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# Employee Incentive Plans – What you need to know


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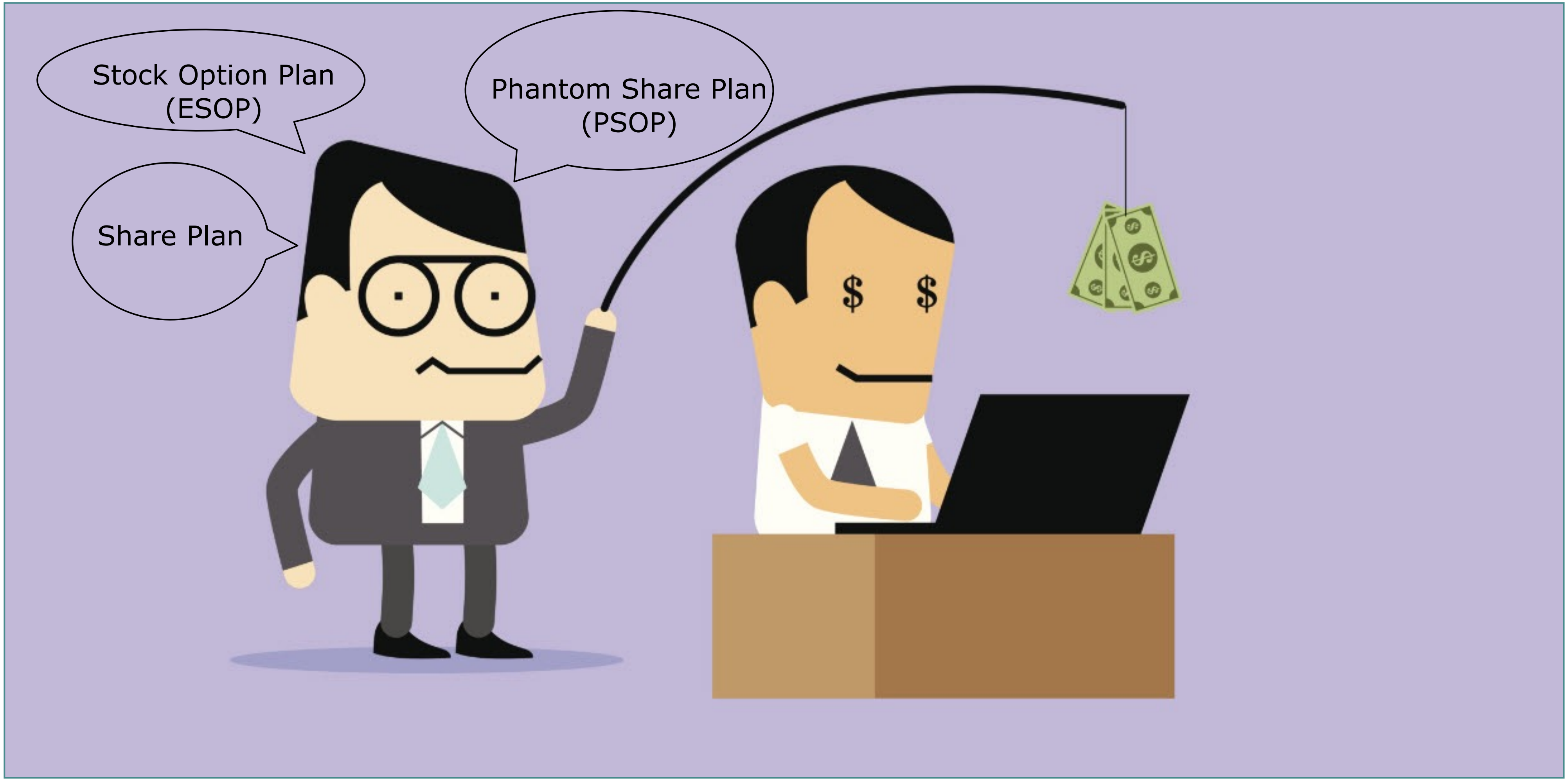


https://www.channel.mechanics.com/getting-spiffs-right/

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# Content

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- **Tax Aspects - Overview**
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# Why Employee Incentive Plans?

