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Germany

EMPLOYEE INCENTIVES

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This country-specific Q&A provides an overview of employee incentives laws and regulations applicable in Germany.

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GERMANY

EMPLOYEE INCENTIVES



1. What kinds of incentive plan are most commonly offered and to whom?

There are many different incentive plans, which are usually very individually tailored both to the company and then again to the individual employee groups.

- **Newly founded companies** are often only capable of paying comparatively low salaries. To incentivize and attract talent, **start-ups** (in particular) offer their key employees “real” equity shares or at least an option on equity shares in the start-up.

Other employees often receive virtual (phantom or non-equity) shares, which lead to an only financial claim against the company in the event of the sale of the start-up.

Target agreements are very rarely concluded in start-ups.

- However, in **medium-sized companies**, target agreements are still common for management employees and are usually linked to EBITDA or other company targets.

For employees in line below management, medium-sized companies often additionally link the target agreements to individual targets.

Virtual shares are still rare in medium-sized companies because, in contrast to a start-up, they rarely work towards an exit.

In medium-sized companies, there are often also commission entitlements, especially for employees in sales or production.

- A decline in target agreements for newly hired employees can be observed in **large publicly listed companies**. This decline is mainly related to the habituation of many employees to fulfilling company targets and the resulting decline in incentivising power of target agreements. Large publicly listed companies therefore incentivise a high percentage of their

employees – and no longer only executives – (at least additionally) through share (option) packages (mainly stocks or stock options).

Many companies still use the inflation compensation bonus that can be paid until 31 December 2024 up and amount up to EUR 3,000.00 free of tax and social security contributions to mitigate rising costs.

In addition to these material incentives, immaterial incentives (flexible arrangement of working hours and the possibility of working mobile or from home, “workations” and paid/unpaid leaves of absence, spending budgets on tech equipment, unlimited vacation arrangements) are also becoming increasingly important.

2. What kinds of share option plan can be offered?

There are no specific types of share option plans under German law. Therefore, there is a big variety in share option plans depending on the size, type and purpose of a company.

Companies can offer options on “real” equity shares (e.g. stocks or shares in a limited liability company) or on virtual (“phantom”) shares. There are only few legal requirements for virtual shares, so that companies are basically very flexible in their implementation.

- For both equity and virtual the following applies: The option is normally subject to a vesting period following which the entitled employee may exercise its option during a fixed period. The option can be linked to performance related prerequisites. In case an employee leaves the company, the non-vested options are usually forfeited, and the exercise period of an already vested option is reduced significantly.
- For stock option plans there are more strict regulations: Companies must comply with the requirements of the German Stock

Corporation Act. Companies provide their employees with a corresponding number of share options, which the company has purchased or created through an increase of capital. Typically, share option plans grant the option to employees to buy stocks at a defined price (which is usually lower than market value) or to receive shares for free. The price saved is a non-cash benefit that must be taxed if it is not tax-privileged.

- Options on shares in a limited liability company are due to their complexity and lack of flexibility very rare. In particular, cost-intensive formal requirements may be applicable at the time of allocation or at the latest when exercising (or selling) the option.

3. What kinds of share acquisition/share purchase plan can be offered?

There are no specific types of share acquisition/share purchase plans under German law. However, the requirements mentioned under number 2. also apply a fortiori to share acquisition/share purchase plans when issuing stocks or limited liability company shares.

4. What other forms of long-term incentives (including cash plans) can be offered?

Companies usually offer the following other long-term incentives:

- Target agreements
- Carried interest
- Company profit participation
- Company pension scheme
- Paid leaves of absence / Workation
- Secondment
- Lifetime working hours account (Employees can save up extra hours and retire early under full remuneration)
- Unlimited Vacation Policies
- Spending budget on (tech) equipment

5. Are there any limits on who can participate in an incentive plan and the extent to which they can participate?

In principle there are no limits on the employees that can participate in the incentive plan. However, excluding certain groups from the incentive plan could be in conflict with the General Equal Treatment Act and may thus lead to a claim by the excluded employees. A direct

or indirect distinction on race, ethnic origin, sex, religion or belief, disability, age or sexual identity is in principle prohibited. An employer cannot treat participants that are in an equal position unequally, unless there is an objective justification.

