New opportunities, familiar challenges: How the Future Financing Act is changing ESOPs

Today, 24 November, the German Federal Council (Bundesrat) approved the so-called Future Financing Act (*Zukunftsfinanzierungsgesetz*). Among other things, this changes the framework conditions for the taxation of *Employee Stock Ownership Plans* (ESOPs) for start-ups.

Thanks to the new regulation the problem of dry income taxation can be avoided in a large number of cases. *Dry income* situations generally arise when start up employees receive discounted shares in the company. This is due to the fact that the discount constitutes taxable income at the time the shareholding is granted, even though the employees cannot sell the shareholding in the near future and it is completely uncertain whether they will generate income from the shareholding at a later date. The special statutory provision for start-ups in Section 19a German Income Tax Act (GITA, *Einkommensteuergesetz*) makes it possible to defer taxation until the shareholding is sold.

The regulation already introduced in 2021 had proven to be impractical in the past, in particular since taxation always took place when employees left the company. This can now be avoided if the employer assumes liability for the income tax (see Section 2.2). In addition, the new regulations extends the scope of application to significantly larger companies than before (see Section 1.1).

However, the 25% lump-sum taxation initially included in the draft bill for the benefit granted on the transfer of the shareholding was not implemented. Full taxation as income remains, which can merely be postponed to a later date. The more favourable taxation as income from capital gains (26.4% or up to 28.5% for a shareholding of at least 1%) only applies to increases in value that arise after the shareholding has been granted and are realized upon sale.

Shortly before the parliamentary procedure was completed, the so-called group clause was also removed on the recommendation of the Parliament's Finance Committee. German employees of foreign start-ups with German subsidiaries can therefore not claim the tax deferral. In the opinion of the tax authorities, the regulation also does not apply to German start-ups whose employees are employed in a subsidiary (e.g. for regulatory reasons).

From a tax perspective, the new regulation allows employees to benefit in part from more favorable taxation as capital income upon exit. However, the changes made during the legislative process have significantly impaired its practicality.

Even more serious are the doubts about the practicability of the regulations with regard to the framework conditions under corporate law. The legislature missed the opportunity to introduce an improved framework here as well.

For founders and investors, it is regularly advisable to restrict the admission of employees as shareholders in order to prevent influence on decisions of existential importance (e.g. capital increase, exit) or the granting of comprehensive information rights. In addition, the transfer of GmbH shares always requires notarial certification.

If the company wants to enable its employees to benefit from the tax advantage, it will therefore usually be necessary to avoid direct shareholdings of the employees as GmbH shareholders, but to choose an instrument that fulfills the requirements of a shareholding within the meaning of Section 19a GITA for tax purposes. This means additional structuring effort, ongoing costs and legal and tax uncertainties.

Possible solutions include pooling employee shareholdings in a partnership or by granting sub-participations or using trust structures. The granting of participation rights (*Genussrechte*) instead of actual shares is also a conceivable solution. The extent to which these concepts are suitable as a genuine alternative to VSOPs will become clear in the near future.

An overview of the most important changes is provided below. In more detail:

1. Extension of the scope of application of Section 19a GITA

1.1. Significant expansion to include larger and older companies

Section 19a GITA requires that the company does not exceed certain (SME-) thresholds at the time of the transfer of the shareholding. These parameters are to be raised in accordance with Section 19a (3) GITA so that larger companies can also fall under Section 19a GITA:

– up to 1,000 employees (previously: 250 employees),

– annual sales of EUR 100 million (previously: EUR 50 million) and

– Annual balance sheet total EUR 86 million (previously: EUR 43 million).

The time frame is also significantly extended. For example, it is sufficient if the three thresholds mentioned were met at the time of the transfer of the shareholding or in one of the six preceding calendar years (previously: at the time of the transfer or in the preceding calendar year).

The date of foundation of the company can be up to 20 years ago at the time of the transfer of the shares (previously: twelve years).

1.2. Granting of shares also by shareholders of the company

In future, Section 19a GITA will also cover other situations that were previously not or not expressly covered by the provision, namely cases in which the shares are not transferred by the employer itself, but by a shareholder of the employer. This regulation is to be welcomed, as ESOP programs that are not associated with the creation of new shares or the formation of a reserve for the company's own shares are now also eligible. In addition, it facilitates the implementation of ESOPs at the expense of individual shareholders (groups). However, the restriction still applies that, in view of the tax authorities, this can only relate to shares in the employer company (see section 3.1).