## Attracting The World's Best Talents

- Attracting, retaining and motivating high potential talents
- Startups usually don't have sufficient cash available in order to pay market based salaries to employees, let alone bonuses
- Entrepreneurship of employees through participation
- Provide employees with additional incentive to increase their efforts on behalf and in the best interest of the company
- Catch up and stop losing talents to US companies
- VCs require employee incentive plans

# Overview Employee Participations I

| "Real" Equity Participation | Cash Participation |
|---|---|
| 'Real' equity participation means that employees ultimately receive real shares in your business. This encourages high employee commitment, and may create an opportunity for tax-free capital gains in Switzerland.<br><br>**Instruments**:<br>• Employee share plans<br>• Stock option plans | Cash participation 'Phantom' share plans are cash settled plans that economically mirror the development in the value of real shares but result in a cash payout for the employee. This means no shares are allocated, which generally results in less complexity.<br><br>**Instruments**:<br>• Phantom shares |

**Opportunity to become a shareholder**

**Remuneration in cash**

# Overview Employee Participations II

| Share Plan | Stock Option Plan | Phantom Stock Plan |
|---|---|---|
| Under share plans, employees either get the right to purchase shares of the employer, usually at preferential conditions, or receive shares for free. | Free option to buy shares: right to acquire shares at a fixed price during a predefined period of time in the future. | Right to buy, on a virtual basis, phantom shares that mirror the growth of the employer's shares. No voting or dividend rights. |

