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Switzerland

INSIGHT: Swiss Lump-Sum Tax Regime—Recent Changes

BY FLORAN PONCE

Over the past decade, lump-sum taxation has been hotly contested in Switzerland. Lump-sum taxation allows high net worth individuals to be taxed based on their annual expenditures, rather than their annual income.

Lump-sum taxation is attractive not only because it is often financially advantageous, but also because the taxpayer is not required to report non-Swiss income to the Swiss tax authorities, which provides a higher degree of privacy.

Lump-sum taxation has been criticized by some Swiss political parties as unfair and in violation of the principle of equal treatment. Other political parties support lump-sum taxation and argue that it is comparable to tax regimes that exist in other countries, such as the U.K.'s resident non-domiciled status, and that it boosts Switzerland's economy and increases tax revenue.

Lump-sum taxation has survived recent efforts to abolish it, but major changes entered into force on January 1, 2016; and on July 24, 2018, the Swiss Federal Tax Administration issued new guidelines on lump-sum taxation (Circular no. 44 of July 24, 2018 on lump-sum taxation for federal direct taxes).

Floran Ponce is a tax partner at Lenz & Staehelin, Geneva.

This article considers the political context surrounding lump-sum taxation, reviews the updated lump-sum tax rules, and provides readers with practical planning points.

Political Context

In 2009, the canton of Zurich voted to abolish lump-sum taxation. This sparked a renewed debate in Switzerland as to whether lump-sum taxation should be abolished, with many cantons subsequently voting on the issue and some deciding to abolish lump-sum taxation.

Federally, the issue was put to a vote, and in 2015, the Swiss people voted to keep lump-sum taxation for federal income tax. This was due in part to opposition from the French-speaking cantons of Geneva, Valais, and Vaud, since a significant part of their tax revenue comes from lump-sum taxpayers and these taxpayers often benefit the local economy.

Following the Zurich vote, the Swiss Federal Council submitted to Parliament modifications to the existing lump-sum tax regime. Parliament adopted the Federal Council's recommendations and modified the Federal Direct Tax Act (''FDTA'') and the Federal Tax Harmonization Act (''FTHA''). The Ordinance on Lump-sum taxation of March 15, 1993 was replaced by the Ordinance on Lump-sum taxation of February 20, 2013 (''OLST'').

The changes, which toughen the eligibility criteria, entered into force on January 1, 2016.

The New Rules

Eligibility Foreign nationals who have not resided in Switzerland during the previous 10 years may opt to be taxed on a lump-sum basis, provided that they do not exercise a gainful activity in Switzerland. Upon request, federal income tax (Article 14 of the FDTA), as well as cantonal and communal (communes are similar to municipalities) income taxes (Article 6 of the FTHA) will be levied on a lump-sum basis.

Foreign nationals can opt to be taxed indefinitely on a lump-sum basis (Article 14(2) of the FDTA), as long as they do not acquire Swiss nationality or exercise a gainful activity in Switzerland. Volunteer activities in Switzerland are permitted, so long as they remain inconsequential.

Swiss nationals with a second nationality are not considered foreign nationals for the purposes of lump-sum taxation.

The new FTA guidelines clarify that individuals returning to Switzerland may opt to be taxed on a lump-sum basis if they were subject to lump-sum taxation upon their departure, even if that was less than 10 years ago (Circular no. 44, [2.3]).

Under Swiss tax law, married couples (and registered partners) residing in the same household, are treated as a single taxpayer and both spouses have to fulfill the above-mentioned conditions in order to benefit from lump-sum taxation (Circular no. 44, [2.4]). The cantons are no longer permitted to make exceptions; if one spouse ceases to fulfill the conditions, then both spouses lose the right to be taxed on a lump-sum basis and will be subject to ordinary taxation.

Tax Base The lump-sum tax base is calculated based on the taxpayer's annual expenditures (Article 14(3) of the FDTA) in Switzerland and abroad (Circular no. 44, [3.2]).

Typically, the following expenses are taken into account:

- food and clothing;
- housing (including heating, cleaning, etc.);
- social security payments;
- wages paid to household staff;
- maintenance and alimony payments;
- money spent on children (including education abroad);
- travel, entertainment, and spa treatments;
- upkeep fees for expensive domestic animals (e.g. horses); and
- expenses related to the use and maintenance of cars, motorboats, yachts, and airplanes.

