Wealth tax for Zurich startup companies: genuine relief or just an illusion?

The resistance from the Zurich startup scene is having an effect. Only eight months after the announcement of the controversial directive by the Tax Authorities of the Canton of Zurich on how to determine the value of startups for purposes of the wealth tax (Vermögenssteuer), the Department of Finance is once again revising the applicable practice. According to the directive issued by the Department of Finance on 1 November 2016, the asset value is to be applied to startup companies in the future not only for the first three or five years (depending on the sector) but until such time as representative financial results are available.

I. The problem
For a long time now, the Canton Zurich, or rather its Tax Authorities have been the brunt of criticism for creating obstacles for startups on account of the way in which it has been determining the value of startups for the purposes of the wealth tax (Vermögenssteuer). The Tax Authorities of the Canton of Zurich considered the subscription prices paid on the occasion of financing rounds to be equal to the current market value of the shares in the company concerned and thus also to represent its value for the wealth tax. The resulting tax-able value often bore no relationship to the company’s true earnings and assets situation at that particular point in time, since it was then frequently still going through the loss-making phase. That led to a considerable tax-on-assets burden being placed on the founders, who generally only drew very small salaries, given the losses made by their company to begin with.

By contrast with that, other Cantons have been applying the so-called «practitioner method» (Praktikermethode) as envisaged in the circular from the Swiss Tax Conference, valuating a company by using past earnings and asset values even if it goes through new rounds of financing. Admittedly, that circular also makes provision for fair market values to take precedence over the formula value calculated by applying the practitioner method, but the Cantons place different interpretations on the question as to whether a financing round for startups establishes a fair market value or not.

II. The Tax Authorities of the Canton of Zurich’s communication of 1 March 2016
In order to alleviate the problem referred to above to some extent, the Tax Authorities of the Canton of Zurich made an announcement on 1 March 2016, stating that subscription prices paid during financing rounds were not to be taken into consideration for the first three years after a business was founded (or for the first five years for companies in the biotech and medtech sectors) for assessing the wealth tax and that the taxable value would be derived solely from the asset value. In the fourth and fifth year, the subscription prices paid during financing rounds would then be considered in part and thereafter in full when determining the value for the wealth tax.

There were three considerable exceptions to this principle. It was not applicable:

(a) if shareholders to date sold shares in considerable amounts (generally 10%) to an independent third party (for example as part of a «secondary deal»),

(b) if the company determined its fair market value itself or if the income tax value of a share (in conjunction with employee shares and/or options) was higher than the asset value, and

(c) if employee options were exercised at a value higher than the asset value.

In these cases, the corresponding values were to be taken as equal to the value for the wealth tax.

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III. The Tax Authorities of the Canton of Zurich communication of 1 November 2016
The fixed time limit on the one hand, and the various exceptions on the other hand led to a situation in which the startup scene in Zurich put up vehement resistance against the Tax Authorities practice. Now that resistance has been rewarded with at least a partial success:

What is now is that for startup companies the asset value is to apply not just for three or five years (depending on the sector) but until such time as representative financial results are available – as set out in the corresponding circular from the Swiss Tax Conference. Subscription prices paid during financing rounds are only to be decisive if they are paid after completion of the build-up phase.

IV. Remaining uncertainties
At first sight, the new directive from the Department of Finance would appear to bring about a considerable alleviation to the issue of wealth tax for founders of startups. A closer look, however, shows that certain questions remain unanswered for the time being:

- Who is covered by the term «startup company»?
  According to the instruction from the Department of Finance, companies with an innovative (usually technology-driven) and scalable business model, that are in the process of being built up, are considered to be startup companies. As of when a business model is regarded as innovative and scalable is, however, a matter for interpretation. It is, nonetheless, our assumption that the tax authorities will adopt a broad-minded approach.

- When do representative financial results become available or when has the build-up phase been completed?
  Can a company rely on its financial results not being considered as representative until it achieves positive ones and thus on its build-up phase continuing accordingly? Or might its financial results be regarded as representative before then (for instance on the grounds of increasing sales figures)? Might it be that just one positive budget for the following business year or even a positive half year or fourth quarter of a business year is sufficient to establish a representative financial result? In this matter too, the Tax Authorities have relatively broad discretion. The answers to these questions will only come when we know what the tax authorities are actually going to do in practice.
What is to apply if representative business results are available but no subscription prices?

According to the Department of Finance’s instruction, what is basically applicable is the circular from the Swiss Tax Conference and thus the practitioner method. What, however, is to happen if representative financial results are indeed available but if the earnings capacity (and thus the value computed using the practitioner method) is nonetheless below the asset value? In this case, does the asset value count as the minimum value or, to put it another way, is the existence of representative financial results then ignored? Or might low or even negative financial results lead to the value for the wealth tax falling below the asset value after completion of the build-up phase?

Which exceptions are applicable?

According to the Department of Finance’s instruction, exceptional treatment is applied in those cases in which taking the asset value as the basis would lead to contradictory results on account of particular circumstances. This wording reminds us of what was said in the communication of 1 March 2016, in which the word «contradictory» is used to describe the above-mentioned exceptions. According to the first information we received from the Tax Authorities of the Canton of Zurich they will apply the exceptions mentioned above also under the new directive.

It is in connection with employee participation programmes, in particular, that the exceptional provisions mentioned lead to the critical outcome of the allocation or acquisition of a few participation rights (especially if, in this respect, the use of a formula value for income tax purposes is waived) causing the value for wealth tax purposes to shoot up for all the participation rights. In that case, company founders who want to reward their employees for their commitment by granting them participation rights in the company get punished with higher taxes on their net assets. Assuming that the reservations mentioned in the communication of 1 March 2016 seems to be also applicable within the validity of the new communication, company founders must continue to be cautious in implementing employee participation schemes, keeping an eye on wealth taxes.

V. Conclusion

There can be no doubt that the new communication from the Tax Authorities of the Canton of Zurich will bring relief for many startups. It is likely to have reduced the temptation to move the registered office of companies for fiscal reasons to a Canton with a more favourable valuation method before the end of the current year. It is, however, our view that we will have to wait for clarification of the above-mentioned questions before we find out whether the further details and the shift in practice do indeed create conditions that are at least as good as in other Cantons – as the Tax Authorities promise in their press release. On that point, it must be considered, in particular, that assessment on the basis of the asset value might be less advantageous for a startup than assessment applying the practitioner method for as long as the company’s earnings capacity is lower than its asset value.

VI. Recommendation

At the time of writing and against the background of the new means of assessing the wealth tax, there are two recommendations that we can issue:

(a) Startups which are still producing negative operating results should as far as possible avoid new financing rounds at the end of business years. They would have the effect of boosting the company’s asset value on the relevant day on which tax is assessed, even if the corresponding resources turn out to be quickly consumed in the next business year.

(b) A certain amount of caution is still called for in issuing employee shares and/or in exercising employee options, keeping an eye on the consequences those actions would have for the other shareholders when it comes to wealth taxes. It is recommended to call on the services of experienced advisers particularly as far as this point is concerned.

We should be happy to deal with any questions and to analyse specific circumstances.

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