Court requalifies capital gain as taxable employment income

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Corporate Tax, Switzerland

Introduction

Generally, when a Swiss individual sells his or her own company, the capital gain should be tax free. There are various exceptions to this rule, with the newest introduced by an April 2015 court decision which requalified the entire tax-free capital gain as taxable income from employment. This decision is important for any corporate buyers acquiring a Swiss company from a Swiss entrepreneur. The buyer may become liable for social security contributions of approximately 12% – in the worst case, on the entire purchase price. Therefore, corporate tax directors involved in M&A transactions in Switzerland would be well advised to analyse carefully potential risks and costs, which normally emerge only some years after the acquisition.

Income from employment instead of capital gain

On April 3 2015 the highest Swiss tax court rendered a decision in which it requalified the whole capital gain resulting from a sale of a company as taxable employment income.

In that case the executive employee and partner of a finance company decided to spin off part of the financial business into a new company. Just one month after the spin-off, the partner sold his shares in the newly founded company to a bank. The partner and the bank agreed that the purchase price for the shares would be paid in four instalments. The first instalment was due immediately, with the others due each year for the following three years, on the condition that the selling partner would still work at the company.

The court held that making payment of the purchase price dependent on the continuation of the employer-employee relationship is atypical of a sales contract. This provision suggests that payment is made not for the transfer of ownership of the shares, but as compensation for future work to be performed by the seller as an employee of the company. From an economic (and therefore tax) point of view, these payments must be considered to be a sign-on bonus and retention bonus.

Risks for buyers acquiring Swiss company

In cases where the seller is supposed to continue working for the company because, for example, his or her specialist knowledge is required, the amount paid to the seller for continuation of the working relationship will likely qualify as income from employment. However, many questions arising from this qualification remain open, such as which entity is considered to be the (factual) employer – the employer under private law (ie, the target) or the purchasing company – and which entity is liable for a possible source tax obligation. However, most important are the potential social security consequences, since the respective amount will likely also be subject to Swiss social security of approximately 12%.

Comment

The buyer of a Swiss company should analyse potential risks in order to anticipate additional costs when negotiating the purchase price. One way to ensure certainty regarding possible requalification is to discuss the situation with the Swiss tax authorities in advance. Alternatively, the contracts should be structured accordingly.

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