

February 2026

TRAPS OF THE REMUNERATION OF THE EMPLOYEE/DIRECTOR HAVING AN INTEREST AS SHAREHOLDER IN THE SAME COMPANY: SALARY VS DIVIDEND

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1. Introduction

Shareholders of legal entities having an interest of at least 10% in the share capital and carrying out an activity for the same legal entity as an employee and/or director can choose between dividends and salary with regard to their remuneration.

The question that arises is, therefore, to determine the right balance between the dividend amount and the salary to be received as taxable income.

2. Tax issues

To give an answer to the question above it is opportune to define the different tax treatment of dividend income and of salary or any other remuneration for a dependent activity performed for a legal entity.

On the one hand, the salary or any similar remuneration for dependent activity is entirely (100%) taxable in accordance to the Swiss income taxation laws applicable to individuals, on the other hand, the taxable base of the dividend¹ is reduced to the extent of 70% of the gross dividend amount as deliberated by the shareholder's meeting (on a cantonal basis²)³.

3. Issues relating to social security contributions

Salaries (and similar remunerations) and dividends differ with regard to aspects relating to social security contributions.

¹ it should be noted that this refers only to shareholdings of at least 10% in the share capital.

² On federal basis the taxable base is 60%.

³ Whether or not the dividends are attributable to participations forming part of the private asset or the commercial asset.

Social security contributions are in fact due on the determining salary (understood as salary plus bonuses, director's fees, etc.), while dividends, being a remuneration on invested capital are exempted from such contributions.

The reader of this note will easily see a double advantage in case of dividend distributions: on the one hand, a reduced income taxation and, on the other, no duty to pay social contributions on such dividends.

Therefore, in order to minimise social and tax burdens, the shareholder as employee/director of the same company in which he has an interest is incentivized to allocate more dividends than to benefit of an arm's lengths remuneration for his dependent activity.

From the point of view of the Swiss Federal social insurance fund, this means a deficit or lack of contributions and for this reason accurate inquiries are made to assess whether or not there is an adequacy between distributed dividends to the shareholder as employee/director and the remuneration received. In case of abusive discrepancy, part of the dividend will be requalified as salary subject to social security contributions.

4. Right balance between dividend and salary, arm's lengths principle of adequate remuneration

The answer to the following question is therefore of importance: what is meant by congruity of the salary in case of an individual who, in the same company, has an interest as qualified shareholder and is at the same time employed (or acts as a director) and who, therefore, benefits both of a salary and a dividend? In other words: When is there an adequate proportion between dividends and the salary?

Two are the conditions that have to be taken into account and must both be met:

- First the salary must be qualified as competitive and market conform, i.e. it must be in line with the remuneration which would have been paid to a third party in the same situation, role, area of responsibility and therefore the remuneration has to be arm's length; ;
- Second, the dividend amount shall not be qualified as excessive. This is the case when the dividend amount distributed to the shareholder/employee does not exceed 10% of the equity capital (understood as capital including open and hidden reserves).

There is a disproportion only in the case both the conditions are integrated (too low salary and too high dividend). Only in such a case, the social security fund office will requalify part of the excessive dividend (the exceeding part of 10% of the equity capital) into salary with a corresponding computation of the social security contribution to be transferred to such office.

Vice versa once the inquiry of the salary amount determines an arm's length remuneration and consequently qualifies as a competitive salary the dividend test becomes superfluous and an excessive dividend (understood as higher than 10% of the equity capital) does not create any prejudice from the perspective of the social contributions.

5. Conclusion

For SMEs having shareholders who are at the same time executives, directors or employees in general, the proportions between the salary amounts and the distributed dividends need an accurate examination in order to avoid undesirable consequences being the requalification of dividend amounts in remuneration for dependent activity (or director's fees) with adjustment of the social contributions.

Decisive is the appropriateness and market conformity of the remuneration of the employee/director participating in the company's capital, as in this case the question of the amount of the dividend payment no longer arises.

We would like to explicitly point out that the herewith described two conditions need of course, to be examined on a case-by-case basis and a specific assessment and advice is recommended for each individual situation.

For further information on the above, please do not hesitate to contact us and for more detailed information on Switzerland, Canton Ticino tax and legal environment see our web site www.steimle-consulting.ch

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