EMPLOYEE PARTICIPATION

Profit Participation Rights (#Genussrechte) – tax attractive alternative to VSOPs?

Profit participation rights are not yet the first choice for incentivizing employees of an exit-driven startup by allowing them to participate in the future success of the startup. However, they offer a more favorable taxation scheme compared to participants in virtual share option programs (VSOPs), without encountering the same governance challenges and formal requirements associated with equity-based programs for employees.

To challenge the dominance of VSOPs, profit participation rights must combine the practical advantages of a VSOP with the tax benefits of equity-based programs. Achieving this without creating taxable dry-income is currently feasible only for the employees of a startup through the application of the revised section 19a of the German Income Tax Act (*Einkommensteuergesetz – EStG*).

Below, we have outlined the key features of a profit participation right designed for employee incentivization. It is our common goal that these essential structural principles facilitate a market-wide acceptance as well as a future recognition by tax authorities.

What are Profit Participation Rights and how can they be utilized for Employee Incentive Purposes?

Profit participation rights are financial instruments under German law that allow for flexible structuring due to the absence of a detailed legal framework or definition. This flexibility enables companies to tailor these rights to their specific needs.

In the context of German limited liability companies (*GmbHs*), profit participation rights can create contractual entitlements that mirror the financial benefits of shareholders (without the issuance of 'real' shares). These benefits include profit sharing, participation in liquidation proceeds and, in particular, the chance to have a share in future exit proceeds (via a sale of the profit participation rights in the context of an exit).

Unlike shareholders, holders of profit participation rights do not receive the same information, control, and voting rights. This distinction allows companies to offer financial incentives without diluting control or complicating governance, *e.g.*, associated with a cap table filled with (former) employees.

Finally, and important to note, profit participation rights are (under the general conditions) suitable to make use of the advantages of section 19a EStG for the benefit of the startup's employees, *i.e.*, avoiding dry income taxation upon issuance with respect to any benefit-in-kind resulting from a difference between the contribution (*Einlage*) made by the beneficiary with respect to the profit participation rights and their fair market value. Payments based on the profit participation rights to the beneficiaries which are exceeding the fair market value at grant are then subject to favorable German capital gains taxation (*Kapitalertragsteuer*) when realized (again, without the issuance of 'real' shares), which is a major advantage of the beneficiaries compared to VSOPs.

What's the difference between Profit Participation Rights and Virtual Share Options?

When it comes to employee incentivization, profit participation rights and VSOPs offer distinct yet comparable benefits.

The profit participation right mirrors the economic rights of common shares. Holders of these rights receive the same financial rewards upon an exit as the holders of common shares, typically the founders. Similarly, beneficiaries under a VSOP are entitled to remuneration or participation claims with respect to specified liquidity events as outlined in the VSOP plan terms.

Neither profit participation rights nor VSOPs convey beneficiaries with shareholder rights beyond mere participation in the startup's profits.

To obtain the profit participation right, the beneficiary shall make a modest cash contribution (*Einlage*) to the startup, which represents their risk stake in the startup. The beneficiary holds a claim for repayment against the startup for this contribution. However, there is no guarantee that the beneficiary will recover the payment made, especially in scenarios like the liquidation of the startup.

Beside these rather 'structural' considerations, a major advantage of profit participation rights is their more favorable tax treatment. Specifically, if structured appropriately, they can benefit from the application of section 19a EStG and capital gains taxation.

Proposal on how to structure a Profit Participation Right – Key Theses on the path to a market-standard

When structuring a profit participation right for German employees (*i.e.*, German tax resident employees) of a German startup*, the following theses should be considered:

1. In line with the participation of a common shareholder (typically the founders), the profit participation right is issued for a contribution mirroring the nominal value (*Nennwert*) of a common share with corresponding economic *pro rata* rights (*i.e.*, EUR 1 per profit participation right with same financial rights as a common share with a EUR 1 nominal amount).
2. The fair market value of the profit participation right is based on an external appraisal to be prepared in timely context with the issuance.
3. The repayment claim of the profit participation right is adjusted over the term of the profit participation right, taking into account both profits and losses. It is proportionally decreased by losses and, if previously adjusted downward, is (re-)increased by profits up to the initial contribution amount.
4. The profit participation capital ranks *pari passu* to the capital restitution claims of the shareholders.
5. The profit participation right participates *pro rata* (on the same level as common shares) in any dividend distributions during its term (although dividend distributions are obviously rather rare in startup land) and, in the event of the startup's dissolution, in any liquidation proceeds.
6. The profit participation right is subjected to a negative vesting.
7. Beneficiaries holding a profit participation right participate in an exit by selling their profit participation right during an exit to certain shareholders (not the startup itself) designated by the startup. For reasons of transaction security, this is backed-up by way of a call option to be granted by the beneficiaries.
8. The beneficiary is not entitled to specific voting, control, objection or information rights under the profit participation right.
9. With respect to any vested profit participation rights, the startup commits to irrevocably declare – in line with section 19a EStG – to be liable *vis-à-vis* the competent tax authorities for any payroll taxes in case of a (later) disposal of the profit participation right to avoid wage tax accrual in case of (earlier) termination of the employment relationship in a good leaver event or the expiration of 15 years stipulated by mandatory law.

**It needs to be considered that the benefits from the application of section 19a EStG only apply for employees of the issuing startup but not for example for its freelancer, third-party service-provider, members of the advisory board that are not employees of the startup, etc.*