of 22.6% per annum and then, pari passu, the Capital Reserve I and the nominal capital, including the Capital Reserve III. The amount in excess of this was to be disbursed pursuant to the participations in nominal capital and in the Capital Reserve III.

The advisor and the investors concluded a participation agreement in connection with the acquisition of the participation. This included a limitation of the right of disposal (disposals only with the investors' approval) and a so-called leaver scheme, i.e. a purchase right for the investor in the case of a good or bad leaver event. In the case of a change of control sale, the participation agreement provided for a tag and drag along right for the advisor. In the subsequent course of the investment, additional managing directors also participated in the holding company on the same conditions. The advisor declared the sales proceeds realized upon sale of the company as capital gains pursuant to Sec. 17 Income Tax Act.

After objection of the investigation service for tax offenses, the tax office assessed the sale proceeds from the participation as earnings from self-employment pursuant to Sec. 18 Income Tax Act. The tax office corroborated their legal opinion, in particular, on the close link between the advisor and the investors.

Through his know-how, his contacts and industry knowledge, the advisor was a guarantor for the successful restructuring and the subsequent profitable exit. The sale proceeds therefore were assumed to correspond to a performance-based component of remuneration. In addition, the advisor was not just participating on the same conditions as the investors. He realized a return of 1,935% on his contributed capital, while the investors would have only realized a return of approximately 245%. In this respect, the advisor had a disproportionately high profit participation. It did not depend on the risk of loss connected with the investment, because there is an immanent risk of loss in proceeds from self-employment.

The plaintiff opposed this. The advisory and participation relationships should be considered separately. The contractual agreements complied with market standards. The profit sharing was also not disproportionately large, because interest and the repayment of the shareholder loans and Capital Reserve II would have had to be earned first before he would have received any money.

Decision of the Fiscal Court

The Fiscal Court followed the assessment of the tax office and qualified the advisor's sale proceeds as income from self-employment pursuant to Sec. 18 Income Tax Act. In their statement of grounds, the Fiscal Court stated that the acquisition of the participation was occasioned by the independent function practiced by the advisor. In this respect, the principles for the qualification of income from employment developed by the Federal Supreme Tax Court should be applied accordingly to the advisor participation. In the second part of the statement of grounds, the Fiscal Court also states that the participation of the advisor would concern necessary business capital of his advisory activity.

From the perspective of the Fiscal Court, the arguments that speak for remuneration are

- the close link between the advisor and the investors, which according to the opinion of the senate led to a reciprocal interdependence between the participation and the advisor's activity;
- the disproportionately high returns from the investment, in which the senate considered the entire investment for comparison on the side of the investors and not just each payment made to the nominal capital and the Capital Reserve I (the senate is convinced that the investors would not have granted such a participation to an external third party);
- the limited group of participants for the participation (only managers and advisors);
- the lack of ongoing earnings on the investment.

The court does not see any sufficient counter-arguments in the overall assessment that

- both, the acquisition and sale of the equity participation occurred at market price, and
- the advisor bore a risk of loss in a six-figure amount. In terms of the risk of loss, the senate states that there is an immanent entrepreneurial risk in the type of income for independent work pursuant to Sec. 18 Income Tax Act, and therefore an existing risk of loss is less important for the delimitation from other types of income than for income from employed work according to Sec. 19 Income Tax Act.

With regard to the qualification as necessary business capital, the Fiscal Court states that the participation is an auxiliary activity that is not different from the advisor's self-employed activity. Without the advisory agreement, the participation would also not have come about. The participation in the holding company also allowed the advisor a certain amount of control with regard to the actual implementation of his advisory suggestions that he would not have otherwise had. In addition, in this respect the participation decisively promoted the advisory activity, since thereby the opportunity for additional profit would be connected to successful advisory services.

The revision of this judgment is pending in the eighth senate of the Supreme Tax Court under file number VIII R 21/17.

Assessment: Do court rulings on management participations apply mutatis mutandis?

The judgment of the Fiscal Court of Baden-Württemberg is not to be endorsed in this case. Systematically, the grounds do not convince. Provided that the Fiscal Court wants to use the principles of court rulings for income from employment in employee or management participations accordingly for the advisory activity, in this respect there is no reason to oppose this, since an advisor also provides a service in exchange for a fee, just as the employed manager. In this case, the difference between the two types of income is reduced by the fact that the advisor provides the service independently, and thus is not dependent on instructions, while the manager provides the service within the scope of an employment relationship and is thus dependent on instructions. An additional differentiation does indeed not seem necessary at this point. In this respect, one can definitely follow the Fiscal Court.

