

Employee Stock Options in the EU and the USA

FINAL REPORT

AUGUST 2002

Germany

Contents

	Page
Germany	
1. General remarks	4
1.1 History	4
1.2 Current situation	5
2. Key features of stock option plans	5
3. Taxation	7
3.1 Time of taxation	7
3.2 Taxable gain	7
3.3 Type of tax	7
3.4 Capital gains taxation	8
3.5 Tax consequences for the granting company	9
3.5.1 Social security contributions	9
3.5.2 Corporate tax deduction	9
3.5.3 Other	10
4. Issues for employees	10
4.1 Reporting obligations	10
4.2 Cashflow issues	10
4.3 Change in employees residence status	10
5. Issues for employers	11
5.1 Reporting obligations	11
5.2 Withholding obligations	11
6. Legal issues	12
6.1 Process/timeframe	12
6.2 Employment law	13
6.3 Data protection	13
6.4 Stock exchange issues	13

6.5	Securities law	14
6.6	Financial assistance	14
6.7	Other	14
7.	Sourcing shares for stock option plans	14
8.	Role and influence of existing shareholders	18
9.	Accounting	18
10.	Miscellaneous	20
11.	Special points of note	21
11.1	Mitigation of income tax	21
11.2	Mitigation of social security contributions	21
11.3	Mitigation of tax on sale of shares	21
11.4	Special provisions for SMEs	21

Germany

1. General Remarks

1.1 History

- 1.1.1 Under the German Stock Corporation Act ("AktG") there are detailed provisions regarding stock options for stock corporations. There are two types provided for, "naked options" and "convertible bonds options". The provisions in the AktG also cover the different methods of sourcing the shares needed for a stock option plan, e.g. conditional capital, permitted capital, regular capital and acquisition of own shares.
- 1.1.2 Before the introduction of the Corporate Sector Supervision and Transparency Act (KonTraG) on 1 May 1998¹, it was not legally possible to issue options unless they were based on convertible bonds. Even with convertible bonds it was not certain whether they were feasible, because various shareholders had made claims against this kind of stock option plan in the German courts². As a result of this uncertainty, only large enterprises like Volkswagen, Deutsche Bank and Telekom operated stock option plans before May 1998.
- 1.1.3 The position changed following the introduction of the KonTraG on 1 May 1998, when it became possible to grant options to subscribe new shares ("naked options"). Since then, stock option plans have been implemented more broadly.
- 1.1.4 The KonTraG permitted the grant of naked stock options to employees of a company and members of the management board without the need to use convertible bonds or option bonds³. It also established the conditions necessary for conditional capital increases in respect of the grant of naked stock options.⁴
- 1.1.5 It was the aim of the KonTraG to implement naked stock options as part of management remuneration, to improve the liquidity of stock corporations, and to unite shareholders and management/employees by virtue of a common goal. The introduction of KonTraG has not prevented the continued use of options based on convertible bonds and option bonds.
- 1.1.6 There are no specific regulations regarding the tax treatment of employee stock options. The general rules regarding taxation of employee benefits and the date at which such benefits are taxed have not been changed in recent years. However, the taxation of stock options has been a topic of discussion in literature with a particular focus on whether the benefit should be taxed at the date of grant, vesting or exercise.
- 1.1.7 The taxation of stock options has been influenced substantially by case law. In 1972 the highest German tax court Bundesfinanzhof ("BFH") ruled that the granting of an option does not constitute taxable income at the date of grant. Furthermore, an option does not qualify as an asset if it is not transferable⁵. In 1999 the BFH decided that employee stock options might qualify as assets. However, as long as the options are not

¹ Sections 192, 193 of the German Stock Corporation Act (AktG).

² According to section 221 AktG.

³ See section 71 para 1 No 8 AktG.

⁴ See section 192, para 2 No 3 and section 193 para 2 No 4 AktG.

⁵ BFH: 10.3.72, BStBl II 1972, p. 596.

transferable, tax will be levied at the date of exercise rather than at the date of grant⁶. After that ruling, some commentators have argued that taxation should occur at the date of grant rather than the date of exercise⁷ and some have argued that the taxable moment should be the date when all restrictions on exercise have lifted (the vesting date)⁸. However, in 2001 the BFH confirmed the approach taken in its 1999 ruling.

- 1.1.8 With two judgements in 2001, the BFH ruled for the first time that benefits derived from an employee stock option plan remunerate duties that are to be performed between the date of grant and the date of exercise. This ruling is significant in relation to non-resident employees as it clarifies which part of the benefit is subject to tax in Germany, if the taxpayer is not a tax resident at the date of exercise⁹.
- 1.1.9 In addition, with the most recent judgment, the BFH again confirmed that it is not arguable that the benefit of employee stock option plans arises at the vesting date.¹⁰

1.2 Current situation

- 1.2.1 In Germany stock option plans are predominantly established by large stock corporations¹¹ quoted on the regular stock exchange or medium stock corporations quoted on the New Market, especially in the information technology sector.
- 1.2.2 There are no special stock option plans aimed at specific sectors or companies. There are no official statistics available to estimate how widely stock option plans are used in Germany. An estimate is that nearly 70 out of the 100 major stock corporations in Germany have established stock option plans for middle and upper management. In relation to the New Market it can be estimated that nearly 90 % of the stock corporations have or intend to establish stock option plans¹².
- 1.2.3 There have been discussions within the German Government in relation to implementing rules that would ensure that tax arose at grant of options. However, until now there have been no changes.
- 1.2.4 There is currently a case pending at the BFH concerning whether the benefit derived from the exercise of stock options qualifies for a special tax rate, which applies to exceptional payments received in any one year, remunerating duties performed over several years¹³.

