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NEWSLETTER N°7

Editorial

Lump-sum taxation in Switzerland is at the heart of the debate, to such an extent that one sometimes has difficulty in gaining a clear idea of the status of the situation and the outlook. We thus essentially wanted to conduct an intermediate review of the position, recalling the current conditions and those likely to result from the new federal law recently adopted by our Parliament. However, this intermediate situation is characterized by considerable uncertainty owing to the referendum that might allow the people to decide to abolish outright this truly historic tax regulation, which is 150 years old!

This being the case, we do not hide the fact that the debate on its legitimacy and abolition has already largely achieved its objective owing to the tightening up of the applicable conditions, which are no longer necessarily competitive and advantageous if compared, for example, with those offered by other European countries, even though the latter are quick, in other contexts, to complain about unfair competition from our country. Thus it is an emotionally charged debate full of subjective psychological considerations that we will avoid in this newsletter, which focuses on the facts and the current objective technical data.

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Chief Executive Officer

LUMP-SUM TAX: A SURVEY OF THE PRESENT POSITION (A supplement to Newsletter N°3)*

A great favourite with wealthy foreigners wishing to set up home in Switzerland, the lump-sum tax arrangement has many critics abroad and is presently a subject of heated debate within the country at both federal and cantonal level. Right now, though the lump-sum system remains unchanged in the majority of cantons, five of them have decided to abolish it outright, while another four have elected to raise their tax thresholds. Other cantons might be stating their position on this subject in the near future. At the federal level, a popular initiative seeking abolition has been lodged. The political and fiscal authorities have mostly declared themselves in favour of maintaining the arrangement. With a view to preserving the lump-sum tax and ensuring that Switzerland remains tax-competitive, the Federal Council is proposing an increase in the taxable expenditure and a tightening of the conditions for access to this type of taxation, resulting in a general increase for lump-sum taxpayers. These new measures will come into force on 1 January 2016 at the latest.

1 *Origins and mechanism of the lump-sum arrangement*

The origins of the lump-sum tax date back to 1862 when, to promote tourism and the economy, the canton of Vaud decided to offer this facility to foreigners not engaged in any gainful activity. The example of Vaud was followed by the canton of Geneva in 1928 and then by the Confederation in 1935. To this day, lump-sum tax assessment is reserved mainly for foreigners, Swiss citizens being allowed to claim this status only for a period of one year. Furthermore, it is open only to persons taking up residence in Switzerland for the first time or after an absence of at least ten years. In addition, the absence of any gainful activity has now become a prerequisite for the granting of lump-sum status. Lump-sum taxation differs from the traditional system in that it is based on the standard of living of the taxpayer rather than on his income or assets. Back at the beginning, this approach was dictated essentially by considerations of a practical nature. The authorities took the view that it would often be impossible for the tax administration to identify and verify the income and assets of the taxpayers in question. Accordingly, the tax was calculated, in accordance with the ordinary tax scales, on the annual spending of the taxpayer and his dependants. In practice, this amounts to estimating the annual costs borne by the taxpayer in relation to the standard of living enjoyed by himself and his family (housing, food, leisure, vehicles, travel, etc).

Under the current rules, the basis for the taxpayer's assessment must meet certain requirements in terms of amounts. On the one hand, it must be not less than five times the annual rent, respectively the rental value, of the accommodation occupied by the taxpayer. The classification of the property occupied can thus have a direct impact on his tax bill. On the other, most of the cantons have laid down absolute thresholds denominated in Swiss francs below which a lump-sum rate cannot be fixed, irrespective of the actual spending of the taxpayer. In the canton of Geneva, for example, the lump-sum tax must amount to at least CHF 300 000.

Finally, the assessment of the lump-sum taxpayer may be modified by certain items of income or assets. This applies to all elements of the taxpayer's income or assets originating in Switzerland, as well as to certain foreign sources of income, namely so-called "treaty income". This consists of income for which the taxpayer has sought the application of a double taxation agreement to which Switzerland is party, as well as income from countries which is expressly provided for in the agreement with Switzerland.

2 *Challenges, divisions and economic issues*

Many voices have been raised against lump-sum assessment. Its opponents consider it to be an unjustified privilege granted to certain foreigners. They believe it to be arbitrary and contrary to the principle of equality. Some of them further point to a lack of transparency in the practice of the tax authorities and maintain that the proper conditions are not always met.

The initial breach was opened in Zurich, the first canton to abolish the lump-sum tax at cantonal level in 2009. Since then, Schaffhausen, Appenzell Outer-Rhodes, Basle-City and Basle-County have also voted in favour of abolition. On the other hand, the lump-sum tax has been maintained in the cantons of Saint-Gallen, Thurgau, Lucerne and Berne, though subject to stricter conditions. In Glaris, the population has refused to modify the existing situation.

Other cantons could soon be voting on this subject, including particularly Aargau and Zug. In the canton of Vaud, as the number of signatures needed to validate the popular initiative has not been achieved, a draft bill has been launched in parliament. In Geneva, an initiative was lodged with the Chancellery in January 2012 and the State Council intends to oppose it with a counter bill with a view to retaining the lump-sum tax. An initiative, launched at federal level in April 2011 with the aim of abolishing lump-sum taxation throughout the country, was lodged on 19 October 2012.