# Employee Share Plan

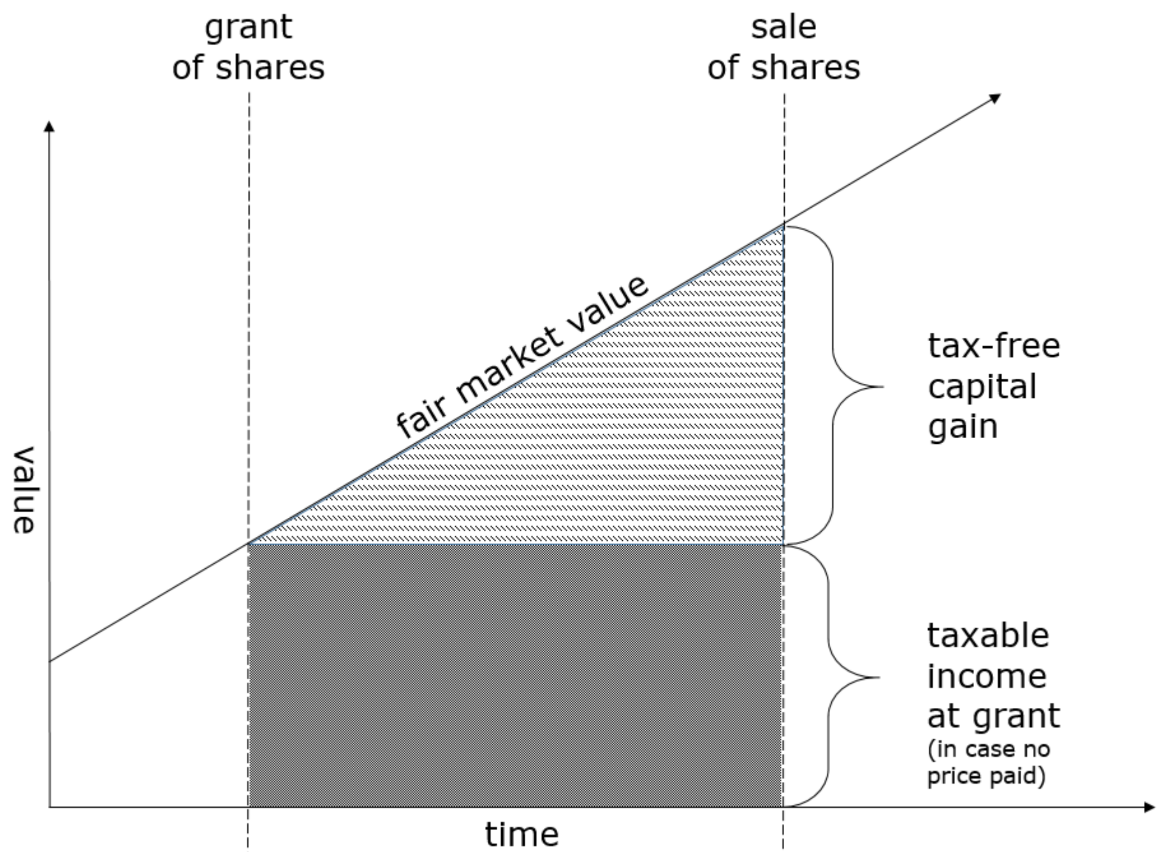

https://theorgworld.com/shares

# Employee Share Plan

- Right of the employee to receive shares of the company
- Share price: very low or even for free
- Not often used in the startup ecosytem due to tax reasons
- Taxable event: grant of the shares
- Big plus: Possibility for a tax-free capital gain in case of a liquidity event

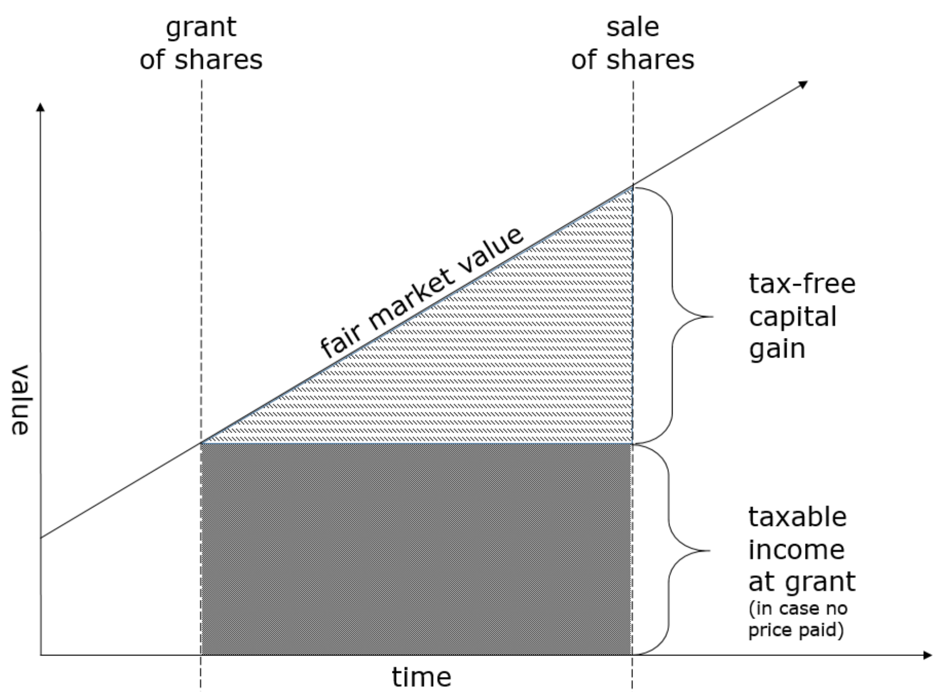
# Employee Share Plan – Taxation

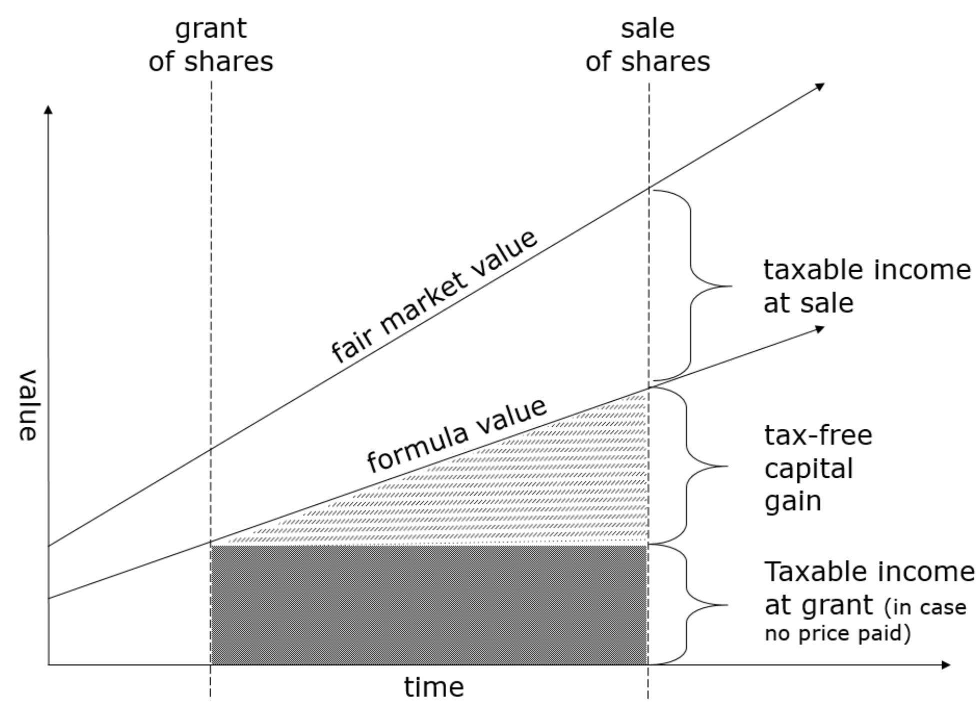
- Taxation of the shares at the grant date (fair market price): Difference between the fair market price at the grant date and the price paid by the employee= taxable income of the employee
- Possibility of a tax-free capital gain



