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Newsletter

Special Edition

Wealth Tax on Shares in Start-ups – New Rules in the Canton of Zurich

In the recent past, the Canton of Zurich has been heavily criticized for its practice to value start-up companies for wealth tax (Vermögenssteuer) purposes based on investment prices paid in financing rounds, whether or not the company has generated any profits. Founders and investors in start-up companies have therefore been subject to substantial wealth tax which sometimes exceeded their financials resources. As a reaction, the Zurich Cantonal Tax Administration has published today new practice directives providing for a reduced taxation for an initial phase of a start-up. However, according to those directives, shareholders in start-ups may only benefit from such a regime if the reduced valuation is not overruled by higher valuations, e.g. under any employee participation schemes or any sales transaction that would be deemed significant.

New rules for the valuation of shares in start-ups for wealth tax purposes

By Maurus Winzap
lic. iur., LL.M., Attorney at Law
Certified Tax Expert
Partner
Phone +41 58 658 56 05
maurus.winzap@walderwyss.com

and Florian Gunz Niedermann
lic. iur., LL.M., Attorney at Law
Partner
Phone +41 58 658 56 94
florian.gunz@walderwyss.com

and Alexander Nikitine
Dr. iur., LL.M., Attorney at Law
Partner
Phone +41 58 658 56 32
alexander.nikitine@walderwyss.com

For many years, Swiss start-up companies used to be valued for wealth tax purposes based on the so-called «simplified method» (*Praktikermethode*). Such method, in essence calculating an average of earnings (double-weighted) and substance (single-weighted), with substance being considered the floor, typically led to a valuation which was reasonably low for wealth tax purposes.

In the recent past, however, the Zurich Cantonal Tax Administration has tightened its practice in accordance with Paragraph 2(5) of Circular 28 issued by the Swiss Tax Conference by enforcing a taxation based on the valuation applied in the most recent financing round conducted by the relevant start-up. In cases where a start-up raised new funds based on a two- or three-digit million company valuation and where its founders still held significant stakes, this led to considerable tax bills and respective shortage in cash for the relevant founding shareholders. As a result, the Zurich Cantonal Tax Administration has been heavily criticized for its approach (which, as some people claim, was not in line with the approach taken by other Cantons), materially impairing the attractiveness of Zurich as a hub for Swiss start-ups.

As a reaction, the Finance Department of the Canton of Zurich initiated discussions with members of the start-up community and their advisors, leading to new practice directives which have been issued today by the Zurich Cantonal Tax Administration (see www.steueramt.zh.ch/internet/finanzdirektion/ksta/de/aktuell.html) and which provide for a reduced taxation for an initial phase of a start-up, effective immediately. However, shareholders in start-ups may only benefit from such a regime if the reduced valuation is not overruled by higher valuations, e.g. under any employee participation schemes or any sales transaction that would be deemed significant.

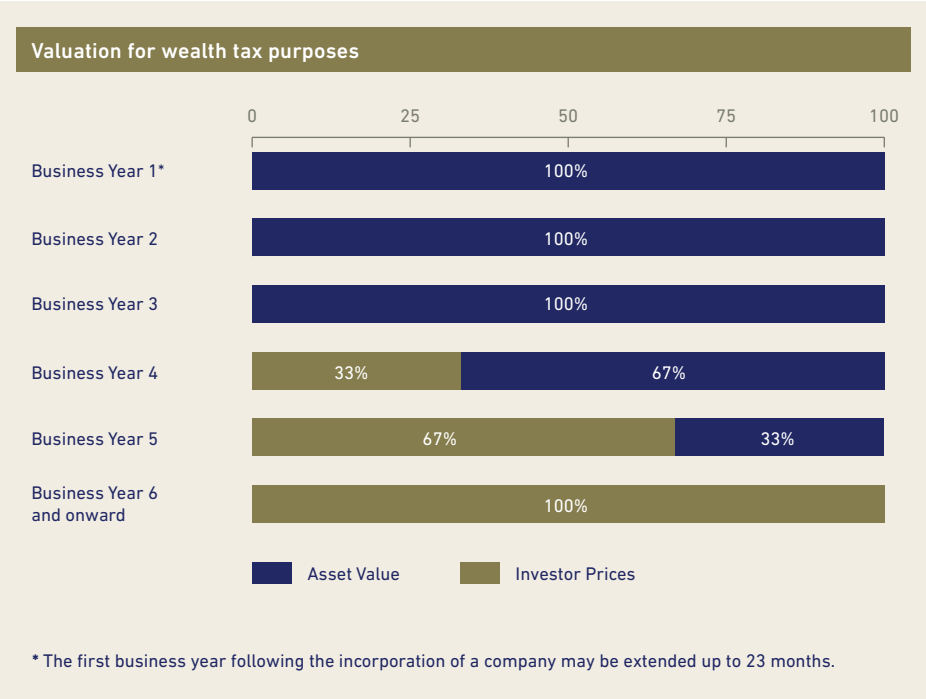
These new directives must be deemed a compromise between the original approach (applying the so-called simplified method) and the regime of a valuation based on financing rounds, as applied until most recently. Moreover, since they seem to express the view that the current legal framework does not provide for additional leeway, further easements for start-ups are likely to require actions by the legislative body.

