CORPORATE TAX - SWITZERLAND

Tax relief on employee shares in start-ups and other non-listed companies

13 November 2020 | Contributed by Walder Wyss

AUTHORS

Fabienne Limacher

Maurus Winzap

Introduction

Under the current tax framework, the non-uniform cantonal tax practices on the capital gains treatment and valuation of employee shares in start-ups and other non-listed companies lead to different tax consequences for employees depending on their place of residence.

By means of its updated version of Circular Letter 37 on the taxation of employee shareholdings of 30 October 2020, the Swiss Federal Tax Administration (SFTA) created a favourable framework for start-ups and enhanced the legal certainty and predictability of the tax consequences with regard to non-listed employee shares.

Background

In general, any right to equity-based compensation that is attributable to a former, current or future employment relationship is qualified as a so-called 'employee shareholding'.

In case of (real) employee shares, there may be tax consequences at the time of the:

- acquisition of the shares; and
- the sale of the shares (as described in more detail below).

By contrast, capital gains from the sale of privately held shares that do not qualify as employee shares (ie, private investments) are generally tax free.

In this context, start-ups and other non-listed companies are typically confronted with the question of under which circumstances an employee may realise a tax-free capital gain. The updated version of Circular Letter 37 sheds light on:

- the valuation method for determining the pecuniary benefits from real employee shareholding schemes;
- the capital gains treatment from the disposal of employee shares; and
- the demarcation between a private investment and employee shareholdings.

Against this backdrop, this article provides an overview of the relevant Swiss tax rules associated with the taxation of employee shares and the changes to Circular Letter 37 that will apply as of 1 January 2021.

Valuation of non-listed employee shareholdings

For non-listed companies as start-ups and early-stage ventures, a genuine fair market value is typically unavailable or is not accepted as such by the Swiss tax authorities for tax purposes unless an effective and material (as a rule above 10%) third-party transaction involving these shares has taken place. Therefore, a generally accepted valuation method formula value must be determined for Swiss tax and social security purposes (eg, earnings before interest, taxes, depreciation and amortisation x multiple – net debt). Such a formula value is usually agreed with the competent tax authorities (by way of an advance tax ruling) and is used for the determination of taxable benefits, if any, from employment in connection with the acquisition and disposal of the employee shares.

In this context, the updated version of Circular Letter 37 newly states in Clause 3.2.2. that the so-called 'practitioner method', whereupon the substance is weighted once and the capitalised earnings value is double-weighted with substance being considered the floor, is an acceptable formula value to reflect a fair market value of employee shareholdings. The calculation details concerning the practitioner method are set out in Circular Letter 28 of the Swiss Tax Conference of 28 August 2008. However, companies are still free to determine a different valuation formula acceptable to the tax authorities. In practice, the tax authorities are fairly well versed and receptive for different valuation approaches, but typically do not accept discounted cash flow-based approaches or par value (of the shares).