# Employee Share Plan – Tax Ruling

- With a pre-approval of the tax authorities ("Steuer-Ruling"), the income tax can be levied on a formula value (e.g. based on EBIT, EBITA, revenue or other financial indicators), which leads to a reduction of the taxable amount (for startups, the formula value is almost always lower than the fair market value)
- In case of a later sale, often only the increase of the formula value will be considered tax-free, while any exceeding capital gain will be taxed as income



# Employee Share Plan - Pros and Cons

| Employee Share Plan | |
|---|---|
| **Pros** | **Cons** |
| • Possibility of allowing employees to participate in the long-term increase in value of the employer<br>• Possibility of participation through voting rights and thus greater identification with the employer<br>• Possibility of a tax-free capital gain | • Possibly high capital investment by employees with corresponding tie-up of their funds<br>• Employees bear the price risk, up to and including total loss in the event of bankruptcy<br>• High administrative effort (allocation, procurement, custody, information, etc.)<br>• taxable event: grant/transfer of shares |

# Stock Option Plan


://newventurist.com/2017/01/stock-options-post-13-startup-briefs/

# Stock Option Plan – General Remarks

| ***What is a Stock Option?*** |
| --- |
| – Right of the employee to acquire a defined number of shares in the employer at a (preferential) price fixed in advance on the basis of the employment relationship during or after the expiry of a certain period (vesting period) |

| ***Participants of Stock Option Plan*** |
| --- |
| – Employees<br>– Members of the Board of Directors<br>– Consultants/Advisors |

# Stock Option Plan – General Remarks

## *The 3 main pillars*

### Grant

Employee receives right to exercise a share purchase right

### Vesting

Date from which the option right can be exercised

### Exercise

Date at which the right to purchase shares is exercised

# Stock Option Plan – General Remarks

***Relevant Documents***

- **Stock Option Plan**: Basic document with all the relevant terms (grant, vesting, acceleration of vesting in case of a liquidity event, exercise)
- **Allocation Agreement**: Actual grant of the options to the employee (deviation form the plan possible)
- **Notice of Exercise**: Options granted under the Stock Option Plan are exercised by the employee by the filing of a written notice of exercise to the Company

# Stock Option Plan – Main Terms

## Grant

- Board of Directors of the Company selects the participants and the number of Options granted at its absolute discretion
- Option Price: Free of charge
- Evidenced by an Allocation Agreement
- Possibility of deviation from the ESOP in the Allocation Agreement

# Stock Option Plan – Main Terms

## Vesting Schedule

- Vesting = Earning the options over time (or based on performance)
  - Accelerated vesting is typical upon liquidity event (exit/IPO)
  - Forfeiture in case of termination of employment during vesting period
- Standard vesting period
  - 2-4 years with a one-year cliff

