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Taxation of employee equity incentives in Switzerland

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Key takeaways:

- Employee participations can be designed such that they allow for a tax-free capital gain on a value increase that has occurred after vesting.
- Employers should carefully monitor their employment withholding tax obligations especially in situations where employees are taxable in Switzerland during only a part of the vesting period.
- Requesting an advance tax ruling from the Swiss tax authorities for certainty on the employee participations tax treatment is both possible and recommended.

1. Introduction

Employee stock ownership plans and other employee equity incentives are often an attractive tool for both employers and employees. Apart from commercial reasons for employee equity incentive programs such as performance-related remuneration, long-term motivation and retention of employees, as well as cost and cash effectiveness for the employer, the tax treatment often plays a crucial role.

The current Swiss rules for taxation of employee equity incentives became effective at the beginning of 2013. The Swiss Federal Tax Administration issued circular no. 37 on 22 July 2013 specifying its practice, based on the new legislation. An additional circular no. 37A, focusing on taxation at the level of the employer, followed on 4 May 2018. Some cantonal tax administrations have issued additional guidelines.

This summary outlines the general principles of taxation of employee equity incentives in Switzerland and points out specific issues, which often arise.

2. Overview on Swiss taxation rules

2.1 What is an employee participation for Swiss tax purposes?

Whether a benefit an employee receives is treated as an "employee participation" is a crucial question because "employee participation" incentives are generally subject to employment income tax and social security contributions. A tax-free private capital gain is then possible only under specific circumstances (see 2.2 below), while capital gains derived from other privately held equity are generally tax-exempt

Every kind of equity or entitlement to equity, or to a payment depending on equity performance attributed to an employee because of an employment relationship most often qualifies as an employment participation for Swiss tax purposes. Generally speaking, an equity incentive qualifies as employment income if there is a nexus between the equity grant and the employment. This regime also includes situations where the employee receives equity from an affiliate of the employer entity. Even the transfer of equity below fair market value, from the individual shareholder to an employee of the shareholder's company, generally qualifies as an employment equity incentive rather than a donation for Swiss tax purposes because of the nexus between the benefit and the employment.

If the employee pays the fair market value for the equity, there is usually no employee equity incentive. Even in such cases, however, the Swiss authorities may claim taxation as employment participation if the employee had the opportunity to purchase the equity based solely on the employment.

Employee equity incentives typically relate to stock in a corporation limited by shares. Equity in companies with similar features as shares, such as profit participation rights without voting rights or the membership rights of a limited liability company, may also qualify as employment participation for Swiss tax purposes. As regards membership interest in a partnership, this is not entirely clear. While equity incentives for employees not yet partners in the partnership are rather rare, these constellations do occur and should then generally follow the Swiss taxation rules for employment participations with respect to the grant. Regarding the ongoing taxation of partnership interest, however, there are other rules because an investment in a partnership generally qualifies as a self-employed business activity, from a Swiss tax point of view (rather than as employment income or investment income), unless it is a passive investment partnership.

2.2 What are the general Swiss taxation rules for employee participations?

Swiss employment income tax law distinguishes between "genuine" and "non-genuine" employee participations. "Genuine" employee participations are stock/shares and other rights representing a part of the equity of the employer entity or of an affiliate of the employer entity, as well as options for the acquisition of such rights. All other kinds of employee participations, which only represent a prospective entitlement to a cash payment or to equity, such as restricted stock units, phantom stock, or stock appreciation rights, qualify as "non-genuine" employee participations.

Incentives derived from genuine employee participations, except for options that cannot yet be exercised at grant and/or are not listed, are subject to Swiss employment income tax at the time the employee receives an irrevocable entitlement to the equity (i.e., at vesting). That is, the difference between both the value of the equity at vesting and the purchase price paid by the employee (if any) is subject to Swiss employment income tax. Capital gains achieved after vesting (or capital losses suffered after vesting) are generally tax free (or not tax-deductible).

If a share or similar genuine employee participation is subject to an alienation blocking period, a discount of 6% per year applies to the share's value at vesting, subject to Swiss employment income tax (discount for up to 10 years). Swiss social security contributions generally follow the Swiss employment income tax treatment.

Incentives derived from non-genuine employee participations, as well as options that cannot yet be exercised at grant and/or are not listed, are taxed only upon "realization"/exercise. That is, the entire benefit is being taxed once the employee receives a cash settlement and/or converts his rights into genuine equity. Unlike genuine employee participations, there is no risk of a potential, non-deductible capital loss.

2.3 How does the valuation of employee equity work for Swiss tax purposes?

Most often, the valuation of employee equity incentives is based on the market value. For instruments, for which a real time fair market is not available, the applicable value is considered to be the value as determined by the employer, in accordance with a suitable and recognized formula (formula value). Two common methods are, for example, (1) the discounted cash flow method, which involves calculating the current net value of expected future revenue and (2) the capitalized earnings method, which consists of comparing several levels of a company's expected revenue (e.g., turnover, EBITDA, EBIT, etc.) in relation to competitors in the same industry by applying multipliers of the market/industry in question. The employer's individual case may determine which valuation methodology is most suitable. Generally, the cantonal tax authorities are rather open-minded as regards the various methods as long as they make sense. The method, once chosen, must be applied for the entire duration of the employee equity incentive plan.

