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Tax-optimised employee share plans for privately held Swiss companies and start-ups

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Like listed companies, many private companies and early-stage ventures offer their employees one or more share plans. Some companies restrict participation in share plans to senior executives or offer senior executives different plans from those offered to other employees. If carefully planned and well structured, such plans may be extremely favourable for Swiss employees in financial and fiscal terms.

Background

Performance-based cash payments, such as exit bonus payments and payments under long-term phantom (option) share plans, are very common in Switzerland but are relatively unattractive from a pure tax perspective. Such payments are treated as salary, subject to ordinary income taxes at rates varying from roughly 20% to 40%, depending on where the employee resides in Switzerland, and uncapped social security charges of currently 12.75%. In principle, the same holds true with respect to cash-settled options.

In a typical share option plan, the employer grants an employee a free option to buy shares. The option normally has a vesting period, and once it vests, the employee can exercise it for a fixed price which can be lower than the market value during a fixed exercise period. Typically, when an employee leaves the company, an option that has not yet vested lapses. Options are generally subject to (salary) income taxation at exercise – that is, when the employee gets actual shares.

Taxation and valuation of non-listed employee shares

Employee shares are taxed:

- upon allocation of the shares – that is, when the employee acquires the shares under a share plan;
- when they exercise the options under an option plan; and
- potentially upon disposal of such shares (see "excess profit" 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.

The taxable amount upon allocation of employee shares, subject to income taxes and social security charges, is calculated as the difference between the fair market value of the shares and the price at which they are sold to the employee. A discount of 6% per annum is granted for blocked shares (up to 10 years with a maximum discount of 44.161%).

For non-listed companies as start-ups and early-stage ventures, a fair market value is typically not available and respective market valuations are not accepted as market 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 multiple) by the employer. Such a formula value is usually agreed upon 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 Circular Letter 37 on the taxation of employee shareholdings, dated 30 October 2020, the Swiss Federal Tax Administration (SFTA) states that the so-called "practitioner method", whereupon the substance is weighted once and the capitalised earnings value is double weighted with the 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 well-versed and receptive to different valuation approaches, but typically do not accept discounted cash flow-based approaches or par value (of the shares).

Taxation upon acquisition of employee shares

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 shares represents a monetary benefit for the employee and is subject to income tax and social security charges.

Taxation upon 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 the 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 charges. However, pursuant to Circular Letter 37, the excess profit will be treated as a tax-free capital gain after a five-year holding period.

Founder shares
Circular Letter 37 clarifies that founder shares (ie, shares subscribed for at the time of the company's incorporation) 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 pari-passu conditions
Circular Letter 37 confirms that if an employee acquires shares at conditions like those granted to an independent third party, those shares will not qualify as employee shares, so a capital gain realised in the disposal of such shares remains tax-free. 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 respective 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.

Comment

For non-listed companies, there is great flexibility to agree on a valuation method (formula value) with the Swiss tax authorities, typically resulting in clearly lower-than-market entry prices for the employees and allowing for a partially tax-free exit before five years and a completely tax-free exit after a holding period of five years. For start-up companies, in practice, the entry price may quite often be as low as the face value of the respective class of shares (typically the common shares). Careful planning is, however, required for all sorts of sweet equity (to include growth shares and ratchet shares) and carried interest structures resulting in a disproportionate return of investments for employees and managers in an exit event.

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