Employee Benefits

Swiss to change taxation of stock options – new rules

The taxation of employee stock options in Switzerland is undergoing a revamp. A new legislative proposal and a recent 'information letter' will significantly change the current tax rules and probably impact on present ruling practices even before the measure becomes law. ***Peter Reinarz, with the international law firm of Bär & Karrer in Zurich,*** *reports.*

The Swiss federal income tax treatment of 'employee shares' and 'employee stock options' is currently summarised in a circular letter issued by the Federal Tax Administration on 30 April 1997 ('the 1997 Circular'). As far as cantonal income taxes are concerned, the cantonal tax authorities tend to more or less follow the federal guidelines.

Current taxation features

The main features of the 1997 Circular can be summarised as follows:

Employee shares

Shares of the employer company or an affiliated or parent company of the employer which are transferred to an employee are considered taxable income in kind to the employee, to the extent that the market value of the shares exceeds the purchase price paid (if any) by the employee. Income is deemed to be realised at the time of the transfer of ownership.

If the transferred shares are subject to restrictions or limitations on their transferability by the employee (including obligations to deposit the shares with the employer, redemption or forfeiture rights of the employer upon termination of the employment etc), a discount of 6% per annum with a maximum of 10 years is applied to the market value of the shares; the taxable benefit is still deemed to be realised on the transfer date.

The following table shows the effect of the share value discounts in the case of transfer restrictions:

Effect of share value discounts – Transfer restrictions

Restriction Period	Discount	Residual Value
1 Year	5.660 %	94.340 %
2 Years	11.000 %	89.000 %
3 Years	16.038 %	83.962 %
4 Years	20.791 %	79.209 %
5 Years	25.274 %	74.726 %
6 Years	29.504 %	70.496 %
7 Years	33.494 %	66.506 %
8 Years	37.259 %	62.741 %
9 Years	40.810 %	59.190 %
10 Years	44.161 %	55.839 %

In the case of 'restricted' shares, the taxable amount corresponds to the market value, minus discount, minus purchase price paid by the employee. Only full years of restriction are taken into account for applying the discount.

The Swiss employer has to certify the amount of the taxable benefit in the annual salary certificate to be issued to the employee. On request of the tax authorities, the employer has to furnish further information necessary to determine the taxable amount. On the other hand, the Swiss employer may treat all expenses and losses incurred with employee stock as tax-deductible business expenses.

The subsequent sale of employee shares by the employee to a third party will generally not result in any further tax consequences, given that such shares are normally deemed to be private assets of the employee and that capital gains realised on such private assets are exempt from Swiss tax.

Employee stock options

The current tax treatment of employee stock options is somewhat more complex. The 1997 Circular draws a basic distinction between 'valuable' and 'non-valuable' options.

While 'valuable' options are generally taxable at the time they are granted to the employee, 'non-valuable' options are not as such taxable; income taxation may occur only at the time the 'non-valuable' option is exercised by the employee, according to the rules pertaining to employee shares (see above).

In general, employee stock options are deemed to be 'valuable' options as their value may be determined by an expert appraiser (typically a bank) based on a recognised option valuation model (typically the so-called 'Black Scholes formula', which uses the following parameters: spot price of underlying share as of option grant date; exercise price; option life term; dividend yield of underlying share; volatility; risk-free interest rate).

However, in some circumstances stock options may be considered to be 'non-valuable', which is frequently the case when there exists no open market for the underlying shares or when the option features include too may individual parameters. In addition, options are deemed to be "non-valuable" when they have an exercise period exceeding 10 years or are subject to restrictions concerning exercise or transfer of more than five years.

In the case of 'valuable' options, the option value as of the time of the option grant, minus the consideration charged to the employee for the option (if any) is considered taxable income in the employee's hands.

Employee stock options may likewise be subject to restrictions. For example, they may not be exercisable or transferable during an initial period (if such restricted period exceeds five years, the option is deemed 'non-valuable'). Such restrictions are again taken into account in the calculation of the taxable benefit (which is still deemed to be realised at the date of the option grant).

In a first step, the option value is determined as if no restriction applied. In a further step, the parameter 'spot price of underlying share' in the option valuation model is discounted at 6% for each full year of the restriction, ie as follows:

Employee stock options
Discounted 'spot price of underlying share'

Restriction Period	Discount	Residual Value
1 Year	5.66 %	94.34 %
2 Years	11.0 %	89.0 %
3 Years	16.038 %	83.962 %
4 Years	20.791 %	79.209 %
5 Years	25.274 %	74.726 %

As 'valuable' options are taxed when they are granted, the subsequent exercise (or sale) of the option (or the sale of the underlying shares) does not normally lead to any further tax consequences for the employee; any benefit realised upon the option exercise or sale is normally considered a tax-free capital gain on private movable assets. On the other hand, losses on options that were taxed as income upon granting cannot be deducted from the taxable income.

Open issues

Recent practical developments

There are several issues in connection with employee shares and stock options that are not dealt with in the 1997 Circular. Some of these issues are addressed below.

