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Structuring Business Succession Properly:

Avoiding tax pitfalls, preserving value

Those who transfer their business to employees or family members usually think first of the purchase price, financing, and continuity. From a tax perspective, however, even a seemingly fair negotiated price can become problematic: If the purchase price is not accepted by the tax authorities, the successor may face tax consequences even though no cash is received ("dry income"). Depending on the legal structure, pricing, and residence of the parties, the tax consequences can vary significantly.

1. When does the purchase of shares become taxable income?

When transferring shares to successors who are already active in the company or will work there in the future, employee share ownership is often the focus from a tax perspective. In such cases, the tax authority examines whether the shares are being sold on preferential terms to the successors. Especially in the case of SMEs, *market values from third-party transactions* are usually lacking. In such cases, the *formula value* determined using a suitable and recognized method is considered the relevant value for tax purposes (so-called "formula value principle," FTA Circular 37 of October 20, 2020). In practice, there are a variety of suitable formulas (e.g., EBIT, EBITDA, revenue, or net income multiples). The valuation in accordance with Circular 28 of the Swiss Tax Conference – i.e., the *wealth tax valuation* – is also widely recognized. However, cantonal practices regarding suitable formulas vary.

If the shares are valued using such a recognized and suitable formula and sold to the successors, this does not result in taxable income from an employee share ownership plan for the successors at the time of acquisition. If the shares are resold by the employee within five years of acquisition, the increase in value within the formula is tax-exempt. However, if the sale price exceeds the formula value, a taxable *excess gain* may arise. The excess gain is considered taxable income and is additionally subject to social security contributions. After five years, such excess gain may remain tax-free under certain circumstances.

2. Why negotiated purchase prices can be a tax issue

In business succession cases, the purchase price is often not derived using a suitable formula but is negotiated between the seller and the successor. This purchase price is often lower than, for example, the company's wealth tax value. If the sale price is not agreed upon in advance

with the tax authorities, taxation of the difference relative to a suitable formula – in the Canton of Zurich, for example, the wealth tax value – is likely. Such taxation is burdensome for the successors because the income from an employee share ownership is not accompanied by an inflow of cash (so-called “dry income”).

3. Cantonal practices regarding business successions: No uniform solution

Various cantons have recently published guidelines or practice notes setting out differing tax consequences of share transfers in the context of business succession. In other words, the tax regulations regarding the formula value principle are (partially) overruled. Two cantonal practices are summarized below – though other cantons (including Appenzell Innerrhoden and Appenzell Ausserrhoden; Glarus, Graubünden, Schwyz, Solothurn, and Thurgau; although not all practices have been published) also provide for differing rules regarding employee share ownership.

The *Canton of Aargau* introduced a solution for business succession at the end of 2025. Even if a transfer takes place at a preferential price (i.e., for example, at only 50% of the wealth tax value), no taxation occurs at the time of transfer. However, the application of this practice is subject to extensive conditions. These include, among other things, a prior ruling request to the Aargau Cantonal Tax Office as well as the transfer of a controlling majority to the successors. In addition, the successors must sign a so-called *“revers*,” in which they acknowledge any potential differential taxation (purchase price at the time of the acquisition ./. subsequent sale price) should the shares be resold within 10 years.

In *the Canton of St. Gallen*, the practice distinguishes between whether the purchase price calculation is made transparent using a formula value or not. If a formula value is available, it is generally accepted. In this case, St. Gallen’s practice does not differ from the tax consequences of an ordinary employee share ownership plan. If no formula value is available, the sale price is also accepted as a formula value. This results in no taxable income at the time of the share acquisition. However, if the shares are resold within five years of purchase, the difference between the purchase price and the sale price is taxed as income.

4. What entrepreneurs should clarify before implementation

In addition to special cantonal rules, the acquisition structure can also influence the tax treatment, for example, if the acquisition is made through an acquisition holding company. Depending on the circumstances, the regulations regarding indirect partial liquidation must also be taken into account.

For transfers of shares within the family, different issues arise compared to internal corporate solutions, depending on cantonal practices, particularly regarding gift tax, advance inheritance, equalization among heirs, and estate planning.

It is therefore essential to analyze a succession plan from a tax perspective before implementation. Valuation methods, purchase price, acquisition structure, financing, and cantonal practices should be clarified early on. It is advisable to coordinate in advance with the competent tax authorities in the cantons of residence of the sellers and buyers by obtaining a tax ruling. This helps avoid significant tax burdens after implementation.

We are happy to advise you on all tax and civil law issues related to succession planning.

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