# Relocation of French start-ups to the United States: the puzzle of profit-sharing mechanisms for French tax residents

A number of French start-ups make the choice to transfer their head office to the United States or to locate themselves there through a transaction commonly referred to as a "flip", i.e. the creation of a holding company under US law, followed by a contribution of all of the shares of the French company to the holding, so that the French operating company ultimately constitutes a wholly-owned subsidiary of the holding company under US law.

These relocation operations, in spite of providing access to a larger consumer market in the United States, are justified initially by allowing the access to new sources of investment. Indeed, US investors usually want to have control over the legal and tax environment by acquiring a stake in a US holding company.

Nevertheless, while these transfers to the United States provide financing opportunities, they remain expensive and trigger tax consequences that can be significant. As the transfer of a head office has the same consequences as a cessation of activity from a tax perspective, these flips most often take the form of a contribution of shares of the existing French company to a new US holding company as long as the former has a minimum of value and unrealized gains or if it has tax losses to preserve in France. This contribution also enables the French contributors to benefit from a tax neutrality thanks to the benefit of the tax deferral, a mechanism frequently available to foreign investors in the form of a roll over.

In addition to these technical considerations, these transactions are also a source of complexity in the implementation of incentives mechanisms for French tax resident executives and employees. This last difficulty is particularly underestimated in the preliminary evaluation of the opportunity of a relocation to the United States.

## 1. A difficult recourse to BSPCE, a standard profit-sharing mechanism under French law.

The instrument typically used by start-ups in value or profit-sharing schemes for their employees and/or managers is the "*bon de souscription de parts de créateur d'entreprise*" (BSPCE), issued and allocated pursuant to article 163 bis G of the French General Tax Code, which allows the latter to subscribe, during a given period, to shares of the company at a price set at the time of allocation of the BSPCE (the exercise price).

The BSPCE benefit from a favorable legal regime as there is no limit to the number of BSPCE that can be issued/allocated.

They also benefit from a favourable tax and social security regime after three years of presence in the company, in particular , there is noemployer's social contribution due by the company and, in the current turbulent context of management packages in France, they have the advantage of being legally defined and secured.

To be eligible to issue such instrument, the company must meet certain conditions, including the requirement that at least 25% of the company's capital shall be owned directly and continuously by individuals or by legal entities which are themselves directly held for at least 75% of their capital by individuals[1].

The implementation of a flip makes the recourse to BSCPEs difficult, as :

(i) the new structure makes it unlikely that 25% of the capital of the French company will be held continuously by legal entities, which are themselves directly held for at least 75% of their capital by individuals. This would require that at least 75% of the share capital of the US holding company be held directly by individuals, which in the presence of investment funds, family offices or similar, appears largely theoretical ;

(ii) even if the French company remains eligible for BSPCEs, the allocation of BSPCEs at the level of the French company would give rise to a complex capital structure (at two levels, with potentially only French employees in the share capital of the French company - in addition to the U.S. holding company) requiring, for example, commitments to contribute the shares resulting from the exercise of the BSPCEs to the benefit of the U.S. holding ;

(iii) finally, although French law theoretically allows the application of the preferential tax and social security for BSPCEs for foreign companies granting profit-sharing instruments to French employees, the US company and the instrument used (e.g., warrants) must fully comply with the legal and regulatory requirements applicable to French companies regarding the eligibility for BSPCEs. This situation is rarely implemented in practice.

## 2. The implementation of alternative US law mechanisms

Faced with a complex recourse to BSPCEs, the founders have to decide between the different US law instruments and analyze the transposition of the regime of each instrument into French law, in order to ensure that any preferential tax and social security regime applies to allocations made to French tax residents.

Under US law, the two main[2] types of instruments issued to retain employees and certain managers are (i) shares of restricted stock (or restricted stock units) (RSU) or (ii) stock options (SO).

[1] Article 163 bis G II. 2. of the General Tax Code: "[...] For the determination of this percentage, the participations of venture capital companies, regional development companies and financial innovation companies are not taken into account as long as that there is no relation dependence within the meaning of Article 39(12) between the company benefiting from the contribution and these companies. Similarly, this percentage does not take into account the participations of venture capital funds, specialized professional funds covered by Article L. 214-37 of the French Monetary and Financial Code as it read prior to Ordinance no. 2013-676 of July 25, 2013 amending the legal framework for asset management, professional private equity funds, "sociétés de libre partenariat", local investment funds or innovation investment funds. The same applies, under the same conditions, to participations held by structures equivalent to the companies or funds mentioned in the second and third sentences, established in another Member State of the European Union or in a State or territory that has concluded a tax treaty with France that contains an administrative assistance clause to combat tax evasion or avoidance.

[2] Warrants, which are comparable to "*Bon de souscription d'action*" under French law, are rarely used in the context of employee profit-sharing plans in the United States. In addition, their disadvantageous tax and social security regime under both US and French law (with a risk of reclassification as salary) makes them a largely unused instrument in practice.

RSUs are similar to "*actions gratuites*" under French law, and offer beneficiaries the possibility of becoming shareholders, usually free of charge, after a vesting period, and sometimes subject to compliance with a condition of presence and the achievement of objectives. As in France, they may also be subject to a retention period and regulated by a shareholders' agreement (particularly with regard to the exit).

Stock options are similar to "*options de souscription ou d'achat d'actions*" under French law, and allow beneficiaries to subscribe for or acquire shares, during a given period, at a price set in advance at the time of grant. Once again, a contractual framework is generally provided once the options are exercised and the underlying shares acquired by the beneficiaries.

