The Structure of Employee Share Ownership Programmes in Start-ups and SMEs in the Light of the Reform

Employee share ownership programmes have the potential to bring benefits and opportunities for all parties involved.

Young companies can use employee share ownership programmes to compensate for competitive disadvantages. Often they can hardly compete financially against established companies in the market for the best talent. So to compensate for this deficit in the fight for highly qualified skilled workers, other means of incentivisation are needed: Companies offer potential employees a shareholding in their company as an attractive supplement to their salary. This way, highly qualified employees can be attracted without the fixed salary costs becoming too high for the young company.

We all work with greater motivation when we participate directly in the fruits of our labour. The employee can thus be successfully motivated and tied to the company through participation in companies, as he or she shares in the financial success of the same. This leads to lower fluctuation, lower sick leave and growing willingness to work. The employee is not only working for his employer, but also for himself. This leads to an increase in productivity and personal satisfaction of the employee. Not least, employee share ownership programmes also mean the opportunity for private wealth accumulation for the employee.

However, employee share ownership programmes do not only offer advantages to those directly involved. Employee share ownership also means promoting innovation. Good framework conditions for employee programmes can prove to be a locational advantage for a sustainable start-up ecosystem. Employees often become entrepreneurs themselves through employee share ownership programmes, either by founding new companies themselves or by reinvesting the wealth they have gained through their share ownership in other start-ups.

To ascertain the impact of the reform on the structuring of employee share ownership programmes, this paper first looks at the **requirements** that are fundamentally placed on employee share ownership (cf. 1). This is followed by a presentation of the **current structures** of employee share ownership programmes (see 2) as well as a brief description of the **reform** (see 3). The article concludes with an outlook on whether and to what extent the planned reform will lead to changes in the structuring practice (cf. 4).

1. REQUIREMENTS FOR EMPLOYEE SHARE OWNERSHIP PROGRAMMES

To achieve the aforementioned benefits and opportunities, there are some requirements to be met by the framework conditions of employee share ownership programmes. The form and structure of the employee share ownership programme must

in particular not give rise to negative effects on the employee which counteract the purpose of incentivisation.

In this respect, the following issues should be taken into account:

- Taxes
- Formal thresholds
- Options for flexible arrangements
- Competitiveness in international comparison

1.1 Taxes

The tax structuring is crucial. From a tax point of view, the following objectives are particularly desirable: Firstly, it should be avoided that the employee receives a taxable monetary benefit without actually receiving liquidity at the same time (so-called dry income problem). Secondly, the tax burden for the employee should be as low as possible. The employee should not be placed in a worse position with regard to his shareholding in the company than the founders themselves.

1.2 Formal thresholds

In addition, the implementation of an employee share ownership programme must be feasible for the parties. This means a minimum of formal requirements, preferably without an appointment with a notary.

1.3 Options for flexible arrangements

Especially for the founders/shareholders, a flexible structure with regard to participation rights under corporate law is crucial.

1.4 Competitiveness in international comparison

In addition to these considerations, it is also decisive that employee share ownership programmes are also competitive in international comparison in order to retain skilled workers in Germany as a business location.

The combination of these factors makes employee share ownership programmes attractive for skilled workers and companies and thus determines which form of employee share ownership will prevail in the future.

2. CURRENT STRUCTURES OF EMPLOYEE SHARE OWNERSHIP PROGRAMMES

There are almost no limits to the imagination when it comes to the (legal) structuring of employee share ownership programmes. However, there are essentially three different basic models for setting up an employee share ownership programme: "Genuine" company shares, share options (ESOPs, Employee Stock Option Plans) and virtual employee share ownership programmes (VSOPs, Virtual Stock Option Plans).

Each of these basic models leads to different consequences in terms of taxation, applicable formal requirements and freedom of structuring. In the following, we will outline the three basic models and address the options for deviating from the current legislative conception in each case.

2.1 "Genuine" company shares

Genuine shares have the advantage that they are the most concrete for employees and thus provide the highest incentive.

