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Tax environment for start-up companies – with a special focus on wealth tax

Switzerland is often considered as an attractive location for a start-up company due to the possibility of collecting a tax free capital gain on a later sale of shares. However, potential wealth tax implications are frequently neglected by young entrepreneurs. The rules on the determination of the tax value of a start-up company may result in a significant wealth tax burden despite the fact that no profits have been generated yet.

DETERMINATION OF THE TAX VALUE FOR WEALTH TAX PURPOSES

The rigid application of the valuation practice as well as recent developments in this regard caused uncertainty and criticism amongst young start-up businesses.

Contrary to most EU countries and the United States, Switzerland imposes a wealth tax on the net assets of an individual taxpayer. The wealth tax is based on the fair market or tax value of an asset as per December 31 of the relevant tax year. In case of domestic and/or foreign unlisted companies for which neither a pre-exchange nor an off-exchange price quote is available, the tax value is assessed based on specific criteria.

The practice adjustment by the Zurich Cantonal Tax Office with regard to wealth tax has led to uncertainty on the part of many start-ups.

In order to ensure a uniform appraisal of non-listed securities the Cantonal tax authorities agreed on specific valuation rules laid down in Circular Notice No. 28 of the Swiss Tax Conference (STC) «Guidelines on the valuation of securities without an available fair market

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value for wealth tax purposes» (CN 28). According to these Guidelines newly-formed commercial, industrial and service companies are, as a rule, to be valued based on their substance for the year of formation as well as for the following start-up phase. As soon as presentable business results are available, the average earnings of the last two business years are additionally to be taken into account (so-called “simplified method” or “Praktiker-methode”). While the substance is weighted once, the average earnings are double-weighted.

This simplified method is also applicable to start-up companies. However, if a significant sales transaction takes place or a financing round is conducted by the start-up, wealth tax is based on the price realised on the market. If such significantly higher value is taken as the tax value, a young entrepreneur may find himself in a position of not being able to pay the wealth tax.

The determination of the value for wealth tax purposes is of great importance for start-ups because regularly no profits are generated during the development phase.

The entrepreneurs have therefore taken the view that the price paid by an investor was not reflecting the value of a start-up since it is typically significantly above the current market value. The surcharge paid by an investor provides the start-up with financial resources for further expansions and/or the development of the main business idea. Only the future will tell whether or not the investment of an investor will be successful.

Following discussions with representatives from the business community, the Zurich Cantonal Tax Office deemed it necessary to take the valuation of start-up companies presented above into due consideration. In order to strengthen Zurich as a location for innovation, an adjustment in practice was decided taking the low profitability of start-up companies during the start-up phase into account. The new practice has been in effect since March 1, 2016 and applies to all tax assessments that are not yet final.

Adjusted practice of the Zurich Cantonal Tax Office

The new rules provide that prices paid by investors are disregarded in the first three business years after the incorporation of the start-up company. In the subsequent two business years, the wealth tax value is based on the average between the net asset value and any investor price paid. While the average investor prices are single-weighted and the net asset value double-weighted in the fourth business year, the average investor prices are

Young entrepreneurs should keep an eye on the tax framework from the very outset. In particular it should be ensured that in case of a successful sale of the participation the gain on the sale can be collected in a tax-exempt manner.

Severine Vogel, Attorney-at-Law, MLaw, LL.M., certified tax expert

double-weighted and the net asset value single-weighted in the fifth business year. As from the sixth business year, the wealth tax value will solely be based on investor prices paid. With regard to start-ups from the biotech and medtech industries the initial phase is extended from three to five years due to the longer development process. The wealth tax value is therefore based on the net asset value for the first five business years.

However, there are a few exceptions to these basic rules in particular, if shares in the start-up company are sold to a significant extent (as a rule ≥ 10%) or if the company determines its fair market value for the purpose of an employee participation programme. In such case, the transaction price or the determined fair market value is considered to be the relevant value for wealth tax purposes.

