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→ Reforming taxation of employee equity participations

Employee equity participations are very popular in M&A practice, especially in private equity and venture capital transactions. The reason for this is the interest of investors in retaining the (top) managers of the target company in the long run to keep relevant know-how within the company and to be able to increase the profitability of the investment.

In order to alleviate the previously existing problem of dry income (or phantom income) and thus to make employee participation programmes more attractive from a tax perspective, the legislator introduced a new Sec. 19a of the German Income Tax Act (ITA) with legal effect as of 1 July 2021. This article provides an overview of the new regulation and its implications for the M&A practice.

Starting point: The dry income problem

Since employees often do not have the financial means to acquire shares in the employer company at market value, shares are often transferred to employees at a discount or free of charge.

In case of an acquisition of shares at a discount or free of charge, the difference between the market value and the purchase price (= non-cash benefit) qualifies as income from employment for tax purposes and is also subject to social security contributions. The applicable tax rate is based on the general progressive income tax rate (max. 47.5%). The tax liability arises at the time of the acquisition, so the employee may be subject to a considerable tax burden without receiving any liquid funds (so-called dry or phantom income problem).

Introduction of Sec. 19a ITA

Due to the introduction of Sec. 19a ITA, taxation and the corresponding dry income problem may be postponed for a maximum period of twelve years if shares in the employer company are transferred at a discount or free of charge. In this case, wage taxes actually due are not initially levied, but only the amount of the non-cash benefit granted is recorded on the employee's payroll account. However, social security contributions are still payable at the time the shares are acquired. As an additional benefit, the tax-exempt amount of the non-cash benefit arising from the transfer of shares has been increased from 360 Euro to 1,440 Euro. The prerequisite for applying the tax exemption is, however, that the acquisition of shares must be open to all employees.

The tax deferral model under Sec. 19a ITA is applicable for all employees who are granted shares in the employer company at a discount or free of charge after 30 June 2021 alongside their normal salary. However, the model only applies to shares held in employer companies that fulfil the criteria specified in the EU's SME definition (< 250 staff headcount, turnover < 50 million euro or balance sheet total < 43 million euro) at the time of the transfer of the shares or in the previous year and which were founded less than twelve years ago. It also applies to indirect shareholdings where shares are held in the employer company indirectly via an (asset managing) partnership. It does not apply, however, to any form of option rights – apart from the shares transferred upon exercise of a (stock) option previously granted – and virtual shares held in the employer company, as no dry income results from these cases.

The tax deferral granted under Sec. 19a ITA is not applicable in the following three cases:

- all or parts of the granted shares were transferred for a consideration or free of charge;
- the employment relationship with the employer was terminated; or
- twelve years passed since the transfer of the shares.

If one of these criteria is met, tax becomes due, with the amount of the taxable non-cash benefit to be determined on the basis of the fair market value of the shares granted at the time of the transfer, not at the time the respective criterion is met.

Implications for M&A practice and conclusion

The introduction of Sec. 19a ITA has alleviated the dry income problem in case of transfers of shares in the employer company at a discount or free of charge and has made employee equity participations more attractive from a tax perspective. However, Sec. 19a ITA only provides for a tax deferral which automatically ends after twelve years at the latest, social security contributions are

still payable at the time of the acquisition and the tax-exempt amount of 1,440 Euro results only in a small tax relief.

In addition, the new regulation provides for a narrow scope and is therefore only relevant in M&A practice if start-ups founded less than twelve years ago and qualifying as SMEs are acquired. Another point of criticism is that no statutory valuation principles have been introduced to determine the fair market value of shares in start-ups for tax purposes, so it is still difficult for employees to reliably assess the amount of the non-cash benefit they will receive from the transfer of shares at a discount.

In summary, although the introduction of Sec. 19a ITA is to be welcomed, the opportunity for a far-reaching reform of the taxation of employee equity participations has unfortunately been missed.

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→ The long shadow of Wirecard – The introduction of FISG

A little more than a year ago, the Wirecard scandal shook the capital market. In order to restore confidence in the German capital market and to prevent balance sheet manipulation, the German legislator passed swiftly the Act to Strengthen Financial Market Integrity, or FISG for short.. FISG came into force on 1 July 2021.

