ESOP – A LOOK ABROAD

Other countries, other customs? In view of the current domestic reform in the area of employee share ownership, it is worth taking a look at other legal systems. We made enquiries in our network and received exciting answers on the design of employee programmes around the world. In the following, we focus on the most common implementation of employee share ownership programmes in the start-up industry of the respective country. This overview, based solely on the information from our survey, is partially simplified and not exhaustive.

To begin with, even the prevalence of employee share ownership programmes varies greatly. While in Israel, regulations for the promotion of employee share ownership programmes have been in place for more than 30 years and are used as standard in the start-up scene there, in Latvia, for instance, the application of employee share ownership programmes is rare. This is also reflected in the different density of regulations. While countries such as France, Sweden and the UK even have specially created share types, many countries, such as Estonia or Latvia, have only a few tax regulations. What is striking: Not one of the countries we covered has no special regulations on employee share ownership programmes at all. Despite varying relevance in country practice, the importance of employee share ownership programmes is recognised everywhere, at least to some extent.

This is also illustrated by the fact that employee share ownership programmes have often been part of new legislation in recent years. For instance, new legal frameworks were created in France in 2015, in Sweden and Poland in 2018 and in Finland in 2021.

The main reasons for these new legislative initiatives were the elimination of dry income (in the case of Finland and Poland) or even the creation of separate share/option types (France, Sweden). In France, there is also an obligation for companies with more than 50 employees to have them participate in the profits. This can be done through bonus payments, but also through employee share ownership programmes.

DRY INCOME

Dry income arises when an employee receives a monetary benefit, e.g. through the transfer of options/shares at a discount, without receiving any liquidity. The employee must pay tax on the monetary benefit at his income tax rate, regardless of whether he has the necessary liquidity.

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WEAKNESSES AND STRENGTHS OF THE INDIVIDUAL LEGAL REGIMES

If we ask our colleagues about the main weaknesses and strengths of their jurisdictions regarding employee participation, parallels can be found. In countries that have created their own share/option types, the ease of implementing employee schemes is seen as a particular advantage. In general, tax incentives in particular are appreciated. Thus, 75 % of the colleagues surveyed perceive the tax advantages as the greatest strength of employee participation in their country. Interestingly, the challenges also seem to be

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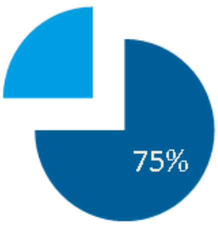
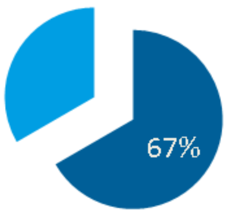


66.66 % feel that the scope of the tax incentive is misplaced



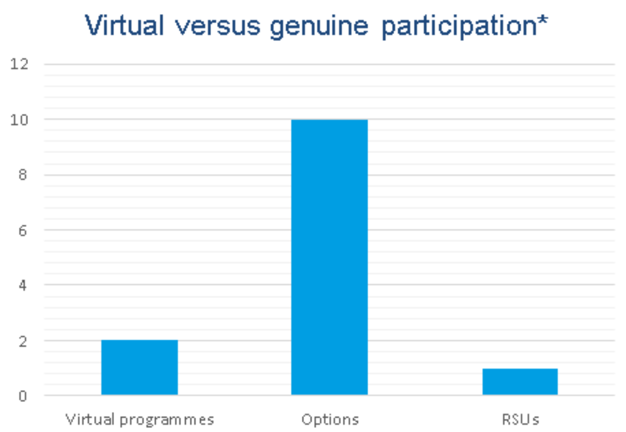
similar across the individual countries. As many as two thirds of the people surveyed say that the conditions entitling them to tax incentives are misplaced.

This is due to, among other things, certain requirements on the holding period of options/shares (Israel), requirements on the enterprise value (Austria), requirements on the legal form (Poland), on the status as an employee of the issuing company (Lithuania), on regulatory reporting obligations (Estonia, Latvia), and on the obligation to offer programmes to a majority of employees (Finland). In addition, the occurrence of dry income (Austria, Switzerland), dilution (USA) and the fact that invested shares simply expire on exit (Sweden) were cited as the biggest disadvantages.

It becomes apparent that other legal regimes are facing similar challenges as the German legislator. The dry income issue dealt with in the reform, which is still preoccupying Austria and Switzerland and has also only been eliminated in other countries by recent legislative changes, illustrates this in an exemplary manner. In addition, the German discussion on the conditions under which tax incentives for employee share ownership programmes are justified (companies, maximum 10 years after foundation, SMEs) can also be found in the international context.