No correct application of the existing court rulings

However, the Fiscal Court did not correctly apply and recognize the principles of the Supreme Tax Court ruling in its judgment. According to the judgment of the Supreme Tax Court of 4 October 2016, the acquisition and sale of the participation at market price is of particular importance. The assumption of an effective risk of loss from the participations is also important for the delimitation. Both criteria are fulfilled in the existing case. Nevertheless, the Fiscal Court did not view them as fundamental for a qualification as income from capital assets, or rather Sec. 17 Income Tax Act.

Instead, it is based primarily on the close link between the advisor and the company and the limited group of participants in the investment. However, both are immanent in an employee participation, as the Supreme Tax Court has repeatedly determined.[9] A manager who works exclusively for his employer's company has

[9] BFH of 17 June 2009, VI R 69/06, German Federal Tax Gazette II 2010, 69 with further references; recently BFH of 4 October 2016, IX R 43/15, German Federal Tax Gazette II 2017, 790.

an even closer relationship with the holding company than an advisor. If here the advisor worked almost exclusively for the company, there is rather the question of whether the conditions for self-employment are still given, or whether after all an employment relationship must in fact be presumed. Here this differentiation is not at all relevant.

The lack of dividend distributions does not speak against a capital investment, as the Supreme Tax Court has determined repeatedly in regular court rulings.[10] The fact that here no dividends were distributed was a consequence of the profit distribution agreement and, if applicable, the financing agreements with the banks. It was, however, not excluded that positive earnings from the participation would be realized.

Disproportionate subscription of equity instruments as indication for remuneration?

The material point for the Fiscal Court lies in the particular configuration of the capital structure and the disproportionate profit sharing connected thereto. The Fiscal Court is of the opinion that the return on the individual ordinary shares from the advisor and investor is not to be compared, but rather the investor's total investment in relation to the advisor's investment. Due to the disproportional subscription of capital instruments in this case (the advisor did not provide shareholder loans or contribute to the preferential capital reserve II), the advisor in fact realized a significantly higher return than the financial investor.

However, this is irrelevant for two reasons:

- First, the shareholders of a company are in principle free to structure the capital relationships as they see fit. The principle of financing freedom that was developed in another context leaves the decision up to the shareholders, whether and to what extent they also provide loan capital in addition to

[10] BFH of 14 March 2017, VIII R 38/15, German Federal Tax Gazette II 2017, 1040 and VIII R 25/14, German Federal Tax Gazette II 2014, 1038.

equity capital.[11] This also applies in any case to the extent that different forms of financing also have different economic consequences.

- On the other hand, the selected capital structure is connected with a significantly higher risk of loss for the advisor as compared to the investor. The eighth senate of the Fiscal Court did not deal with this fact at all.

The fifth senate of the Fiscal Court of Baden-Württemberg had a similar case to decide at almost the same time (but involving a manager)[12]. Here, the manager had also acquired only ordinary shares, while the investor also subscribed to preferential shares with a fixed return. The fifth senate was of the opinion in this respect that only the returns of the respectively acquired capital shares could be compared with each other, because the other shares were vested with different rights and obligations and therefore of course differed in value. Insofar as the Fiscal Court applied the yield of the investor's entire investment for the comparison, in the opinion of the fifth senate this was a case of inadmissible ex-post treatment. Because, due to the high fixed return of the preferential share class, it cannot initially be foreseen that such a high sales revenue can be realized on the ordinary shares. Namely, if the profit was not sufficient to satisfy the preferential capital instruments, the investor would have realized a profit, but the management would have completely lost its investment.

There is nothing to add to this argumentation and judgment. It correctly determines the economic consequences of the investment, which also cannot simply be disregarded for taxation.

Irrelevant risk of loss?

The advisor's risk of loss is therefore not to be considered, according to the opinion of the eighth senate of the Fiscal Court of Baden-Württemberg, be-

[11] Cf. BFH of 5 February 1992, I R 127/90, German Federal Tax Gazette II 1992, 532; of 20 June 2000, VIII R 57/98, DB 2000, 2098.

[12] Fiscal Court Baden-Württemberg of 9 May 2017, 5 K 3825/14, res judicata.

cause it should be immanent in the income from self-employed work. Indeed, entrepreneurial risk is part of the picture of a self-employed person in income tax law. In addition, the capital sphere is included in the taxation for income from self-employed work, because it involves profit income. However, the case at hand concerns the qualification of remuneration. In this case, a risk of loss is just as little immanent as it is for an employed person. Because, in the case of advisory services, the self-employed person also initially has an unconditional claim to payment for the work done, just as an employee. Something else could apply if the participation is the advisor's business capital and the risk of loss applies to the asset value. Then other assessment criteria apply, as can be seen in the following.