# Stock Option Plan – Main Terms

## Vesting Schedule

Unless otherwise agreed upon in the Allocation Agreement, and subject to the conditions precedent set out in Sections 8.2 and 9.4, Options awarded to Participants under the terms of the Plan will vest in instalments over a period of four years as follows :

a) on the first anniversary of the Grant Date, 25% of the Options shall vest, it being understood that the date of the first anniversary shall be considered a cliff period . A cliff period means that prior to the first anniversary of the Grant Date, 0% of the Options vest, but on the first anniversary of the Grant Date, 25% of the Options shall vest and thereafter the Options shall vest each month ;

b) subsequently to the first anniversary of the Grant Date, each month 2.0833% of the Options shall vest; fractions shall be rounded down to the next full number;

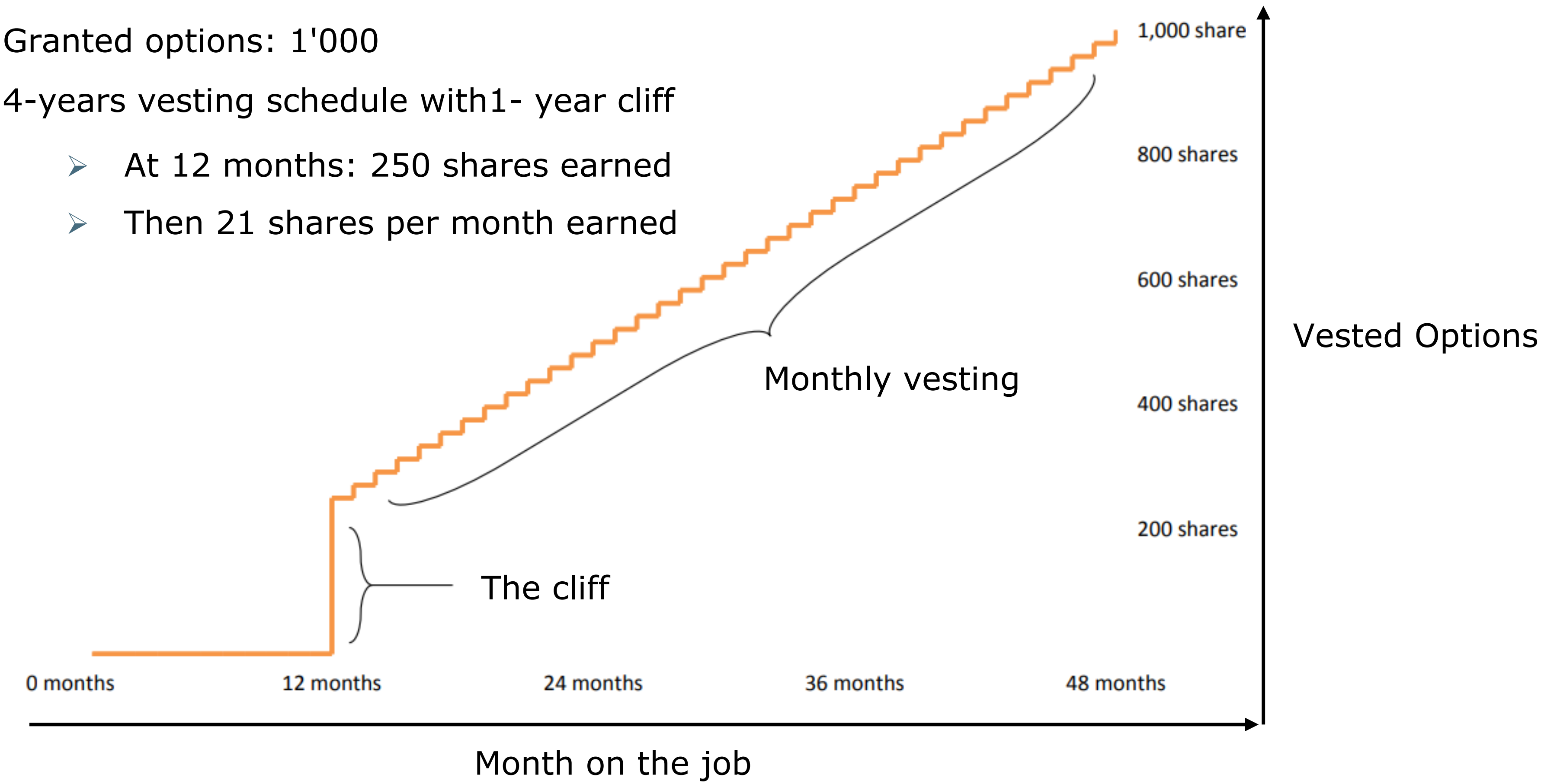
c) on the fourth anniversary of the Grant Date all Options granted to Participants shall fully vest.