VIRTUAL VERSUS GENUINE PARTICIPATIONS

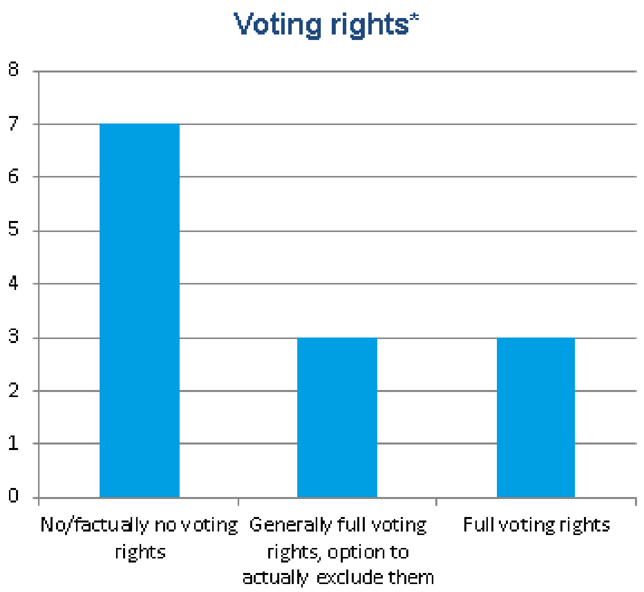
When implementing an employee share ownership programme, the following basic question must be clarified: What type of participation does one choose? A distinction is made here between virtual and real participations. Virtual participations replicate the cash flows (i.e. dividends/sale proceeds) of real shares only in terms of contractual obligations. In the case of real participations, either options (often in the form of restricted stock units, RSUs) or genuine shares are issued directly. In international country practice, forms of genuine participation are significantly more popular. This is partly because they are specifically subsidised by the respective legislators. As in Germany, virtual programmes are usually subject to taxation according to the unfavourable income tax. Solely their flexibility and the possibility of avoiding dry income leads to virtual programmes also being used, at least in part, in the countries we surveyed. This is the case in Austria, Poland and Switzerland.



* Result of the survey in 12 countries: In Switzerland, options and virtual programmes are equally relevant in practice.

SHAREHOLDER RIGHTS

Employee share ownership programmes are structured differently as regards the employees' shareholder rights. This is of particular relevance, as companies have an interest in keeping the shareholder structure as simple as possible in view of potential investors and agile decision-making processes. Virtual programmes have the advantage that shareholder rights are not transferred in the first place. Our colleague Philip Rosenauer considers this, along with formal requirements, to be the reason why virtual programmes have become established in Austria. But even in countries where forms of real participation are most common, it is not uncommon to find ways to circumvent voting rights under employee share ownership programmes. This way, the models of genuine participation are approximated to some extent to those of virtual programmes. In Lithuania, for instance, options may only be exercised in the event of a change of control. They must then be sold immediately after exercise. Hence, shareholder rights in fact never exist. In other countries there are full shareholder rights which can be excluded if necessary. And finally, there are countries in which employees simply have full shareholder rights. This is the case in Switzerland, for example, which is why share options and virtual programmes are equally popular there.



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The actual arrangements in Israel and Latvia are particularly interesting. In Israel, shares are administered by a trustee. The shareholder rights are exercised by a manager, often the chairman of the board, by power of attorney. In Latvia, there are different ways to circumvent shareholder rights. On the one hand, it can be contractually agreed that the minority shareholders are obliged to vote in the same way as the majority shareholder. On the other hand, it is possible for the majority shareholder to exercise voting rights by power of attorney.

In Germany, such an arrangement would only be possible in part: e.g. in the case of the GmbH, shares could not be fully administered by a trustee, since absolute and relative inalienable rights are inherent in the shares. This is one of the reasons why virtual programmes are very popular with start-ups in practice. If real shares are granted, there is the possibility in Germany to bundle the shares of all employees in an employee company and thus minimise the complexity of the shareholder structure.

FINANCIAL PARTICIPATION

The ways of financial participation do not differ significantly in the country practices we studied. In forms of genuine participation, the employee benefits through dividend payments and the sale of shares. In virtual programmes, these payments are replicated. In some cases (e.g. Poland) there are no dividend payments for employees, and in the USA the dividends from an RSU are held in a trust account until they are released.

STRUCTURING DETAILS

Vesting is used in each of the countries examined here. The structure is quite similar: usually there is a cliff of one year and then a vesting period of three to four years. Vesting/holding periods are often due to tax rules. The question of how to deal with vested shares in the event of a change of control of the company is, though, handled differently. In France and Lithuania, there are often acceleration clauses so that all share options are released upon a change of control. In Sweden, however, such options expire without compensation.

