SWEDEN

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Q&A

Please provide a brief overview on how an ESOP in a start-up is usually structured in your jurisdiction (of particular interest: virtual or real participation programs, market practice with regard to vesting, participation (exits, proceeds and dividends) and voting rights).

• Under Swedish law, a company cannot have a "pool" of already issued employee options held by the company and then allotted to employees at various point in time (cf. US-style schemes). As a starting point, the company will need to issue new options at each point in time options are to be allotted to the employee.

• There are several structuring options for employee equity incentive schemes (warrants, em-ployee options, qualified employee options, synthetic options, share-based vesting schemes etc.). Real participation schemes are most widely used (cf. synthetic/virtual programs).

• Issuance of warrants used to be the most common scheme for incentivizing employees in start-ups in Sweden. However, warrant programs typically require an initial investment by the employee in order to achieve a favourable tax situation. Accordingly, after critique that the available employee equity incentive schemes put Sweden at a competitive disadvantage in terms of attractiveness as a location for start-ups compared to other jurisdictions, new and more beneficial tax regulations for Swedish start-ups issuing qualified employee stock options ("QESO", Sw. kvalificerade personaloptioner) to employees came into force in January 2018.

• In short, if the company and the employee meet certain criteria (detailed in law), the company can issue QESO to the employee for free, which gives the employee the right (but not the ob-ligation) to purchase newly issued shares in the company for a fixed-price (i.e. strike price, typically almost zero) at a fixed date 3-10 years into the future (i.e. vesting). The QESO implements cliff vesting as a general rule.

• The QESO-legislation is rather new and there has not been a lot of case law developed around it. The legislation is ambiguous in parts, leading to some uncertainty in the implementation of QESO in practice (primarily as relates to hedging of the program). We have no official statistics on the adoption rate of QESO, but from our experience, it has not been as widely adopted as was probably intended for. The amount of matters relating to the adoption of QESO-schemes has however picked up recently. However, traditional warrant-schemes are still widely used in start-ups.

• QESO schemes are (generally) entirely agreement based and not registered with the Swedish Companies Registration Office. Agreements are entered into with the employees, and thus the QESOs are “issued” by the company’s board of directors. No shareholder mandate to issue QESO is required. If a sale of the company occurs before the QESO have vested, the stock options may become invalid and thus worthless (however depending on how the sale is structured). This is one major critique against the legislation.

• As previously stated, QESO legislation has received criticism for its design and scope (not all start-ups qualify to use QESO).

• Main features of QESO structure – important to note that the features are mandatory and set out in law

    o Minimum three-year vesting with a maximum maturity of 10 years. If an employee quits before the end of the initial mandatory minimum three-year vesting period, the stock options will become invalid (no good leaver / bad leaver mechanism during that period can be implemented). The three-year mandatory minimum vesting period is thus in practice a cliff for the options.

    o There are prerequisites on the company when issuing the QESO - e.g. needs to be an unlisted limited liability company of smaller size (less than 50 employees and net sales or balance sheet total max. SEK 80 million, during the previous financial year before the issue of QESO) and must not have conducted operations for more than 10 years. Moreover, companies conducting certain types of business are disqualified from issuing QESO - e.g. banking or financing business, real estate trading, financial instrument trading, real estate leasing.

    o The value (calculated according to a special rules) at the issuance of the QESO-scheme is a maximum of SEK 3 million per employee and a maximum of SEK 75 million for all employees.

    o Main prerequisites regarding the employee (i.e. the option holder):

        - Employed during the initial three-year vesting period – if the employee leaves during this period, the options automatically become invalid and cannot be used.

        - At least 75% of a full-time job during the initial three-year vesting period (i.e. 30h per week).

 The employee needs to receive a minimum salary amount during the initial three-year vesting period (currently approx. SEK 890,000 in total the period)

 The employee or its related parties may not own or control, directly or indirectly, more than 5% of the shares or votes in the company. This disqualifies most founders from QESO-schemes.

 There is uncertainty on how to handle QESO when employees are not working from and taxed in Sweden. The QESO is intended for Swedish companies with Swedish employees, and may not work if the employee works from abroad (this is still to be clarified in case law).

o No protection from dilution.

o Regarding participation, there are no voting rights attached to the QESO.

o The options are tied to employment and cannot be sold.

o Market practice is not set, as the rules have not been in place for that long. However, from our experience to date,

 Options are usually sold at quota value or current market value.

 Most programs mature after the three-year initial mandatory vesting/cliff. If the vesting is set to longer than three years, however not common, the QESO may be made subject to reverse vesting after the three-year cliff.

Please provide an overview of the respective tax situation an employee finds him-/herself in when he/she participates in a real/virtual equity investment program (applicable taxes and approximate tax burden (a) at the time of the investment and (b) at the time when revenues therefrom are received).

• The benefit, i.e. the allotment of the QESO to the employee at no cost/premium, is tax-free. The future value increase of the shares is taxed as capital gains if and when the employee sells the shares in the future. The applicable capital gains tax is often 25 %, but may range from 20 % to just over 50% depending on factors such as company ownership structure, employee wages, municipal tax, etc.

Are there any tax advantages for an employee if the revenues based on the equity investment are reinvested in start-ups or other companies?

• Not connected to the QESO rules. There are however separate (and unrelated) investor deduction rules when an investor acquires shares in a company of a smaller size in connection with the company's formation or a new share issue.

Are there any tax advantages for the company if an ESOP is established in the company?

• Not *per se*. However, compared to traditional warrant schemes if not priced at market value, QESO-schemes are tax-beneficial for the company, as the company does not need to pay social security contributions if the option is not priced at market. Traditional warrants, when not priced at market, are taxed as salary (i.e. a tax effect for both the employee and the company - approx. 55 % income tax for the employee plus approx. 31 % social security contributions for the company).

Please highlight one pro and one con of the legal set up with regard to ESOPs in your jurisdiction.

PRO: Tax beneficial and relatively easy and cheap to implement, compared to traditional warrant schemes.

CON: The design of the QESO-schemes is often to the detriment of the holder (i.e. employee), minimizing the impact of the incentive. For example, if a sale of the company occurs before the stock options have vested (minimum 3 years), the stock options in many cases become invalid and thus worthless (depending on how the sale is structured). Moreover, the three-year initial mandatory minimum vesting/cliff is a long time in a start-up where employees with different skill sets are required in different stages of maturity and growth – in some cases employees will have moved on before the three-year vesting/cliff.