This article provides a brief overview of FISG and, in particular, addresses the enhanced internal governance of listed companies.

Overview

The provisions of FISG apply exclusively to listed companies, i.e. all companies whose shares are admitted to trading on a regulated market. Companies whose shares are traded over-the-counter are not covered by the new regulations.

To prevent balance sheet manipulation in the future, FISG introduces regulations aimed at various bodies of companies dealing with annual financial statements. These are, within the framework of internal governance, the management board and the supervisory board of the company as well as the auditors appointed to audit the annual financial statements, as part of external governance.

In order to enhance external governance, FISG introduces some regulations that are intended to increase the independence of auditors from the company being audited, such as:

- Increased professional scepticism in audits
- Increased liability of auditors
- Limitation of the possibility of advising and auditing PIEs (*public interest entities*).

Internal control system

Following the introduction of Article 91 (3) of the German Stock Corporation Act (AktG), management boards of listed companies are now legally required to set up an internal control system (ICS) and a risk management system (RMS). The ICS and RMS must be effective and appropriate to the scope of business activities and the risk situation of the company.

Previously, management boards were free to decide whether and how to implement an ICS and an RMS. Although the German Corporate

Governance Code (DCGK) included a correspond-ding recommendation to implement such systems, there was no obligation to follow it.

This freedom of the management board has now been limited by FISG to the effect that it is free to decide only on how to structure the ICS and RMS.

In specific terms, in order to avoid liability, this means for management boards of listed companies: they are required to implement an ICS and RMS and to provide evidence that, when designing the ICS and RMS, the principles of *the Business Judgement Rule* have been observed with regard to the business activity and the risk situation of the company.

Supervisory Board

FISG has strengthened the role of the supervisory board in the process of approving annual financial statements. This is to be achieved, on the one hand, by the introduction of new requirements regarding the expertise of the supervisory board members, and on the other hand, by the extension of the supervisory board's competences.

Until now, the supervisory board had the freedom to decide whether it formed an audit committee to exclusively deal with audit-related issues. Especially smaller supervisory boards with three or six members have so far decided not to form an audit committee and fulfilled its tasks incidentally, which is no longer possible now. All supervisory boards of listed companies must now form an audit committee. In this respect, it should be noted that the chair of the supervisory board cannot be the chair of the audit committee at the same time.

Furthermore, every supervisory board of a PIE (*public interest entity*) will have to appoint one member with expertise in accounting and another member with expertise in auditing. Previously, it was sufficient to have one member with expertise either in accounting or auditing. However, the new regulation does not mean that new supervisory board members must immediately be appointed to fulfil this requirement. It is sufficient to meet this requirement during the next supervisory board elections or the next reap-pointment of a member.

Finally, the audit committee will in the future have the right to obtain information directly from the heads of company departments dealing with the audit; it will therefore no longer have to request it from the management board. All members of the audit committee will have such right, whereas the members will not contact the company employees for information directly, but rather the chair of the audit committee will gather all questions and forward them to the relevant employees.

Conclusion

Due to the Wirecard scandal, politicians had to react and did respond respectively by introducing FISG. It remains to be seen whether it will effectively eliminate balance sheet manipulation in the future.

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→ Transaction advisor in the process of corporate refinancing

Refinancing is the process through which companies raise fresh capital by replacing the existing financial obligations with new contracts that have updated terms, i.e. loan amounts, interest rates or repayment schedules. Typically, refinancing is used either to obtain better financing terms due to better credit rating or reduced interest rates, or to raise capital for

operations (e.g. working capital financing) and for investments (e.g. M&A or growth projects).

However, refinancing might also be an important source of liquidity in times when earnings and cash are lower than usual due to external shocks. This option is even more significant now, as the spread of the COVID-19 pandemic and the resulting lockdowns have had a negative effect on demand in many industries (i.e. automotive, aerospace, hospitality). A drawback of refinancing in times of low earnings is that the terms and covenants of new loan agreements are likely to be stricter, as the uncertainty of future cash flows and the risk of default increases.

