Reform of the French Tax Treatment of Carried Interest

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The French Senate adopted on November 24, 2008 an amendment relating to the tax treatment of carried interest units. If adopted by the French National Assembly, this amendment would apply to FCPRs created after January 1, 2009. At this stage of the legislative process, it is possible (and probably desirable) that the text adopted by the French Senate will be amended by the French National Assembly.

The French FCPR fund vehicle is comparable to an Anglo-Saxon limited partnership. The FCPR is not an independent legal entity, but rather an unincorporated fund involving a joint beneficial ownership of the underlying investments by the limited partners. There were, prior to the enactment of the new law on August 4, 2008, two categories of FCPRs: the so-called “accredited FCPRs” and the so-called “simplified FCPRs”. Simplified FCPRs are more flexible than accredited FCPRs.

Investments held in portfolio by FCPRs (including the new contractual FCPRs) are managed by a French management company accredited by the AMF (The French securities regulator). Vis-à-vis third parties, the legal title of the investments rests with a bank, acting as custodian for the FCPR, such investments being beneficially owned by the limited partners through the A and B units issued by the FCPR.

FCPRs ordinarily issue carried interest (“C”) units, the tax treatment of which is currently under discussion before the French Parliament.

1. Current Tax Treatment

Carried interest (“C”) units are allocated to members of the management team and entitle them to a portion of the capital gain realized by the fund (usually 20%) in accordance with the applicable waterfall formula.

As carried interest (“C”) units are allocated to fund managers in consideration of several criteria that reflect their success in managing the FCPRs’ portfolio, there has for a long time been a question as to whether any income and/or gains derived from those units by members of the management team could be treated by the French tax authorities as employee compensation subject to income tax at a progressive rate (which currently could be as high as 40%).

In guidelines issued on March 28, 2002, the French tax authorities clarified the tax treatment and indicated that carried interest (“C”) unit holders may benefit from capital gains tax treatment (currently a flat rate of 18% that does not include social security contributions), provided that the following conditions are all met:
• the carried interest ("C") unit holders are members of the management team at the time of the subscription for or purchase of such units;
• the subscription or purchase of carried interest ("C") units corresponds to a capital investment; the practice has however led to a minimal investment in comparison to the investments made by other FCPR unit holders;
• the carried interest ("C") units only represent one class of the units issued by the FCPR;
• the members of the management team do not hold other (A or B) units issued by the FCPR for which they would seek the benefit of the income tax exemption available to holders who undertake to hold their units for five years and to reinvest in the FCPR any amount distributed by the FCPR during such five year period; and
• the remuneration received otherwise (salary, bonus) by the members of the management team is not significantly below the industry’s standards.

This regime only applies to carried interest ("C") units issued by French FCPRs. Carried interest units issued by entities formed elsewhere (such as limited partnerships governed e.g. by UK, US or Jersey law) cannot benefit from such treatment. There is therefore currently some doubt regarding the tax treatment of gains realized by the holders of carried interests issued by such entities.

2. Content of the Proposed Reform

Pursuant to the amendment adopted by the French Senate, any income and/or gains derived by members of the management team from carried interest ("C") units would, from now on, be considered as employment income, taxable as such at the progressive income tax rates.

The proposed legislation however maintains taxation under the capital gains tax regime for any gain realized upon the sale or repurchase of carried interest ("C") units, provided that certain conditions are met. These conditions, some of which merely formalize the above mentioned administrative guidelines dated March 28, 2002, would nevertheless prove to be far more restrictive than under the current treatment.

The conditions to be met for the application of capital gains tax treatment under the proposed legislation in addition to those mentioned above would be the following:

• the carried interest ("C") units should be subscribed at a price "in obvious relation to the unit’s value";
• the carried interest ("C") units should represent at least 1% of the total amount of subscriptions raised by the FCPR; and
• the amounts to which the carried interest ("C") units give rise should be paid, at the earlier, at least five years after the setting-up of the fund and after the full repayment to the holders of other units.

The first condition (acquisition for a “price in obvious relation to the unit’s value”) raises two issues:

• if we consider that this concept means that carried interest ("C") units have to be
purchased at their fair market value, then arises the issue as to how to determine such fair market value (which appears extremely complicated in practice at the time of their issuance). Indeed, if such units give rise to a large capital gain in relation to a minimal investment, the realization of profits on carried interest ("C") units is by definition entirely uncertain at the time they are issued. Taking into account the waterfall provisions ordinarily applicable in FCPRs, the capital investment of the members of the management team might not even be reimbursed.

The second (1%) condition would require the members of the management team to invest significant amounts in the fund (even if the level of commitment required from the management team is in line with the industry’s current standards). Assuming that members of the management team would not have at their disposal sufficient funds to subscribe the carried interest ("C") units, financing provided by an entity of the group, by way of a loan, could be contemplated.

One upside to this reform is that this treatment would in theory apply (under the same conditions) to carried interest units issued to French residents by entities established in a Member State of the European Community.

Accordingly, subject to the conditions applicable to French FCPRs as mentioned above, the capital gains tax treatment could apply for instance to interests in limited partnerships organized under English law held by French tax residents. However, this favorable treatment could not apply to partnerships organized under US or Jersey law.

The fact that this favorable tax regime would also apply to certain foreign entities does not resolve the permanent establishment issues that may be encountered by non French private equity houses that invest and have a local team in France. These issues typically arise from the rather artificial separation of “advisory” services performed in France and investment decisions made outside of France. The setting-up of a FCPR in France appears to be effective in protecting these foreign entities and therefore their investors from any potential French income taxation.

The proposed reform would allow the members of the French management team to benefit from the favorable tax regime for the interest they hold in foreign investment funds representing their carried rights.

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings Paris lawyers:

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