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Keeping key management and employees incentivised in a tax efficient manner

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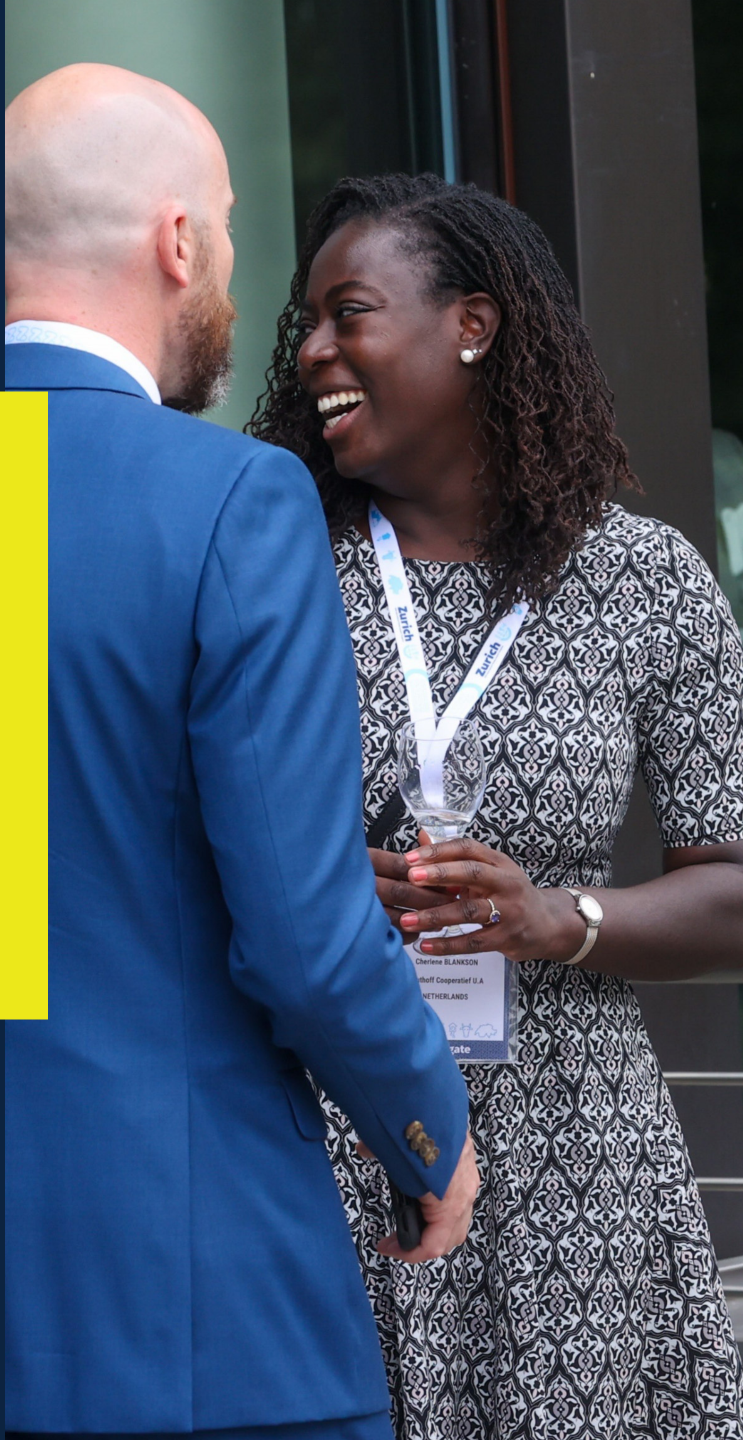

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Keeping key management and employees incentivised in a tax efficient manner

Annual Tax Conference
11 March 2023 | Bergen, Norway

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INTERNATIONAL ASSOCIATION OF YOUNG LAWYERS

Agenda

- Background & considerations
- Jurisdiction highlights
- Case study
- Concluding remarks

Background & Considerations

Some background

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Why incentivize ?

Minimize transition risks

Retain and attract knowledge and expertise

Align the interests of management and investors (goals & risk)

How important ?

One of the absolute key factors for value creation in PE Fund portfolio companies

Typicalities

10-20% of the total equity

Vesting (+ potential performance conditions)

External factors (e.g., tax efficiency) affect design/structure

General considerations

Some considerations to keep management teams intact

- Participation pool
- Type of incentives: cash based or equity based
- Vesting schedules
- Performance parameters
- Exit clauses
- Tax, labor and social security

Tax considerations

Equity rollover – General tax issues

- Structuring rollovers (taxable vs tax-deferred)
- Tax-free (deferred) rollover schemes

Additional incentive – General tax issues

- Income type (cash/income vs gains/equity)
- Time of taxation
- Valuation for tax purposes
- Company deduction

Country highlights

Bulgaria

Ivan Alexander Manev
DPC Law Firm

Employee and management incentives in Bulgaria

- Shortage of qualified employees and managers in many sectors
- Unprecedented low level of unemployment
- **Flat 10% tax** rate and increase in foreign investments
- Traditional incentives in almost all sectors - social benefits (company car, food vouchers, home office)

Employee and management incentives in Bulgaria

- Equity-based incentives – mainly **stock options** or **phantom shares**
- Deferred interest bonuses - not very common, granted mainly for managers in the financial sector
- Not explicitly regulated apart from the general labor and corporate provisions
- No restrictions to the amount and structure of the equity-based incentives
- Usually granted to specific positions - e.g. high and mid-level management, key employees.