2. Key features of stock option plans

- 2.1 There are no specific tax favoured stock option plans in Germany.

⁶ BFH: 23.7.99, BStBl II 1999, p. 684.

⁷ Isensee, DStR 1999, p. 143; Neyer, BB 1999, p. 130; Portner, DStR 1998, p. 1535.

⁸ e.g. Kroschel, BB 2000, p. 179.

⁹ BFH: 24.1.2001, BStBl II 2001; p. 509 and p. 513.

¹⁰ BFH: 20.6.2001, DStR 2001, p. 1341.

¹¹ See BHF Bank AG, Federal Gazette 1987, Page 4063; Continental AG, Federal Gazette 1995, Page 4843; Daimler Benz AG, Federal Gazette 1996, Page 4324 and Federal Gazette 1997, Page 5066; Deutsche Bank AG, Federal Gazette 1996, Page 4036; Nixdorf Computer, Federal Gazette 1989, Page 2176; Puma AG, Federal Gazette 1996, Page 2188; SAP AG, Federal Gazette 1994, Page 4484; Henkel KGaA, Federal Gazette 1997, Page 3356; Schwartz Pharma, Federal Gazette 1997, Page 12454; Volkswagen AG, Federal Gazette 1997, Page 4783; Metallgesellschaft AG; Federal Gazette 1998, Page 2121.

¹² Source is Achleitner/Wollmert, stock options, Stuttgart 2002 (2nd Edition)

¹³ BFH: VI R 136/01

- 2.2 Stock options granted pursuant to the KonTraG are subject to a minimum term of two years.¹⁴
- 2.3 If a stock option plan pursuant to the KonTraG does not take into account the minimum term of two years, shareholders may demand that the company extend the term to two years. It is not possible for employees to breach this minimum term because this period is a specified condition of option grant¹⁵.
- 2.4 There are no legal requirements regarding a maximum term for which a stock option must subsist but in general stock option plans provide that options must not be exercised after a maximum period of ten years following grant.
- 2.5 Naked options may only be issued to the management and the employees of the company itself and any affiliated companies. Members of the supervisory board and freelancers are specifically excluded from participating. No such requirements exist in relation to plans based on convertible bonds etc.¹⁶
- 2.6 Single employees or groups of employees with comparable rights and duties may only be treated differently if an objective reason exists¹⁷.
- 2.7 There are no specific restrictions on the nature of the shares over which options may be granted under a stock option plan, but usually companies only grant options over ordinary shares of their own stock.
- 2.8 While no specific restrictions exist on the type of company that may grant options under a stock option plan, difficulties exist for certain types of company. A company with limited liability (GmbH) would have to notarise an option contract in order to grant options, and this is both expensive and work intensive. A corporation not listed on the stock exchange would face problems in determining the share price when required for tax purposes, and employees would have no market where these shares could be traded.
- 2.9 The price payable on option exercise may not be below nominal value of the underlying share. It is recommended that the option price equals the fair market value ("FMV") of the shares at the time when the option is issued to the employee to avoid benefiting employees at the expense of shareholders. Granting options at FMV ensures that employees only benefit from the increase in share value from option grant, and to grant discounted options risks provoking claims from shareholders¹⁸.
- 2.10 Tradable options are not common in Germany. To be tradable an option merely needs to be transferable; it does not have to be listed on an exchange.

¹⁴ Section 193 para 2 No 4 Stock Corporation Act (Aktiengesetz, "AktG").

¹⁵ Section 193 para 2 No 4 and section 243 para 1 AktG.

¹⁶ section 193 para 2 AktG.

¹⁷ General principle of German Labour Law.

¹⁸ Section 9 para 1 AktG.

3. Taxation

3.1 Time of taxation

- 3.1.1 Options are subject to income tax and social security contributions at the time of exercise.
- 3.1.2 There is no charge to tax or social security contributions at the time of grant even if the option is granted at less than FMV.¹⁹ If the option is transferable on the open market it may be taxable at grant, but such options are rare so they are ignored for this report. In the case of convertible bonds the timing of taxation is not fully clear; a case is still pending at the Federal Court of Finance (BFH)²⁰.
- 3.1.3 Neither is there a charge to tax or social security²¹ at the time of vesting²².

3.2 Taxable gain

- 3.2.1 The taxable benefit is calculated as the difference between the share price at the date of exercise and the exercise price²³.
- 3.2.2 Employee social security contributions are levied on the total employment income. The contributions are, however, capped, so no additional contributions are levied if the employment income exceeds a certain level per annum. Contributions for 2002 are capped at:
- Old age pension: €54,000.
 - Unemployment insurance €54,000.
 - Health insurance €40,500.
 - Disability insurance €40,500²⁴.

3.3 Type of tax

- 3.3.1 The benefit derived from the exercise of employee stock options is subject to income tax and taxed as employment income²⁵. The benefit is also subject to a solidarity surcharge²⁶. If the employee has registered for church tax, the benefit is also subject to church tax²⁷.
- 3.3.2 The benefit is added to all other taxable income and the tax rate is applied to the total income from all sources less certain deductions granted under German tax law.