As a general rule, the new practice directives will apply to start-up companies incorporated in Zurich and assessed for wealth tax purposes by the Zurich Cantonal Tax Administration. In our view, it should also be possible for shareholders living and paying their taxes in the Canton of Zurich to benefit from these new practice directives with regard to start-up companies set up in other Cantons. In addition, it is expected that the Zurich Cantonal Tax Administration will submit its new approach to the Swiss Tax Conference for debate. Thus, the new Zurich directives could serve as inspiration for other Cantons and for a nation-wide approach.

Key Points of the New Practice Directives (in force as of 1 March 2016)

Principle: Staggered «grace period»

– Investment prices paid by (venture capital) investors during the *first three business years* after incorporation of the start-up shall be disregarded. The value for wealth tax purposes shall be the asset value as per Paragraph 11 *et seq.* of Circular 28 of the Swiss Tax Conference (valuation according to the simplified method).



- In the subsequent *two business years,* the value for wealth tax purposes shall be the average between the net asset value and investor prices.
- In the fourth business year, the average investor prices shall be single-weighted and the net asset value shall be double-weighted.
- In the fifth business year, the average investor prices shall be double-weighted and the net asset value shall be single-weighted.
- As from the sixth business year, the realized investor prices shall be solely relevant.

Specific rules for biotech and medtech sectors

Provided that the start-up company is subject to regulatory development processes of the biotech or medtech sectors, the asset value shall be relevant during the *first five* business years.

In the subsequent two business years, the value for wealth tax purposes shall be the average between the asset value and the investor prices. In the sixth business year, the average investor prices shall be single-weighted and the net asset value shall be double-weighted. In the seventh business year, the average investor prices shall be double-weighted and the net asset value shall be single-weighted. As from the eighth business year, the investor prices shall be solely relevant.

Reservations

According to the new directives, the aforementioned valuation guidelines shall not apply if the result is inconsistent from a tax-system perspective. Cases of inconsistency include the following:

- When existing shareholders, acting alone or together with other shareholders, sell a significant number of shares (as a general rule: 10%) to an unrelated third party, the actual transaction price shall be relevant for wealth tax purposes. In this scenario, a formulary approach shall be ruled out.
- In case the company determines for whatever purpose its own fair market value, the value thus determined shall constitutes the minimum value for wealth tax purposes. This applies in particular in the event of employee participation schemes (shares and options). In this case, the value for wealth tax purposes must not be lower than the one for income-tax purposes.
- If employee stock options are exercised, the actual strike price paid shall constitute the minimum value for wealth tax purposes.

Individual valuation

Notwithstanding the basic principles set out above, an individual valuation of the shares is possible in the event of objective differences regarding the financial condition of investors/shareholders and other groups of shareholders. This applies for instance in the event of so-called exit preferences in favour of investors/shareholders.

Effective date

This new practice enters into force immediately (1 March 2016) and applies to all pending cases that have not yet been finalized.

Walder Wyss Ltd.
Attorneys at Law

Phone + 41 58 658 58 58
Fax + 41 58 658 59 59
reception@walderwyss.com

www.walderwyss.com
Zurich, Geneva, Basel, Berne, Lausanne, Lugano