Stock options

- Possibility for the employee to purchase stocks at a preferential price (usually 20% discount) after vesting period

- In rare cases - stocks are provided to the employee free of charge (RSUs)

- No regulations or limit on the length of the vesting period

- Usually 5 years – 25% granted after 2 years

Phantom shares

- Provided where stocks or equity are not convenient
- Provide for a cash bonus in case of exit
- In some cases - provide for "phantom" dividends
- If the employment is terminated - the benefit is lost.

Taxation

- No specific rules – incentives are taxed as part of the remuneration
- 10% flat income tax and social security contributions
- Tax is withheld by the company
- Almost no applicable benefits or exemptions

What is taxed

- The discount for purchasing the stocks by the employee upon exercising the option
- The value of the stocks, if they are provided free of charge
- Monetary payments related to phantom shares - capital gains, dividends

Tax Issues

- Time of taxation of stock options
- Evaluation of not listed stocks
- No binding advance rulings
- 10% tax on phantom dividends **vs.** 5% dividends tax

Snapshot

Belgium

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Snapshot: Belgium

Executive incentive compensation (types)

Traditional: salary, benefits in kind, company car, allowances,…

Non-Equity: non-recurring result-based bonus, warrants (financial instrument), occupational pension plan, bonus agreement or policy, royalty scheme, profit bonus,…

Special expat tax regime (2022) >> 30% tax-free expense reimbursement

Equity

- stock options (warrants)
- alternatives: **full-value equity** (e.g. stock, restricted stock units (RSUs) & performance stock units (PSUs) – typically granted by a foreign parent), can also be **liability-based**

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Snapshot: Belgium

Executive incentive compensation (taxation)

Belgian Stock Option Law (26 March 1999)

- Taxation **at grant** (acceptance within 60 days after offer date)
- Lump-sum valuation (tax due on 18% of underlying share value)
- 18% can be reduced to 9% (i.e. exercise period, transferability, hedging,…)
- Taxed at progressive tax rates (from 25% up to 50%), but in general no social security
- Capital gain realized afterwards is **tax-free**
- "**in the money**" (strike price is below underlying market share value? discount added as a taxable benefit)

→ Belgian system is considered **complex, unfair & outdated**

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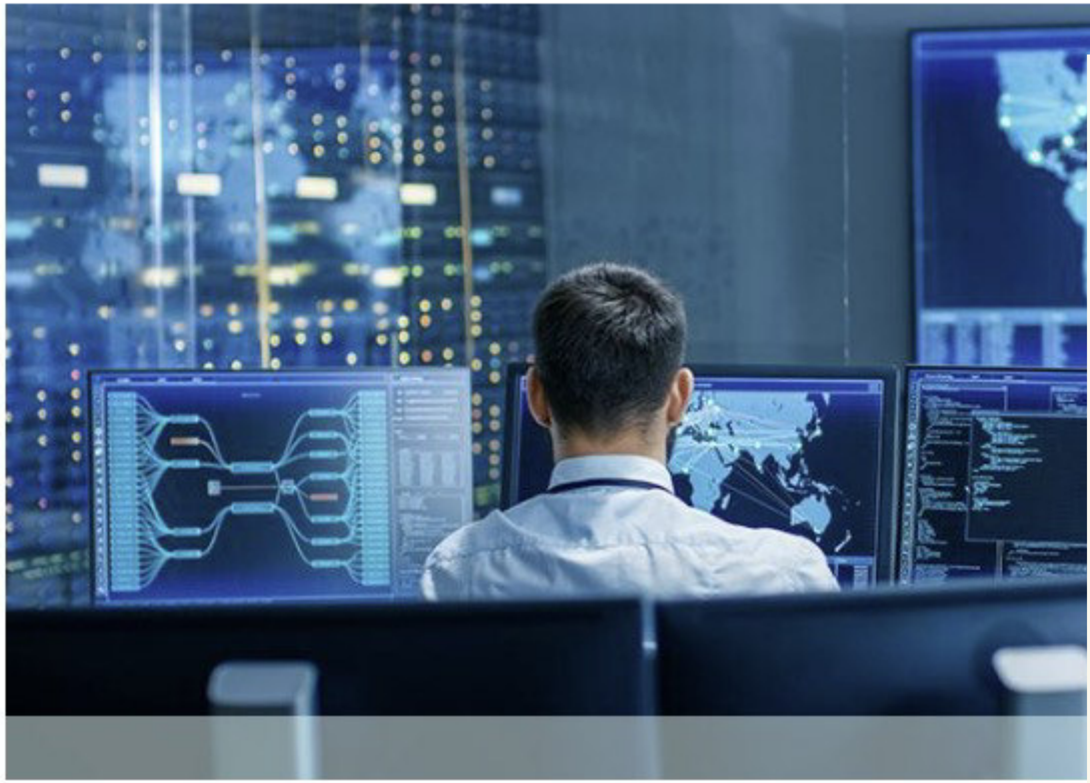
Belgium's first unicorn: billion-dollar start-up Collibra

Brussels-based data specialist Collibra – a spin-off of VUB, one of Flanders' 5 universities – has received USD 100 million from CapitalG, the investment arm of Google's parent company Alphabet. This makes the start-up worth more than USD 1 billion and the first-ever 'unicorn' in Belgium.