Usually, the tax base is seven times the annual rent (or deemed rental value, if the taxpayer owns the property) of the taxpayer's primary residence, if the taxpayer is the head of the household. The tax base for other taxpayers is usually three times their annual pension for housing and food at their primary residence.

In practice, the tax base is determined by an advance ruling issued by the tax administration of the canton in which the individual will take up residence. The process starts with discussions with the competent tax authorities, but a written request for a ruling will need to be filed, along with supporting documents. Taxes are levied on the agreed tax base at the ordinary rate (Article 4(2) of the OLST).

The tax base cannot be less than the ''control calculation'', which takes into consideration certain Swiss-source income (Article 14(3) of the FDTA; Article 5 of the OLST).

Swiss-source income used for the control calculation includes:

- real estate income from immovable property situated in Switzerland;
- income arising from movable property situated in Switzerland;
- income from Swiss securities;
- debt claims, if the debtor resides/ has its statutory seat in Switzerland;
- participation rights, if the company has its statutory seat in Switzerland;
- income from copyrights and patents used in Switzerland; and
- income from Swiss social security and pension plans.

Foreign-source income is also taken into account for the control calculation, if the taxpayer receives partial or total foreign tax relief on the basis of a double tax agreement (''DTA'') concluded with Switzerland (see Tax Treaty Benefits, below).

The minimum tax base for federal income tax is 400,000 Swiss francs ($410,000) (Article 14(3) lit. a of the FDTA).

Some cantons also levy wealth tax on lump-sum taxpayers. Generally, taxable wealth is determined on the basis of the taxable income marked up by a certain percentage (usually 10 or 20 percent), but cantonal practices vary.

Tax Treaty Benefits Generally, individuals subject to lump-sum taxation can claim benefits under DTAs, provided that the income is included in the ''control calculation.'' However, they cannot claim any tax credit on the residual foreign tax.

Some DTAs (concluded with Austria, Belgium, Canada, Germany, Italy, Norway, and the U.S.) prohibit individuals taxed under the lump-sum system from enjoying treaty benefits. However, they can claim treaty benefits under the ''modified lump-sum'' system, if they declare all income from these countries, including income for which treaty relief is not requested. In this case, Switzerland taxes the declared income and the taxpayer may obtain a tax credit for the residual foreign tax.

Relationship to Other Taxes Individuals taxed under the lump-sum system are not exempt from other taxes, such as gift and inheritance tax and acquisition tax.

Gift and inheritance tax are levied at the cantonal and communal level; there is no federal gift or inheritance tax. They are levied by the canton where the donor/deceased resided; rules and rates can vary greatly from one canton to another.

Individuals who receive services from foreign businesses in excess of 10,000 Swiss francs in a calendar year must pay an acquisition tax of 7.7 percent (Article 35(2) lit. b of the VAT Act of June 12, 2009). (A special rate of 3.7 percent applies to some items, such as hotel stays, and a reduced rate of 2.5 percent applies to essential, everyday items like food.)

Lump-sum taxpayers must also pay social security contributions. The maximum annual social security contribution paid by individuals with no gainful activity in Switzerland is currently 23,900 Swiss francs, which is paid until the taxpayer reaches the age of 65.

Planning Points

The recent changes to the lump-sum tax regime should result in less criticism, so it is unlikely that lump-sum taxation will be abolished in the near future, especially in the French-speaking cantons.

Even with the recent modifications, lump-sum taxation remains an attractive option for many individuals. The lump-sum tax regime permits high net worth individuals to take up residence in Switzerland under favorable tax conditions, especially in the French-speaking cantons and in the canton of Bern, which would otherwise be unattractive from a tax standpoint.

Individuals wishing to take up residence in Switzerland and be taxed on a lump-sum basis should be aware that under the new eligibility criteria and increased thresholds, the minimum tax base for federal income tax is now 400,000 Swiss francs and the minimum tax base for cantonal and communal income taxes ranges from 200,000 to 600,000 Swiss francs.

Additionally, since foreign-source income for which treaty relief is granted is included in the ''control calculation,'' it is not always favorable to declare foreign-source income. Before foreign-source income is declared, the increase in Swiss tax should be compared with the foreign tax relief. This is especially true for individuals taxed under the ''modified lump-sum'' system.

Finally, individuals who wish to be taxed on a lump-sum basis must make the request prior to becoming a Swiss resident.

Floran Ponce is a tax partner at Lenz & Staehelin, Geneva.

He may be contacted by email at: floran.ponce@lenzstaehelin.com.