Vesting periods

The issue of contractual vesting periods is often encountered especially in connection with stock option plans. While the 1997 Circular takes into account transfer or exercise restrictions in the valuation of options or underlying shares, it pays no regard to vesting periods.

As a matter of fact, stock option plans often provide that options granted to employees do not immediately fully vest; instead, the vesting is spread out over a number of years (eg, one-third of options granted vest after one year, one-third after two years and one-third after three years). During the vesting period, the options may still be forfeited or withdrawn upon occurrence of certain events.

The Zurich Administrative Court has recently ruled (20 November 2002) that stock options can only be taxed once the employee has acquired a full and irrevocable right to the options, which is the case only when the options have fully vested. The underlying case concerned an option that had been granted in the year 2000, but became unconditional only some years later.

The Zurich court decision leaves many questions open, on which guidance is expected to be issued by the tax authorities in due course.

Forfeiture of vested restricted shares

In the case of restricted shares a situation may arise that the shares have to be returned under the contract, for example, as a consequence of an early termination of the employment.

The Zurich tax authorities have developed a practice according to which the employee may in such a situation report a negative income in the amount of a discounted market value of the shares, minus any consideration received in return for the shares. The discount amounts to 6% for each full year of remaining restriction on the shares at the date of their return or forfeiture. The negative income may be claimed even where the original transfer or vesting of the shares did not result in any benefit subject to tax.

Early withdrawal of restrictions on shares

The original restriction period on employee shares gives rise to a 6% per annum discount on the taxable value of the shares. If the original restriction period is subsequently shortened down, a further taxable benefit may arise at the time of early expiry of the restriction. Such benefit corresponds to the difference between the shares' market value as of the date of early expiry of restrictions and the theoretical discounted market value as of the same date, had the restrictions not expired early. Each full year of otherwise remaining restriction gives rise to a 6% discount.

Any consideration paid by the employee for the early withdrawal of the restrictions may be deducted from the taxable benefit. To the extent that such consideration exceeds the benefit as calculated above, the balance may be reported as a negative income, provided that the consideration is based on a contractual obligation (such a situation may arise, for example, under a share plan that provides for a forced buyout by the employee of remaining restrictions in the case of an early termination of the employment).

New information letter

Clarification on taxation

On 6 May 2003, the Federal Tax Administration released an 'information letter' (*Rundschreiben*) to the cantonal tax authorities concerning the taxation of employee stock options with vesting clauses. The information letter clarifies that, while the 1997 Circular remains in force in principle (ie even 'blocked' or 'restricted' options are to be taxed at grant in principle), options with vesting clauses should only be taxed once the rights under the options have been definitively and unconditionally be acquired by the employee.

That point in time would not necessarily coincide with the contractual 'vesting' of the option, given that even 'vested' options are often still subject to certain conditions precedent (other than mere waiting periods) that have to be fulfilled before the option can effectively be exercised or disposed of (typical examples: ongoing employment relationship at the date of exercise; reaching of individual or company performance targets; etc).

The information letter also refers to the fact that (vested) options which are still subject to these kind of conditions should be considered 'non-valuable' options within the meaning of the 1997 Circular (ie taxation would occur only once the effects of the conditions fall away or when the option is effectively exercised, respectively).

Draft legislative proposal

New tax rules

The Federal Government has recently published a draft proposal for new tax legislation in the area of employee shares and employee stock options, which is currently in the public consultation process. The new legislation would also be reflected in the federal law on intercantonal tax harmonisation and thus become binding upon the cantons as well.

Definition of 'genuine' employee stock participation

The draft proposal clarifies that the specific tax rules on employee stock participation (as set out below) are only applicable to 'genuine' share and option plans. An employee participation is considered 'genuine' when it entitles the employee to acquire directly or indirectly (through exercise of call options, 'derivative' participation) equity rights (such as shares, non-voting shares, profit rights or co-operative quotas) in the employer company, the parent company of the employer or another publicly traded group company.

Taxation of benefits under 'non-genuine' employee participation schemes

Any programmes which only entitle the employee to

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receive a cash consideration, such as phantom stock plans, stock appreciation rights etc, are not considered 'genuine' share or option plan.

Moreover, even equity options are not considered 'genuine' where the acquisition or exercise of the right is subject to individualised conditions that render any valuation under the standard models impossible.

As a rule, any benefits from 'non-genuine' participation schemes are deemed to be realised and become taxable at the time the employee acquires an unconditional right to the benefit (which is usually at the point in time in which the right can be exercised or a cash benefit is received).

A particular rule is designed to reduce the effect of income tax progression in the year the benefit is taxed: While the entire benefit is taxed together with any other taxable items, after taking any applicable deductions into account, the benefit may be spread over the relevant number of years (from grant to exercise or cash receipt) for the purpose of determining the applicable income tax rate.