Notwithstanding the basic principles set out above, the adjusted practice of the Zurich Cantonal Tax Office allows for an individual valuation if there are objective differences regarding the financial condition of investor shareholders and other groups of shareholders. This applies for instance in the event of so-called “exit preferences” in favour of the investors; in particular, if the investors hold preferred stock and/or the founder shareholders agree with the investors, in an agreement among shareholders, that in the event of liquidation or a sale, the investor shareholders will be treated more favourably than the founder shareholders. Such exit preferences for the benefit of the investors are common and reduce the value of the founder shares considerably. These issues may be accounted for in an individual valuation.

Practice in other Swiss Cantons

No public statements have been made as to potential adjustments of the practice as outlined in CN 28 in other Swiss Cantons. This is due to the fact that many Cantons do not apply the rules of CN 28 at all and impose wealth tax on the net asset value even if higher investor prices are available. In addition, many Cantons are not faced with these issues at all. According to its own statement the Canton of Zurich has by far the most start-up companies domiciled within its borders. The Zurich Cantonal Tax Office announced discussing the valuation of start-up companies within the competent body of the Swiss Tax Conference, whose members include all 26 Cantonal Tax Offices and the Swiss Federal Tax Office. It is yet to be hoped that a business-friendly solution can be found jointly.

In addition, it is expected that the Zurich Cantonal Tax Administration will submit its new approach to the Swiss Tax Conference for debate. Thus, the new Zurich directives could serve as inspiration for other Cantons and for a nation-wide approach.

It should be taken into account that financing rounds can potentially have a substantial impact on the wealth tax of young entrepreneurs.

Natalie Peter, Attorney-at-Law, Dr. iur., LL.M., TEP

Assessment and Outlook

The practice adjustment by the Zurich Cantonal Tax Office is a step in the right direction and helps to establish a friendly tax environment. It is, however, not far-reaching enough. The start-up phase of three and/or five years, respectively, is often too short for a start-up to reach marketability. It is questionable why wealth tax should be based on investor prices rather than applying the so-called “simplified method” or “Praktikermethode” which is used for all other companies including small-to-medium size companies.

The adjusted practice of the Zurich Cantonal Tax Office is a step in the right direction and improves the tax environment. However, it is not far-reaching enough.

During past months, representatives of the business community have also criticised the change in practice as not far-reaching enough. Based on the continuing criticism, the Zurich Cantonal Tax Office and the Zurich Finance Director held a press conference on May 19, 2016 but nonetheless stood by the adjusted practice. In order to achieve further-reaching improvements via political channels, the main-line political parties and the Green Liberal Party subsequently submitted to the Zurich Cantonal Parliament an urgent postulate and a motion, respectively.

According to representatives of the business community, a solution could also be found through an interpretation of law such that, for example, the company tax value based on the last financing round will only be considered on a pro rata basis. For example, if one-fifth of the company changes ownership, only one-fifth of the paid price is to be taken into consideration. It remains to be seen whether the Zurich Cantonal Tax Office, with increasing criticism, will be persuaded to make a further-reaching practice adjustment after all or whether an improvement may only be obtained via the political route.

ATTRACTIVENESS OF SWITZERLAND AS A TAX LOCATION

Despite continuing criticism with regard to wealth tax, Switzerland is still an attractive location for start-ups from a tax perspective. In comparison to other countries, both the income tax rate for young entrepreneurs as well as the corporate tax burden for start-ups is low.

A major advantage of Switzerland as a tax location is the tax exemption for private capital gains. If a successful young entrepreneur sells his shares in a start-up company, the gain on the sale is generally tax-exempt. However, there is a need for tax planning if the sale of the shares is coupled with future cooperation in the company, or if the price to be paid for the shares is dependent on the future performance of the company, or if a non-compete covenant is agreed upon.

Switzerland is an attractive location for start-ups from a tax perspective despite continuing criticism with regard to wealth tax.