Only vested Options are exercisable.

# Stock Option Plan – Main Terms

## Standard vesting with a Cliff

- Granted options: 1'000
- 4-years vesting schedule with1- year cliff
  - At 12 months: 250 shares earned
  - Then 21 shares per month earned



# Stock Option Plan – Main Terms

| Exercise |
| --- |
| • **Exercise date:** Date at which the right to purchase shares is exercised (usually only vested Options are exercisable)<br>• **Exercise period**: e.g. 10 years since vesting, after this date the option expires and can no longer be exercised<br>• **Exercise price**: amount that the employee must pay to turn one option into one share of stock (e.g. Nominal Value at the Grant Date)<br>• It is generally in the best interest of both company and employee if the strike price is set as low as possible<br>➢ This is because options are typically exercised only after an acquisition or IPO, so while a higher strike price costs the employee more, none of the current shareholders benefit |

# Stock Option Plan – How much to grant?

| A Typical Distribution Schedule | |
|---|---|
| **Seniority** | **Equity Allocation** |
| First 10 employees | 10% |
| Next 20 Employees | 5% |
| Next 50 Employees | 5% |

Early-stage equity grants are always a negotiation, but generally:

- CTO: 1-5%
- Key Developer or Engineer: 1-2%
- Other functional Team Member: 0.5-1.5%
- No non-founding member of the senior team should receive over 10%

# Stock Option Plan – How much to grant?

**Determine the Value of Option Grants**

Base salary as negotiated with the employee at the time of hire or promotion

**Value of Option Grant = Employee Base Salary x Options Multiplier**

Options multiplier is decided based on the employee's role in the HR segmentation schedule

# Where to get the shares from?

| Treasury Shares | Conditional Capital Increase ("Bedingte Kapitalerhöhung") |
|---|---|
| • Shares can be bought back on the market or from the known shareholder base or from the founders<br><br>**Advantage**:<br>• Dilution of share capital can be avoided.<br><br>**Precondition**:<br>• Company must have sufficient liquid funds<br>• Company must have sufficient freely usable equity capital ("freiverwendbares Eigenkapital")<br>• The nominal value of the total shares acquired must not exceed 10% of the nominal share capital<br>• Voting rights and all other rights associated with own shares are suspended during the period in which the company holds the own shares | • Standard<br><br>• To be included in the articles of association<br><br>• The general meeting decides on the maximum amount (nominal value) by which the capital may be increased<br><br>• The nominal value of the conditional capital may not exceed half of the existing share capital<br><br>• The preferential subscription rights ("Vorweg-zeichnungsrecht") of the existing shareholders are withdrawn in favour of the option rights of the employees. |