Taxation of employee shares

The proposal confirms the present tax treatment of employee shares. The value of the shares (minus consideration paid, if any) is considered to be realised when the employee acquires an unconditional claim on the shares. Restrictions on transferability etc on the shares are taken into account by annual discounts of 6% (for a maximum of 10 years, according to the table set out above) on the share price, as under the present practice.

Special share pricing rules apply to shares of private companies which are not publicly traded:

- If the company was either formed at least 5 years prior to the share grant or is owned to the extent of more than 25% by a company whose shares are publicly traded, the share value is determined according to the formula (2 x earnings value + 1 x net asset value):3, or at least the net asset value.
- The net asset value only is relevant in the case of newly formed companies.
- Other valuation formulae are acceptable if the buyer can or has to sell the shares according to such formula only.
- If a fair market value is nevertheless known, such market value will prevail.
- If the private company goes public within one year of the acquisition of the employee shares, then 50% of the difference between the formula value and the price paid for the shares in the IPO will be taxed as an additional benefit (the other 50% is deemed to be a tax-free capital gain). However, no additional benefit is taxed if the initial share valuation reflected a real market value.

Taxation of 'genuine' employee stock options

General rule – Benefits from 'genuine' employee stock options are principally taxable at the point in time the employee acquires an unconditional right to the option. Such unconditional acquisition may either occur already at grant of the option or, if the option is subject to a vesting period or similar conditions, at fulfilment of the vesting or the conditions.

Calculation of taxable value of employee stock options – Once a 'genuine' employee option has become unconditional, the taxable value of the option is principally determined on the basis of the Black Scholes valuation model (see above).

However, fixed values are introduced for certain valuation parameters. The new valuation approach is simplified by the use of the following standardised, fixed parameters:

volatility = 20%;
risk-free interest level = 4%;
dividend yield = 1%.

The other option valuation parameters (spot price of underlying share, strike price, exercise period and exercise/transfer restrictions) remain variable and are defined in the terms of the option grant. The relevant spot price of the underlying shares corresponds to the average closing price on the stock exchange of the last 20 trading days prior to the unconditional acquisition (vesting) of the option.

The taxable benefit corresponds to the option value as at the date of unconditional acquisition, minus price paid for the option (if any). If the option, once unconditionally acquired, is still subject to exercise restrictions, such restrictions are taken into account by applying a 6% per annum discount (for a maximum of five years, according to the table set out above) to the parameter 'spot price of underlying shares'.

Special rule: taxation upon exercise under certain conditions – The proposed law provides that employee stock options may alternatively be taxed upon exercise only, if the following conditions are met:

- The employee must have given an unconditional and irrevocable statement in writing no later than the date of unconditional acquisition of the option to the effect that a taxation on exercise is opted for. The statement must be enclosed with the personal tax return. If the unconditional acquisition ('vesting') of the option occurs in several tranches over a certain period of time, then the first statement will be valid for all options of the same grant. The employee will be bound by the statement for any options acquired (even if from different grants) during a given calendar year.

- The strike price of the options must not be lower than the spot price of the underlying shares at the time of the option grant.
- The options must be non-transferable.
- The employer has to certify the unconditional acquisition ('vesting') of the option on the salary certificate and describe the option terms in an exhibit. Furthermore, the employer has to certify the amount of income realised upon exercise of the option in the salary certificate and specify the same in an exhibit.
- The employer is liable for the payment of applicable wage withholding tax upon exercise of the option, if the employee has unconditionally acquired the option while being resident in Switzerland and exercises the option while being resident abroad. Wage withholding tax is due even if the option plan is administered by a foreign affiliate of the employer.

The value realised upon exercise is calculated according to the rules on employee shares (see above). The proposed law provides for a taxation of the value realised upon exercise to the extent of 50%; the other 50% would be deemed to constitute a tax-free capital gain.

The outlook

Impact on current ruling practice

The proposed new tax legislation on employee participation schemes has not as yet passed the parliamentary debate. It is not expected that the new law will become effective before 2004 or 2005. However, some of the principles set out in the draft legislation (such as taking account of the effects of vesting periods in option plans) are also reflected in the latest information letter of the Federal Tax Administration and recent court cases and it is anticipated that such principles will to some degree influence the ruling practice of cantonal tax authorities even before entry into force of the new law, even though the transition rules of the draft legislation set out that employee shares and options which were granted prior to enactment of the new law will be taxed according to the previous practice.

Remarkably, the draft transition rules provide that, where options granted prior to enactment of the new law are treated as 'non-valuable' options, ie with a tax point upon exercise according to the previous practice, the benefit of the 50% tax exemption according to the new law will be applicable even if the unconditional acquisition of the option occurs prior to entry into force of the new law.

It remains to be seen whether the application of this favourable rule will be limited to cases where the option is effectively exercised only after entry into force of the new law.

PETER REINARZ, Bär & Karrer, Zurich. Tel: +41-58 261 5000. Fax: +41-58 261 5001. E-mail: p.reinarz@baerkarrer.ch. Web: www.baerkarrer.ch.