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

The Swiss Federal Tax Administration introduces a favourable capital gains treatment on the sale of non-listed employee shares and other attractive rules that mainly affect start-ups and other early stage ventures.

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Update of Circular Letter No. 37 on the taxation of employee shareholdings

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 the Circular Letter No. 37 on the taxation of employee shareholdings of 30 October 2020, the Swiss Federal Tax Administration (SFTA) creates a favourable framework for start-ups and enhances 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 the 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 (i) at the time of the acquisition of the shares and (ii) at the time of the sale of the shares as described in in more detail below. In contrast, capital gains from the sale of privately held shares that do not qualify as employee shares (i.e. private investments), are generally tax-free.

In this context, start-ups and other non-listed companies are typically confronted with the question under which circumstances an employee may realize a tax-free capital gain. The updated version of the Circular Letter No. 37 on the taxation of employee shareholdings of 30 October 2020 sheds light on (i) the valuation method for determining the pecuniary benefits from real employee shareholding schemes; (ii) the capital gains treatment from the disposal of employee shares; and (i) the demarcation between a private investment and employee shareholdings.

Against this backdrop, an overview of the relevant Swiss tax rules associated with the taxation of employee shares as well as the changes to the Circular Letter No. 37 that will apply as of 1 January 2021 is provided in the following.

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 and/ 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) needs to be determined for Swiss tax and social security purposes (e.g. EBITDA x Multiple – Net debt, etc.). 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 the disposal of the employee shares.

In this context, the updated version of the Circular Letter No. 37 of 30 October 2020 newly states in clause 3.2.2. that the so-called practitioner method (in German: "*Praktikermethode*"), whereupon the substance is weighted once and the capitalized 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 laid down in Circular Letter No. 28 of the Swiss Tax Conference of 28 August 2008. However, the 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 (i) DCF based approaches and (ii) par value (of the shares).

Taxation upon the acquisition of the employee shares

Although the taxation principles concerning the acquisition of the employee shares have not been altered in the updated version of the Circular Letter No. 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.

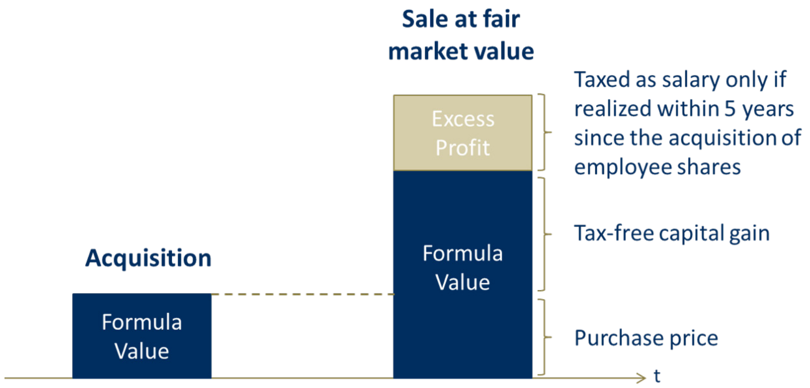
Taxation upon the disposal of the employee shares

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"; in German: "*Übergewinn*"), i.e. 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 the Circular Letter No. 37, the "excess profit" will also be treated as a tax-free capital gain after a holding period of five years.

Depending on exactly where the employee is tax-resident in Switzerland, employees may realize a fully tax-free capital gain on the disposal of employee shares after a holding period of at least five years (e.g. according to the current Zurich tax practice) already today.

However, the respective adjustment of the Circular Letter No. 37 ensures an equal treatment of the employees irrespective of their place of residence and hence, minimizes cantonal distortions.



Founder Shares

It is clarified in clause 3.4.4. of the updated version of the Circular Letter No. 37 that founder shares, i.e. 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 the Circular Letter No. 37 further specifies that if an employee acquires shares at conditions similar to those granted to an independent third party, these shares do not qualify as employee shareholdings.

In this context, it must be noted that, according to the current tax practice, employee shares are only considered as being acquired at third-party conditions if (i) the transaction is material (i.e., at least 10% of the shares are sold), (ii) entered into among third parties (and not only between current shareholders and the company) and if (iii) it has taken place reasonably soon (i.e., generally within 6 months) before/after the acquisition of the shares and the respective price is applied. We assume that these strict requirements will also apply in the future.

Conclusion

By adjusting Circular Letter No. 37 that will be applicable as of 1 January 2021, the SFTA provides for more legal certainty. In particular, the possibility of realizing 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 incentivize new talents.