In such cases, it is extremely important to structure the sale properly to avoid a portion of the purchase price being taxed. In order to ensure the tax-exempt status of the capital gain it is highly recommendable to involve a tax lawyer when planning to sell a stake in a start-up company. If deemed necessary, the planned sale is further to be discussed with the tax authorities in advance in order to confirm the tax exempt nature of the capital gain by means of a binding tax ruling. §

Severine Vogel

Particularly in the case of start-ups, which have a low amount of share capital and a small board of directors, it is important to pay special attention to adherence with the mandatory organization of the corporation and the provisions for the protection of the corporate assets.

Damian Hess, Attorney-at-Law, lic. iur., LL.M.

Pitfalls for (young) companies

Following a successful incorporation of the start-up, important provisions of law must be observed in order not to endanger the further existence of the company and to protect the involved persons from unwanted legal consequences. Based on a brief case study using the example of a stock company, certain (avoidable) pitfalls will be described below.

INITIAL SITUATION

A and B, who are friends, form their own family office and, for this purpose, incorporate the AB Family Office Ltd. with a share capital of CHF 100,000. A and B manage the business and C, another friend, is appointed as the sole member of the board of directors. Bank X grants a loan to AB Family Office Ltd. for the purpose of financing the business.

Unfortunately, the business does not go well. AB Family Office Ltd. is unable to acquire any client during the first year. During the second year, director C resigns, without being replaced. Soon, the assets of AB Family Office Ltd. practically consist only of the loan sum, that has nearly been depleted and that A, B and C used, despite the poor course of business, to pay out salaries and board of director fees. Bank X demands the immediate repayment of the entire loan sum, whereupon it is informed that AB Family Office Ltd. is currently not in a position to repay the loan.

PITFALL 1: DEFICIENT ORGANIZATION

Because director C resigned and no replacement was appointed, AB Family Office Ltd. was missing the corporate body of a board of directors that is required by law. Therefore, a so-called deficiency in organization is on hand.

If a corporate body that is required by law is missing, the court may appoint such a body upon the petition of a creditor of the corporation and at the cost of the corporation.

In such cases, the court may, upon the petition of a shareholder, a creditor of the corporation or the registrar of the Commercial Register, impose a deadline to the corporation in order to restore the legally proper situation, subject to the threat of dissolution. The court may itself appoint the missing corporate body or even an

administrator, dissolve the corporation and order the liquidation or cause other appropriate measures to be taken. The corresponding procedural costs as well as the costs of possible measures as ordered by the court are – in principle – borne by the corporation. In the present case, therefore, Bank X, as a creditor of the corporation, could, for instance, petition for the appointment of a director or for the direct dissolution of AB Family Office Ltd.

PITFALL 2: DIRECTOR'S LIABILITY

Because the stock corporation is a capital-related corporate body and only the corporation's assets are liable to cover its liabilities, the stock corporation law includes a number of provisions for the protection of the corporation's assets. For example, the share capital and the legal reserves may not be used for the payment of dividends. In addition, the board of directors must propose restructuring measures to the shareholders' meeting in case the assets no longer cover one-half of the share capital and one-half of the statutory reserves. In the case of over-indebtedness, i.e., when assets are no longer on hand to cover the liabilities of the corporation, the board of directors must deposit the balance sheet with the court except subordination agreements of the creditors of the corporation are on hand to the extent of the over-indebtedness.

In the present case, because the only assets still on hand consist merely of the remainder of the loan sum, it is clear that the corporation has been over-indebted for quite some time and that the balance sheet should have been deposited and bankruptcy proceedings commenced already. Furthermore, the payment of salaries and director fees should have been stopped and restructuring measures should have been taken. Because the liability substrate of the corporation is practically consumed, Bank X must write off the loan. If restructuring measures had been initiated on a timely basis or if at least the balance sheet had been deposited with the court, the damages could potentially have been mitigated.

