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Switzerland | Tax | June 2015

Employee equity award programs
New draft guidance on what can companies deduct

Equity awards are common incentives for executives in Switzerland. The employee tax treatment has become much clearer over the last 3 years, but up to now little has been written by the authorities on what corporate costs can be deducted. The Federal Tax Administration wants to remedy this situation by providing **guidance in a new tax circular letter (no. 37A).** It is currently in a draft format for cantonal tax administrations and other interested parties to comment. Below is an **overview of the relevant points addressed** in the initial draft and **what it means for Swiss companies.**

Overview

The main aspects addressed in the initial draft of the tax circular letter 37A are the following:

- When settling awards through the distribution of treasury shares the share value gains between the date of acquisition of the treasury shares and the date of allocation to employees are taxable and losses are deductible.
- The possibility to deduct a salary expense in the case of issuance of shares through a conditional capital increase.
- Where a Swiss employee does not receive shares in the Swiss subsidiary but in the listed parent company, the Swiss subsidiary may enter into a call option agreement with the listed parent to receive shares for employees

when needed (inter-company option hedging). The purchase price for such call options shall equal its market value and represent a deductible expense for the subsidiary and a taxable income for the parent.

- If the employing entity books accruals in view of future share allocations or cash settlement, such accruals should generally be deductible.

For the sake of clarity, it shall be noted that the new circular is not intended to have any impacts on the Swiss *individual* tax treatment and employer reporting obligations in connection with equity-based compensation.

Further comments

Introductory note

Scope: The initial draft deals only with corporate income tax deductions without addressing other types of corporate taxes such as stamp and withholding taxes. Since this draft is still a work in progress, these topics might be added in subsequent versions.

New deductions: While the topics addressed in the draft are mostly in line with the tax practice in the German-speaking part of Switzerland, they would introduce the opportunity to have some additional corporate tax deductions that haven’t been available up to now for companies located in the French-speaking part of Switzerland where cantonal authorities have generally been more restrictive on these kinds of deductions.

Assumptions taken: The initial draft uses certain assumptions and setups that are rather uncommon in practice and may not necessarily be beneficial for many companies in Switzerland. For instance, the draft refers to the employing subsidiary having the obligation to transfer shares to the employees. In reality, shares are usually transferred by a parent company directly to employees of the subsidiaries with an inter-company cost recharge to have the expense at the level of the employing entity. Furthermore, the circular assumes that there is a market value for shares, and it does not address the additional challenges of non-listed companies when determining the tax relevant value for the purposes of equity-based compensation.

Use of employee’s previous working activity to pay in for newly issued shares

The initial draft suggests that an expense is allowed despite there being no cash disbursement. The conditional capital increase is based on a mere booking procedure. For this reason it might not be accepted by auditors in the process of the capital increase – especially in connection with share awards where employees receive shares for free.

Inter-company option hedging

The initial draft presents an uncommon method to be used by employing companies to obtain shares. According to this method, the employing entity enters into a call option agreement with the listed parent company to receive shares for employees when needed. According to our experience, this does not reflect the common setups in practice. A more common approach not mentioned in the circular letter would be the following:

1. Shares are transferred by the parent company directly to the employees of the subsidiaries.
2. The related costs are charged to the employing subsidiaries based on a written inter-company recharge agreement.

While an inter-company option hedging structure may provide for an additional deductible expense to the employing subsidiaries (in the amount of the option price at grant), it also leads to further complexities:

- Valuation of the option triggers additional complexity and might be challenged by tax authorities.
- The initial draft circular assumes that the share acquisitions between the parent company and the subsidiary shall always be at market conditions. For exercising a call option with a fixed exercise price, this would usually not be the case; and if the exercise price should be meant to always equal the current fair market value, then the option price at grant would basically be nil.
- If the share price decreases, the subsidiary might rather purchase the shares in the market at current (lower) values.

Accruals for share awards and "phantom" awards

According to the initial draft circular letter, accruals booked for the future settlement of share awards or share-based cash payments can also be deducted for Swiss corporate tax purposes. While such deductions mostly have been granted in the German-speaking part of Switzerland already, it is a welcome addition for companies in the French-speaking part where some cantons did not allow such deductions in the past. It is interesting to note that these kinds of accruals are not mentioned in the part of the circular letter related to stock options. It is not yet known if that was just an oversight.

What does it mean for you?

Given that this circular has yet to be issued, no immediate action is required. Nevertheless, we recommend that you already now take the opportunity to verify your existing processes, inter-company cost allocations, booking entries and corporate tax deductions in connection with your equity-based compensation programs in Switzerland. Moreover, given the common use of treasury shares to settle share awards, we also recommend reviewing the potential Swiss stamp tax implications and ability to "dedicate" treasury shares to extend the withholding tax deadline from 6 to 12 years.

If you would like your structures and processes to be reviewed to benefit fully from the available corporate tax deductions, please feel free to contact us.

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