Valuation of unlisted shares for wealth tax purposes

Switzerland is one of a handful of countries in which individuals are subject to a wealth tax. While this tax is not levied by the Confederation, the cantons are required to levy it under the Federal Act on the Harmonisation of Direct Taxes of the cantons and communes (FHDT). Wealth tax is levied on the taxpayer's worldwide net wealth, with the exception of certain exempt items (e.g., personal items for everyday use) and real estate assets located abroad, although the latter are taken into account for the determination of the tax rate.

The FHDT requires assets to be valued at market value, although it is specified that the earnings value may be taken into account in an appropriate manner (Art. 14 para. 1 FHDT). The market value is the price that would be obtained if the property were sold under normal conditions. The earnings value on the other hand, is obtained by capitalising the earnings. However, the FHDT does not specify the rules according to which the market value – which is supposed to be objective – must be determined. Case law states that the cantons have broad discretion in the choice of the method to be applied and in the inclusion or exclusion of the earnings value in their regulations (Swiss Supreme Court ruling 128 I 240). This latitude left to the cantons explains, among other things, the great differences in the assessment of the tax value of real estate by the different cantonal tax authorities.

With regard to the valuation of shares for wealth tax purposes, a distinction must be made between listed shares, which are valued at their stock market value at the end of the tax period, and unlisted shares. The latter are valued on the basis of Circular No. 28 of the Swiss Tax Conference (STC 28), which implements the rule of Art. 14 para. 1 FHDT. Although the circular is only a guideline and therefore not binding, it is recognised by consistent case law as an adequate and reliable method for estimating the market value of unlisted shares (Swiss Supreme Court ruling 2C_953/2019). Furthermore, in view of the considerable leeway of the cantons, the Swiss Supreme Court has always limited its review to arbitrariness when reviewing the valuation of an asset for wealth tax purposes. As a result, in practice the valuation rules set out in STC 28 are generally applied strictly and are extremely difficult to challenge.

Valuation of unlisted securities under STC Circular No. 28

Unlisted shares that are regularly traded over the counter are valued at the last available price for the relevant tax period (§2.2 STC 28). For shares that do not have a quotation, the value is estimated according to the so-called «practitioners' method», unless they have been subject to a substantial transfer between independent third parties (§2.5 STC 28). Indeed, such transfers are deemed to represent the market value of the shares and should therefore be taken into account. The term "substantial" does not have a uniform meaning in tax law, so it must be examined on a case-by-case basis whether such a transfer is made. Nevertheless, a transaction volume of around 10% per year can be qualified as substantial (2020 STC commentary 28, p. 4).

The practitioners' method takes into account the value of substance, i.e. the value of the company's net assets, and the value of earnings, which is obtained by capitalising the net profits of the relevant financial years, plus or minus the write-backs and deductions listed in STC 28 (e.g. minus an extraordinary capital profit following the sale of an operating building). The capitalisation rate is

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composed of the interest rate of risk-free investments and a premium for fixed risks. Currently it is 7%, regardless of the company's sector of activity. This is an old, past-oriented method, which differs significantly from more modern valuation methods, such as the discounted cash flow (DCF) method which is based on a projection of future results and is not accepted by the tax authorities for the valuation of shares (2020 STC commentary 28, p. 3).

According to the practitioners' method, the value of the company is the weighted average between the earnings value, which is doubled, and the substance value, based on the following formula:
VC = (2EV + SV) / 3[1].

To obtain the earnings value, there are two models. The first one takes into account the results of the period n-1 and n, the latter being doubled. The second model weights the average of the results of years n-2, n-1 and n. The cantons automatically apply one or the other of these methods, although the company whose shares are valued may request the application of the other method, which must then be applied for the following five years (§7.3 STC 28). The earnings value is established as follows:

Model 1:
[(2Pn + Pn-1)/3] x (100/capitalisation rate)[2]
Model 2:
[(Pn +Pn1 + Pn2)/3] x (100/capitalisation rate)[3]

[1] VC : Value of the company; EV : Earnings value; SV: Substance value;
[2] Pn/Pn-1: Net profit for financial year n/n-1
[3] Pn/Pn-1/Pn-2: Net profit for financial year n/n-1/n-2

Exceptions and adjustments to the practitioners' method

The value of holding, asset management and finance companies, as well as real estate companies, corresponds to their substance value (§38 STC 28; §42 STC 28); no earnings value is taken into consideration.