Regardless of the reasons that push a company towards refinancing, the primary goal in the refinancing process is to increase the likelihood of obtaining financing on reasonable terms. In this respect, the choice of a competent transaction advisor becomes highly important as their expertise and guidance bring added value in every step of the refinancing process.

The refinancing process

The typical corporate refinancing process consists of the following 4 stages:

1. **Evaluation** – analyse internal (profitability, liquidity and investments) and external (credit rating, interest rates, shocks) environment to assess the need for capital through refinancing;
2. **Preparation** – select the corporate finance and transaction advisors, collect and analyse the data to develop the credit story and business case and discuss the areas for due diligence (financial, commercial, technical, etc.);
3. **Implementation** - contact potential creditors, provide information (incl. business plan, due diligence reports) and conduct Q&A sessions with potential interested parties;
4. **Closing** – negotiate and finalize the refinancing process.

Main focus areas

Having a clear focus during every stage supports an efficient management of the refinancing process as it not only results in lower (internal & external) costs, but also increases the chances of obtaining appropriate financing conditions.

In the evaluation stage, it is important to allocate resources appropriately by effectively and continuously monitoring the external and internal environment and its effect on liquidity using a comprehensive set of KPIs. Reluctance to address this task can lead to a delayed response to liquidity problems, which can consequently trigger a restructuring process or even default.

Collecting financial and non-financial data is essential to ensure a reliable flow of information during the preparation stage, as they are the key input factors for the analyses to develop the credit story and the business case. Inconsistencies between data sources and failure to incorporate non-financial KPIs can lead to inaccurate financial figures and business plan estimates. This brings us to the next important step of the preparation stage, namely developing the story which the company wants to communicate to its potential financing partners. The key messages need to be supported by the financial analyses and the reason for the refinancing must be clearly indicated (i.e. better credit rating, growth investments, or reduced liquidity). At this stage of the process, it is necessary to look at the figures from a creditor's perspective and analyse why they should support the refinancing of your company.

In the implementation stage, the main focus is to provide the interested parties with all necessary information so that they can make an informed decision. This also involves Q&A sessions with potential financing partners to address any questions they might have regarding the company's financial situation.

Importance of a transaction advisor

The refinancing process can be lengthy and involve many hurdles for the company. For this reason, it is important that a competent transaction advisor is available to assist the company throughout the process.

During the preparation stage, the transaction team will assist the company in compiling, preparing and reconciling financial and non-financial data from multiple sources, thus increasing process efficiency and information consistency. Moreover, when developing the credit story, the transaction advisor not only analyses and visualises the data, but also adds value by appropriately underpinning the message the company wants to deliver to investors with the analyses. This added-value consists in conducting a sense-check of the business plan assumptions and evaluating financial data that are of significant importance to potential financing partners such as adjusted EBIDTA, free cash flow and working capital. As a result, the transaction advisor will support and refine (through Financial Due Diligence) the company's refinancing by anticipating the needs of potential financing partners.

In the next stage, namely implementation, the experience of transaction advisors will provide useful insights during the Q&A sessions. As transaction advisors have expertise on both sides of a transaction, they can anticipate and address the areas of importance for financing partners and facilitate the refinancing process. This proved to be particularly beneficial in the next stage as it lays the foundation for the negotiations.

Finally, the transaction team provides (indirect) support even after the refinancing process has been completed. Companies will benefit from using the insights gained from the transaction advisor during the previous refinancing process. In the future, they will know where to place focus when analysing the relevant KPIs, what aspects and data are important for financing partners and how to increase the efficiency of future financing initiatives and thus minimise the costs incurred.

Conclusion

When conducting a refinancing process, the primary goal of the company is to increase the likelihood of obtaining financing on reasonable terms. As the path towards refinancing can be challenging, the choice of a transaction advisor can be of crucial importance for the outcome of the refinancing process. A competent team of transaction advisors not only prepares the Financial Due Diligence, but also supports developing and refining the company's credit story by taking an outside-in approach to analysing the company that considers the needs of the financing partners so that they can make an informed decision.