1.3. Explicit extension of the scope of application to shares with restricted transferability

With the introduction of a new Section 19a (1) sentence 3 GITA, the legislator clarifies that Section 19a GITA also applies to shares with restricted transferability which the beneficiary employee cannot actually dispose of, e.g. due to standard market vesting regulations. This is in line with general principles and is therefore only to be regarded as a clarification of the legislator.

2. Extension of the deferral of taxation

2.1. Extension of the subsequent taxation period

The subsequent taxation period pursuant to Section 19a (4) GITA is extended from twelve to 15 years. At this point in time at the latest, the income taxation of the pecuniary benefit from the discounted transfer of shares will take place if no other taxable event has been triggered by then or the new regulation on the assumption of liability (see section 2.2) takes effect. Originally, an extension of this period to 20 years was planned.

2.2. No "dry income" if the employer assumes liability

In addition to the extension of the subsequent taxation period, taxation in accordance with Section 19a (4) GITA, which is triggered, for example, by the termination of the employment relationship or the expiry of the 15-year period, can be waived under certain conditions and postponed further into the future until the employee actually sells or transfers the shareholding. In many cases, the legislator is thus actually solving the dry income problem in a welcome way.

The requirement for this is that the employer irrevocably declares that the employer is liable for the relevant wage tax of the employee at the latest as part of the income tax declaration (*Lohnsteueranmeldung*) following the expiry of the 15 years or the termination of the employment relationship. It is then no longer possible for the employer to make a liability-releasing declaration, as otherwise provided for under the wage tax rules for employers.

This opens up a practical option for avoiding the taxation of *dry income* in the long term. A typical example is when an employee leaves the company as a "good leaver" while retaining (at least part of) the shareholding. If the employer assumes liability for future wage tax in this case, no taxable event is triggered at the time of the leave.

The employer's liability secures the tax authorities' tax claim, particularly in cases where employees have moved abroad at the time of the sale.

In the case of liability claims, however, the transfer of unrestricted shares by employees or restructuring of the company may lead to a liability event for the employer. In this context, employers will have to create security mechanisms to avoid those events (e.g. by prohibiting employees from transferring shares under the law of obligations, e.g. to personal holding companies) or to ensure the enforcement of recourse claims (e.g. by withholding from wages) against employees after a liability claim has been made.

2.3. Leaver cases: Taxation on departure on the basis of actual remuneration

In leaver cases, it will be ensured in future that only the remuneration actually paid to the employee is used as the assessment basis for taxation. Affected leaver cases are those in which the employee leaves the company and the company reacquires the shares - either because the shares are not yet vested in accordance with the applicable vesting rules or because the participation agreement grants the company a call option at a certain price for this case. Only the remuneration actually paid to the employee(s) will be considered for taxation purposes.

3. Measures not implemented in connection with the amendment to Section 19a GITA

3.1. Deletion of the group clause

The new version of the regulation does not open up the preferential treatment under Section 19a GITA for cases in which the shares are not granted by the employer itself, but by affiliated companies. The group clause was still included in the draft bill and was only deleted by the Parliament´s Finance Committee shortly before the final deliberations in the Federal Parliament (*Bundestag*). The deletion of the group clause further increases the legal uncertainty regarding the applicability of the provision to shares in affiliated companies, which would be in line with the wording and the prevailing opinion in the literature.

A clarifying legal provision on the application to affiliated companies within the meaning of Section 18 (1) German Stock Corporation Act (*Aktiengesetz*) could have significantly increased the attractiveness of the provision in practice, e.g. to favor the participation of employees of a domestic subsidiary in a foreign parent company.

3.2. No deferral of taxation through lump-sum taxation

The option of lump-sum taxation with a tax rate of 25% and the assumption of liability by the employer for the tax arising on the sale of the shareholding, which was still provided for in the draft bill, was already removed in the revised draft bill of August 2023.

4. Further changes in connection with employee share ownership schemes

In addition, the maximum tax-free amount for employee shares per year in Section 3 No. 39 GITA will be increased from the current EUR 1,440 to EUR 2,000. An increase to EUR 5,000 was originally planned. The use of the tax-free amount does not require that the participation is granted in addition to the salary already owed (so-called additionality requirement, *Zusätzlichkeitserfordernis*) and is therefore also possible if the shareholding is acquired through conversion of the compensation.