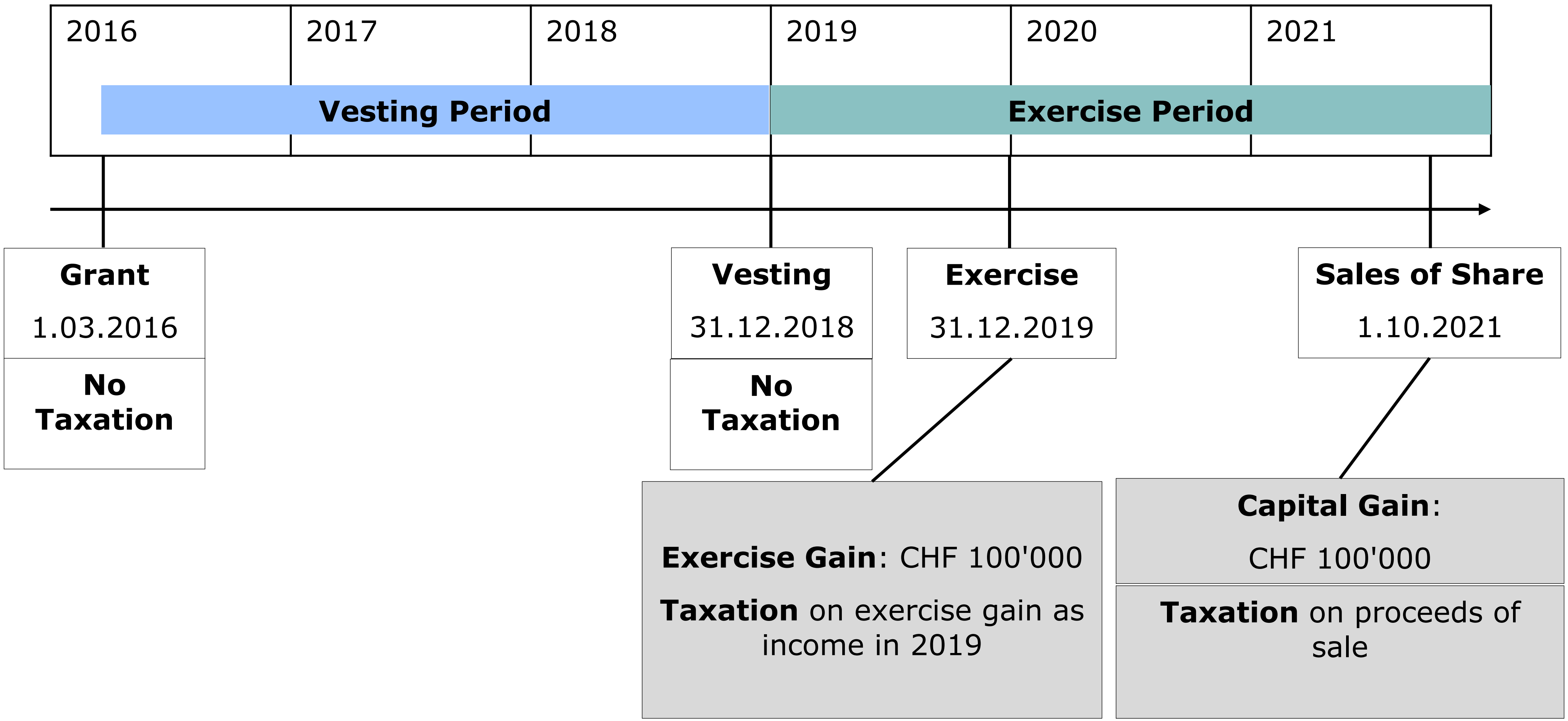
# Where to get the shares from ? – Conditional Capital

The share capital according article 3 will be increased under exclusion of the shareholders’ subscription rights by a maximum amount of CHF 18'634.07 through the issuance of up to 1'863'407 fully paid in registered common shares with a nominal value of CHF 0.01 each through the exercise of new or already granted option rights to the members of the Board of Directors, the management, the employees and the advisors of the Company according to one or several employee share option plans approved by the Board of Directors. The transferability of these shares are limited according to the Articles of Association

# Stock Options – Taxation

Tax specifications based on the following assumptions:

