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Q&A's: VSOP vs. ESOP – New tax legislation in Germany

1 What is what and what is the difference?

a. Definitions

VESOP stands for virtual employee stock option program and means a virtual version of a regular stock option program. A VESOP is an employee participation scheme that is aimed to grant the beneficiaries a payment claim (regularly) vis-a-vis the company in the event of a sale of the company ("Exit"). There are no shareholder rights connected to a virtual option or a virtual share. Virtual shares or virtual options are subject to vesting in order to bind the beneficiary to the company. It is all about the payment claim in the event of an Exit. The latter is generally calculated as if the holder of a virtual option / virtual share would be a holder of common shares in the company.

ESOP stands for employee stock option program or stock ownership program. The latter definition also includes to real shares, not only options. For purposes of this overview, we stick to the first definition – and will describe the tax rules for real shares below in section 2. Under an ESOP the beneficiary is granted options to acquire actual shares in the company. If the options are exercised, the Beneficiary can purchase common shares in the company at a pre-agreed price that regularly is below fair market value ("FMV"). In most ESOP programs the options can only be exercised in the event of an Exit. Also, the options are subject to vesting to bind the beneficiary to the company. ESOPs regularly provide for an obligation on the part of the beneficiary to adhere to a shareholder's agreement once the options are exercised. As a consequence, once the options are exercised in the event of an Exit and the common shares purchased, the beneficiary is obliged to co-sell the newly acquired common shares alongside all other shareholders.

b. Tax consequences

VESOP: Due to the fact that claims under an VESOP have a purely contractual character and given that no real shareholder rights are connected to a VSOP, the payment claims triggered at the Exit are subject to the personal income tax rate of the beneficiary. This was not altered by the new Future Financing Act ("ZuFinG"). Given that claims are regularly only triggered when an Exit occurs, the grant of the virtual options / virtual shares itself or the vesting thereof does generally not trigger income taxation.

ESOP: A standard ESOP scheme in which the granted options can only be exercised in the event of an Exit, followed by a sale of the shares then received, does not differ notably as regards its tax consequences form a VSOP. This is because in the event of an Exit where the options can be exercised and the common shares are purchased below FMV and then sold at FMV, the difference between the purchase price paid and the fair market value also is subject to income taxation (i.e. not capital gains tax). Here again, the personal income tax rate of up to 47.5% applies. The new ZuFinG does not change things here.

Pros and Cons

VSOP legal Pro's and Con's: Given that a VESOP does not trigger any shareholder rights, VSOP programs are easy to maintain for the company, keep the capitalization table clean and the beneficiary does not need to put any private money into the scheme to purchase common shares. The beneficiary consequently never looses own money when being ja holder of virtual options or virtual shares even if the company files for insolvency. The downside for the beneficiary is the higher personal income tax of up to 47.5 % on the payment claim in the event of an Exit.

ESOP legal Pro's and Con's: Since a standard ESOP linked to an Exit does only create options to acquire (and co-sell thereafter) common shares in the event of an Exit the maintenance of a regular ESOP does not differ significantly from a VSOP. An ESOP is a bit harder to settle in the event of an Exit given that actual shares are acquired and sold which (for a GmbH setup) requires at some point the notarization of the acquisition/sale and therefore the involvement of a notary and can be (a bit) costlier compared to a VSOP. The downside for the beneficiary is again the higher personal income tax of up to 47.5 % on the difference between the purchase price paid and the FMV realized in the event of an Exit.

2 What does the new ZuFinG do and why is it a thing?

The new ZuFinG addresses - amongst others - the dry income tax issue if common shares of an employing entity are purchased by an employee/managing director of said employing company at a price that is below FMV and not directly sold to an acquirer. In this case the beneficiary generally would have had to pay income taxes on the difference between the FMV and the purchase price paid for the common shares, however, would have to pay the income taxes from his own funds as the beneficiary usually is prohibited in selling the common shares other than in an Exit scenario. In short, due to the "dry income" scenario, the employee would have been burdened with taxes without corresponding income.

The ZuFinG changed Section 19a of the German Income Tax Act ("GITA") that now allows certain small and medium sized company's[1] to postpone the payment of the relevant income taxes to an Exit event. When there is an Exit, the postponed wage taxes will become due at the indidividual income tax rate (up to 47.5 %) applicable to the relevant employee. Further, the gain between the FMV at the time the common shares were transferred to the employee and the FMV at the time of the Exit when they are sold to an acquirer, i.e. the purchase price paid by the acquirer, will be subject to the more favorable capital gains tax (approx. 26.4 % below 1 % shareholding quota and up to 28.5 % in all other cases).

However, there are other taxable events at which the beneficiary would be obligated to pay the postponed income tax and these are – inter alia - (i) the employee leaving the company or (ii) after expiry of 15 years without an Exit. These two scenarios, which would still generally trigger the dry income tax issue, can be circumvented if the employer irrevocably declares that the employer is liable for the relevant income/wage tax of the employee. The employer's liability secures the tax authorities' tax claim. To clarify, if the employer declares to be liable for the income taxes the scenarios (i) and (ii) no longer trigger the postponed income taxation (i.e. no taxation when leaving the company or after expiry of 15 years). Generally, only an Exit would trigger the postponed income taxation. Downside, a sale of the relevant shares by the beneficiary would still trigger the postponed income taxation for which the company is then liable. Here, protection measures must be agreed in a shareholder's agreement.

