The French Carried Interest Tax Regime

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France’s 2009 Finance Bill enacted into law the tax regime for carried interest returns. Provisions of section 15 of the Finance Act reform the income tax regime for owners of French venture capital (VC) vehicles (fonds commun de placement à risques, or FCP, and société de capital-risque, or SCR) holding carried interest rights issued by FCPRs and SCRs. Section 15 of the Finance Act is based on the Arthuis amendment.

These units and shares entitle their owner to a share of profits once ordinary investors have received their investment return (an average of 20 percent of the capital gains on the vehicle). Apparently rejecting the reform trend seen in various countries that has led to major changes in income qualifications and income tax rates, the French Parliament passed a set of conditions allowing the capital gains tax treatment described below.

Initially, income from carried interest rights was not addressed in the French Tax Code (FTC). Section 78 of the 2002 Finance Act merely indicated that shares or units of VC vehicles granting different rights on the vehicle’s assets or proceeds because of the type of person (that is, employees or directors) do not benefit from the personal income tax exemption received by external individual investors. The tax regime applicable to income earned by holders of C shares or units was in the French tax authority (FTA) guidelines, which listed requirements that must be satisfied. According to this doctrine, a carried interest return was considered a capital gain subject to an overall tax rate currently at 30.1 percent (18 percent plus 12.1 percent for social charges) and was not subject to the common salary regime, which has a higher tax bracket of 40 percent (without payroll taxes).

The French venture capital association recommends using the phrase “units and shares with subordinated return.” Jean Arthuis, French senator and president of the Senate Finance Council, initiated the reform.

Commonly referred to as C shares and units, in contrast with ordinary shares or units (A and B) owned by external investors. Effective January 1, 2009, the lucrative shares or interests (shares or similar economic rights whose return is considered a reward for the recipient’s activities) are subject to Dutch income tax at a progressive rate up to 52 percent. Under current U.S. tax law, a carried interest return is taxed at the 15 percent capital gains rate. Policymakers are questioning whether the income should be considered compensation for services, taxed at the ordinary income rate of up to 35 percent. Because of the economic crisis, an increase in revenue tax would be expected for fiscal 2011.

No reference is made to the tax investment requirement listed in section 163 quinquies B of the FTC regarding the tax regime applicable to resident individual investors (exemption) and resident corporate investors (from a reduced corporate income tax rate to an exemption). However, the VC vehicles should at least meet the legal investment requirement in the French financial and monetary code (Code monétaire et financier), in sections L. 214-36 and R. 214-38 for funds and in Law 85-695, dated July 11, 1985, for SCRs.

Payroll taxes amount to an average of 25 percent for employees and an average of 45 percent for employers.
The recipient, who was treated as an investor for CGT purposes, was required to invest an amount in the fund or in the company, although the level could be determined by agreement when the fund was created or upon issuance of new SCR shares. Carried interest rights also had to represent a single class — that is, they had to be acquired at the same price and grant the same rights as capital gains on the disposal of securities. Holders of carried interest rights were unable to purchase A or B rights. Holders had to receive income for their regular activities in an amount meeting industry standards.

Amending the tax regime of carried interest rights did not involve a substantial modification in either the income requirements or tax rates. Profits of carried interest rights are still treated as capital gains and are subject to a 30.1 percent tax rate. This tax treatment is in line with the French venture capital association’s recommendations, which point out that carried interest holders are investors whose investment success is linked to the success of the underlying investment of the VC vehicle.

The favorable tax regime reintroduces former conditions of the FTA guidelines (A) and adds rules related to the value of the investment and its duration (B).

A) Carried interest rights must represent one class of units or shares. Investors holding them cannot purchase other units or shares granting a personal income tax exemption (12.1 percent social charges still apply). The personal tax exemption is, under some conditions, granted to individuals investing in VC vehicles. Because carried interest rights relate to an investment preventing them from being considered compensation, units or shareholders must receive regular income from the management company of the VC fund or from the SCR employing them.

B) Carried interest rights must be purchased at their fair market value. This requirement emphasizes the necessity of having the potential recipient of carried interest income economically involved in the VC vehicle activity and of avoiding any free allocation of carried interest rights or an undervalued price. However, evaluation of units could lead to difficulties, considering the amounts of latent capital gains on disposals of underlying assets and the characteristics of the preferred return (that is, the hurdle rate).

Carried interest rights must represent at least 1 percent of the global amount of the subscriptions in the VC fund or company. This threshold will require an important financial commitment from French management teams performing investments requiring significant capital calls. The French Parliament allows an adjustment to a lower percentage to be made by decree after the French financial markets authority (Autorité des marchés financiers) delivers an opinion. The level of investments in industry standards should be taken into account for high-risk funds such as FCP (fonds commun de placement et innovation) and FIP (fonds d’investissement de proximité), two main types of FCPRs, in addition to the standard FCPR, for which the required investment from fund managers is often less than 1 percent of the subscriptions.

Income from carried interest rights must be issued after five years (at least) as from the date of constitution of the FCPR or the date of the share issuance for SCRs.

FCPR management teams will receive their carried interest returns once the capital contributions of other unit holders (individuals, corporate investors, and nonresidents) have been repaid.

The reform allows French management teams of foreign VC entities set up in the EU or in the European Economic Area to profit from the tax regime as long as the new requirements are met. Thus, management teams of foreign funds (U.S. or U.K. limited partnerships) benefit from the same secured treatment in the case of a tax audit (whereas they were not mentioned in FTA guidelines 5 I-2-02). However, private equity activities create other issues among different countries. To what extent does a French team of a nonresident VC fund create a PE in France? Difficulties also can arise when the fund, the management company, and a local company are established in different countries.

Current carried interest holders still benefit from the former tax regime, whose conditions are set forth in the FTA guidelines, as the reform will be implemented from the publication date of the decree — and at the latest, June 30, 2009 — for newly created FCPRs, and, regarding SCRs, for shares issued starting the same date. However, new vehicles are being set up for future years and will quickly fall under the scope of the new rules. As a result, the expected decree should be examined now to see if its investment requirement takes market practices into account.

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9Although new text (section 80 quindecies of FTC) has been added to the FTC to clarify that an ordinarily carried interest return is treated as wages and salary.

10See supra note 5.

11Provided the VC entity is established in an EEA country that has concluded with France a bilateral tax treaty containing an administrative assistance provision to prevent tax evasion.