- Employment relationship in Switzerland
- Tax residency in Switzerland



# Stock Option Plan - Pros and Cons

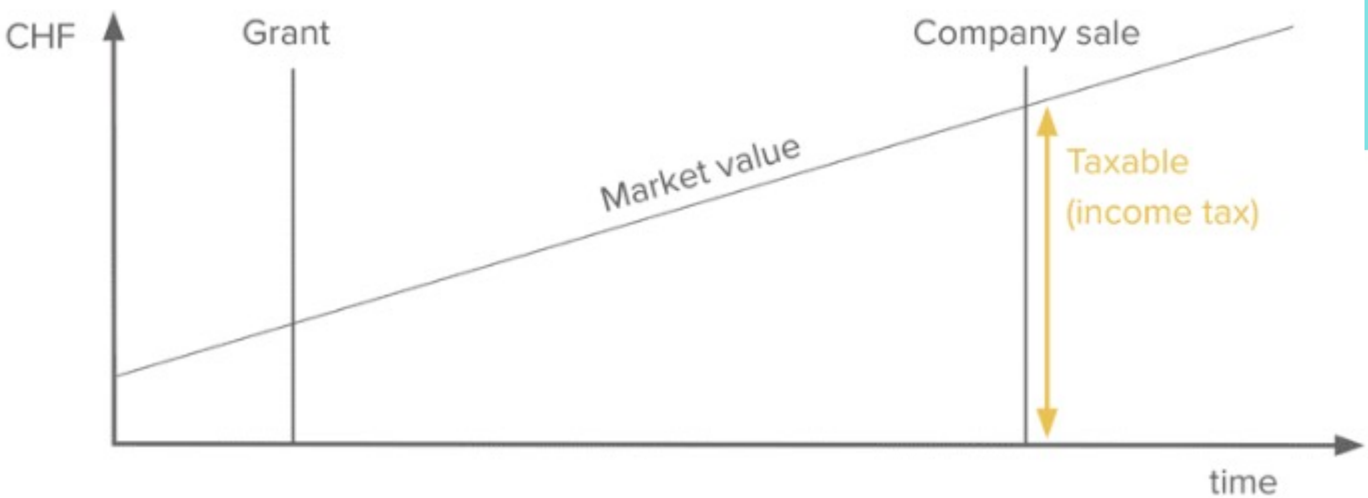
| Stock Option Plan | |
|---|---|
| **Pros** | **Cons** |
| • Motivation of employees leads to personal performance enhancement<br>• Venture capitalists require ESOPs<br>• Tax- and social contribution - relevant at exercising and not at grant of options<br>• Employee has the possibility to exercise options only in case of a liquidity event<br>• Globally recognised | • Possibly unfavourable expansion of the shareholder base (more shareholders on the cap table)<br>• ESOP may involve a high administrative effort and corresponding costs<br>• no tax-free capital gain |

# Phantom Stock Plan

https://www.iconspng.com/image/50637/fantasma-prueba

# Phantom Stock Plan

- Instrument that mirrors the economic effects of a real equity-based instrument, but at the end of a predefined period the payout will be in cash (no possibility to receive ownership of equity)
- Fictitious shares representing fictitious participation in the value of a company
- The company pays out the issued phantom stocks in cash in the event of a liquidity event
- Grant and Vesting similar to ESOP

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# Phantom Stocks - Pros and Cons

| Phantom Stock Plans | |
|---|---|
| **Pros** | **Cons** |
| • No expansion of the shareholder base<br>• Relatively low administrative costs<br>• Motivation of employees leads to an increase in personal performance<br>• No use of employee's funds, no commitment of employee's funds | • Employee cannot become a shareholder<br>• US VCs may insist on an ESOP<br>• No tax advantages for the employees<br>• No savings in wage costs possible |

# Tax Aspects- Overview

| Employee Shares | Stock Options | Phantom Stocks |
| --- | --- | --- |
| • subject to **income tax**:<br>➢ as salary at the time of grant/transfer<br>➢ difference between the market value of the shares and the price to be paid by the employees<br>• **Possibility of Tax-free capital gain:** sale of employee shares held as private assets<br>• Employee shares are subject to **wealth tax** | • subject to **income tax**:<br>➢ as salary at the time of exercise/sale<br>➢ entire sale proceeds or exercise gain after deduction of any production costs is taxable<br>• **No tax-free capital gain** | • subject to **income tax**:<br>➢ entitlements from the phantom stock are part of the salary<br>➢ taxation takes place at the time when the employee receives the cash payment<br>• **No tax-free capital gain** |

# Implementing an ESOP (or PSOP) – Step-by-step Process

Discuss/negotiate plan within board of directors, with key employees and investors, if any

↓

Draft and finalize plan based on discussion/negotiations (usually done by financial or legal advisors in cooperation with the start up)

↓

Ensure funding of shares is secured (articles of association, shareholders' agreement)

↓

Have plan (including allocation agreement) approved by BoD (written decision of the BoD required)

↓

Have plan and allocation agreements signed by the company and the individual participants

↓

Don't forget to list the granted incentives in the employees' yearly salary statement (Lohnausweis und Beilage dazu) and the tax return (pro memoria)

# Key Takeaways

- Instrument to attract and keep the best talents
- Sooner or later investors and/or employee require employee incentive plans
- Take your time to decide on the right form (shares, stock option or phantom shares)
- Get advice from professionals (accountants, lawyers and tax experts)
- Think about tax consequences

# Q&A

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# Thank you and feel free to get in touch in case of questions!

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