¹⁹ Section 11 Income Tax Act (Einkommenssteuergesetz, "EStG"); BFH: 24.1.2001, BStBl. II 2001, p. 509

²⁰ Knoll StB 2002, p. 88

²¹ Section 23a SGB IV; Guidance by Social Security Authorities 26.6.99. ("Besprechungsergebnisse der Spitzenorganisationen der Sozialversicherungsträger vom 26.6.99").

²² Section 11 EStG ; BFH v. 24.1.2001, BStBl. II 2001, S. 509.

²³ Sections 2, 8 and 32a EStG

²⁴ Sections 223, 241-248 SGB V; sections 158-160 SGB VI, section 341 SGB III. In Eastern Germany pension and employment contributions are capped at € 45,000 p.a.

²⁵ Sections 11 and 19 EStG.

²⁶ Section 1 Solidarity surcharge tax act ("Solidaritätszuschlagsgesetz").

²⁷ Local Church tax legislation.

- 3.3.3 The benefit is subject to the ordinary progressive income tax rates. The highest marginal income tax rate in 2002 is 48.5% with the solidarity surcharge levied at 5.5% of the income tax (not the taxable benefit). The marginal rate including solidarity surcharge is therefore 51.17%²⁸. Tax rates can be affected by family status, so that if one of the spouses earns less than the other, the overall amount of tax paid by the couple can be reduced.
- 3.3.4 The taxable benefit is also subject to social security contributions; old age pension insurance, unemployment insurance, health insurance and disability insurance²⁹. These are levied on all employment income (up to the earnings caps set out at 3.2.2).
- 3.3.5 The rates applicable to the taxable benefit for 2002 are:
- Old age pension 19.1 %.
 - Unemployment insurance 6.5 %.
 - Health insurance 13.5% (average).
 - Disability insurance 1.7 %.
- 3.3.6 The employer is liable for half of the contributions. The employee is liable for the remaining half³⁰.

3.4 Capital gains taxation

- 3.4.1 On the disposal of shares acquired on the exercise of an option, any gain arising may be subject to tax but only if the shares are disposed of within one year after the exercise of the options³¹. However, if the employee holds stock representing at least 1% of the nominal capital of the company or more gains are always taxable.³²
- 3.4.2 Tax is levied on the difference between 50% of the proceeds and 50% of the cost of acquisition. The cost of acquisition is assumed to be the share price at the date of exercise³³.
- 3.4.3 The capital gain is subject to income tax³⁴, at the individual's marginal tax rate³⁵ (see 3.3.3). However, capital gains are exempt from taxation if all capital gains realised in a calendar year do not exceed €511³⁶.
- 3.4.4 There are no social security contributions due on the sale of shares.
- 3.4.5 If the shares are sold at a loss within a period of one year after exercise the capital loss

²⁸ Section 32a EStG

²⁹ Section 23a SGB V; Guidance by Social Security Authorities 26.6.99. ("Besprech-ungsergebnisse der Spitzenorganisationen der Sozialversicherungsträger vom 26.6.99").

³⁰ Sections 223, 241-248 SGB V; sections 158-160 SGB VI, section 341 SGB III.

³¹ Section 23 EStG.

³² Section 17 EStG.

³³ BFH v. 20.6.2001, DStR 2001, S. 1341.

³⁴ Section 23 EStG

³⁵ Sections 3, 3c and 23 EStG.

³⁶ Sections 2, 23 and 32a EStG.

arising can be offset against capital gains, but not against other sources of income³⁷.

3.4.6 The loss can either be carried back to the preceding year or carried forward (for an unlimited period) and offset against other capital gains³⁸.

3.4.7 There is no wealth tax in Germany.

3.5 Tax consequences for the granting company

3.5.1 Social security contributions

3.5.1.1 There are no employer social security contributions due at the date of grant or the date of vesting³⁹.

3.5.1.2 There may be a liability to employer social security contributions at the date of exercise. The taxable benefit is subject to old age pension insurance, unemployment insurance, health insurance and disability insurance⁴⁰. The rates for 2002 are set out at 3.3.5 and 3.3.6 above. Contributions are capped as set out at 3.2.2 above.

3.5.2 Corporate tax deduction

3.5.2.1 In general the employing company will be entitled to claim a deduction against its profits for corporation tax for the costs of an option plan⁴¹. There are no specific requirements or formalities for securing the deduction, or deadlines for submitting a claim.

3.5.2.2 To claim a deduction, costs will have to be accounted for in the statutory accounts of the company⁴². The administrative and implementation costs of a stock option plan will always be accounted for and deductible. The cost of the 'spread' (i.e. the difference between share value at exercise and exercise price paid) will only be deductible if this cost appears in the accounts, and the accounting treatment will depend on how shares are sourced to satisfy option exercise (see section 9).

3.5.2.3 The corporate tax deduction will be available at the time the costs are accounted for in the balance sheet.⁴³

3.5.2.4 A recharge of costs to or from another group company should be based on a written recharge agreement⁴⁴. The agreement needs to be set up prior to recharging any costs but not necessarily prior to the granting of any option, and must be on an arms length basis⁴⁵. Provided the amount recharged is shown as a cost in the accounts, a deduction will be available.