The implementation of one or more profit-sharing schemes in the context of a fundraising requires (i) an analysis of these various instruments under both U.S. and French law, and (ii) the implementation of both a U.S. plan and a French sub-plan specifically governing grants to French tax residents.

Thus, with regard to French law and in order to benefit from the preferential tax and social security regime, the founders will ensure that the provisions of the sub-plan comply with the conditions set out under articles L. 225-97-1 et seq. of the French Commercial Code concerning RSUs and articles L. 225-177 et seq. of the French Commercial Code concerning stock options. For example, in the case of RSUs, the cumulative duration of the vesting and retention periods must not be less than two (2) years and the grant (i) must not concern employees or corporate officers holding more than 10% of the company's capital, (ii) must not result in a single beneficiary holding more than 10% of the capital, or (iii) collectively, must not represent more than 10% of the company's share capital on the date of the decision to grant (with some exceptions). Concerning stock options, in particular, the total number of options granted and not yet exercised may not give the right to subscribe to a number of shares exceeding one third of the share capital and no allocation may concern employees or corporate officers holding more than 10% of the company's capital (with certain exceptions). It will also be necessary to align the definitions and consequences of any disability, death or retirement of the beneficiary with the French standard and to be vigilant with regard to the process of authorizing the granting of these instruments in order to verify their compliance with French law (especially the duration of the authorization given by the general meeting of shareholders to the Board of the U.S. company), as well as any "acceleration" of vesting in the event of a change of control of the granting company (for example, in order to comply with the cumulative duration of the vesting and retention periods, which may not be less than two (2) years). From experience, while these arrangements may raise questions and make US legal advisors somewhat "uncomfortable" in arranging a US parent plan, in practice they are rarely so restrictive that a French sub-plan cannot be implemented.

With regard to the French tax and social security system, trade-offs can be made in the light of the following considerations:

- first of all, it is almost certain that the absence of a French sub-plan and, more generally, of the benefit of the preferential regime on RSUs or SOs, while not completely excluded for US groups with French subsidiaries that would not wish to change the slightest characteristic of the instruments granted to US employees as well as to French employees, is not conceivable for start-ups. Indeed, the additional cost of employer and employee charges on the acquisition gain realized by the French beneficiaries will undoubtedly be too significant to be contemplated, especially if it remains borne by the French subsidiary employer and is not re-invoiced to the new US parent company;

- even with a sub-plan, the SO regime is not particularly favorable for French beneficiaries, who are taxed as a salary on the acquisition gain and subject to social security charges that are not very different from those under ordinary law. On the other hand, the interest is to be able to support employer's contributions on a reduced basis (market value of the options or 25% of the real value of the underlying shares at the date of grant) when a low valuation of the granting company can be defended, which is obviously the case for start-ups in early stage. Of course, this contribution is payable at the time of the grant, which is a real disadvantage, but in view of recent case law, it is now possible to ask for its restitution if the conditions for exercising the right are not ultimately fulfilled. In this case, the question of the valuation of the stock options will arise, which may be different depending on the approach used (409A valuation in the US vs. valuation by an expert in France);

- with a sub-plan, RSUs remain the most commonly used instrument in a transatlantic context. This is easily explained since the tax and social security regime applicable to the acquisition gain is really more favorable than the regime applicable to a salary/bonus for the beneficiary and the French employer, and all the more so since it is only triggered at the sale of the shares for the former and at the end of the vesting period for the latter.

Of course, more "philosophical" considerations also come into play. RSUs converted into free shares by definition do not require any investment or risk-taking for the beneficiary, granting him a "minimum" benefit in the end, unless the company loses all value. Conversely, stock options may well be worthless if the exercise price turns out to be above the market price at the time of exercise, and the beneficiary will only receive the excess value above the exercise price and not the full sale price of the underlying stock.

## Advantages and disadvantages of alternative instruments under French law

| French law instrument<br><br>US instrument | *Actions gratuites (AGA)*<br><br>Restricted stock units (RSU) | *Options de souscription ou d'achat d'actions*<br><br>Stock-options | *Bons de souscription d'actions*<br><br>Warrants |
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| **Advantages** | - Favourable and safe fiscal and social regime | - Employer's social contribution (30%) higher than AGA's but on a reduced base (if justified by the valuation) | - No specific conditions to comply with<br>- No social security charges, flat tax on capital gains |
| **Disadvantages** | - Low employer's social contribution (20%) but on a potentially higher base (if the vesting is long and/or the increase in value since the grant is high) | - Unfavorable tax and social security regime for beneficiaries<br>- Stock-options valuation issues | - Risk of requalification of the gain as salary for the employees, the greater the link with the employment contract will be established |

Finally, the choice of instrument(s) will also depend on the tax analysis performed at the US level, as US tax residents may also benefit from the management package.

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As a result, these different parameters demonstrate the importance for the founders to analyze the opportunity of accessing a source of financing and/or a US relocation in all its aspects, in particular with regard to the impact on the implementation, in the context of the planned financing round or in the future, of an efficient profit-sharing mechanism for French beneficiaries. All the financial, legal and tax aspects need to be considered at this time and may call into question the relevance or timing of a relocation. This analysis will also help justify, in negotiations with the potential investor, the relevance of maintaining the company's current structure or, failing that, the inclusion in the financing or business plan of an additional envelope to cover any additional costs related to the future profit-sharing scheme to be set up.

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