If the board of directors and the managing persons of a stock corporation do not observe the provisions for the protection of the corporation's assets, this can lead to personal liability.

The board of directors and managing persons are liable (among other things) for the damages that they have inflicted on the creditors of the corporation through an intentional or negligent breach of their duties. Bank X, as a creditor of the corporation, could thus claim damages from the managers A and B and from the former director C personally for the credit losses by means

of liability actions. The calculation of the claims to damages would depend on the circumstances of the case and the specific faults of the involved persons.

PITFALL 3: CRIMINAL LIABILITY

Whoever is required to manage the assets of another or to supervise such asset management and, in violation of his duties, causes or permits that these assets are damaged, fulfills the offense of disloyal business management. Based on case law of the Swiss Federal Tribunal, the corporate assets of a one-man stock corporation are deemed to be another person's assets in relation to the sole shareholder who acts as manager because the mandatory provisions for the protection of the corporate assets serve also for the protection of third parties.

Anyone who, as sole member of the board of directors of a one-person stock corporation, breaches the provisions for the protection of the corporate assets, risks criminal proceedings.

In other words, anyone who, as sole director of his own one-man stock corporation or as director or manager, with the approval of all shareholders, violates the provisions for the protection of the corporate assets, may still be liable to criminal sanctions. In the present case, the shareholders A and B, as the managers, and the director C paid out salaries and fees until the corporate assets were practically depleted instead of initiating restructuring measures or at least depositing the balance sheet with the court. As shown above, Bank X thereby incurred damages. Such payments, which in the case of A and B can also be classified as (concealed) profit distributions, are in breach of duty within the meaning of the Swiss Penal Code and therefore constitute a criminal offense. Furthermore, the elements of additional criminal offenses, such as bankruptcy offenses, might be fulfilled.

SUMMARY

The mandatory prerequisites in terms of the organization of the corporation as well as the provisions for the protection of the corporation's assets must be satisfied at all times. Otherwise, compulsory liquidation proceedings may be imminent, and the responsible persons must expect civil and criminal law consequences. §

Damian Hess, Sarah Vettiger

The formation of a start-up is a step into the unknown – reason enough to get at least the calculable legal risks out of the way at an early stage.

Stefan Scherrer, Attorney-at-Law, Dr. iur.

Legal considerations in connection with the formation of start-ups

During the preliminary stages of the formation of a start-up, it is worthwhile to place the focus on legal topics as well in order to avoid unpleasant surprises at a later phase of the enterprise. In addition to tax structuring, the topics of primary importance also include the choice of a legal form and the structuring of the enterprise with a view to future capital needs.

ADDRESS LEGAL TOPICS PROACTIVELY

It goes without saying that, during the preliminary stages of the formation of a start-up, topics such as the preparation of a business plan, the conduct of a market analysis and the raising of capital are paramount. Nonetheless, it is worthwhile to take legal aspects into consideration as well. In this regard, in particular, the following questions are of importance:

- Who will hold equity interests in the enterprise?
- How much capital will be needed and when, and who will supply the capital?
- Is personal liability an option, or should the liability be limited?
- How rapidly should the enterprise grow?

The answers to these and similar questions have a decisive impact on the legal structure of the enterprise. This is clearly shown with respect to the decision on the legal form in which the enterprise should be managed.

BE PROACTIVE IN CHOOSING THE LEGAL FORM

The legal form defines the legal vessel within which your start-up enterprise will operate in the future. The choice of the legal form has not only legal consequences, but also personnel-related, financial and tax consequences. The following criteria are decisive for the choice:

Liability:
By selecting a limited liability company (GmbH) or stock corporation (AG), it is possible to limit the financial entrepreneurial risk to the share capital. On the other hand, those who manage their enterprise as a partnership or sole proprietorship will be liable without limitation, including with their private assets. The higher the estimated financial risk of the enterprise, the more it is recommendable to

It is particularly important for start-up companies that the business be provided an appropriate and sustainable legal basis from the very beginning. Our experts have many years' experience in advising young entrepreneurs and accompanying them from the outset on their path to success.

form a GmbH or AG.