2.1.1 Taxes

However, they usually lead to the dry income problem mentioned above: the shares are usually granted to the employee at a discount (e.g. at par value) or free of charge by the company. This "discount" that the employee receives on the shares represents a so-called monetary benefit, which as such is taxable for the employee. The tax office bases the time of taxation on the inflow of the taxable monetary benefit. This happens at the time of the transfer of beneficial ownership. In the case of genuine shares, this is usually the time of the transfer of the shares, as all rights deriving from the shares (right to receive profits, participation and voting rights) are transferred to the employee. The problem for the employee is that he/she has gained a taxable monetary benefit without having received liquid funds from which he/she can pay this additional tax burden. Moreover, the amount of tax to be paid cannot be ignored or disputed: in the view of the tax offices, the monetary benefit is income from (salaried) employment, which is taxable at the personal income tax rate. If, for instance, the employee receives 1 percent of the shares of a company free of charge, which is already worth EUR 10 million at the time of the transfer, the employee must pay tax on the monetary benefit, in this case EUR 100,000, at his/her income tax rate. Assuming an income tax rate of 42 percent, the employee must pay EUR 42,000 in taxes. This is a considerable burden, since at this point in time no liquidity is flowing to him/her. It should also be noted that many employees who decide to take a job at a start-up often come straight from university and consequently have not yet been able to build up private assets to easily bear the sudden tax burden.

To ease this tax burden, companies offer loans to their employees, which are paid for by withholding a portion of their salary each month.

Through an appropriate legal structuring, it is theoretically possible to exclude these profit withdrawal, participation and voting rights under corporate law to the greatest possible extent and thus also to prevent the transfer of beneficial ownership. The employee would de facto be the owner of the shares and would not have to pay tax on them because of the lack of beneficial ownership. Although this would eliminate the previously described tax dry income problem, in practice this arrangement is extremely unattractive, since a genuine equity participation without any profit or voting rights has no incentive effect.

Therefore, if a company decides to structure the employee share ownership programme as a genuine equity participation, the associated taxable monetary benefit would rather be accepted, even if the positive effect on the employee might be partially reversed, as often considerable liquidity is already required in order to pay tax on the monetary benefit through the inflow of the shares. Such taxation of the monetary benefit is based on the tax rate applicable to salaried employment (i.e. up to 45 percent). Dividends and increase in value are then taxed at the considerably lower capital gains tax rate of 25 percent.

2.1.2 Formal thresholds

The transfer of genuine shares is subject to the formal requirements under corporate law that apply depending on the form of company. For the limited liability company (*GmbH*) as the most common form, this means a notarial authentication and the submission of a new list of shareholders to the commercial register.

The statutory formal requirements cannot be circumvented even by special structuring of the transfer. For the transfer of genuine shares, the notarial appointment is unavoidable.

2.1.3 Options for flexible arrangements

As a rule, company shares go hand in hand with participation rights under corporate law. The increased issuance of (genuine) employee shareholdings consequently leads to a higher number of shareholders and thus also to higher administrative expenses. This is because each shareholder has all the rights of co-determination and participation. This can complicate decision-making processes, as the GmbH, for instance, is designed for a manageable, personalistic group of shareholders. In addition, too large a group of shareholders can have a detrimental effect on potential investors.

This problem can be countered by bundling the employees' shareholdings in an employee-owned company. Consequently, the employees do not have a direct stake in the company, but rather an indirect one via an employee company. This means that the company is not confronted with a large number of new shareholders, but that the interests of the employees involved are represented by a single legal entity.

2.1.4 Competitiveness in international comparison

Abroad, forms of genuine share ownership are the rule, so that international employees in particular expect this kind of shareholding.

2.2 ESOPs

In contrast to the transfer of genuine shares, ESOPs grant a claim under the law of obligations to the transfer of shares. In the case of a GmbH, for instance, this can be implemented through the creation of authorised capital. This works in such a way that the managing director is already authorised in the articles of association to issue new shares without the need for further shareholder resolutions.

2.2.1 Taxes

The employee has neither voting nor participating rights prior to exercising the option. Consequently, beneficial ownership is not already transferred when the option is granted, so that the tax dry income problem does not initially materialise here. At the time of exercising the option and transfer of the shares, the employee must pay tax on the monetary benefit corresponding to the genuine share. The monetary benefit resulting from the difference between the market value at the time of exercise and (the previously agreed) strike price is taxed as income from salaried employment. This puts participants in ESOPs in a worse position than employees who receive genuine shares. They must pay tax at the higher income tax rate on the increase in the value of the company shares between the granting of the share option and its exercise.

2.2.2 Formal thresholds

When granting the share options, formal requirements must also be taken into account (in the case of the GmbH: notarial authentication). And also when exercising the options, e.g. in the case of the GmbH, the use of the authorised capital must be registered with the commercial register, and in addition the new list of shareholders must be submitted to the commercial register.

2.2.3 Options for flexible arrangements

Since the share options are/can usually only be exercised upon exit, the question of participation rights under company law does not arise. Here, too, it would be possible to reflect the participation and profit participation rights under corporate law by means of agreements under the law of obligations. Depending on the structure, however, this would again lead to an immediate transfer of beneficial ownership and thus to immediate taxation. For this reason, a genuine equity participation could then be agreed from the outset by issuing genuine shares, as the workaround via the options in conjunction with agreements under the law of obligations would not offer any added value.