For stocks options there is an additional rule: The total nominal value of shares in respect of options may not exceed 10 percent of the nominal share capital.

Non-employees (e.g. consultants or other freelancers) may also be included in incentive programs. However, the high risk that they will be considered as employees (including all employee benefits such as protection against dismissal) must then be taken into account.

6. Can awards be made subject to performance criteria, vesting schedules and forfeiture?

Awards can be made subject to performance criteria, vesting schedules and forfeiture.

With regard to performance criteria, it is important that these criteria are defined before the start of the "performance period" so that employees know what their individual performance expectations are. Otherwise, the employer risks having to pay in full even if the performance targets are not met. Performance criteria are therefore more commonly subject to target agreements. For share option and virtual option plans companies and employees usually agree on vesting periods. However, these vesting periods can be shortened if the defined performance criteria are met (acceleration clauses).

Forfeiture clauses can be agreed by companies and their employees. Forfeiture clause must be clearly and comprehensibly worded to not be deemed invalid. Usually, a forfeiture clause differentiates according to the reason for the employee leaving the company (distinction between "good" and "bad" leavers). The conditions and consequences for a case of good leaver or bad leaver must be explicitly and comprehensibly stated in the clause.

7. Can awards be made subject to post-vesting and/or post-employment holding periods. If so, how prevalent are these provisions both generally and by reference to specific sectors?

In case of a share option plan (stocks or equity shares) the agreement of a temporary limited holding period

after vesting and exercising the share options is generally permissible. The employee becomes the owner of the shares at the time the options are exercised but is banned to sell the stocks for a limited period of time to motivate the employee. Terms of up to three, in some cases even up to ten years, are considered permissible by courts.

Post-vesting holding period provisions are sometimes agreed in management incentive plans when the exercise of the awards is linked to an exit event. Post-employment holding period provisions are not very common.

8. How prevalent malus and clawback provisions are and both generally and by reference to specific sectors?

Some management incentive plans contain malus and clawback provisions. Specific remuneration payback rules apply in an Ordinance with respect to special employees of financial institutions (Institutsvergütungsverordnung). Payments made against these regulations could be null and void and need to be returned. However, it is controversially discussed whether the legal elements of the Ordinance are sufficiently defined to form an effective basis for the reclaim.

For other employees clawback clauses are hard to enforce. German labour courts often consider such clauses as invalid.

9. What are the tax and social security consequences for participants in an incentive plan including: (i) on grant; (ii) on vesting; (iii) on exercise; (iv) on the acquisition, holding and/or disposal of any underlying shares or securities; and (v) in connection with any loans offered to participants (either by the company operating the incentive plan, the employer of the participant (if different) or a third party) as part of the incentive plan.

(i) on grant;

The requirements for taxation and social security contributions depend on the type of incentive plan. The general rule is that the tax burden and the obligation to pay social security contributions occur when the employee receives something of immediate value (e.g. payment of a bonus).

In case of a share plan, income taxes (up to 45 % of gross income) and social security contributions must be paid at the time of the grant (ca. 19,4 %, up to the contribution assessment ceiling for the social security contributions).

(ii) on vesting;

During the vesting period employees are usually not receiving anything of immediate value. Equity and virtual shares and options are only valuable if the vesting ends.

(iii) on exercise;

The exercise of the share leads at latest to an immediate value of the employee. Taxes and social security contributions must be paid.

(iv) on the acquisition, holding and/or disposal of any underlying shares or securities; and

The acquisition of shares in execution of an option is a taxable event and social security contributions must be paid. Employees receive immediately the valued share. Therefore it must be noticed that not only the grant is taxable (income tax) but also the sale of the shares is taxable (capital gains tax).

(v) in connection with any loans offered to participants (either by the company operating the incentive plan, the employer of the participant (if different) or a third party) as part of the incentive plan.

Company loans are only taxable if the company waives the repayment. However, the companies offer in most cases loans with lesser rates of interest. This interest rate advantage can, under further circumstances, be taxable and social security contributions must be paid.

10. What are the tax and social security consequences for companies operating an incentive plan? (i) on grant; (ii) on vesting; (iii) on exercise; (iv) on the acquisition, holding and/or disposal of any underlying shares or securities; (v) in connection with any loans offered to participants (either by the company operating the incentive plan, the employer of the participant (if different) or a third party) as part of the incentive plan.

