SWISS TAX CONSEQUENCES IN CONNECTION WITH THE SALE OF SHARES: LIMITATIONS OF THE PRINCIPLE OF TAX-FREE CAPITAL GAINS FOR INDIVIDUALS

In a recent decision, the tax appeal court of the Canton of Zurich dealt with the taxation of capital gains in connection with the sale of shares by individuals and the possible treatment of such capital gains from a Swiss income tax perspective. In general, if individuals residing in Switzerland realize a capital gain from the sale of tangible assets, such capital gain should not be subject to Swiss income taxes. This applies in particular to capital gains in connection with the sale of shares (or other participations in companies) by an individual if the shares were held as private assets. However, there is no rule without exception and the following should be considered by individuals selling their shares in a company.

Sale of shares granted in connection with an employee incentive plan

It is a widespread practice of employers to grant to its employees and/or consultants shares, options or other participation rights in the company at a discounted price. Such allocation of participation rights is usually subject to an employee incentive plan with terms and conditions regarding, inter alia, sale restrictions, obligations to return the shares and valuation rules. The gain from the sale of employee shares in listed companies after the vesting period is usually tax-free for the seller (exceptions may apply to shareholders who received their shares before an IPO). However, if employee shares in non-listed companies are sold, or if employee shares are re-sold to the employer, the proceeds from such sale may qualify as taxable income, in each case depending on the specific terms of the employee incentive plan.

Consideration for past and future employment

It is a regular occurrence that a shareholder sells his/her shares in a company and continues to work for the company as a manager and/or employee. If part of a share purchase price should be considered a remuneration for future salaries it would likely be treated as taxable income by the Swiss tax authorities. In addition, according to several court decisions payments from third parties (i.e., buyer of the shares) may also qualify as taxable income from employment if such payments are made in connection with the employment of the seller. It is, therefore, irrelevant (at least with respect to the qualification as income from employment) whether payments are made by the buyer of the shares or by the respective company (employer) itself.

According to the decision of the tax appeal court of the Canton of Zurich dated 30 January 2018 (ST.2016.224), a share purchase agreement included the following provision (translated by the authors):

> "The purchase price for the shares was determined by mutual agreement, taking into account the seller's merits for the C group. Compared to the formula agreed in the shareholders' agreement, the present purchase price includes a substantial surcharge."

Based on this provision in the share purchase agreement, in particular due to the mentioned merits of the seller and the substantial surcharge paid, the tax authorities of the Canton of Zurich requalified a significant part of the sales price as compensation for possible financial claims in connection with the employment of the seller (difference between the sales price and the valuation pursuant to a valuation based on the "practitioner's method"). However, the seller was able to demonstrate that there was no reason to assume that part of the sales price should be treated as a salary because he had always received an appropriate base salary and even a share in the company's revenues. Furthermore, he demonstrated that there was no legal basis for a bonus entitlement in his employment agreement. The tax appeal court finally decided in favour of the seller, but not without disclosing a dissenting minority opinion of the court.

Consideration for non-compete clauses or other obligations

The seller of a company is frequently required to sign a non-compete clause for a certain period of time after the sale of the shares. In such cases, tax authorities have argued that part of the purchase price was paid as a compensation for the acceptance of a non-compete clause and, therefore, part of the capital gain for the shares was requalified as taxable income of the seller. However, depending on how

a non-compete clause or other contractual obligations are drafted in the share purchase agreement, it may not lead to such income tax consequences for the seller (or at least the income tax consequences can be reduced).

Also, other kind of contractual obligations may be imposed on the seller and may lead to an additional compensation included in the sales price. Such compensations are deemed to be income for the seller in return for the carrying out or not carrying-out of a particular activity. Thus, Swiss tax authorities have regularly requalified part of the tax-free capital gain into taxable income of the seller whenever such compensation was linked to a particular activity that should (or should not) be carried out by the seller.

As another example, the Swiss Federal Supreme Court confirmed in its decision 2C_731/2017 that payments in connection with a termination of an employment ("Mutual Termination Agreement") to former shareholders of a company qualify as taxable income. If considered earlier, the sellers could have used the respective part of the sales prices for a contribution into a pension plan or other retirement fund and it may not have been subject to income taxation.

Earn-out or hold-back payments

It may be in the interest of a buyer that part of a consideration for shares becomes payable only several years after the purchase (earn-out). The respective payments become due if the seller complies with certain contractual obligations, or if the company reaches certain business results during a certain period after the sale of the shares. This is often the case if the seller should continue to be employed by the respective company; so called hold-back payments may create an incentive for the seller to stay further employed. Due to the close connection between the employment and the payments, tax authorities may in such cases requalify a tax-free capital gain into taxable income.

Accrued profits

The latest financial statements of a company usually build the basis for the valuation and the determination of a purchase price for the shares of a company. Such financial statements do not include the profit of the company accrued during the current business year until the date of the sale. The seller usually has an interest to receive a compensation for this accrued profit. If such accrued profits were distributed as dividends, they would qualify as taxable income of the shareholder. However, if the accrued profits are part of the purchase price for the shares sold it can be argued that this should qualify as a tax-free capital gain. Of course, this provides that no indirect partial liquidation is triggered at a later point in time by the purchaser (see below).

Indirect partial liquidation / transposition

In connection with the concept of the so called “indirect partial liquidation” the sale of shares by an individual to a legal entity may lead to a subsequent requalification of a tax free capital gain into taxable income in all cases where (cumulative requirements): (1) the company whose shares are sold distributes funds already existing at the time of the sale to the seller within five years after the sale of the shares, (2) the company whose shares are sold had funds exceeding the amount usually required for ordinary business operations and part of such reserves could have been distributed at the time of the sale, and (3) the seller was aware (or should have been aware) of the intended distribution of funds by the purchaser to finance the purchase of the shares. To reduce such tax risks for the seller, corresponding commitments of the purchaser should be agreed in all share purchase agreements.

In addition, a capital gain from the sale of shares may not be tax-free if the seller sells or contributes the shares into a company in which he/she owns at least 50% (so called “transposition”). However, with the right proceeding (i.e. booking of the contribution in the right reserves) such a contribution should not qualify as a transposition.

Summary

The above examples (not conclusive) show that it is worthwhile to take Swiss tax issues into consideration during the negotiation of share purchase agreements, and to analyze such transactions from a Swiss tax perspective in advance. Since significant amounts are usually at stake if a company is sold, it may also be advisable to address potential tax questions in an advance tax ruling request with the responsible tax authorities.

Our tax advisors and lawyers would be happy to support with any further questions you may have regarding this topic.

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