Good leaver/bad leaver provisions are often used in the event of termination of employment, for instance in Poland, Finland and Switzerland. In Sweden, all shares and options lapse if the employee resigns within three years; there are no good leaver/bad leaver arrangements possible here, which is strongly criticised in the country. The German draft reform provides for a shift in the taxation of the monetary value benefit when shares are transferred. The employer will only have to pay taxes after ten years/ at the time of an exit/change of employer. In this context, it is criticised in particular that the early taxation in the case of a change of employer also accrues if the separation is on good terms. In view of the regulations in other countries and the dynamic developments in the start-up sector, there is a need for change here. In principle, however, it is possible to agree good leaver/bad leaver clauses in Germany without further ado.

TAX TREATMENT

The tax framework is a decisive factor in determining which form of employee participation will prevail. In the following, we have looked at the most widespread form of employee participation in the start-up sector in each country. We have assumed the best case scenario for tax purposes. This presentation cannot capture the complexity of the respective tax system, but it should provide a simplified overview of the tax mechanisms and subsidies of the individual countries.

In each of the countries we studied, tax regulations have been established specifically for employee share ownership programmes. The tax burden, though, differs considerably. In Austria, as in Germany to date, virtual programmes with correspondingly high taxation have prevailed despite tax advantages for genuine programmes. In Austria, for instance, any cash flow that reflects genuine shareholdings is taxed at up to 55% (in Germany: up to 45%). In Switzerland, where options and virtual shares are equally popular, the tax burden on virtual programmes is 32.8 - 42.8 %, depending on the canton. In the case of forms of real participation, be it genuine shares or options, one construction is particularly widespread: If special conditions are met, the granting of options is tax-free; moreover, no payment is due to the authorities when the options are exercised or RSUs are transferred. The employee is only asked to pay when the shares are sold. The tax burden is usually between 20 and 40%.

There are specific features in Switzerland and the United Kingdom. In both countries, the monetary benefit that the employee receives when an option is transferred to him or her below market price must be taxed at the time the option is exercised (in Switzerland, depending on the canton, at 32.8 - 42.8 %, in Great Britain at up to 53.8 %). However, if special conditions are met, the sale of the shares in Switzerland can be completely tax-free. In Great Britain, within the framework of the EMI options, the tax burden on the sale of shares is 10% under certain conditions.

One of the main triggers for the upcoming reform of employee share ownership in Germany is the dry income issue. This is already avoided in most countries by taxation only becoming due at the time of sale of shares and thus at a moment of inflow of liquidity. In Austria and Switzerland, the dry income issue still exists, which is why virtual programmes are very relevant in practice there. But also in Great Britain taxes must be paid when an option is exercised. Here, this leads to options being exercised only immediately before an exit.

Special requirements for tax incentives can be found in the table. These vary considerably. Depending on the country, a wide range of companies benefit or merely very few. In Poland, for example, the tax incentives are tied to the legal form of a joint-stock company. However, this is not a typical legal form for start-ups, so they can generally not benefit. As mentioned above, these requirements are often met with strong criticism in the respective countries.

	Israel	Estonia	Latvia	Poland	USA	Lithuania	Finland
Type	Options	Options	Options	Options	Options	Options	RSU
Tax burden when options are transferred	Tax-free	Tax-free	Tax-free	Tax-free	Tax-free	Tax-free	Not relevant
Tax burden when options are exercised	Tax-free if the requirements of the tax incentive (Section 102) are met	Tax-free if the requirements of the tax incentive are met	Tax-free if the requirements of the tax incentive are met of the special regulations are met	Tax-free if the requirements of the tax incentive are met	Monetary benefit according to AMT (Alternative Minimum	Tax-free if the requirements of the tax incentive are met	Tax-free if the require-ments of the tax incentive are met
Tax burden when shares are sold	Capital gains tax: 25%	Income tax: 20%	Capital gains tax: 20%	Income tax rate: 19%	Capital gains tax for ISO (Incentive Stock Options)	Income tax: 15-20% plus Social security contributions: 19.5% - 22.5%	Capital gains tax: 30 - 34%
Most important prerequisites for the tax incentive	▪ Development of a plan, which must be approved by the tax authority ▪ Appointment of a trustee who is also responsible for ensuring the payment of taxes ▪ Establishment of a lock-up period of two years (exception: exit/co-sale obligation) ▪ Notification of the tax authority about granting of options 45 days in advance	▪ Exercise of options takes place three years after they are granted ▪ In case of complete exit before expiry of the three-year period: taxation of the monetary benefit pro rata	▪ Minimum term of the vesting period: twelve months ▪ Employment of the employee with the company for the entire twelve months ▪ Duty to inform the tax authorities ▪ Options are exercised within six months after termination of the employment relationship	▪ Implementation by joint-stock company with registered office in Poland ▪ Adoption by resolution of the general meeting of the joint-stock company/its parent company	Yes	▪ No exercise of options within three years after they are granted ▪ Conclusion of the ESOP agreement after 1 February 2020 ▪ Employee has exercise right but not obligation	▪ No applicability to listed companies/subsidiaries ▪ Option for majority of employees to participate ▪ Amount of participation dependent on objective conditions