³⁷ Section 23 EStG.

³⁸ Section 23 EStG.

³⁹ Section 23a SGB V; Guidance by Social Security Authorities 26.6.99. ("Besprech-ungsergebnisse der Spitzenorganisationen der Sozialversicherungsträger vom 26.6.99").

⁴⁰ Sections 223, 241-248 SGB V; sections 158-160 SGB VI, section 341 SGB III.

⁴¹ Section 8 KStG, sections 4 and 5 KStG.

⁴² Section 5 EStG.

⁴³ Section 5 EStG.

⁴⁴ Section R 31 para 5 Corporation Tax Directives (Körperschaftssteuerriichtlinien, KStR).

⁴⁵ Section R 31 para 5 KStR.

3.5.3 *Other*

- 3.5.3.1 VAT sales tax and stamp duty/transfer tax have no impact on the operation of employee stock option plans in Germany.

4. **Issues for Employees**

4.1 **Reporting Obligations**

- 4.1.1 There are no reporting obligations for employees at grant, vesting or exercise of options.
- 4.1.2 The employee needs to report the sale of the shares on his individual income tax return, if the disposal is subject to tax (see section 3.4)⁴⁶. The employee has to report the sale price, the price of the shares at exercise and the costs related to the disposal of the shares on his tax return.
- 4.1.3 The tax return needs to be filed by 31 May following the year in which the shares are disposed of. If a tax adviser represents the employee, the deadline is 30 September⁴⁷.
- 4.1.4 Any claim for the carry back or carry forward of a loss arising on the sale of the shares has to be applied for in the annual tax return for the year in which the loss was realised. The deadlines for such a claim are the same.

4.2 **Cashflow Issues**

- 4.2.1 There are no special tax rules or corporate practices to alleviate cash flow problems in relation to the income tax and social security contributions liabilities arising on the exercise of the options. However, in practice these tax liabilities are often covered by the immediate disposal of some of the shares acquired at exercise.

4.3 **Change in employee's residence status**

- 4.3.1 The income tax and social security contributions positions would differ if:
- The employee is tax resident at the vesting of the option but was not tax resident at the date the option was granted.
 - The employee is not tax resident at vesting but was tax resident at the date of grant.
 - The employee is not resident at grant, not resident at vesting but resident in between.
- 4.3.2 If at the date of exercise, an employee is a tax resident of a country with which Germany has entered into a double taxation treaty, the employee may be entitled to claim a treaty exemption for part of the taxable benefit. The taxable benefit derived from the exercise of an employee stock option is, from a German point of view, under the scope of Article 15 of the OECD Model treaty. If the options remunerate duties that have been partly performed in another treaty country, the employee can generally claim an exemption for the part of the taxable benefit corresponding to the period of work performed in the other

⁴⁶ Sections 23, 25 EStG.

⁴⁷ Section 149 General Tax Act (Abgabenordnung, "AO").

country. The BFH ruled in 2001 that benefits derived from employee stock options generally remunerate duties performed between the date of grant and the date of exercise. Therefore the employee may be entitled to an exemption based on Article 15 of the OECD Model Treaty for that part of the benefit corresponding to the period of duties performed in the other country, calculated on a pro rata time basis⁴⁸.

4.3.3 Where the employee is not tax resident at exercise but was tax resident at the date of grant, Germany will not tax the total benefit. Only the part of the benefit that relates to work performed in Germany between grant and exercise is subject to tax in Germany that is calculated on a pro-rata time basis. The benefit is taxed under the tax rules for non residents⁴⁹.

4.3.4 Where the employee is not resident at grant, not resident at exercise but resident in between, the total benefit will be pro-rated and taxed in Germany only to the extent earned in respect of German duties.⁵⁰

5. Issues for Employers

5.1 Reporting Obligations

5.1.1 There are no reporting obligations at grant or vesting.

5.1.2 There are no reporting obligations for the employer in relation to the exercise of stock options unless it is not possible to meet the withholding obligations (see section 5.2).

5.1.3 There are no reporting obligations for the employer in respect of the sale of the shares.

5.2 Withholding Obligations

5.2.1 There are no withholding obligations at grant or vesting.

5.2.2 At the date of exercise the employer must withhold wage tax at the individual's tax rate.⁵¹

5.2.3 The employer must withhold the tax liability arising in respect of the stock option from any payment that qualifies as employment income under section 19 of the German Income tax act⁵².

5.2.4 If the employer cannot withhold the full wage tax because the level of salary did not generate sufficient cash, the employer is obliged to report this fact to the tax office in charge of the employer's tax affairs⁵³.

⁴⁸ Art. 4, 15 and 23 OECD Double Taxation Treaty. BFH: 24.1.2001, BStBl. II 2001, p. 509.

⁴⁹ Section 49 EStG.

⁵⁰ Section 49 EStG.

⁵¹ Sections 38, 38a EStG.

⁵² Section 38 EStG.

⁵³ Section 38 para 4 EStG.

5.2.5 If the employer did not withhold wage tax, because he was not aware of the withholding obligation, the employer is entitled but not obliged to correct the withholding from the next salary payment. If he does not correct the withholding, he is obliged to report this to the tax office in charge of the employer's tax affairs. The tax authorities will then claim the tax back from the employee⁵⁴.