Belgian tech pride Collibra flags out to the Netherlands

According to Collibra CEO Felix Van de Maele, the main reason for the legal change is the Belgian system of stock options. ©Collibra

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Snapshot: Belgium

Executive incentive compensation (issues)

- Taxation **at grant**: significant contribution from low/mid-level executive

→ The Netherlands: new regime in 2023 (pay taxes upon exercise/postpone until stock is sold)

- Disconnection: stock option expense vs ultimate benefit realized
- SMEs have **different needs** than larger companies (e.g. cash-settled, full-value share units)
- Cash-constrained start-up prefers **equity structure** over liability structure

→ Relationship between shareholders vs. between company & employees

→ No cash requirement to settle awards vs. cash needed to pay tax at grant

→ Importance of deferral or vesting component (**retention** of key personnel)

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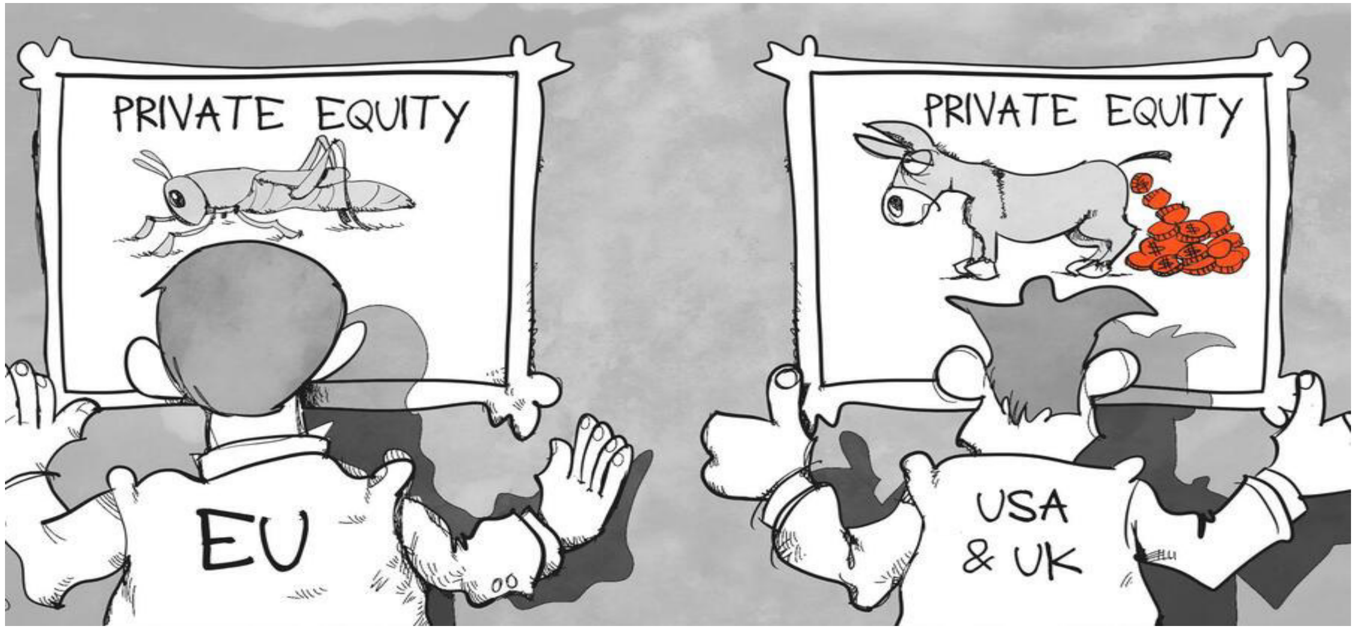
Snapshot: Belgium

Executive incentive compensation (objectives)

- What is competitive in a specific industry? (ultimate goal: attracting talent)
- SME: equity plan = coalesce management team around a common goal
- Tailor-made solution for retention of key personnel (deferral of compensation and vesting/forfeiture conditions)
- Balance between measures of success >< employee influence
- Shareholder dilution is a concern? Liability plan/warrants more attractive
- Leave **sufficient flexibility** for timing of tax payment (grant, vesting, exercise, cash out)

Snapshot

Germany



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Snapshot:Germany

- **Types of income**
  - Employment income
  - Self-employed income
  - Business income
    - Commercial
    - Sale of share: participtation > 1% for the last 5 years in an opaque corporation
  - Capital gain
    - Short-term (≤ 1 year): fully taxable
    - Long-term (> 1 year): tax free
- **Tax rate:** no preferential rate
- **Risk for employers:** liable for wage tax (withholding tax)

Focus

Switzerland

The usual suspects

- Management employees and specialists that are posted temporarily to Switzerland by their foreign employer may deduct **additional professional expenses** or such costs may be paid by the employer (e.g. moving costs);
- **Fringe benefits** are quite common but may be taxed (e.g. company car). Exceptions are tax free such as discounts on goods or services usual in the industry;
- **Expenses may be paid on a lump-sum basis** (e.g. representative expenses).
- Contributions to **pension plans** for management (including having better

StockPlans

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Who is covered?

