Changes in the national tax law destroy one of the biggest advantages for start-ups

Employee Stock Ownership Plans (ESOPs) in Switzerland

Employee options were an attractive financial instrument before the tax law was changed per 01.01.2021. Prior to the changes employees could exercise their options when the fair value of share prices was still low as the company was in a very early stage – and then the entire capital gain until a successful trade sale was usually tax free. In our experience, this was one key criteria why many professional venture capital investors decided to build up their companies in Switzerland. With the changes in the tax law capital gains are all of a sudden taxed as income in many situations. This destroys one of the biggest advantages of Switzerland for start-ups in the life sciences, high-tech and other industries.

The good news is that tax-free capital gains can partly be preserved with the right share option plan, capital structure and valuation approach! Hoffmann & Partner supports its clients in the implementation of such plans, capital structures and valuations plus the respective tax rulings, with the goal to minimize the tax impact.

Situation before the tax law changes

When employees exercise options: The difference between fair market value as defined by tax authorities (usually a formula value) and exercise price is seen as income and income taxed plus subject to social security. Nevertheless, for young start-up companies, this difference is usually small as formula values lead to low valuations; and the resulting taxes at exercise are very low. No other taxes were charged thereafter as generally the sale of shares, e.g. in an exit (M&A activities such as company trade sale, IPO or merger) results in a tax free capital gain for private individuals, which are tax residents in Switzerland.

New tax law since 01.01.2021

As per 01.01.2021, the Swiss tax authorities changed the tax treatment of the capitals gain of employee shares sold at exit. If the shares are sold within a period of five years and a change of valuation methodology happened, the capital gain is subject to income tax*. **A change of valuation methodology usually results for companies that are not listed at the stock exchange** as the shares are

valued with a conventional formula approach when exercised whereas they are valued with a fair market value approach, when sold on the market. Thus, options exercised and the received shares sold within five years leads to full taxation.

Companies therefore might consider whether to switch to a solution where at exercise the fair value of shares is determined by the price per share paid in the last financing round. In this case, no change of valuation methodology would occur and the tax free capital gain between exercising and selling the shares would be intact. But by doing so, employees can no longer exercise their options early as at exercise the difference between fair value of shares and exercise price will usually be high and trigger high taxes when exercising.

*Read also the "Kreisschreiben 37", version of 30 October 2022 for more details.

Solutions to minimize tax impact

By using a capital structure with preferred shares to finance the company and common shares as a basis for the share options, and by establishing and ruling correct valuation models to determine a discount between preferred and common shares, tax-free capital gains can partly be preserved.

By applying correct valuation methodologies to value common and preferred shares, a common share value is usually low in the early years of a start-up company. But once a start-up company becomes successful and is sold at a high transaction price, the common shares are typically (almost) as valuable as preferred shares. By applying a ruling that includes the application of this correct valuation methodology when options are exercised as well as when shares are sold, no change in valuation methodology occurs. Thus, employees can still exercise options early at (usually) low values and low taxes - and realise a tax-free capital gain when later the common share value increases a lot.

Hoffmann & Partner was able to successfully establish such tax rulings. Talk to our experts to learn more about it.