5.2.6 The employer has to file a wage tax declaration on a monthly basis⁵⁵. The amount must be withheld and paid to the tax authorities by the 10th day following the month of exercise⁵⁶.

6 Legal Issues

6.1 Process/Timeframe

6.1.1 It is estimated that it would take an average period of three months to implement a stock option plan from commencing drafting the plan rules to the date when the first option can be granted.

6.1.2 The time period, and applicable procedures involved in establishing a plan depend on the chosen way of sourcing shares for the stock option plan, for example conditional capital, permitted capital, acquisition of own shares for naked options, or options by means of convertible bonds.

6.1.3 Generally the procedure can be outlined as follows:

- Shareholders decision to implement stock option plan.
- Appointment of consultants.
- Preliminary establishment of the conditions of the plan.
- Presentation of the plan to the employees/management.
- Drafting of the resolutions and contracts.
- Shareholder's approval of the capital increase of up to 10 % of the initial capital (either as resolution of consent or general empowerment of the management board).
- Notification and registration of the capital increase at the commercial register.
- Grant of the stock options by the management board to the employees.
- Notification and registration of the exercise of stock options at the commercial register⁵⁷.

⁵⁴ Section 41c para 1 EStG.

⁵⁵ Section 41a EStG.

⁵⁶ Section 41 a EStG.

⁵⁷ Sections 198, 199 (Stock Corporations Act, Aktiengesetz "AktG") AktG.

6.2 Employment Law

- 6.2.1 Provided that employer and employee are parties to a collective agreement ("Tarifvertrag") such an agreement is collectively binding. A reduction of a collectively agreed salary in exchange for stock options is invalid and allows the employee to claim for payment of the difference⁵⁸.
- 6.2.2 The "principle of equal treatment" prohibits discrimination of employees in equal positions, with no substantial reason. The principle also applies to part-time employees and individuals on fixed-term contracts⁵⁹. Where a distinction is made between full-time and part-time employees or between permanent and fixed term employments, this must have a reasonable cause beyond the difference in working time or nature of employment.
- 6.2.3 Under German labour law a successful claim for unfair dismissal may only result in a socially unjustified termination and a continued employment relationship, but not in damages against the value of lost options. In the case of continued employment, the employee remains entitled to exercise his options, if all other conditions are fulfilled.⁶⁰
- 6.2.4 It should be noted that as a general principle of German law, where stock options are granted as an additional benefit, a forfeiture clause not exceeding a period of five years (that options lapse if employment ceases within five years of grant) may be considered admissible⁶¹.
- 6.2.5 Where share options are a substantial part of contractual remuneration, such a forfeiture clause will be invalid. Therefore the employee will be able to exercise the share option even after termination of the employment relationship.

6.3 Data Protection

- 6.3.1 Assuming that the employer is processing data that it has already obtained from employees with the necessary consents, and that the data is not being transferred to a third party, no further consents are required for the implementation of a stock option plan. However, if the employer has to obtain new data, or transfers it to a third party, employee consents may be required.

6.4 Stock Exchange Issues

- 6.4.1 Generally there are no requirements to file/register the plan itself. However, any capital increase requires shareholders' approval and the shareholders usually have to decide on the major points of the stock option plan - for example the distribution of subscription rights among members of the management and employees, performance targets, periods for the granting and exercise of the subscription rights, and the waiting period for the initial exercise of the subscription rights.

⁵⁸ Section 4 para 3 Collective Agreement Act ("Tarifvertragsgesetz").

⁵⁹ General Principle of German Law. Section 4 para 1 and 2 Part-Time and Fixed-Term Act ("Teilzeit- und Befristungsgesetz").

⁶⁰ Section 1 Employment Protection Act ("Kündigungsschutzgesetz").

⁶¹ General Principle of Law derived from sec. 624 Civil Code (Bürgerliches Gesetzbuch, "BGB").

6.4.2 When a company instigates a stock option plan the public will be informed about the stock option plan by the details contained in the shareholders' resolution. Furthermore, the annual report has to describe details of the stock option plan⁶².

6.4.3 There are no restrictions on employees holding foreign shares or options over foreign shares. The company is allowed to grant option rights over shares in foreign affiliated companies⁶³.

6.5 Securities Law

6.5.1 There are no securities law issues to consider.

6.6 Financial Assistance provisions

6.6.1 There are no prohibitions on a company giving financial assistance to employees for the purchase of its own shares as long as the employee will become fully entitled to all rights connected with these shares and as long as this transaction will not be used to circumvent the rules regarding the repurchase of own shares. If this is the case, then the financial assistance rules will be applicable⁶⁴.

6.7 Other

6.7.1 Employees do not have any rights to votes or dividends prior to exercise. Only if the employee has stock options by means of a convertible bond might he/she be guaranteed a dividend or fixed interest rate.

6.7.2 An employee can transfer his shares by way of a normal offer on the stock exchange within the terms of a stock option plan. Usually stock option plans foresee certain trading windows, e.g. two weeks after the quarterly report of the company has been published, when employees may sell their shares to minimise the danger of insider trading.

6.7.3 The costs associated with the transfer of shares consist of the broker fees and bank fees. The shareholder has to bear these costs.

