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December 2016

news

Further-reaching practice adjustment: Zurich improves the tax environment for start-up companies

The Canton of Zurich amended its practice with regard to the taxation of start-up companies for the second time this year.

Until 1 March 2016 – when the Zurich Cantonal Tax Office amended its practice regarding the valuation of start-up companies for the first time – the fair market value of a start-up company for wealth tax purposes was assessed based on the Circular Letter No. 28 of the Swiss Tax Conference «Guidelines on the valuation of securities without an available fair market value for wealth tax purposes» (CL 28).

According to CL 28 newly-formed active businesses are generally to be valued based on their equity for the year of formation as well as for the following start-up phase. As soon as reliable 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 “Praktikermethode”). While the equity is weighted once, the average earnings of the last two business years are double-weighted.

This general rule is also applicable to start-up companies. However, there is a special rule laid down in CL 28 stating that if a higher price is achieved in a sales transaction between third parties – including financing rounds conducted by the start-up company – the fair market value for wealth tax purposes is based on this higher price. This rule has a considerable impact on the entrepreneur’s wealth tax burden. If such significantly higher value is taken as the tax value, an entrepreneur may find himself in a position of not being able to pay the wealth tax.

While many Cantonal Tax Offices ignored this special rule, the Zurich Cantonal Tax Office applied it rigidly. This led to strong criticism. The entrepreneurs had taken the view that the price paid by an investor does not reflect the value of a start-up company. The investor prices are typically substantially higher in order to provide the start-up company with financial resources for further expansions and/or development of the main business idea in hopes of paying off in the future. Entrepreneurs are not in a position to sell a stake to a third party at such a high price.

Prices achieved in financing rounds will only be taken into account for wealth tax purposes once reliable business results are available.

Following discussions with representatives from the business community, the Zurich Cantonal Tax Office decided to amend its practice by taking the low profitability of start-up companies during the start-up phase into account. The new rules provided that prices paid by investors are disregarded for a limited period of time after the incorporation of the start-up company.

However, this first practice adjustment was criticised by the business community as not being far-reaching enough since the privileged start-up phase set by the Zurich Cantonal Tax Office of three years, or five years respectively for start-ups from the biotech and medtech industries, is generally too short to reach marketability.

Due to the continuing criticism as well as political pressure, the Zurich Finance Ministry finally decided to make a further-reaching practice adjustment by amending the Cantonal directive with regard to the appraisal of securities and assets for wealth tax purposes. The amendment came into effect in November 2016 and overrules CL 28 with regard to start-up companies.

According to the amended directive, start-up companies are valued based on their equity for the entire start-up phase. Prices achieved in financing rounds will only be taken into account once reliable business results are available.

Since start-up companies have neither been defined on federal nor cantonal level, the amended directive also provides for a definition. Start-up companies are qualified as companies that are organised in a corporate form such as a corporation (Aktiengesellschaft, AG) or a limited liability company (Gesellschaft mit beschränkter Haftung, GmbH) with an innovative business model – which is usually technologydriven – that is in the start-up phase and scalable. In other words, start-up companies are companies that develop innovative technological products or services and have not yet successfully established themselves in the market but with the aim of reaching marketability in the near future.

By implementing this far-reaching practice adjustment, the Canton of Zurich has finally improved the tax environment for start-up companies in a satisfactory manner. §

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