Start-ups and Employee Equity Grants: All Good Thanks to the Future Financing Act?

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For the first time, start-ups will be able to provide employees, who are subject to German taxation, with free or discounted true-equity grants under favorable tax conditions. This is the bottom line of an amendment to the German Income Tax Act (GITA) that took effect on 1 January 2024.

Start-ups can be at a disadvantage because they are not able to offer international salaries for talented individuals on a par with international corporations. To compensate for this, they frequently make employee equity grants that come with a deferred opportunity – albeit dependent on the company's success – to participate in the proceeds of a subsequent trade sale or IPO. There is a problem, however: according to a study by venture capital firm Index Ventures, the regulatory framework for employee equity grants in Germany is amongst the worst in the world.

Although making employee equity grants may not be the easiest exercise under complex German corporate law, the real hurdle is unattractive tax treatment. The taxation of so-called "dry income" plays a key role: if employee equity grants are made

free of charge, or at a reduced price, the employee receives a non-cash benefit amounting to the difference between the fair market value of the equity grant and the payment made for it (if any), which is subject to income tax at the time the grant is issued. The employee must therefore pay tax on this non-cash benefit without simultaneously receiving any money that could be used to pay the tax liability.

To avoid these disadvantages, the German start-up ecosystem has often resorted to granting virtual shareholdings (VSOPs). However, VSOP payments qualify as part of an individual's salary and are therefore taxed at the (typically higher) rate of personal income tax. VSOPs are also an unusual, makeshift construct in an international context. For these reasons, among others, virtual shareholdings are unattractive, especially for much sought-after international talent.

The previous government attempted to resolve this unsatisfactory situation by introducing a special regulation to incentivize employee participation in start-ups. Under this regulation, introduced on 1 July 2021, taxation is initially "deferred" if a start-up makes discounted or free employee equity grants and the non-cash benefit is only taxed when certain events occur. However, German start-ups have made virtually no use of the incentive since its introduction due to serious shortcomings. Primarily, this is seen as an overly narrow scope, which excludes the majority of fast-growing start-ups, as well as compulsory retrospective taxation upon termination of the employment contract, or after 12 years since the grant, which leads to dry income taxation.

The Future Financing Act amends the special tax regime with effect from 1 January 2024. The scope of its application will be significantly expanded, meaning that fast-growing start-ups and scale-ups (with fewer than 1,000 employees and an annual turnover of no more than EUR 100 million, or an annual balance sheet total of no more than EUR 86 million at the time the grant is made, or in one of the six preceding years and not founded more than twenty years before the grant) will also be able to benefit from the incentive.

In addition, retrospective taxation leading to dry income can be avoided if the start-up assumes liability for income tax. Retrospective taxation will only take place when the employee disposes of the grant, i.e., typically upon exit. At this point in time, the employee also receives proceeds from the sale giving them the necessary liquidity to pay the taxes. By carefully structuring the employee equity programs, the start-up can ensure that the tax liability is actually repaid and so avoid disadvantages for itself. As a result, dry income is no longer taxed.

From a tax perspective, employee equity grant programs are now much more attractive for employees as the increase in value after the grant that is realized upon an exit is subject to a capital gains tax rate of 25% (plus solidarity surcharge and church tax, if applicable). Proceeds from a VSOP, on the other hand, are subject to significantly higher taxation at the personal income tax rate. The extended scope will also enable a

significantly larger number of start-ups to make use of this option. However, the issue of valuing the equity grants remains unresolved, albeit an under-valuation of employee grants will no longer result in taxation of dry income, but will only have a tax impact at the time of exit.

In future, there will be various ways of structuring equity grants. In order to grant "real" company shares that are well-known and attractive in an international context, it makes sense to utilize proven structures such as pooling vehicles – for example, in the form of a German limited liability partnership (*GmbH & Co. KG*). Using the tax advantages of Section 19a GITA, shares could be granted and transferred in a comparatively flexible manner without overburdening the corporate governance of a start-up with many immediate shareholders.

Start-ups that already have virtual participation programs in place should nevertheless consider the revised version of Section 19a GITA and its consequences. Under certain circumstances, an existing virtual participation program can be converted into equity grants making use of Section 19a GITA. Virtual participation programs could also potentially be left untouched in principle or "capped" for further increases in value, and beneficiaries could be granted "real" employee shares within the scope of Section 19a GITA to participate in future increases in value.

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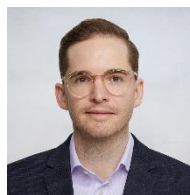Partner
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