2.2.4 Competitiveness in international comparison

In principle, share options are also common in the international environment but in Germany a large part of the tax burden is incurred at the time the option is exercised. In the international environment, it is common for employee programmes in particular to be promoted by options in the start-up sector in that no tax burden is incurred even when the option is exercised, but only when the shares are sold. Germany is not competitive in this respect.

2.3 VSOPs

Now, **VSOPs** merely represent a claim under the law of obligations to a monetary amount, i.e. a share in the proceeds, the amount and maturity of which replicate genuine shares. The parties involved are completely free to decide on the concrete structuring.

2.3.1 Taxes

The employee can either be treated one-to-one like a true shareholder and also participate in the current profit and dividends or only participate in the proceeds in the event of an exit. Here it is advantageous that the dry income issue can be avoided through appropriate structuring (essentially no granting of membership rights).

However, all cash flows (i.e. also any replicated dividend payments and increases in value) must be taxed as income from employment. Also, since VSOPs are profit-sharing schemes in themselves, which only imitate genuine employee share ownership, they do not benefit from the tax allowances that apply to genuine employee share ownership.

2.3.2 Formal thresholds

There are no legal formal requirements. This allows for flexible handling. However, at least written agreements are recommended.

2.3.3 Options for flexible arrangements

In principle, the parties are completely free to choose the concrete arrangement of the virtual employee share ownership programme. There are no statutory participation rights under corporate law. Theoretically, though, these rights can be replicated through agreements under the law of obligations (the tax consequences must be taken into account here).

2.3.4 Competitiveness in international comparison

Such an arrangement is not competitive with genuine shares, especially for international talents.

Despite these disadvantages, employee share ownership programmes in the form of VSOPs have become established in the practice of start-ups in Germany.

	Genuine shares	ESOPs	VSOPs
Taxation			
Dry Income Issue	Yes, directly at the time of transfer of the shares	Yes, at the time of exercising the option	No
Threshold Amount	Yes	No	No
Tax rate	At the time of transfer: Income tax rate In the case of subsequent profit distributions: Capital gains tax rate Proceeds of sale in the event of an exit: Capital gains tax rate	At the time of the occurrence/granting of the income under the law of obligations: no taxable inflow Upon exercise of the option: Total increase in value from granting of the option with income tax rate Proceeds of sale in the event of an exit: Capital gains tax rate	All income from the virtual participation is taxable at the income tax rate
Formal requirements (based on the example of a GmbH)	Notarial authentication, entry in commercial register	Notarial authentication, entry in commercial register	No formal requirements
Participation rights under corporate law	Generally yes; can be bundled through employee shareholding company	Generally only after exercise of option	Generally no, but can be replicated under the law of obligations (possible tax consequences to be

			taken into account)
Competitiveness for talent in international comparison	high	moderate	low
Overall attractiveness	Basically the best way to motivate and retain staff, but dry income makes it impracticable.	Not attractive due to formal requirements and unfavourable taxation.	At present usually most attractive due to flexibility, lack of dry income problem and lack of alternatives despite considerable tax burden

3. THE REFORM - A SHIFT IN PARADIGM?

As we have just shown, there is already the possibility of alleviating some of the negative aspects of the current legal framework through a clever legal arrangement of employee share ownership. Nevertheless, each of the options discussed is deficient. In this respect, virtual employee share ownership has often turned out to be the most attractive model. However, in view of international competition, there is an urgent need to make genuine shares more attractive.

This has also been recognised by the legislator. On 1 July 2021, the new German Fund Location Act (*Fondsstandortgesetz - FoStoG*) has come into force. This includes a reform of employee share ownership. The Federal Ministry of Finance first published the draft bill on 3 December 2020. The Federal Cabinet approved the draft on 20 January 2021, the Federal Parliament on 22 April 2021 and the Federal Council on 28 May 2021. This current reform does not change the framework conditions of ESOPs and VSOPs. It does, though, address the tax problems related to the genuine share ownership. By increasing the tax-free amount from EUR 360 to EUR 1,440 in Section 3 No. 39 German Income Tax Act (*Einkommensteuergesetz - EStG*), the employee's tax burden is reduced and the dry income issue is to be alleviated by a provisional non-taxation. This addresses one, if not the main obstacle of the genuine shares.

