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New Swiss rules on taxation of employee participation plans

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New Swiss rules on taxation of employee participation plans

New legislation on the tax treatment of employee participation plans focuses especially on cross-border situations and stipulates strict reporting duties for employers, explains Rolf Wüthrich of burckhardt.

On January 1 2013 new legislation regarding the tax treatment of employee participation plans entered into force.

The legislation focuses especially on cross-border situations and stipulates strict reporting duties for employers. Rulings obtained in the past which ensured taxation at grant or at vesting are still applicable if taxation (at grant or vesting) took place before January 1 2013. As of that date such old rulings are, however, no longer applicable if taxation at grant or vesting was still outstanding. Rulings not in line with the Circular Letter No 37 of December 14 2012, which was issued to concretise the legislation, are no longer applicable either.

Scope

The new rules intend to ensure more legal certainty, especially in international situations, with respect to the moment of taxation as well as the calculation of the taxable base. Based on the new law the Swiss federal tax administration issued a first draft of the circular letter with guidance regarding its interpretation of the new law. The circular letter is applicable as of January 1 2013 and replaces the Circular Letter No 5 of April 30 1997 as well as the instructions of May 6 2003. The new circular letter is therefore applicable to:

- all employee participation rights granted on or after January 1 2013; and
- all employee participation rights granted before January 1 2013, which are, according to the rules applicable until December 31 2012, subject to income taxation on or after January 1 2013 as well as to all employee participation rights which were granted before January 1 2013 and which should have been taxed under the old rules at grant or vesting, but which were, for whatever reasons, not taxed (subject to the statute of limitations).

Old rulings ensuring taxation at grant or at vesting are still applicable if taxation (at grant or vesting) took place before January 1 2013. As of that date such old rulings are no longer applicable if taxation at grant or vesting will take place on or after January 1 2013. Rulings not in correspondence with the circular letter are no longer applicable.

Employee participation rights

As a first step, the circular letter defines various terms:

- Real employee participation rights: Real employee participation rights grant an employee a participation in the equity of a company by way of shares, option rights or entitlements to acquire such shares. Considered to be free employee shares are shares, of which an employee can dispose of without any restrictions. Blocked employee shares are shares, of which an employee can normally not dispose of, pledge or encumber for a fixed period of time. Employee shares encumbered with

a timely limited or unlimited obligation to return the shares also qualify as blocked shared.
- Free option rights can be exercised or sold after grant. Blocked option rights cannot be exercised or sold during a defined blocking period.
- Entitlements for employee shares hold out the prospect of receiving – against or against no consideration – a defined number of shares. Hereby, the transfer of the shares normally depends on the fulfilment of certain requirements, such as the continuation of the employment relationship. As such prospective rights can be considered as remuneration for a future performance, such entitlements are treated equal to real employee options. Restricted stock units are typical examples of such entitlements.
- Fictive employee participation rights can be described as motivation systems not granting a participation in the equity of a company, but ensuring monetary benefits based on the performance and of the value of the employing company. Such fictive plans are considered for tax purposes as entitlements. Examples of fictive employee participation rights are phantom stocks or stock appreciation rights as well as forms of co-investments.

Blocking period, vesting period and vesting

The circular letter defines a blocking period as a fixed term on a contractual basis, during which an employee is not allowed to dispose of, pledge or otherwise encumber the employee participation rights. Not considered as a blocking period are time windows during which employees cannot sell their shares (for example, for stock exchange reasons, a closed window period).

The vesting period is the period between the allocation of the employee participation right to the employee and the moment at which an employee will achieve full rights in the employee participation rights. During the vesting period an employee can lose its entitlement in the employee participation rights if certain requirements will not or no longer be fulfilled. With expiration of the vesting period the employee achieves full rights in the employee participation rights (vesting). Vested employee participation rights are considered to be granted under a suspensive condition as full rights in the rights are only acquired at vesting.

Taxation of employee share

The difference between the market value of employee shares received and the price paid for such shares, if any, by an employee is considered to be income from employment. As a consequence, such difference is subject to income tax in the year the shares are granted. As qualifying as income from employment, also social security will be due on the income received. A later sale of the shares results, from a Swiss tax point of view, either in a tax free capital gain or a non-deductible loss.