As a general rule, employees have to pay income taxes but the employers transfer the payments to the Federal Republic of Germany and reduce the payment of the

remuneration to their employees accordingly. Regarding the social security contributions employers have to pay those first and can get back half paid amount from their employees. Therefore, the employers reduce the payment of the remuneration accordingly.

Furthermore, employers must pay company taxes.

(i) on grant;

The issuing of shares is recorded as personnel expense under equity within the balance sheet of the company. The company must pay the taxes and contributions mentioned under No. 15.

(ii) on vesting;

The vesting itself does not trigger any taxation or social security contributions for the company.

(iii) on exercise;

The company must pay the taxes and contributions mentioned under No. 15. The exercise of shares is recorded as personnel expense under liability within the balance sheet of the company.

(iv) on the acquisition, holding and/or disposal of any underlying shares or securities;

For the employer no further obligations occur other than to deduct the taxes and social security contributions for the employee and to forward them to the respective authorities.

(v) in connection with any loans offered to participants (either by the company operating the incentive plan, the employer of the participant (if different) or a third party) as part of the incentive plan.

No particularities.

11. What are the reporting/notification/filing requirements applicable to an incentive plan?

Under German law there are no specific reporting/notification/filing requirements applicable to incentive plans.

12. Do participants in incentive plans have a right to compensation for loss of their awards when their employment terminates? Does the reason for the

termination matter?

Employees only have a right to compensation for the loss of non-vested (virtual) shares (or options) if the compensation was agreed on with the company for this specific ending scenario.

In case of target agreements employees can claim for their bonus pro rata temporis if the bonus is intended to reward performance. If the bonus is intended to reward loyalty, the employment contract may provide that employees lose their entitlement to the bonus due to termination.

13. Do any data protection requirements apply to the operation of an incentive plan?

Incentive plans must comply with the EU and German data protection law. Employee data collected in relation to the Incentive Plan must in particular be limited of use to a specific purpose and for a specific time.

14. Are there any corporate governance guidelines that apply to the operation of incentive plans?

The German Corporate Governance Codex (GCGC) applies to incentive plans. The Supervisory Board shall install a clear and comprehensible remuneration system for the members of the Management Board. The Supervisory Board therefore determines the individual remuneration of the members of the management board. The variable remuneration is granted as an incentive and therefore based on stocks.

According to the GCGC, the compensation of the Management Board is also to be aligned with the sustainable and long-term development of the company. The 'Guidelines for Sustainable Executive Board Compensation' expect (but are not mandatory) that relevant ESG criteria are also reflected by (long-term) KPIs.

Incorporating ESG criteria can also make sense from a compliance perspective. Studies show that employees often cheat when it comes to achieving economic group targets. With ESG criteria, cheating is more difficult. For compliance reasons, it is therefore advisable to rely on ESG criteria.

15. Are there any prospectus or securities

law requirements that apply to the operation of incentive plans?

Prospectus requirement

The public offering of securities within the European Union generally requires the publication of a securities prospectus. According to the definition in the European Prospectus Regulation, securities are transferable assets that can be traded on the capital market. If the option rights of a physical or virtual stock option programme are not transferable, as is generally the case, there is no obligation to publish a prospectus. According to the European Securities and Markets Authority (ESMA), non-transferable option rights do not fall within the scope of the Prospectus Regulation. The same applies if securities can be obtained by employees free of charge, as the investment decision is then lacking. If stock options are issued and later exercised without being deducted from the salary, this does not trigger a prospectus requirement.

If the securities are transferable after all, a prospectus must generally be published.

Market abuse regulation

In case of a (request for) listing and trading of shares or any other financial instruments of the company, to which the incentive plan relates, (including the insider trading prohibition) can in general become applicable to the granting, exercise, and subsequent sale of shares.

16. Do any specialist regulatory regimes apply to incentive plans?

Please see exemptions under No. 15.

17. Are there any exchange control restrictions that affect the operation of incentive plans?

Under German law there are no legal exchange control regulations. A notice to the German Federal Bank must be considered if employees receive shares from an abroad company (e.g. parent company of their employer) with a higher value than EUR 12,500 per month.

18. What is the formal process for granting awards under an incentive plan?

- Generally, within the process of granting an incentive plan co-determination and information rights of an

existing works council must be respected.

