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Limits to capital gains exemption – Taxation of earn-outs

Introduction

In this final installment of our series on the limitations of capital gains tax exemptions, we address the issue of the recharacterization of a tax-exempt gain as taxable income in the context of earn-out clauses.

Issue at Stake

It is common for business sale agreements to include a clause known as an "earn-out." This provision stipulates that part of the purchase price is paid to the seller at a later date, contingent upon the occurrence of certain future events. Typically, the price includes a fixed portion and a variable portion, the latter depending on factors such as obtaining administrative approvals, achieving specific revenue targets, or resolving pending legal disputes.

In principle, the entire gain realised from such a sale qualifies for the tax exemption provided under art. 16 para. 3 of the Swiss Federal Direct Tax Act (FDTA). However, under certain conditions, the tax authorities may reclassify the earn-out as taxable income if they believe it compensates something other than the mere transfer of shares. This may occur, for example, when the company's value is closely tied to the seller's personal involvement and the agreement includes continued employment or a non-compete clause.

Key factors to consider

Unlike cases involving indirect partial liquidation or transposition, there is no statutory provision or official circular specifying the conditions under which such a recharacterization may occur. Nevertheless, relevant case law provides guidance on the factors to consider.

The primary question is whether the earn-out truly compensates the transfer of shares or rather some other obligation by the seller. If it is found to reward the continuation of an employment relationship or the respect of a non-compete clause, the earn-out will be treated as dependent gainful income, subject to both income tax and social security contributions.

Indicators that may lead to such a recharacterization include:

- A decrease in the seller's salary following the transaction, suggesting that the earn-out partially compensates for this reduction;
- A sale price that does not align with market value (arm's length principle), where an inflated price may indicate that part of it compensates for other commitments;
- Unequal treatment of multiple sellers, such as higher earn-outs for those required to remain employed for a specific period after the sale;
- A contractual condition linking the earn-out payment to the continuation of employment or compliance with a non-compete clause, clearly indicating it constitutes employee compensation rather than payment for the sale of shares.

In companies where performance and valuation are heavily reliant on one or more key individuals, it is essential that the components of the sale price are clearly defined in the agreement. From the seller's perspective, this means ensuring:

- the sale price reflects market value (possibly supported by an independent valuation),
- any continued salary post-sale remains consistent with prior compensation,
- there is no contractual link between the earn-out payment and continued employment or compliance with a non-compete clause. For the latter, it is often preferable to include a standard penalty clause rather than a conditional earn-out.

Conclusion

The legal uncertainty surrounding the reclassification of earn-outs highlights the need for caution—particularly when a company's value is closely linked to its seller. Careful drafting of contractual provisions is essential to mitigate risks. That said, earn-outs typically result from complex negotiations between parties with diverging interests. As with any sale or restructuring transaction, professional advice is vital, and where appropriate, it is advisable to request a ruling from the tax authorities.

Please do not hesitate to contact us if you have any questions.

valfor TaxTeam

Daniel Gatenby | daniel.gatenby@valfor.ch