	UK	France	Sweden	Austria	Switzerland		Deutschland	
Type	Qualified options (EMI)	Qualified options (BSPCE)	Qualified options (kvalificerade personaloptione)	VSOPs	Options	VSOPs	VSOPs	Genuine shares* *(According to the FoStoG (German Fund Location Act))
Tax burden when options are transferred	Tax-free	Tax-free	Tax-free	Tax-free	Tax-free	Tax-free	Tax-free	Not relevant
Tax burden when options are exercised	Monetary benefit upon granting of options Income tax: up to 40% plus Social security contributions: up to 13.8%	Tax-free if the requirements of the tax incentive are met	Tax-free if the requirements of the tax incen-tive are met	Not relevant	Monetary benefit upon granting of options Income tax: 20% to 30% plus Social security contributions: 12.8% depending on canton	Not relevant	Not relevant	Income tax: up to 45%, but deferral of taxation: only due on sale/change of employer/after ten years
Tax burden when shares are sold	Capital gains tax: 10% *Business asset disposal relief, prerequisite: Employee was employed by company for at least two years before sale, otherwise 20%	Income tax: 12.8% plus Social security contributions: 17.2% *or 30% if employee had been employed by company for less than three years at time of sale	Capital gains tax: 25% (may vary from 20% to 50%)	Sale proceeds are reflected: Income tax up to 55%	Tax-free if the requirements of the tax incentive are met	Income tax: 20% to 30% plus Social security contributions: 12.8% depending on canton	Sale proceeds are reflected: Income tax up to 45%	Capital gains tax: 25%
Most important prerequisites for qualified options	▪ Maximum 250 employees ▪ Gross assets of less than GBP 30 million ▪ Exclusion of certain business sectors: Real estate and financial services ▪ Weekly working hours: At least 25 h/week ▪ Exercise of options possible within 10 years ▪ No control of the company by another company ▪ Maximum size of participation scheme: GBP 250,000 per employee, total GBP 3 million	▪ Foundation of the company less than 15 years ago ▪ Shareholder structure: At least 25% of shares held by individuals or companies that are at least 75% owned by individuals ▪ No stock exchange listing or listing on a regulated EU market ▪ Capitalization of less than EUR 150 million ▪ Scope of application of French corporate income tax	▪ Term of employment of the employee with the company: At least three years ▪ Weekly working hours: At least 30 h/week ▪ Minimum salary of the employee: SEK 890,000 in three years ▪ Maximum participation of the employee: 5% ▪ Maximum size of participation scheme: SEK 3 million per employee, total SEK 75 million. ▪ Limited liability company of smaller size (less than 50 employees and net sales or balance sheet total max. SEK 80 million in the last financial year before issue) ▪ Active for a maximum of 10 years ▪ Exclusion of certain business activities: Banking or financing activities, real estate trading, trading in financial instruments, real estate leasing	No tax incentives for VSOPs, but genuine participations are subsidised by, among other things, an allowance of EUR 3000 if the participation programme is made available to a larger number of employees and the shares are held for at least five years.	Minimum holding period after exercising the option: Five years	No tax incentive	No tax incentive	Foundation a maximum of 12 years ago, SME definition fulfilled

CONCLUSION

The structuring of employee share ownership programmes in international practice is diverse and multi-faceted. Nevertheless, similar problems and thus some parallels can be identified. The key elements are: Tax incentives, their scope, especially with regard to dry income, and the handling of shareholder rights.

An international comparison shows how urgently Germany needs reform in the area of employee participation. Genuine forms of participation are, in contrast to the virtual participation established in German practice, the international standard. The tax burden of virtual programmes in Germany is not competitive. According to the current status of the draft reform, this will change to some extent: By eliminating the dry income problem for a large part of the practical application cases, forms of genuine participation will become more attractive. Yet, in contrast to the majority of other countries, the monetary benefit will also be taxed in these cases. Here, countries such as Lithuania, Finland, France, Israel, Sweden, Estonia, Latvia and Poland remain more attractive.

The FoStoG passed by the German Parliament on 28 May 2021 is a step in the right direction. However, a look at France and Sweden, for instance, reveals that much more innovative approaches would be possible with the creation of a separate type of share specifically for employee participation in young companies. In both countries, the legislation on this is still comparatively young. Overall, employee share ownership schemes are the subject of current legislation in many countries. Germany‘s reform project is in line with this. This is indeed high time, considering that in Israel, for instance, there has already been a systematic promotion of employee share ownership programmes for 30 years.