The choice of the legal form has a decisive impact on the taxation. In the case of AGs and GmbHs, gains will usually be subject to a lower tax rate than in the case of partnerships or sole proprietorships.

Stakeholders:
Those who form and manage an enterprise on their own are very flexible in terms of the structuring. If more than one person is a stakeholder, or should partners become involved later as stakeholders or creditors, corresponding measures are to be taken. The more complex the relationships between the various stakeholders, the more recommendable it is to choose an AG or GmbH.

Capital:
Formation costs and the required minimum capital will depend on the legal form. Already in connection with the formation, consideration should be given to how the capital needs should look in the medium term and how the necessary assets should be obtained by the enterprise. The minimum capital of the GmbH amounts to CHF 20,000 and that of the AG amounts to CHF 100,000, although only one-half of the minimum capital must be paid already upon formation and it is also possible to contribute certain in-kind assets in lieu of cash and to have these count towards the minimum capital.

Taxes:
The choice of legal form has a decisive impact on the taxation. Depending on the legal form, the earnings and assets of the enterprise and of the entrepreneur will be taxed either separately or together. In the case of an AG or GmbH, gains will usually be taxed less heavily than in the case of partnerships or sole proprietorships.

Most frequently, start-ups will be structured as sole proprietorships, AGs or GmbHs. If the relationships are simple and there is little potential for growth, a sole proprietorship can definitely constitute a sensible choice. On the other hand, the AG is the most favorable legal form for enterprises that have high growth targets, in particular due to the limitation of liability and the flexibility with respect to future capital procurement. Due to this flexibility, the AG is one step ahead of the GmbH. Furthermore, in many places, the AG continues to have a better reputation than the GmbH.

In an AG, the relationship between several stakeholders whose level of involvement in the enterprise may differ strongly and who make differing amounts of capital contributions can be governed in a customized manner through an agreement among shareholders. These agreements have in the meantime reached a high degree of standardization and can be implemented with corresponding efficiency.

If, after formation, there is a need to change the legal form, this is possible. A change in legal form, however, may entail certain obstacles and involve certain time and expense.

PLAN YOUR FUTURE CAPITAL NEEDS IN GOOD TIME

The capital needs for the year of formation and the next three-to-five business years should be kept in focus already during the formation phase and be taken into consideration in connection with the structuring of the enterprise. Whoever is unwilling or unable to cover the entire needs out of his own assets will be dependent, sooner or later, on third-party financing and should be suitably prepared.

Make your start-up ready for investments from the very outset in order to facilitate subsequent financings. The stock corporation offers the greatest flexibility in this respect.

The possibilities of gaining access, as a sole proprietor, to third party financing are limited. Depending on the creditworthiness of the sole proprietorship and an assessment of the business risk, a bank will demand additional collateral that is to be paid out of the private assets of the entrepreneur or be provided by third parties. A sole proprietorship is not suitable for the participation of investors.

However, access to debt or equity capital financing is also not easy for start-ups that are in the form of an AG or GmbH. The chances of obtaining a loan from a bank without having to provide collateral in excess of the business assets are low. Accordingly, start-ups strive to cover their capital needs through the risk capital market. Such risk capital financings take place, in the case of an AG, by means of an increase in the share capital or shareholders' equity. As opposed to debt financings, they have the advantage that the new capital does not bear interest and does not have to be repaid.

Apart from a pure debt or equity capital financing, possibilities exist to procure capital from external investors that moves, in terms of construction, between debt and equity capital. Such so-called mezzanine capital, which is structured as convertible loans or option loans or loans with profit-related interest, can be flexibly implemented, in particular in the case of the AG. §

Stefan Scherrer