Employees and members of the board of managing or management, but also future employees but not agents

Which stocks?

Company or a group company stocks and even from de facto employer or shareholders

Time of taxation?

Employee stocks are generally taxable when issued. Restricted or unlisted options are taxable upon sale or exercise.

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Good / bad Leaver

Are you one of them?

Swiss law does not have a definition

Often the definition is set by the employer and is non-negotiable

Typically, cases are defined or a definition of bad leaver and all others are good leavers

Typically repurchase right and/or effect on valuation

Good / bad leaver

Which cases of termination by employee?

- Mobbing
- Sickness

Which cases of termination by employer?

- Economic reasons
- Gross breach of work duty
- Criminal acts

What if the stocks have already been taxed when they are returned?

Snapshot
Spain

Sílvia Niubó
Cuatrecasas

Other-than-tax issues for equity based schemes

Labor:

- Court rulings have held that stock plan benefits are considered salary (in cash, not in kind) for purposes of calculating termination rights, but only the difference between the FMV and the price paid.
- Termination of employment agreement during the vesting period. Courts ruled in favor of the employees.
- Stake over 50%: no employment relationship – lacks dependency and subordination.

Social Security:

- Stock plan benefits are subject to social security contributions.

Other-than-tax issues for equity based schemes

Corporate:

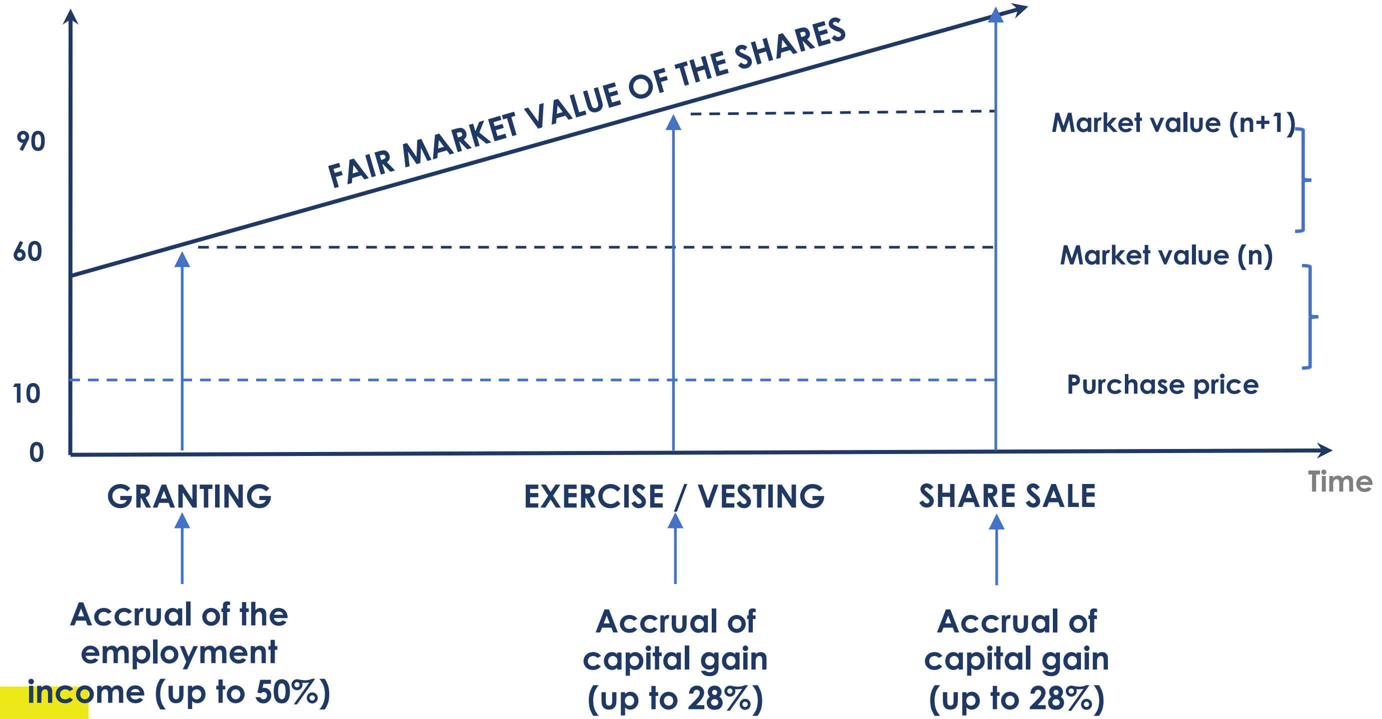
- Incentive plan approval by the general meeting of shareholders if the key person is a **director / administrator** of the company.
- No legal requirements when the key person is a **manager**, but strongly recommended.