Biography

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Rolf Wüthrich is an international tax lawyer whose areas of expertise are national and international tax planning, inbound and outbound transactions, especially between the US and Switzerland, corporate restructuring and acquisitions as well as general corporate secretarial services.

burckhardt provides its clients and their businesses with comprehensive, tailored advice on national and international tax planning issues and structuring, offers corporate secretarial and notary service, supports clients with professional expertise and broad international experience on restructurings, mergers and joint ventures, advises on inbound and outbound investments and in all matters related to compliance, employment, trade and transport law.

For shares traded at the stock exchange the closing value on the day of grant is, in principle, considered the market value to be taken into consideration when calculating the income of the employee. If the participation plan previews a time window during which the employees must accept the share offer, then these rules apply:
- In case of an acceptance period of more than 60 calendar days the relevant market value shall be the closing value at the stock exchange on the day of acceptance;
- In case of an acceptance period of 15 to 60 days the relevant market value shall be the average of all closing values during the acceptance period; and
- In case of an acceptance period up to 14 days the relevant market value can be – as an exception – the closing value on the first day of the acceptance period, if such treatment is previewed in the employee participation plan and the employer has agreed with the tax administration in advance on such treatment.

For shares not traded on the stock exchange the relevant market value is calculated by use of one of the valuation methods accepted by the Swiss tax administration. A method once chosen must, in principle, be applied for a participation plan during its whole duration. In case a fair market value (for example, a price paid at arm's length by an independent party) is known, then such value shall be considered the relevant market value for shares not traded at the stock exchange.

Compared to free shares, blocked employee shares have a reduced value, so a discount is granted on the market value of blocked shares for each year of the blocking period, limited to a maximum discount for 10 years (see Table 1).

Table 1

Blocking period (years)	Discount (%)	Discounted market value (%)
1	5.66	94.34
2	11	89
3	16.038	83.962
4	20.791	79.209
5	25.274	74.726
6	29.504	70.496
7	33.494	66.506
8	37.259	62.741
9	40.810	59.19
10	44.161	55.839

In case of early cancellation of the blocking period an employee realises a monetary benefit from employment resulting in taxable income. Subject to tax is the difference between the discounted market value at the moment of cancellation and the originally discounted value.

If an employee is obliged to return, for example, because of obligations under the plan, to the employer his participation rights, then the employee can either realise a gain or a loss. The gain or loss, as the case may be, is calculated as the difference between the compensation received at the moment of returning the rights and the initial price paid for these rights. A gain will be subject to income tax (no tax free gain). A loss is deductible for income tax purposes.

An entitlement for employee shares is subject to tax at the moment of receipt of the employee shares. The rules applicable to employee shares are applicable.

Taxation of employee options

Free options traded at the stock exchange are subject to income tax at grant. The difference between the market value and the price paid by the employee is considered to be taxable income from employment. All other options are taxed at the moment of sale of the option or the moment of exercise. Subject to tax is in this case the gain realised by sale or exercise.

Taxation of fictive employee participations

Benefits from fictive employee participations are considered employment income and are fully subject to income tax at the moment the benefit is received. No tax free capital gain results.

Taxation of employee participations rights in international relationships

In international relationships these two situations must be distinguished:

- Immigration, in which employees move from abroad to Switzerland; and
- Emigration, in which employees move from Switzerland abroad.

In such situations employee participations rights are granted in one country and realised in another.

In its circular letter the Swiss federal tax administration takes the position that in international situations Switzerland does not have the exclusive right to fully tax the benefits resulting from employee participations plans. The right to tax such benefits must rather be allocated between the involved countries based on the number of working days an employee was resident in each of them during the vesting period. It is not required that the other countries tax such benefits allocated to them. It is important, however, to determine to which country which quota of the total working days is allocated. In case of such sharing of the taxation rights between various countries the employer must issue a statement confirming the allocation of the benefits to the various countries. In case of emigration of an employee from Switzerland abroad the employer must also file such confirmation with the cantonal tax administration.

Wages taxes on employee shares and free employee options traded at the stock exchange

Employee shares and free employee options traded at the stock exchange are taxed at grant. In international relationships an employee may have his residence at the moment of grant either in Switzerland or abroad. In both cases, Switzerland may levy wages tax if the recipient of the benefits is either not resident in Switzerland or is taxed at source in Switzerland. Subject to different rules under applicable tax treaties, different wages tax consequences arise depending on whether the beneficiary is a normal employee, a member of the board of directors or an employee and board member at the same time.