6.7.5 Generally there are no foreign exchange control requirements to file/register the plan itself.

7. Sourcing shares for stock option plans

7.1 There are a number of ways of sourcing shares to meet the exercise of stock options. A conditional capital increase authorizes the company to issue shares in circumstances specified in the shareholder's resolution – for instance on the exercise of stock options or convertible and participating bonds; an authorized capital increase is a general authority to issue shares over a period of up to five years; a regular capital increase where shareholders authorize a specific issue of shares on each occasion of issue; and the purchase of own shares from existing shareholders. Each is described in more detail in the following paragraphs.

⁶² Section 193 para 2 AktG

⁶³ Section 192 para 2 No 3 AktG.

⁶⁴ Section 57 para 1 and section 71 AktG. Pursuant to section 71 para 1 No.1-7 AktG and section 71 para 1 No 8 AktG.

7.1.1 *Conditional Capital Increase*

- 7.1.1.1 A conditional capital increase is the usual form of capital increase adopted by companies⁶⁵. The management board and the chairman of the supervisory board must file an application for registration of the resolution on the conditional capital increase with the commercial register (Handelsregister). The management board also has to file an application for registration of the subsequent issuance of the new shares⁶⁶. The application must be filed immediately after the registration. If the resolution for the conditional capital increase is not registered, the new shares may not be issued. No right to subscribe for new shares exists prior to such date.
- 7.1.1.2 Shareholders' approval, i.e. a 75% majority vote of the shareholders, is required, and the resolution has to lay down the cornerstones⁶⁷ of the subscription right⁶⁸.
- 7.1.1.3 Capital increases of up to 10 % of the initial capital are possible.
- 7.1.1.4 Existing shareholders are statutorily excluded from subscribing for these shares⁶⁹.
- 7.1.1.5 Stock option rights to acquire shares through a conditional capital increase may be issued to employees and management (other than members of the supervisory board ("*Aufsichtsrat*")) of the corporation itself and of all affiliates that are majority-held by the parent corporation.
- 7.1.1.6 The issue of the shares will cause the initial capital to increase. There is a registration requirement for this increase. Failure to comply with this requirement will not invalidate the increase⁷⁰, although it can result in penalties for the Board if it is not carried out.
- 7.1.1.7 The number of people who have a subscription right has to be registered in the annex of the annual statement of accounts⁷¹.
- 7.1.2 *Capital Increase / Permitted Capital*⁷²
 - 7.1.2.1 For a capital increase/permitted capital, authorization is required through Bylaws or through a 75% majority stockholder vote. This authorization is valid for a maximum of five years.
 - 7.1.2.2 Permitted capital is not automatically part of the initial capital and any rights embodied in a stock certificate only arise once the capital increase is registered with the commercial registry.
 - 7.1.2.3 Such an increase can amount to up to 50 % of the initial capital.

⁶⁵ Section 192 para 2 No. 3 AktG.

⁶⁶ According to section 195. According to section 201 AktG.

⁶⁷ e.g. Purpose of the conditional capital increase; the persons entitled to subscribe; the issue price or the basis on which such price is to be computed; and – for resolutions passed pursuant section 192 II No 3 AktG - also the distribution of subscription rights among members of the management and employees, performance targets, periods for granting and exercise of the subscription rights shall apply analogue to conversion rights.

⁶⁸ Section 193 para 2 AktG.

⁶⁹ Sections 192 f. AktG

⁷⁰ Section 192 para 3 AktG.

⁷¹ Pursuant to section 160 para 1 No. 5 AktG.

⁷² Section 202 AktG.

7.1.2.4 The board of directors can be authorized by a shareholders vote to prohibit subscription by shareholders who have previously acquired shares on the market.

7.1.2.5 Problems could occur since existing shareholders can be excluded and this may provoke them to make a claim in this respect.

7.1.3 *Regular Capital Increase*

7.1.3.1 This is not as practicable as the other forms of capital increase, as a separate shareholders resolution would be required every time employees exercise their options and the company requires new shares to satisfy these options⁷³.

7.1.3.2 There are no special rules for the exclusion of subscription rights of existing shareholders to allow shares to be issued to employees. For a valid exclusion, a shareholders' resolution is required which can be invalidated for material or formal errors.

7.1.4 *Convertible and Participating Bonds*

7.1.4.1 This is a work intensive procedure and requires the exclusion of subscription rights for the existing shareholders by a shareholders' resolution; there are strict requirements for the resolution.

7.1.4.2 This is a sensible alternative for stock option plans for the members of the supervisory board because they cannot participate in stock options via a conditional capital increase⁷⁴.

7.1.5 *Acquisition of Own Shares*⁷⁵

7.1.5.1 This is generally prohibited by German Corporate law⁷⁶. However, there are exemptions to the general rule following the introduction of the new statute dealing with corporate law on 1 May 1998, which allows the acquisition of own shares for the purpose of granting options and shares to employees. This method is expensive for companies, due to uncertainties as to when the employees will exercise their options and how many shares will be required.

7.1.5.2 The requirements under KonTraG are as follows⁷⁷:

- A shareholders' resolution is required which must state the highest and lowest value of the shares to be purchased and the amount of shares in comparison to the initial shares (maximum of 10%). The resolution is only valid for 18 months.
- The general rules for excluding the pre-emption rights for the existing shareholders apply; these rules contain rigid formal and material requirements.
- The shares must be fully paid⁷⁸.

⁷³ Section 182 AktG.

⁷⁴ Section 221 AktG.

⁷⁵ Section 71 para 1 No 8 AktG.