- In case of any equity incentive plans, the formal process requires, generally, a formal decision and the entry of the new shareholder structure into the commercial register.

For stock incentive plans a formal process with strict requirements applies. The most important steps are:

- Capital increase by resolution of the Annual Grand Meeting
- Entry of this resolution to the commercial register and publication
- Issuing of the shares to the employees
- For non-equity incentive plans no formal process requirements must be met. Requirements are limited to precise contractual regulation and the participation of an existing works council.

19. Can an overseas corporation operate an incentive plan?

Two cases must be distinguished:

- Overseas companies can operate incentive plans for their German employees. The mandatory requirements under German law must then be met.

In group companies, it is also possible that an overseas parent company operates an incentive plan also for the employees of the German subsidiary company. The employees are then entitled to a payment by the parent company. Under certain conditions (e.g. clear separation from the employment agreement with the German subsidiary and clear communication that the entitlement is only subject to parent company' terms and conditions), the German legal requirements do not have to be respected.

20. Can an overseas employee participate in an incentive plan?

Overseas employees can participate in an incentive plan.

21. How are share options or awards held by an internationally mobile employee taxed?

If internationally mobile employees are qualified as German tax residents (various requirements like e.g.

duration of stay in Germany), they are subject to German income taxation. Employees can check whether they qualify for exemptions under a double taxation agreement.

22. How are cash-based incentives held by an internationally mobile employee taxed?

Please see No. 21.

23. What trends in incentive plan design have you observed over the last 12 months?

The Pay Transparency Directive came into force on June 6, 2023. National legislators may transpose it into national law until June 7, 2026. In particular, it provides for extensive rights to information and reporting obligations in relation to equal pay. There is a trend not to wait until 2026, but to take action now and review incentive plans for equal pay and make adjustments if necessary.

A big trend in 2023 is still the inclusion of ESG indicators in incentive plans. On the one hand, the ESG criteria are very important (especially to younger employees), so that their inclusion serves employee retention and recruiting objectives. On the other hand, more and more companies are pushing for the inclusion of ESG criteria. In addition, there are legal regulations that make it advisable (but still not mandatory) to include ESG criteria in incentive plans.

The conflict between cutting costs and the skilled workers shortage leads to a situation where immaterial incentives (lower costs) are becoming increasingly important. In addition, long-term incentive plans are also becoming increasingly popular – companies that have been hit by crises are trying to retain talent by refusing salary increases and bonuses during the crisis but then at the same time promise them a high financial compensation for the time after the crisis.

24. What are the current developments and proposals for reform that will affect the operation of incentive plans over the

next 12 months?

The Corporate Sustainability Reporting Directive (CSRD) must be transposed into German law at latest by mid-2024. The CSRD is supplemented by the European Sustainability Reporting Standards (ESRS). Put simply, the CSRD regulates the “if” of reporting and the ESRS the “about”. It will entail far-reaching reporting obligations for companies operating in the EU. The companies must report on topics such as environmental and climate protection, diversity, social responsibility and working conditions, as well as targets and procedures for achieving those topics (please see also above under 23.).

National legislators may transpose the Pay Transparency Directive (please see above under 23.) into national law until June 7, 2026. Therefore, over the next 12 months more employers will check their incentive plans for compliance with equal pay aspects.

The Future Financing Act (Zukunftsfinanzierungsgesetz) came into force in December 2023. However, this long-awaited law fell short of the expectations of start-ups and the first draft of the Future Financing Act:

- The tax-free threshold for employee shareholding benefits was increased from yearly EUR 1,440.00 to EUR 2,000.00 (the draft of the Future Finance Act still planned an increase to EUR 5,000.00). However, tax-free employee share ownership schemes can still be financed in full through deferred compensation (in contrast to the draft).
- Start-Ups have long been calling for the so-called “dry-income taxation” which was introduced by the Future Finance Act. This term means that a tax liability exists for ESOPs and VSOPs even if the employee has not yet received any liquid funds from the sale of his shareholding. Therefore, before a start-up is sold or goes on the stock market, employees cannot sell their shares or realise their virtual options. Before the Future Finance Act came into force, employees had to pay tax on their shares after 12 years at the latest. Now this period will be extended to 15 years (the draft planned with 20 years).

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