Advisory board participation as business capital of the advisory board

If the Fiscal Court assesses the sale proceeds from the equity participation as remuneration in the income from self-employment, it is thus not discernible why, alongside this, one must also examine whether the equity participation is the advisor's business capital. In principle, this question did not have to be asked after the affirmation of the remuneration. Conversely, it would have sufficed to assume necessary business capital, in order to be able to assign the sale proceeds to the income from self-employment.

As the Fiscal Court correctly states, according to regular court rulings, equity participations as "financial transactions" are generally not a part of the occupational profile of the independent professions.[13] Only by way of exception can one consider the assignment of an equity participation to necessary business capital of a freelance professional. Economic assets only represent necessary business capital if they directly serve the business. Objectively, they must be allocated for direct use in the business itself. This is the case if they are not in fact essential but relate to the operations in some way and are allocated to serve it.

[13] E.g. BFH of 12 January 2010, VIII R 34/07, German Federal Tax Gazette II 2010, 612 with additional references; of 22 January 1981, IV R 107/77, German Federal Tax Gazette II 1981, 564.

Equity participations should decisively promote the activity of the taxpayer or serve to guarantee the sale of products. In addition, the corporate purpose of the company may not be significantly foreign to the freelance activity of the taxpayer; the participation must enable or supplement a definable freelance activity.[14] This can also be the case if an economic asset is allocated as a substitute for remuneration.

In the present case, the advisory activity – thus the occupational profile of corporate advisors – must therefore be related to the activity of the holding company. According to the reasons for the decision, it is not even known what the activity of the company consists of. In this respect, for this reason no relevant statement on the necessary business capital can be made. As far as the investors specifically depended on the advisor's expertise and his expert knowledge in the holding company's sphere of activity, this merely establishes the suitability of the advisor for the object of his advice. However, this does not say anything about how the advisor utilizes the participation for his further corporate advisory activity.

The reciprocal conditionality of participation and advisory activity also does not suffice for the assumption of business capital. Ultimately, it does not extend beyond a mere causal connection that is immanent in a management participation. The mere causality between activity and participation is not sufficient to superimpose the activity on the capital commitment relationship, in order to make business capital out of the equity participation.

The assumption of the Fiscal Court that the advisor infers a certain control over the actual implementation of his advisory suggestions from his participation is indeed interesting as an argument but is improbable in this case. On the one hand, the information rights of a capital shareholder are usually very limited, in particular if he is a minority shareholder; on the other hand, the necessary information probably rather results from the advisory relationship between the advisor and the client.

[14] BFH of 22 January 1981, IV R 107/77, German Federal Tax Gazette II 1981, 564.

The participation also does not represent a substitute remuneration. This could only be assumed if the participation were acquired instead of the remuneration that is standard on the market. However, this also cannot be inferred from the facts of the case. Rather, it seems that the advisor was by all means remunerated at a standard market rate and actually received an increase in his advisory fee. In addition, the participation was not relinquished at a reduced price but was acquired at market price.

Conclusion

The criteria of the Fiscal Court should be followed with the effect that in principle the same delimitation criteria can be applied to the management participation acquired by advisors or advisory board members as those to the delimitation of incomes from employment and capital gains/assets. There is no recognizable factual reason for a differentiation.

However, these criteria must then be applied consistently. According to the court rulings of the Supreme Tax Court, in this respect the market standards of the purchase and sale price, as well as the assumption of an effective risk of loss, are accorded a material indicative effect. The Fiscal Court has not correctly recognized this in the current case.

The existing risk of loss from the participation can also not be negated on the grounds that a risk of loss is immanent to the income from self-employed work according to Sec. 18 Income Tax Act as compared to the income from employed work according to Sec. 19 Income Tax Act. On the one hand, this contradicts the assumption that the situation of the advisory board participants is comparable to that of a participating manager. On the other hand, this disregards that the advisor also has a claim to remuneration for work performed.

Something else could only apply if the participation were to belong to the necessary business capital. An advisory board participation does not usually involve business capital. Because the operational activity of the respective holding company does not serve to render his further advisory activities. This would only be the case if the advisor were to use the resources of the holding company for his corporate advisory activities. Normally, this cannot be assumed.

The participation also cannot be qualified as a component of remuneration. This applies in any case when the remuneration according to the advisory agreement is consistent with market standards and the participation does not economically supersede a component of remuneration.

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