⁷⁶ Pursuant to section 71 para 1 No 1-7 AktG and section 71 para 1 No 8 AktG.

⁷⁷ In particular section 71 para No 8 AktG.

⁷⁸ Pursuant to section 272 para 4 Commercial Law Statute (Handelsgesetzbuch, "HGB"); section 71 para 2 AktG.

- The company must maintain capital reserves which are required and that they cannot dispose of.
- The 18 months limitation for the authorization to repurchase shares by a shareholders' resolution only relates to the repurchase of shares. The company can keep the repurchased shares for a longer period.
- The shareholders' resolution can use the market value of the shares as a guideline for the highest and lowest value of the shares.
- The company cannot repurchase shares for the only purpose of doing business with their own shares; unfortunately, the statute does not define the term "doing business with own shares"; this needs to be determined by the courts.
- The corporate law principle of equal treatment of all shareholders also applies to the repurchase of shares; if the company acquires the shares on the market, the equal treatment principle is satisfied.

7.1.5.3 There are the following notification requirements:

- The directors have to inform the shareholders⁷⁹.
- A company listed on the stock exchange must disclose all relevant information in the interim report.
- The corporation must inform the Federal Supervisory Office for Trade in Securities (*Bundesaufsichtsamt für den Wertpapierhandel*) about the authorization by the shareholders' resolution to repurchase the shares⁸⁰.
- The corporation has to inform the public ("ad hoc Publizität") with information relating to insider knowledge and details of the options if the grant of the options might have an effect on the share price (the latter requirement will only be relevant if a certain level of option grants is exceeded)⁸¹.

7.1.5.4 It is possible for a subsidiary to hold shares in its parent. However, the same rules have to be followed as if the holding company had directly acquired these shares.

7.1.5.5 The mechanics enabling employees to obtain their shares when the options are exercised are as follows:

- The exercise notice for subscription rights by the employee is submitted in accordance with the plan⁸².
- Issue of the new shares by the management board to the employees after the payment of the agreed value for the stock⁸³.
- Application by the management board for registration of the issue of new shares with the commercial register within one month after the end of the fiscal year⁸⁴.

⁷⁹ Section 71 para 3 AktG.

⁸⁰ See section 6 KonTraG; section 160 para 1 No 2, 5 AktG; section 55 Exchange Admission Regulation ("Börsenzulassungsverordnung") (section 71 para 3 AktG).

⁸¹ Sections 15, 13, 25, 21 Securities Trade Act (hereinafter "WpHG").

⁸² See sections 193, 198 AktG.

⁸³ See section 199 AktG.

⁸⁴ See section 201 AktG.

8. Role and influence of existing shareholders

- 8.1 The role of shareholders is covered in 6.1 and 7 above. The German AktG precludes direct shareholder influence on the day-to-day business of a company unless the management board has submitted a certain matter to the shareholders for approval (sections 111 paragraph 4 119 paragraph 2, AktG). Only decisions concerning the legal and financial structure of the company require shareholder approval, such as capital increases. In place of direct influence the shareholders express their views in the form of resolutions discharging the management and supervisory board and by electing members of the supervisory board.

9. Accounting

9.1 Capital Increase

- 9.1.1 This will normally be used if newly issued shares are used to satisfy option exercises. Until the date of exercise, the accounting treatment is uncertain and one of the two following methods may be chosen depending on the accounting policy of the company concerned – there is no specific regulation that is legally binding:
- 9.1.2 Effect on Financial Statements: The costs of options are categorised as personnel costs in the Profit & Loss account. An accrual is also made in the capital reserve on the balance sheet. The Profit & Loss account cost is based on the FMV of the underlying shares at the grant date and the charge is apportioned over the period from grant to vesting (the service period). There is no adjustment if the option lapses. This approach might be inconsistent with sec. 27 (2) Stock Corporations Act, which provides that obligations to render services must not be made to the object of contributions in kind⁸⁵.
- 9.1.3 No Effect on Financial Statements: In this case no Profit & Loss account cost is recorded and there is no effect on the capital reserve.
- 9.1.4 At option exercise, the accounting treatment is the same as for every capital increase.

9.2 Existing Shares

- 9.2.1 The accounting depends on whether the company purchases shares to satisfy option exercises at the time of grant or at the time of exercise.
- 9.2.2 Purchase of own shares on grant date: Until exercise there will be an accrual in the balance sheet equal to the difference (if any) between the price paid for the shares by the company and the exercise price of the options. The accrual is apportioned over the service period. There is an adjustment of the accrual if an option lapses. At exercise the accrual will be written off.
- 9.2.3 Purchase of own shares on exercise date: The accounting treatment is uncertain. Until exercise there can be an accrual in the balance sheet equal to the FMV of the option (not the shares under option). The accrual is apportioned over the service period, but adjusted at the date of each financial statement and also if an option lapses. An alternative is that the intrinsic value of the option is accrued at grant date, with no apportionment, but that this is adjusted at the date of each financial statement and also if an option lapses. The

⁸⁵ German Accounting Standards Board, Draft-GAS N° 11. Capital reserve: Section 272 para 2 No 2 HGB.

intrinsic value is the amount by which the current market price of the shares exceeds the exercise price of the option⁸⁶. In either case, on exercise the accrual will be written off. The effect on the Profit & Loss account depends on the purchase price at which the company acquires the shares.

