GERMAN FEDERAL TAX COURT DECIDES THAT "SWEET EQUITY" CAN BE TAXED AT BENEFICIAL CAPITAL GAINS TAX RATES – WHAT DOES THIS MEAN FOR FINANCIAL INVESTORS?

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Legal Briefings

The German tax treatment of disposal proceeds of so-called "sweet equity" had until recently been somewhat unclear: While the German tax authorities often tried to apply the regular, top income tax rates of up to c. 48%, taxpayers usually aimed for the more beneficial so-called partial income method (*Teileinkünfteverfahren*) which is in essence a beneficial taxation regime for certain capital gains and typically results in an effective tax rate of c. 31%.

In two recent decisions, the German Federal Tax Court (*Bundesfinanzhof*) has now sided with taxpayers, when it held that the disproportionate subscription of capital instruments by a financial investor and management, which is hidden behind the term "sweet equity", generally does not justify taxation at the top income tax rate – if the relevant participation has been acquired at the market value and certain other requirements are met. The decisions are good news, and will hopefully result in more predictability for holders of sweet equity.

WHAT IS SWEET EQUITY?

Sweet equity aims at incentivising the management of portfolio companies. This is typically achieved by letting management subscribe to a special class of equity instruments, to which exit disposal proceeds are allocated only after the (debt and equity) instruments held by other investors--but if the exit is successful, the proceeds allocated to such sweet equity can be disproportionately greater compared to the management's initial investment. As a result, the management bears a higher risk of loss, but at the same time has disproportionately greater potential upside–the "sweet" equity.

HOW IS IT NOW TAXED IN GERMANY?

While the acquisition of the sweet equity does not result in a tax charge if certain requirements are met (in particular if it is acquired at fair market value), it has so far been unclear if disposal proceeds of sweet equity represent regular (self-)employment income of the managers. If that were the case, top income tax rates of up to c. 48% would apply.

Conversely, if disposal proceeds qualify as capital gains, in most cases the so-called partial income method (*Teileinkünfteverfahren*) would apply, which is in essence a beneficial taxation regime for certain capital gains and typically results in an effective tax rate of c. 31%.

In its two most recent rulings, the German Federal Tax Court (*Bundesfinanzhof*) has now confirmed the latter view. According to the court, in order to achieve such capital gains tax treatment, it is crucial that the sweet equity proceeds are based on the use of **a source of income** that is independent of the manager's employment relationship, and the court presumes this to be the case *inter alia* if:

- The sweet equity is acquired and disposed of at fair market value;
- it conveys the full risk of loss; and
- the contractual relationship governing the terms of the managers (self-)employment with the portfolio company does not, itself contain a contractual obligation to subscribe for and allocate the sweet equity.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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