

# NewsLetter

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## Swiss Tax Treatment of Grants of Stock Options and Shares

**The Canton of Zurich has recently amended the rules governing the taxation of stock options and shares granted to employees. These amendments maintain and clarify the current tax treatment of grants of shares, but a recent decision of the Administrative Court (*Verwaltungsgericht*) has changed the cantonal and municipal tax treatment applicable to the grant of stock options. Under this decision, the value of an option grant is included in taxable income in the tax year in which the option became vested. It has not yet been determined whether this new tax treatment will apply to federal taxes, including social security taxes, or how it will affect the taxation of outstanding stock options. Also, the existing international tax issues remain with respect to grants of options received or exercised while the taxpayer's tax residence is outside Switzerland.**

### Share Grants

The general rule that shares of an employer's stock granted to an employee are subject to Swiss income taxes at all levels (including social security taxes) in the tax year when the grant was made has not changed. The fair market value of the shares on the date the grant was made, reduced by the amount of any purchase price paid by the employee, is included in taxable income for the year in which the grant was made. If the shares were granted subject to the lapse of a vesting period, the fair market value of the shares is discounted at a rate of 6% per year for each year of the vesting period (up to a maximum of ten years).

Following a decision of the Tax Appeal Commission of the Canton of Zurich dated 17 May 2002, the Tax Administration of the Canton of Zurich, on 29 October 2002, released additional guidelines regarding the tax treatment of share grants to employees – in particular, in the following situations:

*Forfeiture of unvested shares:* If shares are forfeited before the lapse of the vesting period, for example upon an employee leaving the company, the discounted value of the shares at the time of the forfeiture (to the extent the loss has not been compensated by the employer) can be deducted from the employee's taxable income for income tax purposes in the tax year in which the forfeiture occurred, regardless of the reason for the termination of the employment relationship.

*Accelerated vesting of shares:* If shares vest on an accelerated basis, then the additional taxable income recognized in respect of the accelerated vesting of the share grant is subject to income and social security taxes in the year in which the accelerated vesting occurred.

*Buy-out of shares:* If an employee who has received a grant of shares which are subject to forfeiture upon leaving the company unless the employee buys the shares for a fixed purchase price, then, upon payment of this buy-out price, there may be a gain or loss which is recognized on the income tax return for the then current tax year (but the loss will only be taken into account if the employee is under a contractual obligation to buy out his or her shares at the end of the employment relationship).

### Stock Option Grants

Under the current, established Swiss tax practice, the value of a stock option granted to an employee is computed as of the date it was granted and that value is subject to income and social security taxes in the tax year in which the grant was made. The value of the option is usually determined by the Black-Scholes method. If the option is subject to a vesting period, then the share price on the date the option is granted is discounted at a rate of 6% per year for each year of the vesting period (up to a maximum of five years) before being used as the basis for the Black-Scholes valuation. Any gain realized upon the later exercise of the option is generally treated as a nontaxable capital gain from the sale of a private (nonbusiness) movable asset.



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If, however, the option is deemed for Swiss tax purposes to constitute an "expectation award" because, for example, (1) the option is subject to a vesting period longer than five years, (2) the term of the option is more than ten years or (3) the option is subject to individual conditions (performance targets, etc.), then the taxation of the option may be deferred until the tax year in which the option is exercised.

This long-standing tax treatment of stock options was altered by a decision rendered on 20 November 2002 by the Administrative Court of the Canton of Zurich (*Verwaltungsgericht*), which ruled that employee stock options are – for Zurich cantonal and municipal income tax purposes – taxable upon vesting and no longer upon grant (the general rule) or exercise (the exception). The decision defined an unvested option as an option which is subject to forfeiture by the employee, whether through termination of employment or failure to achieve performance targets. Conversely, if an option has become vested, then the employee has the irrevocable, nonforfeitable right to exercise the option, either immediately or after the lapse of a restriction period.

The Administrative Court decision applies to Zurich cantonal and municipal income taxes (which result in a combined tax rate as high as approximately 30%), but at this stage it is unclear whether the Zurich tax authorities will apply this new regime to direct federal taxation (which has a maximum rate of 11.5%) and federal social security taxes. It also remains to be seen how the Zurich tax authorities will apply the new regime with regard to outstanding options because the court's decision does not address any transitional issues.

The new Zurich tax practice raises serious issues regarding the intercantonal taxation of stock options which will need to be addressed by the Federal Supreme Court or by an amendment to the Federal Tax Harmonization Law. In addition, there is still no solution for the existing international tax issues (double taxation or no taxation at all) with respect to grants of options received or exercised while the taxpayer's tax residence is outside Switzerland.

### **Action by Employers and Employees**

*General:* Swiss employers have to ensure full compliance with statutory tax reporting requirements: in particular, due completion of wage certificates (together with the provision of detailed information regarding employee share and stock option plans); if applicable, withholding income taxes at the source for non-Swiss employees; and the withholding of social security taxes. Employees are

responsible for the accurate declaration of all taxable employment benefits, including share and option grants.

*Grants of shares:* The new guidelines of the Canton of Zurich do not trigger any immediate need for action. However, both employers and employees will need to duly report the taxable benefits or deductible losses (as the case may be) which may arise on the forfeiture of unvested shares, the accelerated vesting of shares or the buy-out of unvested shares.

*Grants of stock options:* The new Zurich practice applies for all tax periods which have not been finally assessed, and even more important, it is likely to apply to outstanding options which under the old practice are taxable at exercise. Existing rulings providing for taxation at exercise might therefore no longer be applicable. The new guidelines to be issued by the Tax Administration of the Canton of Zurich are expected to clarify some of the open issues with regard to the tax treatment of stock options in the Canton of Zurich, in particular the transitional issues. Employers and employees should then have more certainty as to their statutory reporting and declaration requirements. However, the inter-cantonal and international issues will likely remain until a Supreme Court decision is rendered or new guidelines are issued at the federal level.

### **NewsLetter**

The ww&p NewsLetter provides comments on new developments and significant issues of Swiss law. These comments are not intended to provide legal advice. Before taking action or relying on the comments and the information given, addressees of this NewsLetter should seek specific advice on the matters which concern them.

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