Unlisted foreign companies are also valued on the basis of the practitioners' method, with the exception that the capitalisation rate may vary depending on the relevant currency (2020 EUR rate: 7%, USD 8%).

Holders of minority stakes in an unlisted company are entitled to a lump-sum deduction to compensate for the reduced influence they have in the company and the limited transferability of their shares (§61 STC 28). A deduction of 30% is allowed, if the shareholder holds 50% or less of the voting rights. However, if the minority shareholder receives a suitable dividend, the deduction is not granted (§63.1 STC 28). A dividend is deemed appropriate if the ratio between the yield and the market value of the shareholding amounts to at least a certain percentage determined each year by the Federal Tax Administration. For 2020, a dividend is deemed appropriate if it amounts to at least 1% of the market value of the share (2020 STC commentary 28, p. 81).

For companies whose return is based exclusively or almost exclusively on the performance of a single or majority shareholder, the tax authority may – at the request of the company – take into account the non-marketability of this return by means of a simple weighting of the earnings value (2020

STC commentary 28, p. 10). The value of the company calculated in this way is applicable to all shareholders, including minority shareholders, who are then not entitled to the lump sum deduction. However, this simple weighting is only possible if the company does not employ any other persons, apart from a few persons engaged in administrative and logistical tasks (2020 STC commentary 28, p. 10). This means, for example, that a law firm incorporated as a limited company cannot benefit from this simple weighting if it employs associate lawyers or trainee lawyers.

Simplified example of calculation

A commercial company with a share capital of CHF 1,500,000, divided into 1,500 shares of CHF 1,000 each, has a substance value calculated according to STC Circular 28 of CHF 10,000,000. The financial year n-1 ended with a loss of CHF 2,000,000 and the financial year n with a profit of CHF 3,500,000, of which CHF 1,500,000 came from an extraordinary capital gain. Mr X holds 20% of the capital and voting rights.

The result to be taken into account for the year n-1 is 0, as the earnings value cannot be negative (2020 STC commentary 28, p. 15). The result to be taken into account for year n is CHF 2,000,000, as the extraordinary capital gain is not to be taken into account.

The earnings value therefore amounts to CHF 19,047,620 according to the following calculation:
Model 1: [(2*2'000'000 + 0)/3] x (100/7)

The value of the company is therefore CHF 16,031,747 according to the following calculation:
[(2*19'047'620)+ 10'000'000] / 3

One share of this company is therefore worth CHF 10,687.83. Mr X, a minority shareholder, will be entitled to the 30% deduction, so that his shares will be valued at CHF 7,481.48 each.

Inflexibility of the practitioners' method

The commercial company in the above example is profitable and an investor might be interested in acquiring it at a price that corresponds to the calculated market value. However, if it were not a commercial company but a service company whose value was created solely by the current shareholders, the market value would probably have been exactly the same using the practitioners' method. It is clear, though, that the shareholders of the service company will not be able to sell their shares for that price, since without them the company would not generate any earnings. In this sense, the strict application of the practitioners' method by the tax authorities can lead to shocking results.

Conclusion

Although it is not law, STC Circular No. 28 is systematically applied by tax authorities to determine the market value of shares in unlisted companies. Applying the same formula and the same capitalisation rate to companies active in such different fields as industry, commerce, trades, construction and service can lead to shocking results. A valuation that takes these differences into account would potentially be more complicated but would produce a result that is closer to the real market value of the shares, which, it should be remembered, is supposed to be the value subjected to wealth tax by law. ■