- **Some limitations for treasury stocks (10% / 20%).**

Focus on stock options

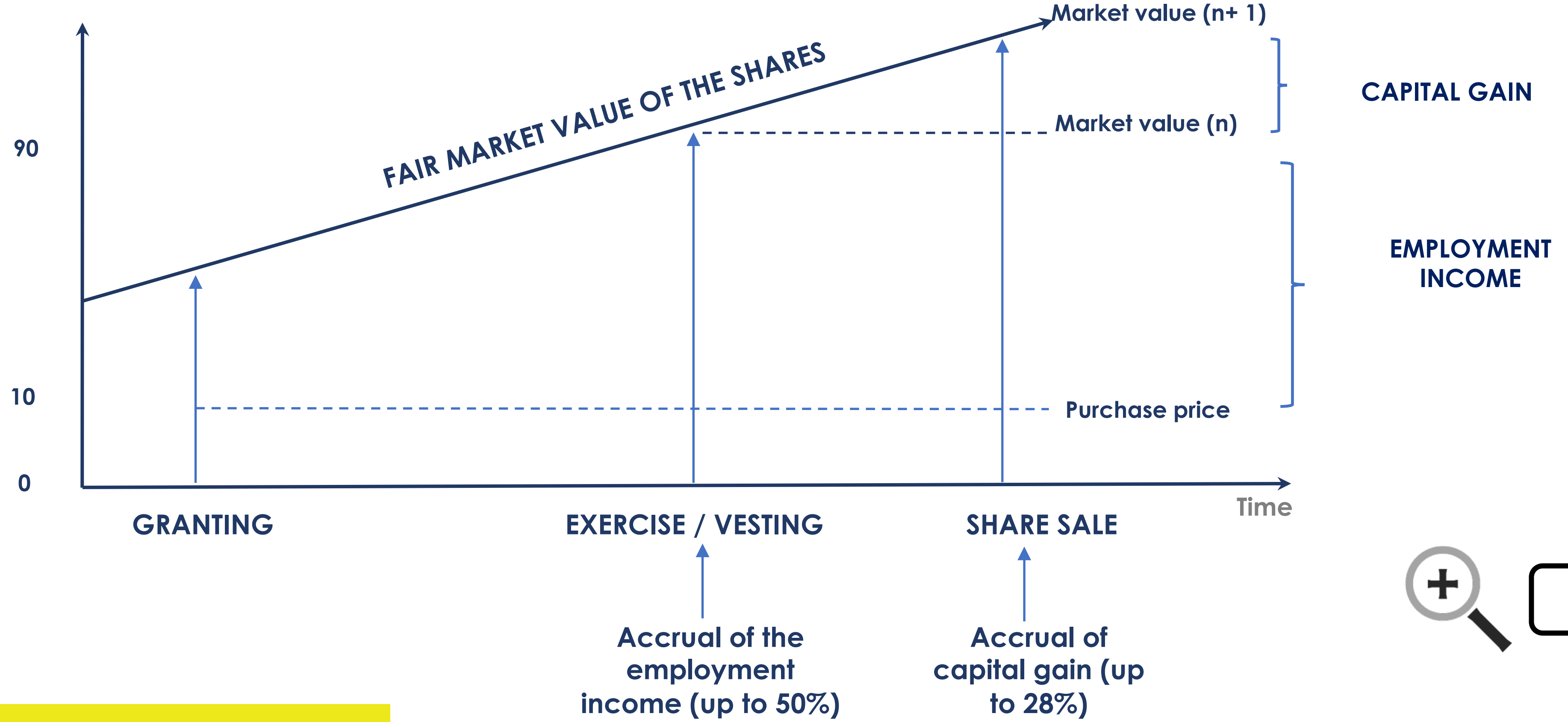
- Different treatment if they are transferable or not and conditional or unconditional.
- No specific regulations, tax treatment based on tax rulings and court case law.

- **Transferable** stock options



Focus on stock options

- **Non-transferable** stock options



Withholding tax?

Tax Incentives

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For stock options:
Exemption of €12,000 provided the offer of the stock options is made to all employees (or group of employees) and under the same conditions.

For long term incentive plans:
30% reduction in the taxable base (limited to a total reduction of €90,000) if income qualifies as irregular:

- Vesting period > 2 years.
- One shot income.
- The exemption has not been applied in a 5-year period.

No need to request a tax ruling.

Case study

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Question 1

Are phantom stocks a good option?

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Question 1

Are phantom stocks a good option?

Hypothetical stocks

Appreciation only

- The employees get only the stock's appreciated value (difference between the current value and the value of the stock when it was granted)
- **What if value goes down?**

Full value

- Employees get the full value of the stock as compensation.

Phantom dividends

- Employees receive a monetary bonus based on the annual profit of the company.

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Question 1

Are phantom stocks a good option?

