EMPLOYEE INCENTIVES – IMPLEMENTATION AND TAXATION

Lexia Growth Academy
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Legal Excellence

FOCUS

- Numerous ways to incentivize employees

- Focus
  - Employee share issue
  - Options
  - Subscription of shares

VALUATION OF SHARES

- Fair value is the value with relevance in taxation
- Fair value = probable selling price between two independent parties on a free market

- Different methods for defining the fair value
  - Comparable transactions between independent parties
  - Calculation based on financial statements
    - Calculation formula for defining the Net Asset Value and Yield Value

VALUATION OF SHARES

- Calculation formula applied by the Tax Authority (simplified):

- Net Asset Value
  - Equity on the balance sheet from latest financial year
  - Corrections, e.g. with differences between fair and tax values of assets

- Yield Value
  - Average of the Annual Yield Values from past three years
  - The Annual Yield Values are calculated with a yield rate of 15 %.

- Fair Value
  - If the Net Asset Value is higher than the Yield Value, the Fair Value is equal to the Net Asset Value
  - If the Yield Value is higher than the Net Asset Value, the Fair Value is equal to the average of the Net Asset Value and the Yield Value

VALUATION OF SHARES

- Fair Value – a simplified example:
  - Net Asset Value
    - Equity per 20x3: 100
    - Asset X: tax value 300, fair value 400
    - NAV: 100 + (400 – 300) = **200**
  - Yield Value
    - Result per 20x1: 60
      - Annual Yield Value: 60/15 % = 400
    - Result per 20x2: 120
      - Annual Yield Value: 120/15 % = 800
    - Result per 20x3: 45
      - Annual Yield Value: 45/15 % = 300
    - Yield Value: (400 + 800 + 300)/3 = **500**
  - Fair Value
    - (200 + 500) / 2 = **350**
    - (350 / number of shares = fair value per share)

EMPLOYEE SHARE ISSUE

- New legislation regarding taxation of employee share issues entered into force on the 1st of January 2021

- Clarification of valuation
  - Mathematical value replacing fair value
    - In simple terms: equity (NAV) / number of shares = mathematical value
    - The mathematical value appears on the tax decision
      - Adjusted with possible capital investments / dividends

  - Simplifies valuation issues

  - Possibility to apply subscription prices below the fair value without tax effects

EMPLOYEE SHARE ISSUE

- Prior to the reform, the difference between the subscription price and the fair value of shares subscribed at unlisted limited liability companies was considered the employees' taxable income

  - Taxation as earned (wage) income with a progressive tax rate of up to over 50 %

  - Exemption: in case the subscription was offered to the majority of the employees, the benefit was taxable only to the amount the subscription price is less than 90 % of the fair value of the shares.

  - Example
    - Subscription price: 50
    - Fair value / share: 350
    - Math. value /share: 100
    - Income: 300 (350 – 50)
    - Taxable amount: 270 (90 % x 300)
    - Tax (tax rate 50 %): 135 (50 % x 270)

EMPLOYEE SHARE ISSUE

- Current regulation
  - From 1.1.2021 onwards, when certain requirements are met, the determination of the taxable amount is based on the mathematical value of the shares issued
    - Self-created goodwill and differences between fair and tax values of assets are excluded from the tax base
  - Previous regulation (fair value, 90 % taxable) still valid

  - Example
    - Subscription price: 50
    - Fair value / share: 350
    - Math. value /share: 100
    - Income: 50 (100 - 50)
    - Tax (tax rate 50 %): 25 (50 % x 50)

EMPLOYEE SHARE ISSUE

- Main points
  - The opportunity to subscribe shares must be offered to the majority of the personnel
    - The number of shares offered to each employee can vary for example depending on the value of the employee's work contribution

  - Applicable only on
    - Employees and managing directors, but not on board members
    - Subscribers owning less than 10 % of the stock

- When selling the shares, profits are taxed with the capital gains tax rate (30 – 34 %).

EMPLOYEE SHARE ISSUE

- Implementation
  - Employee share issue = directed share issue
  - The General Meeting decides on the issue
    - The Board of Directors may also be authorized to decide on the issue
  - The decision must be made by qualified majority, i.e. at least ⅔ of the votes cast and the shares represented at the meeting support the proposal
  - Requires a weighty financial reason for the company
    - E.g. rewarding employees
    - If the issue is done without payment, an especially weighty reason for the company and regarding the shareholders' interest is required
  - Typically, a SHA that specifies, for example, the redemption of shares at the end of the employment relationship, is drawn up
    - E.g. so-called good leaver term may be used

OPTIONS

- Definition
  - Call options give buyers the right, but not the obligation, to buy or sell an underlying asset at an agreed-upon price and date
  - Life cycle:
    - promise
    - grant
    - vesting period
    - vesting
    - exercise
    - restriction period

- Taxation Principles
  - Time of exercise, i.e. the time when subscribing the share, decisive for taxation
  - Taxable income = fair value - total subscription price (option and share)
  - Taxation as earned (wage) income with a progressive tax rate
  - No similar valuation advantages nor limitations on applicability as in employee share issues

OPTIONS

- Example
  - Grant:
    - Option: 150
    - Fair value / share: 50
      - No tax effect at grant
  - Excercise:
    - Subscription: 150
    - Fair value / share: 350
    - Taxable amount: 200 (350 – 150)
    - Tax (tax rate 50 %): 100 (50 % x 200)

OPTIONS

- Implementation
  - The General Meeting decides on the issue of options
    - The Board of Directors may also be authorized to decide on the issue
  - The decision must be made by qualified majority, i.e. at least ⅔ of the votes cast and the shares represented at the meeting support the proposal
  - Requires a weighty financial reason for the company

SHARE ISSUE

- Share issue vs. options
  - When the value is based rather on future yield expectations than on historical financial results or assets, simple share issues can be preferable to options

- Example

• Fair value / share 20x1:	50	
• Subscription price:	50	
• Taxable income	0	(50 - 50)
• Fair value 20x3:	350	

  - No tax effect before selling

- Implementation according to what's described for employee share issues

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