3.1 Tax allowance

By amending Section 3 No. 39 EStG, the current tax-free allowance was raised from EUR 360 to EUR 1,440. The German government's draft had provided for an allowance of EUR 720. This was moved to international standards in the course of the legislative process due to criticism, which pointed in particular to the tax allowances in international comparison (Austria: EUR 4,500 - 7,500; Italy: EUR 2,100).

The prerequisite for tax incentives through tax allowances is that the share ownership is open to at least all employees who have been in a current employment relationship with the company for one year or more without interruption at the time of the announcement of the offer. The definition of employee under tax law applies, so that e.g. employees in marginal employment or trainees are also covered. In practice, this requirement may be an obstacle to benefiting from the tax allowances. Should start-ups, for instance, decide to bind only employees from a certain occupational group to the company through an employee share ownership programme or to involve only executives, they cannot draw on the tax allowances.

3.2 Provisional non-taxation

As a result of the reform, the time of taxation of the monetary benefit arising from the transfer of shares at a reduced rate is postponed. This is only done with the consent of the employee through exemption in the wage tax deduction procedure. A subsequent catching-up of the provisional non-taxation within the framework of the assessment for income tax is excluded. The provisional tax exemption is not accompanied by exemption from social security contributions. Social security contributions must be paid at the time of transfer of shares. In practice, this can lead to additional work and bureaucratic processes and thus prevent start-ups from launching programmes with genuine share ownership. In connection with its approval of the FoStoG, the Federal Council has also decided to ask for the implementation of a joint regulation for tax and social security aspects.

Taxation only occurs in the event of an exit, a change of employer or after a period of 12 years after the transfer of the shares. The employee in the above example would therefore only have to bear the tax burden of EUR 42,000 if there is an exit (in which case liquidity could also flow to him), if he/she changes his/her job or after 12 years have elapsed. Although it is questionable why the employee should be "punished" with the immediately accruing tax burden in the case of a change of employer, there are relevant rules on vesting, including the consideration of good and bad leavers. In the course of the legislative process, this problem was also recognised and an attempt was made to mitigate it in that, if the employer assumes the wage tax in this case, this assumed deduction amount is not part of the taxable salary. From the perspective of the employee, it therefore makes sense to agree on an obligation on the part of the employer to take over the tax when changing employer. Since the assumption of wage tax by the employer will not necessarily be the rule, this problem has not been finally solved and can lead to considerable problems in practice.

The provisional non-taxation is applicable under the conditions that no more than 12 years have passed since the company was founded and that the company fulfils the SME definition of the European Commission (companies with fewer than

250 employees with an annual turnover of no more than EUR 50 million or an annual balance sheet total of no more than EUR 43 million). Employee share ownership via intermediary partnerships remains expressly possible.

The reform does not change the comprehensive formal requirements for the transfer of genuine share ownership; these must therefore continue to be accepted. However, it is already apparent that at least the first obstacle has been cleared. The employee does not face a high claim from the tax office immediately after granting the genuine shares. Nonetheless, a more far-reaching reform would be desirable. The dry income issue is weakened, but by no means eliminated.

4. THE FUTURE OF EMPLOYEE SHARE OWNERSHIP

What does the reform mean for the future structuring of employee share ownership programmes? Practice will show whether the control of shareholder rights and flexible and form-free handling are so important to the founders and investors concerned that they will continue to prefer the virtual forms of participation.

The bureaucratic and time-consuming procedure under which tax and social security obligations diverge and the problem of taxation in the event of a change of employer are reasons why forms of virtual participation still appear attractive. In particular, if the termination of the employment relationship leads to the tax liability for the monetary benefit being triggered and the employee is faced with a sudden payment debt for which he/she is not responsible, the added value of the regulatory complex is lost. The scenario of a change of employer within a few years is not the exception but the rule in the agile and dynamic start-up environment. In addition, young people often work in start-ups that have not yet been able to build up a capital stock, so that they run into financial bottlenecks when they change jobs. This is a side effect of the reform that could cause the spread of genuine share ownership in employee share ownership programmes to fail in practice.

Nevertheless, from the perspective of competition for the best talent, employee share ownership through genuine shares has at least become more attractive. Because of the weakened dry income problem, it is at least easier to fall back on the otherwise tax-advantageous model of genuine shares.

In light of this, companies may not always have a choice if they want to remain competitive in the face of the ongoing shortage of skilled workers, especially in the start-up sector. In this respect, the new reform may well mean a shift in the paradigm of employee share ownership for start-ups and SMEs.

After the topic of employee participation in start-ups was neglected for a long time in regulatory terms, the new FoStoG has given a new impetus that will change the future

structuring of employee share ownership programmes in practice. The topic of employee share ownership is also on the agenda at the European level, so it is worth keeping an eye on future developments.