Despite these differences, virtually everyone is agreed that a repeal is likely to result in some of the lump-sum taxpayers relocating, either to countries offering a more advantageous tax regime or even to other cantons with particularly low rates of ordinary taxation. The situation is obviously not the same for all of the cantons. To date, the two cantons and the three half-cantons which have abolished lump-sum taxation account for no more than 250 individuals. The majority of the beneficiaries used to live in Zurich and it is estimated that around half of them decided to move out before the end of the year following the vote. However, three quarters of the 5 500 lump-sum taxpayers in Switzerland – i.e. more than 4 000 taxpayers – are concentrated in just four cantons: Vaud, Valais, Ticino and Geneva. The economic impact is thus very different for these cantons which have so far maintained this type of taxation. Moreover, it can be seen that the practice of the tax authorities in these regions has been tightened up, probably with the aim of preserving the tax. For example, the tax authorities in Vaud do not permit lump-sum taxpayers to engage in any gainful activity, whether in Switzerland or abroad. As far as Geneva is concerned, the authorities require any application for lump-sum tax assessment to be accompanied by a fairly detailed questionnaire concerning the fulfilment of the conditions for granting, the family situation of the applicant, his sources of income, his assets and, finally, a listing of his annual expenditure worldwide. In the canton of Geneva, the average tax base per taxpayer amounts to around CHF 470 000.

Faced with this situation, the Federal Council proposes to maintain lump-sum taxation but to tighten up on the criteria and to harmonise implementation within the cantons. According to the Federal Council, it is essential to ensure that the Swiss financial market remains an attractive place for investors and to preserve the economic benefits of lump-sum taxation, estimated at CHF 668 million in tax receipts in 2010, not to mention around 22 500 full-time jobs that depend on it. Hence, the Federal Council has submitted a draft law to the two houses of the federal parliament, putting forward a series of measures intended to improve the acceptance of lump-sum taxation by the population at large. A new law was passed on 28 September 2012 and has not been the subject of a referendum. These new measures will apply as from 2016.

3 *Proposals of the Federal Council*

The measures proposed by the Federal Council, which have been widely adopted by the new law, pursue a number of lines of attack. They are intended first of all to ensure a minimum level of assessment for lump-sum taxpayers by raising their spending threshold.

The new law provides, first of all, that expenditure cannot be less than seven times the amount of the rent or, as applicable, the rental value of the taxpayer's home, as against the existing five times. In addition, a new minimum threshold for spending, has been fixed at CHF 400 000 as far as direct federal tax is concerned. The cantons in turn will be obliged to specify a minimum lump-sum of their choice, which could take into consideration their specific characteristics. The cantons of Lucerne and Saint-Gallen have already instituted a minimum threshold of CHF 600 000. In Geneva, it is expected that the cantonal draft bill will be in line with the federal position. The new law further specifies that the tax base consists of total overall spending, in conformity with the practice of the federal tax authorities, and that it will not be limited to spending in Switzerland.

The new law further provides that cantonal taxation will also cover wealth tax. Here too, the cantons are free to define the way in which they want to proceed. But in its message the Federal Council has put forward a number of suggestions, such as an appropriate increase in the amount of the lump-sum or the calculation of wealth tax on the basis of the lump-sum. The trend becoming apparent in a number of cantons is for the lump-sum to be multiplied by twenty in order to arrive at the amount of the taxable assets. For example, with a lump-sum of CHF 400 000, the taxable wealth would then amount to CHF 8 million, that would be liable to the ordinary scale for wealth tax, which can be as high as 1% depending on the canton.

It is also proposed to restrict access to lump-sum taxation exclusively to foreign nationals. Swiss citizens will no longer be able to enjoy the benefit of lump-sum assessment for the first year of their taking up domicile. This modification seems minor, given that this case would appear to be very rare in practice at the present time.

Finally, for couples, each spouse will have to fulfil the conditions for the granting of lump-sum assessment. This solution will no longer be possible if one of the spouses has Swiss nationality. This means that the solution of a "mixed lump-sum assessment" – whereby one spouse is assessed on a lump-sum basis and the other according to the ordinary regime – would in principle not be compatible with the new law.

4 *Prospects*

According to the Federal Council, the proposed adjustment is more in line with the principle of equity, while preserving the attractiveness of the Swiss financial market in the eyes of taxpayers assessed on a lump-sum basis. As far as the Confederation is concerned, its tax receipts could double. The entry into force of these measures is based on a two-stage timetable aimed at applying the new law simultaneously at the cantonal and federal levels as from 2016. The cantons will have a period of two years from 1 January 2014 to adapt their legislation, while at the level of federal tax the new measures will take effect on 1 January 2016.

As for the federal initiative which was lodged on 19 October 2012, it has satisfied the formal requirements, as the signatures collected have been validated by the Federal Chancellery. The people will therefore have to make a choice between outright abolition or a tightening of the conditions for granting lump-sum assessment and an increase in minimum expenditure as provided for by the new law. While it is obviously impossible to predict the outcome of the vote, it is interesting to note that the new law is consistent with the harder line observed in the cantons which preferred the tightening up of lump-sum assessment. If the people were to vote in favour of this second option, taxpayers already assessed on a lump-sum basis at the time the new law comes into force will be able to benefit from a transition period during which the existing conditions will be maintained. The transition period has finally been fixed at five years, which should give the taxpayers affected enough time to adapt to this new situation.

In this environment, it seems wise for any person taxed according to the lump-sum regime to review his/her personal tax situation without delay in the light of the current legislative developments. For persons envisaging taking up residence in Switzerland, an in-depth analysis appears to be absolutely essential, while keeping in mind that the sequence of events could be decisive. ■

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