Here, it should be noted that any added value, resulting from a switch from the formula value principle to the fair market value principle, is, as a general rule, taxable as income at the time of alienation. In the Canton of Zurich, this practice is applied subject to the exception that if the employee participation instrument has been held for more than five years, this profit stemming from the switch from the formula principle to the market value principle would not be taxed additionally but rather be tax free.

2.4 What happens if an employee is allowed to sell the equity before completion of an alienation blocking period?

If an employee is allowed to sell the equity before completing an alienation blocking period, then the tax issue is that, at the earlier vesting, the employee had already benefitted from a tax discount because of the existence of an alienation blocking period (assuming completion of such blocking period). Therefore, the difference between the non-discounted value of the equity at the time of early termination of the blocking period and the discounted value upon alienation is treated as additional taxable income from employment.

2.5 What happens if an employee retransfers vested equity to the employer?

Provided there is a positive difference between the "redemption" price and the (appropriately discounted) fair market value or formula value, the employee realizes taxable income from gainful employment (and not a tax-free capital gain).

If, on the other hand, there remains a negative difference (resulting because the equity is retransferred to the employer below the equity's relevant tax value), the employee realizes a loss related to his employment and can claim an expense deduction in his income tax return in the fiscal year when the re-transfer of the vested equity had taken place.

2.6 Does the employer have to withhold a tax?

In general, employers who are tax residents or have a permanent establishment in Switzerland, must deduct Swiss employment income tax only from employees who are either not a tax resident in Switzerland or who are neither Swiss citizens nor having a permanent Swiss residence permit. This principle generally also applies to employee participations.

As regards employees who have received employee participations while working in Switzerland and who have left Switzerland before vesting, the Swiss employer can be required, however, to deduct Swiss employment withholding tax at vesting. This specific employment withholding tax obligation even applies to employees for which the employer did not otherwise have to deduct any employment withholding taxes.

2.7 What other obligations do the employer and the employee have?

The employer must issue an individual report for each employee not only for each tax period in which the employer has granted equity incentives, but also for each tax period in which the employees have realized such equity incentive instruments in an income tax relevant manner. The employer must provide the employee with the report as an annex to the salary certificate, and he must enclose the report to the employment withholding tax statement if the employee is subject to employment withholding tax.

Generally, an employer is free to draft a report in his own style as long as the minimum reporting obligations are covered. The following information must be included in the report:

- Name of the employee equity incentive plan;
- Date of acquisition of the underlying equity instrument;
- Applicable market or formula value;
- Return obligations;
- Agreed purchase price;
- Number of employee participations that are acquired; and
- Monetary benefit as certified in the salary certificate or in tax-at-source statement.

Furthermore, each year the employer must generally list the beneficiaries of an employee equity incentive plan. The employer must send a list at the beginning of each tax period to the competent cantonal tax authorities. This obligation also applies if the employee participation plan is administered by a foreign group entity or by a third party.

3. Recommendations

3.1 What is the most tax efficient employee equity incentive?

From a mere Swiss tax point of view, shares and similar rights, which qualify as "genuine" employee participations (i.e., which are taxed at vesting) are generally more favorable from a Swiss tax point of view, compared to instruments, which qualify as "non-genuine" employee participations (that are taxed upon realization/exercise). This is primarily because genuine employee participations generally allow the employee to achieve an entirely tax-exempt capital gain on the entire value increase that occurred after vesting. Adding an alienation blocking period after vesting allows an employee to achieve an even lower employment income tax burden because an annual discount of 6% applies for up to 10 years. Because social security contributions follow the Swiss employment income tax treatment, "genuine" employee participations are also most likely more attractive from a social security contributions point of view for both the employer and the employee. If an employer grants employees "non-genuine" employee participations, there is neither control on the amount of social security contributions nor on the potential employment withholding tax that may apply once the equity rights are exercised.

On the other hand, equity instruments qualifying as "genuine" employee participations require the employee to pay income tax and wealth tax as well as social security contributions even if they have yet to receive any cash. Furthermore, there is a potential risk of suffering a non-deductible capital loss. Some groups of employees, in particular lower tier and middle-management, are not always willing to bear such taxes and risk. In this context, employment equity incentives that qualify as "non-genuine" employee participations are still rather common, in particular for performance-related compensation to lower tier and middle-level management.

3.2 How can there be certainty about the tax treatment of the employee share ownership plan?

Even though the legal provisions and the tax authorities' guidelines concerning taxation of employee equity incentives are rather specific, the Swiss tax characterization of an employee equity incentive plan is not always clear. This unclarity arises, in particular, if the plan is governed by non-Swiss law and/or if the relevant equity instruments have not been issued under Swiss law. Also unclear is the valuation methodology to be applied to assess the value of employment equity incentives for instruments that are not listed or otherwise regularly traded. To have certainty, employers (and employees) may request an advance tax ruling from the competent cantonal tax authority. Such a tax ruling is generally binding provided it is obtained before the ruled fact pattern has been implemented and provided the plan is implemented as presented in the earlier ruling request.

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