Taxation of blocked options or options not traded at the stock exchange, entitlements and fictive participation plans

Benefits from blocked options or options not traded at the stock exchange, entitlements or fictive participation plans are

taxed at the moment of exercise or their realisation. Hereby it must be distinguished between "imported" and "exported" participation rights.

Imported participation rights are rights, which were granted when an employee was resident outside of Switzerland, and which are realised when the employee is resident in Switzerland. If, from a Swiss point of view, the participation right is taxable at grant, then it can be exercised or realised tax free in Switzerland. Income from imported participation rights, which are taxed in Switzerland at exercise or realisation, are taxed in Switzerland only on a *pro rata temporis* basis. And income from participation rights, which are taxed at exercise, will also be subject to Swiss wages tax in case an employee resident outside of Switzerland changes, in the period between grant and exercise, group internally and his employment relationship to an affiliated Swiss company. In such a case Switzerland will tax the income realised on a *pro rata* basis (subject to different rules applicable under tax treaties).

Exported participation rights are rights, which were granted when an employee was resident in Switzerland, and which are realised when the employee is resident outside of Switzerland. For rights taxed at grant no special rules are required as such rights will be taxed by Switzerland. Attention should, however, be paid to cases in which participation rights are granted to a non-Swiss resident as a bonus for employment carried out in Switzerland. Such income will be subject to Swiss wages tax. The export of participation rights, which are taxable at exercise, will also trigger Swiss income tax consequences at exercise, if an employee moved abroad during the vesting period. The income realised by the employee will be subject to tax in Switzerland on a *pro rata temporis* basis (ratio of days resident in Switzerland to days resident abroad).

Wages tax must be withheld and paid by the (former) Swiss employer. This obligation even applies to the (former) Swiss employer in cases in which the benefits are not paid by Swiss employer, but by a non-Swiss affiliated company. Wages tax must also be withheld if an employee is resident outside of Switzerland during the whole vesting period; however, working days spent outside of Switzerland during the vesting period will lead to a taxation on a *pro rata* basis (ratio of total working in Switzerland to total working days in vesting period). In case an employee resident outside of Switzerland terminates his employment relationship in Switzerland during the vesting period, then wages tax will be levied at exercise on a *pro rata* basis.

For board members Swiss tax is levied on a *pro rata temporis* basis calculated on the ratio of working days spent in Switzerland to working days spent abroad during the vesting period.

Reporting duties of employers

As of January 1 2013 employers must respect strict reporting duties in connection with employee participation rights. An employer must prepare in every tax period in which employees are granted employee participation rights, as well as in every tax period, in which employees realise Swiss taxable income from the participation rights, corresponding declarations. Special reporting rules apply in other cases, such as early termination of the blocking period, an obligation to give back the participation right received or the change of the valuation method. The reporting obligations also apply in cases the employee participation plan is issued by a non-Swiss affiliated company or is managed by a third party.

The declarations will be used by the tax administration to countercheck if the yearly issued salary statements, in which also such granted participation rights must be included, are correctly prepared. The declarations shall be handed over to the employees together with the yearly salary statement or shall be sent to the tax administration together with the wages tax declaration. However, if a benefit is realised by an employee after termination of the employment relationship, then the employer is obliged to send the declaration directly to the cantonal tax administration of the residence canton of the employee.

For employee options, entitlements and fictive employee plans it is required to issue a declaration at the moment of grant as well as the moment of realisation.

In international relations, in which Switzerland will levy tax only on a pro rata basis, the employer is obliged to declare in the salary statement of the employee the full benefit realised by the employee under the employee participation plan. It will be up to the employee to make in his tax return an international tax allocation and, as a consequence, to exempt the benefit allocatable abroad from Swiss tax.

Advance rulings

It is possible to obtain advance rulings on the tax treatment of employee participation plans. Competent for approval of the ruling request is, in principle, the cantonal tax administration of the residence canton of the employer. It must be noted that a tax ruling on a participation plan issued by one canton must not be binding for another canton. If an employer has employees in several cantons it is therefore be advisable to either obtain in all cantons involved a corresponding tax ruling or to obtain, next to the ruling in the canton of residence of the employer, also a ruling from the federal tax administration.

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