+	−
No dilution of the company's ownership.	Cash on hand at the time of payout.
Employees do not participate in the management.	Appreciated only phantom stocks provide gain only if the share price increases.
Greater flexibility.	In general, no specific tax incentives.
Easy exit mechanism.	Third-party valuation costs.
No taxes upfront.	Phantom dividends are taxed as a bonus and not with dividends tax (Bulgaria).

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Question 2

Are share options preferred over shares?

Key differences

Shares	vs	Share options
Become a shareholder immediately		Have the option to buy shares later - at a pre-agreed price
Typically have voting rights, dividends and any other rights attached to the class		Vesting schedule can incentivise employee performance
Typically given to investors and co-founders		Typically granted to employees, advisors and consultants
Taxed		Not taxed when granted, only when exercised

Key differences

Stock

- Relationship between shareholders
- Shareholder agreements (call/put)
- Immediate ownership
- Vesting possibility
- New shares or existing shares? (dilution)
- Taxed at grant
- Issued at nominal value (premium)
- Reverse vesting
- Useful for pre-funding / pre-revenue start-ups

Stock options

- Relationship company vs employees
- ESOP/LTIP (control + conditional)
- Higher risk factor
- Always vesting component
- Ideal retention method for low-cash companies
- Mostly taxed at exercise (CGT)
- Strike price (discount on FMV)
- Forward vesting (milestones)
- More expensive, complex & time-consuming

Key takeaways

Stock

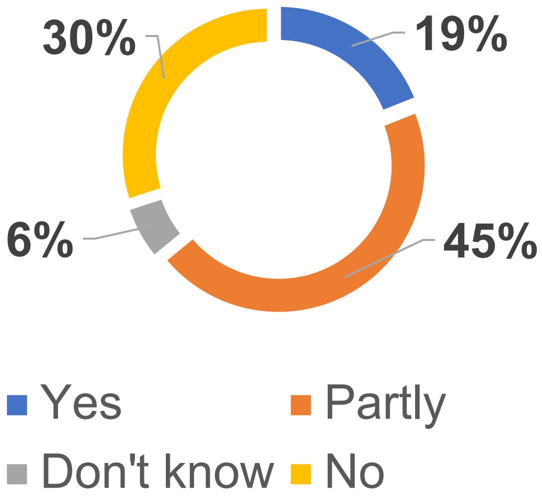
- Easier and less costly
- Direct ownership is more actual
- Increased need for proper shareholder agreement
- Especially in case of employment termination
- Potentially higher tax liability

Stock options

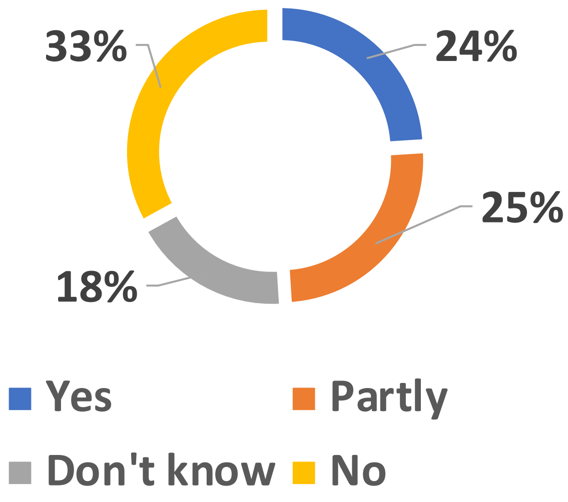
- Higher incentive level
- (delayed) cash injection upon exercise
- Less likely to leave the company
- Complex and costly (more work for lawyers)
- Potentially worthless if business fails

Key takeaways
Focus on SMEs

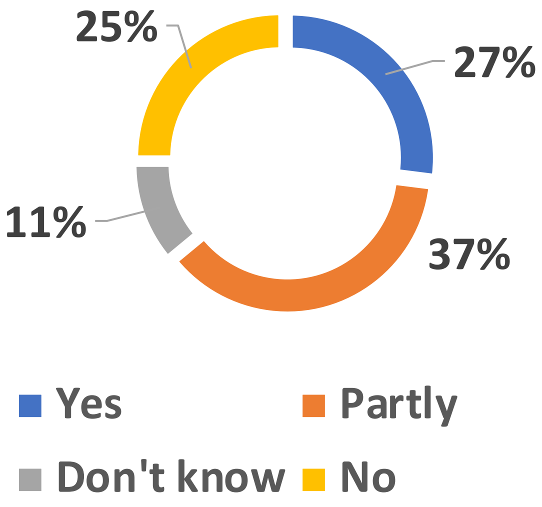
Chance for business development



Increase in profitability



Useful for business succession



Source: VR Equitypartner
(https://www.vrep.de/wp-content/uploads/2022/11/Private-Equity-im-Mittelstand-Studie_2022_final.pdf)

Key takeaways
Focus on SMEs

Purpose	Stock	Stock options
Business development	• Immediate commitment and responsibility • All in: incentive to share all knowledge • At eye level with existing shareholders	• Develop business-relevant skills • Skilled labour shortage: Attractive package for young professionals • More visibility for hidden champions
Profitability	• Need for investments	• Efficient use of existing ressources
Business succession	• Immediate relief for existing shareholders • Core value: Sense of responsibility • Gift Tax: Tax exemptions for discount on FMV	• Chance for most valuable employees (long-term, highly skilled) • Proof that PE investor has a long-term strategy

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Question 3

When will employee stocks be taxed?