Taxation of acquisition of employee shares

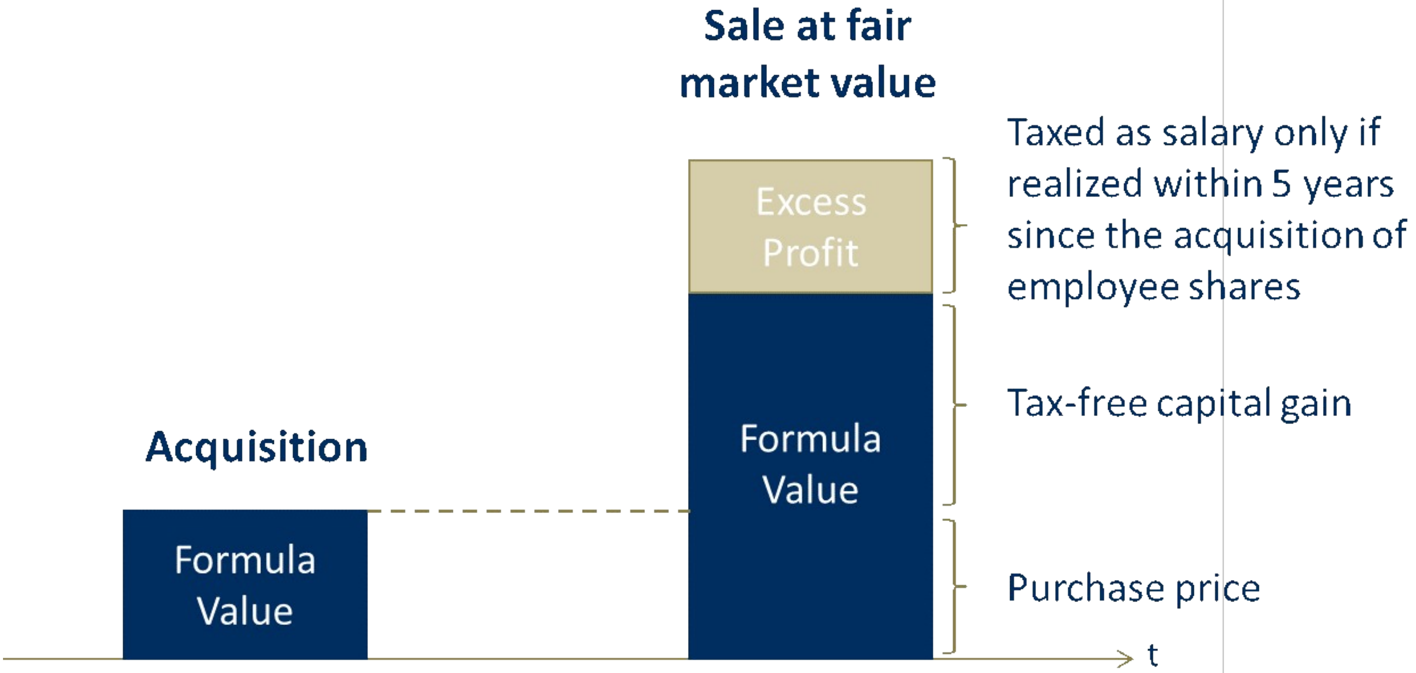
Although the taxation principles concerning the acquisition of employee shares have not been altered in the updated version of Circular Letter 37, it must be noted that any positive difference between the fair market value or formula value, respectively, and the issue price at the time of the acquisition of the employee shareholdings represents a monetary benefit for the employee and is subject to income tax and social security contributions.

Taxation on disposal of employee shares

In the event of non-listed employee shares where the fair market value cannot be determined based on a material third-party transaction, the tax-exempt capital gain is limited to the difference between the formula value on acquisition and the formula value calculated based on the same valuation method at the time of the disposal. Any additional increase in value ('excess profit' – that is the difference between the sales price and the formula value at the time of the disposal), constitutes taxable income from employment subject to income tax and social security contributions.

As probably the most important change in the updated version of Circular Letter 37, excess profit will also be treated as a tax-free capital gain after a five-year holding period.

Depending on exactly where employees are tax resident in Switzerland, they may realise a fully tax-free capital gain on the disposal of employee shares after a holding period of at least five years (eg, according to the current Zurich tax practice) already at present. However, the respective adjustment of Circular Letter 37 ensures an equal treatment of employees irrespective of their place of residence and hence, minimises cantonal distortions.



Founder shares

Clause 3.4.4. of the updated version of Circular Letter 37 clarifies that founder shares (ie, shares subscribed for at the time of the incorporation of the company), do not qualify as employee shares for tax purposes.

While this clarification is welcome, it must be noted that the expression "at the time of incorporation" presupposes proximity to the time of incorporation and accordingly, the shares of late co-founders will likely be regarded as employee shares unless the number of shares and acquisition modalities were already known on the date of incorporation.

Employee shares acquired at third-party conditions

The updated version of Circular Letter 37 further specifies that if an employee acquires shares at conditions similar to those granted to an independent third party, those shares will not qualify as employee shareholdings.

In this context, it must be noted that, according to the current tax practice, employee shares will be considered as having been acquired at third-party conditions only if the transaction:

- is material (ie, at least 10% of the shares are sold);
- has been entered into among third parties (and not only between current shareholders and the company); and
- has taken place reasonably soon (ie, generally within six months) before or after the acquisition of the shares and the respective price has been applied. It is assumed that these strict requirements will also apply in future.

Comment

By adjusting Circular Letter 37 as of 1 January 2021, the SFTA has provided for more legal certainty. In particular, the possibility of realising a tax-free capital gain after a holding period of at least five years creates a favourable tax framework and helps Swiss start-ups and other non-listed companies attract and incentivise new talent.

For further information on this topic please contact Fabienne Limacher or Maurus Winzap at Walder Wyss by telephone (+41 58 658 58 58) or email (fabienne.limacher@walderwyss.com or maurus.winzap@walderwyss.com). The Walder Wyss website can be accessed at www.walderwyss.com.