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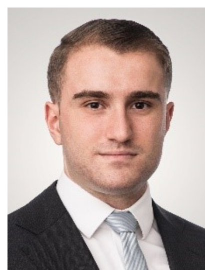

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→ M&A Vocabulary – Understanding Experts

"Deadlock"

In this ongoing series, a number of different M&A experts from the global offices of Rödl & Partner present an important term from the specialist language of the mergers and acquisitions world, combined with some comments on how it is used. We are not attempting to provide expert legal precision, review linguistic nuances or present an exhaustive definition, but rather to give or refresh a basic understanding of a term and provide some useful tips from our consultancy practice.

The term "deadlock" describes a stalemate between two or more parties. In corporate law, deadlock can occur at the level of the shareholders and at the level of the board of directors. While the shareholders can usually intervene and break a deadlock at the level of the board of directors, this is not so easy at the shareholder level.

In this article, we look at the background to a deadlock at the shareholder level, the effects of such a stalemate and the mechanisms by which such a deadlock can be avoided or resolved.

Background of a deadlock

A deadlock at the shareholder level can occur in a joint venture, especially in the case of equal shareholdings and voting rights. Joint venture companies are set up for a variety of reasons. A joint venture allows parties with different strengths to exploit the synergy potential, e.g. in terms of know-how, capital or customer base. The allocation of shares and voting rights should be in accordance with the interests of the parties and the applicable legal provisions.

In international business, however, joint venture companies may also be necessary due to investment restrictions. For example, if the law of the host country requires the foreign investor to form a joint venture with a local party in order to be allowed to carry on business in the host country. The allocation of shares and voting rights are issues that are often prescribed by law.

Regardless of whether a joint venture is based on the interests of the parties or on the investment law requirements of a host country, they can all be confronted with the risk of a deadlock.

A deadlock in a joint venture means that the joint venture parties, i.e. the shareholders of the joint venture company, disagree on key issues.

Effects of a deadlock

A deadlock between the joint venture partners can threaten the existence of the joint venture company. If, for example, the shareholders cannot agree on financing issues, the company may be threatened with insolvency. Legal difficulties can also arise if, for example, the company is no longer able to meet its reporting and publication obligations due to the deadlock. Without corresponding provisions in joint venture contracts, deadlock can only be resolved based on legal regulations, which are sometimes quite vague, especially in developing and emerging countries. Depending on the applicable law, the liquidation of the company or, if possible, the redemption of shares of a joint venture partner are to be considered. However, in many cases the statutory provisions do not lead to a satisfactory result.

Strategies to avoid a deadlock

The risk of a deadlock should be considered already when setting up a joint venture company. In the joint venture contract and, as far as possible, in the articles of association of the joint venture company, a deadlock should be addressed to avoid its occurrence in the first place. Here, for example, the allocation of shares and the respective voting rights as well as dispute resolution mechanisms should be considered. Joint venture contracts usually also contain deadlock clauses, which provide a remedy by defining a deadlock situation and stipulating a share transfer mechanism as well as the termination of the joint venture relationship. Such clauses should be drafted carefully, as some jurisdictions may not acknowledge them. Even if the respective jurisdiction acknowledges a dead-

lock clause, the clause must be drafted as precisely and pragmatically as possible because the relationship of trust between joint venture partners in a deadlock situation is usually shaken. If this is not appropriately regulated, the parties are likely to take judicial or arbitration proceedings, which might not lead to any quick and, pragmatic solution of the deadlock that would ensure company's further existence.

Deadlock situations become even more complex in international business situations where the joint venture was necessary due to local investment restrictions. In such a case a joint venture cannot be terminated without putting the foreign investment at risk. Here, too, a precautionary approach is recommended, for example by including several independent local partners into the joint venture.

Conclusion

A deadlock can threaten the existence of joint venture companies and must be taken into account right from the beginning when setting up a joint venture. With respect to business activities abroad which fall under a foreign jurisdiction, the investor should apply even more caution as otherwise the entire investment might be at risk.

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