Please note that Section 19a GITA provides for a third taxable event which should be avoided. Any transfer of shares then held by the beneficiary would trigger an immediate taxation, cf. Section 19a para. 4 no. 1 GITA.

Currently, Section 19a GITA only clearly applies for German companies and only for the grant of an actual participation in the employer by the employing entity or a shareholder of said company (for example a founder). Further, the participation must be granted in addition and not as a replacement of the regular wages and it must be granted for free or below FMV.

In summary, the ZuFinG makes the grant of an actual participation in a German Company way more attractive. The dry income tax issue can generally be avoided if the Company is willing to declare to be liable for the beneficiary's income tax burden once the postponed income taxation is triggered.

[1] Companies with less than (4x) 250 employees and an annual turnover of less than (2x) EUR 50 million or an annual balance sheet total of less than (2x) EUR 43 million in this year or within the last 6 years, not older than 20 years can make use of the new Sec. 19a Income Tax Act (as amended by ZuFinG).

3 What does the new ZuFinG change as regards ESOPs?

As regards regular ESOPs which connect the exercise possibility to an Exit nothing is changed (see above). However, the new Section 19a GITA makes a difference if the options can be exercised once vested (i.e. not depending on an Exit). In this case an ESOP would be tax wise more attractive for the beneficiaries. If they exercise their options once vested, purchase common shares below FMV and assuming the employer assumes the liability for the postponed income taxation, the latter would generally only be triggered at an Exit event. More importantly, the favorable capital gains taxation would be applied for the difference between the FMV at exercise of the options and the FMV (i.e. purchase price received) at Exit.

4 Are there any downsides from a company's / shareholder perspective?

Having an attractive employee participation scheme is definitively a plus, particularly if it allows for the best possible (i.e. lowest possible) taxation. However, form a corporate and employment law perspective this structure comes with downsides. The most important is that the model only works if actual shares are purchased below FMV. Accordingly, the beneficiaries become actual shareholders of the employer. This means they have shareholder information and participation rights like regular shareholders.

To circumvent this, pooling structures need to be established, through which the beneficiaries hold their common shares in the company while still being under the regime of the new Section 19a GITA. These structures reduce shareholder rights significantly but are complex and trigger additional maintenance costs (separate balance sheet, pooling structure needs be managed etc.) for the employer. From an employment law perspective, any dismissal scenario that needs to be settled because the company has no valid reasons to justify it becomes rather complex to negotiate due to the fact that the employee also is a (direct or indirect) shareholder of the company.

5 Are there downsides from a beneficiary's perspective?

If the option is exercised and the common shares are granted against the payment of purchase price that is below market value, the beneficiary still brings in its own money that can also be fully lost if the company does not perform or becomes insolvent. Under certain circumstances there is also a risk of additional funding obligations provided these apply for all shareholders. The beneficiary is a real shareholder with all positives and negatives that come along with this status.

6 Does the new Section 19a GITA provide for other possibilities to benefit from the outlined new taxation other than real shares?

Generally yes, Section 19a GITA generally also applies if the employer grants so called profit participation rights ("*Genussrechte*"). Provided these also provide for a profit participation right and provided the beneficiary cannot be regarded as a co-entrepreneur within the meaning of Section 15 (1) no. 2 GITA.

However, given that employer granted profit participation rights are mostly unregulated matter, granting profit participation rights in order to use the new Section 19a GITA requires a prior appeal information filed vis a vis the competent tax office ("*Anrufungsauskunft*") to ensure that they really are benefitting from the new Section 19a GITA. Such a measure can be rather time consuming and requires legal advice.

The Federal Civil Court ("BGH") considers the legal transaction aimed at establishing profit participation rights to be a sui generis contract that gives rise to a continuing obligation. For profit participation rights with loss participation, this is sometimes disputed on the grounds that it is in fact a silent partnership. Profit participation rights are always and necessarily of a contractual nature and do not establish shareholder rights. They are limited to a specific monetary claim. Accordingly, holders of profit participation rights are not entitled to any membership-related rights, in particular no voting rights. According to the prevailing view, they also have no right of appeal. According to the BGH, a profit participation holder can demand accountability in accordance with general principles (i.e. has a far-reaching information right). The literary voices affirm even further-reaching information rights, such as the right to participate in the annual general meeting / shareholder meeting, because this does not involve any drastic and significant interference with the shareholders' membership rights.

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Nico's expertise covers individual and collective employment law as well as compliance law. He has provided legal advice to well-known clients in the tech industry, energy provider industry, insurance industry, recruitment industry as well as service industry.

Nico is an expert in the field of structuring employee participation programs (e.g. ESOP, SAR-programs, VSOP etc.) and advises clients on the introduction or modification of such programs as well as on the settlement or replacement of old plans.

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