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Geneva practice on the taxation of employee equity incentive programs

Geneva has published an evolution of its practice on taxation of employee stock and option grants, extending in particular for employees of startups and SMEs the possibility to realize a tax-free capital gain upon exit.

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Setting the scene

Employee stock and option plans are an essential tool for companies and especially start-ups to attract and retain key employees. The tax treatment of such incentive programs plays an important role in their implementation, the possible consequences ranging from a tax-free capital gain for employees to a fully taxable salary (up to 45% taxes, plus social security) upon exit.

Since 2013, the tax treatment of incentive programs is set by law and through more detailed guidance provided by Circulars n°37 and 37A issued by the Federal tax administration (FTA), lastly adapted in 2021. Cantonal tax administrations have also regularly published and adjusted their practice in this respect.

In a nutshell, according to the latest Circulars, the Swiss tax treatment is assessed differently whether shares or options are granted and whether a fair market value (FMV) exists.

a) Grant of shares

For a grant of shares, the principle is a taxation at grant. However, the following applies:

- If a FMV exists, the employee may acquire the shares (i) at the FMV at grant and incur no income tax and social security costs, or (ii) at a price below the FMV or for free, in which cases the difference between the FMV and the purchase price will be a taxable income.

  - A subsequent exit would in principle qualify as a tax-free capital gain for the employee.
  - The notion of FMV is understood very restrictively as third party prices. This may for instance be the price paid by third parties in a significant investment round or the price of listed shares. Most cantons do not accept a valuation as substitute for a FMV.
- If no FMV exists, the employer needs to elect an appropriate formula valuation (AFV) for the purposes of the taxation of employees. The employee may acquire the shares (i) at such AFV at grant and incur no income tax and social security costs, or (ii) at a price below the AFV or for free, in which cases the difference between the AFV and the purchase price will be a taxable income.

  - A subsequent exit within a 5-year period may generate an additional taxable income for the employee. Indeed, in such a case, the capital gain will amount to the formula value increase only, any surplus being considered as a taxable salary. An exit after 5 years will in principle lead to a capital gain for the employee.
  - The practice of certain cantonal authorities is to consider any liquidity event occurring within the relevant 5-year period (e.g. IPO, significant investment round) as a taxable event for employees, even if they do not sell shares.
  - Further restrictions apply in case of repurchase by the employer or in case of unlimited call option of the employer.

In both cases, should the employee not be allowed to sell the shares for a certain period of time, a discount may apply on FMV or AFV for the purposes of assessing the taxation at grant.

b) Grant of options

For a grant of options, the principle is a taxation at exercise. A taxation at grant is only possible if the option is freely tradable, which will generally not be the case for startups or SMEs.

The same principles as for shares apply, all values having however to be assessed at exercise (i.e. existence of a FMV, AFV, taxable salary component). In addition, should an AFV apply, the 5-year period will start upon exercise and not upon grant or vesting of the options.

Latest evolution of the Geneva practice

In a recent publication, the Geneva tax administration has specified its practice in this respect and largely extended the capital gain possibilities for employee incentive programs.

In particular, Geneva will now – upon ruling request and in appropriate cases – allow employers to use a valuation as substitute for a FMV. The acceptable valuation method will depend on the maturity stage of the company. Examples provided are the Swiss practitioners' method (incl. with adjustments) and methods based on multiples. This implies, for such cases, that a subsequent sale (even within the 5-year period) may in principle qualify as a tax-free capital gain for the employee.

Further, should shares be acquired at an AFV, Geneva will only consider a small number of events occurring within the relevant 5-year period as taxable events for employees. Those event are now restricted to an IPO and an effective exit in which employees sell their shares. This will in particular reverse the previous practice qualifying significant investment rounds as taxable events for employees, even if they were not selling shares.

Key takeaways and recommendation

At first glance, option plans seem to present, from a corporate and contractual perspective, several advantages against share plans: options can be easily cancelled, purchase of shares and corresponding taxation is generally deferred until exit. However, this is a misconception and share plans, if designed with the adequate contractual and corporate mechanisms, will prove as effective to manage and efficient as option plans.

From a tax perspective, share plans or option plans will generally result in substantial differences for participating employees: taxation at exit will range from a tax-free capital gain (with a well-designed share plan) to a fully taxable salary (with an option plan). The new practice of the Geneva tax authority reinforces the tax advantages of share plans, in particular for early-stage startups and SMEs which do not foresee a full exit within the next 5 years.

As contractual and corporate mechanisms adequately accommodate both share and option plans, startups and SMEs, especially at early stages, should carefully consider the tax implications of incentive plans, which, in most cases, will only materialize in the context of a future exit. Anticipation is key to implement an incentive program which effectively enables to attract and retain key employees.

Please do not hesitate to contact us in case of any questions.

Legal Note: The information contained in this Smart Insight newsletter is of general nature and does not constitute legal advice.

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