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Question 3

When will employee stocks be taxed?

- Time of taxation varies for different jurisdictions.
- Problem for tax planning of incentives by multinational companies.
- There are three main possibilities:

  1. When the option/RSU is granted.
  2. When the option is exercised and the stocks received.
  3. Upon sale of the stock by the employee.

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Question 3

When will employee stocks be taxed?

Bulgaria

- Shift from taxation of the options to taxation of the stocks
- Tax withheld by employer
- Taxation of capital gains of the employee

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Question 3

When will employee stocks be taxed?

Poll question: When are stock option bonuses taxed in your jurisdiction?

a) upon granting of the stock option
b) upon exercise of the option
c) only at the time of sale of the stock by the employees
d) the bonus is exempt

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Question 4

Does it make any difference whether new stocks are issued (increase of capital) or sold by the investor to an employee?

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New issued shares or existing shares

General considerations

- Depending on the jurisdiction, issuing new shares is an extensive process (unfortunately involving a lot of paper).
- In order to issue new shares, capital (cash) often has to be contributed, which is why financing must be provided.

New issued shares or existing shares

Swiss view

- In general, it does not matter for Swiss tax purposes whether the shares are newly issued or come from the investor.
- However, it may be interesting for the investor from a tax point of view to sell the shares to the employee, provided that he or she can claim the loss for tax purposes.

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Question 5

What about the valuation?

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Valuation

General considerations

- Determing the current (or projected) worth of a company is an inaccurate science
- There is no exact fair market value
- Many techniques or valuation method are used to get a valuation
- These valuation methods are often taken from accounting standards or are prescribed by tax authorities
- Often the profit or the profit expectation will be decisive
- Valuations can be quickly impacted by corporate earnings or other events
- The valuation often also depends on the perspective (tax administration, employee, investor)

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Valuation

Swiss view

- Agreeing about any valuation method of (non-listed) shares by a written tax ruling. Tax authorities are very used this process and open-minded
- In general, the valuation method has to take into account at least something from the profit and loss statement (for example EBIT x 7)
- In case there are no profits yet (start-up) the valuation can be as low as the nominal value of the shares
- As a result, the employee can acquire the shares for free or the nominal value and almost no income taxes are triggered

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Valuation

Swiss view

- In an exit scenario a part or full sale proceeds may be qualified as a tax-free capital gain = no tax or social security contributions
- Such exit scenario is typically given, in case within five years a stake of at least 10% is sold or an IPO arises. After five years the employee may sell the shares without income tax consequences
- For listed companies, a discount may be applied on the stock exchange price (e.g. restricted shares)

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Valuation

German perspective

- Inaccurate science → potential for disputes → more work for lawyers
- How to minimize the tax risks?
  - Swiss approach: Ruling
  - German approach: No rulings on valuation
  - Who is at risk?
    - Grantee
    - Employer: wage tax on employment income
  - Best practice
    - Engage lawyer during negotiation – it's cheaper
    - Plausible parameters for valuation
    - Minutes of negotiations

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Question 6

What happens when employment is terminated?

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Employment termination

Stock options (warrants)

Conditions for **preferential** tax treatment (Law of 1999)

- Vesting period of min. 3 / max. 10 years
- Non-transferable
- No hedging or compensation (any type of loss on option exercise)

→ **Taxation at grant** (no matter what happens after)

→ No longer employee? No right to exercise!

  - Wrongful act of the employer?
  - Abuse of law?
  - Condition is void? (fulfilment depends solely on person with a commitment)

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Employment termination

Stock options vs stock

- Option agreement vs shareholders agreement
- Call-option (put-option)
- Good leaver/bad leaver
- Issues if valuation method not properly defined
- Impact on severance package calculation? (foreign parent)

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Employment termination: Stocks

- **Various connections** between company and employee
  - Share participation
  - Employment contract
  - Right to represent the company as a director

  → Need to cut **all** ties
- **Most difficult part:** Share participation (🇩🇪)
  - All shareholders are **equal**:

    No first class / second class shareholders
  - Option agreement in line with **articles of association**?
  - Circumstances of termination **fully** subject to judicial review
    - Valuation
    - Good leaver / bad leaver: extensive case law

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Employment termination: Stocks

Exemplary clauses (perspective)

- **Good leaver**
  - Statutory notice of termination by employer
  - Shareholders resolution to terminate the directorship appointment
  - Chronical illness
- **Bad leaver**
  - Statutory notice of termination by employee (probably violation of labour law)
  - Insufficient contribution to company‘s success
  - Start-up: Founder reduces his efforts → betrays the trust that inversors have put in him
  - Severe violation of employment agreement

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Question 7

What to think of in case of cross-border employment?