- 9.2.4 Wherever the shares are purchased, the purchase price of own shares is shown as a reserve for own shares (balance sheet, with effect on distributable profits), with a write off of reserve on exercise date⁸⁷.

9.4 Notes to accounts

- 9.4.1 Various information should be disclosed in notes to the accounts. What has to be disclosed in detail has not finally been decided. As an example see Draft-GAS No 11, text 40, which has to be transferred to the (non-consolidated) financial statements:

- 9.4.1.1 "The following information should be disclosed in the consolidated financial statements with regard to share option plans:

- A general description of the individual plans showing the main terms. These include details of exercise prices, performance targets, if appropriate, the number of options, the option period, the lock-up period, the exercise conditions, if appropriate, as well as the calculated value of the rights at the grant date.
- Total staff expenses arising in the reporting period from such plans. The amount relating to members of the representative bodies of the enterprise and of the parent company should be disclosed separately. If several plans exist, the disclosures should be made separately for each plan.
- For each plan, the number of options and the average exercise price should be disclosed separately for all options which were (i) outstanding at the beginning of the year, (ii) granted during the year, (iii) exercised during the year, (iv) forfeited during the year in accordance with the exercise terms, (v) lapsed at the end of the option period, (vi) outstanding at the end of the year, and (vii) exercisable at the end of the year.
- The fair value (intrinsic value plus time value) of options granted during the period as compensation. The fair value of the options granted to members of the representative bodies of the enterprise and of the parent company should be shown separately.
- The method and significant assumptions used for measuring share options. In particular information should be provided on the assumptions used for volatility, the dividend yield and the risk-free interest rate as well as adjustments made to take account of the restricted tradability of options and performance targets.
- The increase in the fair value in options previously granted as a consequence of repricing the exercise price".

- 9.4.2 Compliance with the disclosure requirements listed in para. 40 ensures compliance with

⁸⁶ Section 272 para 4 HGB.

⁸⁷ E.g. section 285 No 9 Commercial Code HGB. See German Accounting Standards Board, Draft-GAS No 11

the disclosure requirements for remuneration paid to members of the representative bodies of the enterprise and of the parent company pursuant to § 314 (1) 6 a HGB.

- 9.4.3 Whether companies generally view the accounting treatment favourably depends upon the interests of the company. There is no majority consensus on the accounting treatment.
- 9.4.4 Theoretically the creditors prefer showing personnel costs. This is because personnel costs reduce the amount of the distributable profit, and this is generally in the interests of creditors.

10. Miscellaneous

- 10.1 German law recognises the concept of a trust. Awards and option grants can be made by an independent discretionary employee benefit trust (with independent third party trustees).
- 10.2 However, there are in fact very few trusts used in conjunction with employee stock option plans. Nevertheless a trust might be used to provide that employees do not exercise their voting rights themselves but exercise them through a trustee as a representative. This legal construction comes close to a voting agreement. Normally the grantor would show the trust property in the accounts.
- 10.3 The legal requirements involved in setting up a trust include that the legal entity has to be incorporated. Further requirements depend on the way the trust is established. If the trust is a company with limited liability it has to be established with the approval of the directors. Furthermore it has to be registered with the Commercial Register.
- 10.4 Sometimes smaller companies issue shares to a partnership under the Civil Code and make the employees partners of this partnership. The advantage of this is that the employees might be seen, from a tax point of view, as owners of these shares. This may avoid any further taxable increase in value.
- 10.5 In addition, the partnership structure ensures that voting rights etc. for all shares will only be exercised by one representative and that the shares cannot be transferred before the partnership is dissolved. Shares are transferred to each employee individually, which takes place after a holding period of between one and five years.
- 10.6 The tax revenues from employee share option plans are not used for a specific purpose. They are part of the total income and corporate tax revenues, which are used for various purposes.

11. Special points to note

11.1 Mitigation of income tax

- 11.1.1 Under German tax law any payments remunerating duties over two or more tax years, might benefit from a reduction in the applicable tax rate. The marginal tax rate levied on the taxable benefit is determined as if only 1/5 of the taxable benefit would have been subject to tax⁸⁸. This will only lead to a significant reduction in tax if the income excluding this benefit is not already subject to the marginal tax rate. In any event this treatment may not be applicable to stock options.

11.2 Mitigation of social security contributions

- 11.2.1 There are no special provisions for mitigating social security contributions arising on income earned over several years.

11.3 Mitigation of tax on sale of shares

- 11.3.1 A capital gain subject to income tax can be avoided if the holding period of the shares exceeds one year. As this is a straightforward means to avoid taxation of a capital gain, it is often used.

11.4 Special provisions for SMEs

- 11.4.1 There are no special stock option plan provisions for SMEs in Germany.

Note: Individual country reports have been prepared covering employee stock options in the EU and the USA. These individual reports are of a general nature and subject to change based on individual circumstances. PricewaterhouseCoopers has also provided the EU with an overview report. This overview report sets out the basis on which the individual reports were prepared and should be referred to as necessary. In particular, it should be noted that the information in the reports is current as at 1 January 2002, unless otherwise stated. In the case of certain known subsequent changes, reference may be made on occasion but a full update exercise has not been carried out. Further information can be obtained from PricewaterhouseCoopers.

⁸⁸ Section 34 EStG.