General considerations

- DTA or no DTA
- Employment income or capital gain?
- Tax timing mismatch
- Sharing the pie: place-of-work principle
- Future incentive / Past reward
- Other implications (social security, termination package, etc.)

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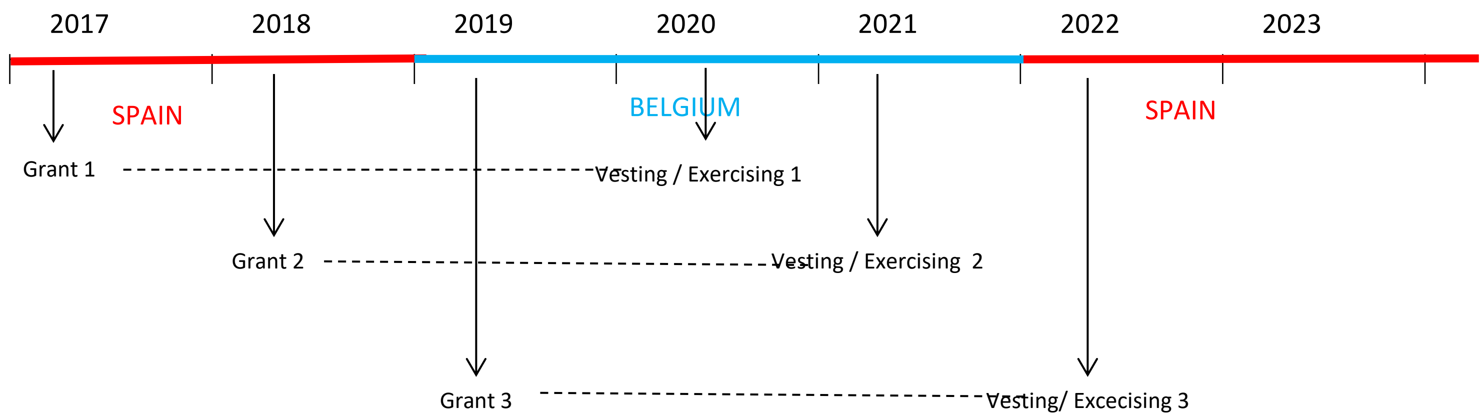
What to think of in case of cross-border employment?



- Residence country vs Source country (place of work)
- Who corrects the double taxation? (credit method vs exemption method)
- And in case of a special tax regime? (impatriate, expat)

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What to think of in case of cross-border employment?

- **OECD approach (2 principles)**

  - option/RSU is granted for **past** achievements
  - option/RSU is granted as a **future** incentive
  → check option agreement for specific conditions!

- **Past reward**: taxation follows international employment situation/salary split (reference period)
- **Ongoing employment** (incentive): reference period between offer/vesting

- Additional sourcing complexity: ***incremental vesting***

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What to think of in case of cross-border employment?

- *Example*

On Jan. 1, 2023, a Belgian tax resident and employee of a Belgian company, is granted 40,000 stock options by the UK parent company:

- 25% (or 1st tranche of 10,000) vests 1 year after grant date (i.e., Jan. 1, 2024);
- 25% (or 2nd tranche of 10,000) vests 2 years after grant date (i.e. Jan. 1, 2025);
- 25% (or 3rd tranche of 10,000) vests 3 years after grant date (i.e. Jan. 1, 2026);
- 25% (or 4th tranche of 10,000) vests 4 years after grant date (i.e. Jan. 1, 2027).

▪ Vesting period 1: Jan. 1, 2023 to Jan. 1, 2024.
▪ Vesting period 2: Jan. 1, 2023 through Jan. 1, 2025.
▪ Vesting period 3: January 1, 2023 through January 1, 2026; and
▪ Vesting period 4: Jan. 1, 2023 through Jan. 1, 2027

→ January to May 2023: UK
→ June 2023 to March 2026: Belgium
→ April 2026 to December 2027: UK

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What to think of in case of cross-border employment?

- *Example*

When the employee exercises all of the options in 2028 (i.e., 5 years after initial offering), and realizes a taxable benefit, they will have to take into account that both Belgium, and UK have a taxing right

% options	% taxing right of Belgium	% taxing right of the UK
1e 25%	41,67% (= 5 months in BE on a total vesting period of 12 months)	58,33% (= 7 months in the UK on a total vesting period of 12 months)
2e 25%	70,83% (= (5 + 12) / 24)	29,17% (= 7 / 24)
3e 25%	80,55% (= (5 + 12 + 12) / 36)	19,44% (= 7 / 36)
4e 25%	66,67% (= (5 + 12 + 12 + 3) / 48)	33,33% (= (7 + 9) / 48)
result	*64,93%*	*35,07%*

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What to think of in case of cross-border employment?

- *Additional complexities*

- What if the employee becomes a UK resident during the vesting period?
- What if the employee starts working for another entity within the same group?
- What if the employee exercises the options in an irregular way?
- What if an exit event occurs at the group level, resulting in an accelerated vesting?

→ **complex exercise!**

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Question 8

What happens if there is an exit / IPO?

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Exit / IPO

General considerations

- Everybody is happy

Conclud
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remarks

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