

# Tax-advantaged residence, lump-sum taxation and the use of pre-immigration trusts in Switzerland

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*Few would deny the benefits of living in Switzerland. The affluent can arrange their affairs to achieve fiscal advantages through a unique lump-sum taxation regime or the establishment of pre-immigration trusts, and EU citizens can more easily move to Switzerland now thanks to recent changes in Swiss immigration law. This article looks at these and other practical aspects of changing one's residence to Switzerland.*

Switzerland is certainly one of the most attractive countries in the world in which to live. Its political and economic stability, combined with excellent communications and transport links, efficient public services, low tax rates and many more advantages make it the ultimate choice for business and residence. Interesting tax planning opportunities are offered by recent changes in Swiss immigration law in conjunction with the unique preferential lump-sum taxation regime available to foreigners who are not gainfully occupied in Switzerland. This makes Switzerland even more attractive as a place of residence, particularly for wealthy EU citizens. Due to the absence of clear rules regarding the legal recognition and taxation of trusts, the use of trusts in the context of pre-immigration tax and estate planning offers interesting possibilities but depends considerably on whether a favourable tax ruling can be obtained from the cantonal tax authorities where the client wishes to reside. Nevertheless, also in this regard Switzerland offers interesting planning opportunities and considerable flexibility for wealthy individuals and families who wish to make Switzerland their home.

## Lump-sum taxation and residence in Switzerland

Foreigners who fulfil certain requirements can avail themselves of a special tax arrangement, often referred to as lump-sum taxation (*forfait fiscal* in French, *Pauschalbesteuerung* in German), whereby Swiss taxes are levied on the basis of expenditures and standard of living in Switzerland rather than on the usual worldwide income and assets.

Swiss tax law requires that a foreigner wishing to benefit from this special tax regime must not have been resident in Switzerland during the last 10 years. Moreover, he or she may not carry out a gainful occupation. Indeed, the lump-sum taxation provisions are aimed specifically at financially independent persons who are not seeking employment in Switzerland. The tax

regulations specify no age requirements or similar restrictions.

However, all foreigners who wish to become resident in Switzerland must, of course, obtain a residence permit under one of the categories provided for by Swiss immigration law. Permits may be issued to foreigners who do not intend to carry on a gainful occupation in Switzerland. In general, retired persons may obtain a residence permit only if they are over 55 years of age, can demonstrate close ties to Switzerland and show that they have sufficient financial means. The key condition here is the minimum age of 55 years, which appears to exclude the possibility of a lump-sum arrangement for younger persons, unless they qualified under special provisions. These are, however, applied very rarely, for instance in the case of celebrities or where it is in the national interest to grant a residence permit to a particular person.

Despite these restrictive regulations, foreigners who do not meet the age requirement under the retired persons category may still obtain a residence permit and benefit from the lump-sum taxation arrangements in some cantons. Provided they agree to pay a certain minimum in annual taxes, which is generally higher than for persons over 55 years of age and which again varies from canton to canton, they may obtain a permit by establishing a company in that canton and receiving a residence permit under the annual cantonal residence permit quota. The cantonal tax authorities will then still qualify them as not pursuing a gainful occupation and thus agree to apply the lump-sum tax regime. While this is possible in some cantons, others do not allow financially independent persons under 55 years of age to obtain a residence permit while at the same time benefiting from a lump-sum tax arrangement.

The changes in Swiss immigration law and regulations resulting from the Agreement on the Free Movement of Persons between Switzerland and the European Union,

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## How the lump-sum tax is calculated

The hypothetical taxable income is based on the rental payments (or the rental value of the apartment or house) in Switzerland, and therefore bears no relation to actual worldwide income or assets. Suppose the annual rental value of your apartment in Switzerland is CHF 50,000. The taxable income is then calculated as five times the annual rent, which amounts to CHF 250,000. This amount serves as the hypothetical annual income on which the normal tax rates apply, which of course vary depending on the canton as well as the commune in which you live. On an income of CHF 250,000, you may expect to pay approximately 40 per cent in taxes, which amounts to a total annual income tax bill of about CHF 100,000, on top of social security contributions. In addition to this calculation for income tax, five times the annual rental value will be capitalised to calculate the taxable hypothetical net wealth on which the cantonal net wealth tax is applied, which would amount to a total wealth tax bill of about CHF 20,000. These two calculated amounts added together will then yield the lump-sum tax payable to the tax authorities and represent your total tax liability, regardless of your worldwide income and assets. If you rent or own a large property in Switzerland, its rental value will be higher and your total annual tax bill will consequently be higher as well.

Just as under ordinary taxation, with a lump-sum taxation arrangement the overall tax rate also depends on the actual place of residence, and there are considerable differences between cantons and even between individual communes. Moreover, other income elements must also be considered when calculating the total tax liability, namely whether assets or sources of income are located in Switzerland or if it is of interest to the taxpayer to claim tax treaty relief under one of the double tax treaties concluded by Switzerland. If the tax on such income exceeds the tax on the lump-sum amount agreed with the tax authorities, then the income tax for the respective year will be levied on the higher amount. Income from all other sources is not relevant and does not therefore have to be disclosed to the Swiss tax authorities.

## Acquisition of Swiss real estate

Swiss real estate has been in high demand by foreigners for a long time. As a result, Switzerland has restricted the right of such acquisition for decades. It is even widely believed that foreigners are not permitted to purchase Swiss real estate. In principle, however, all foreigners who wish to acquire Swiss residential real estate must obtain approval prior to their purchase, which will otherwise be invalid. Such approval is difficult to obtain. A foreigner may be authorised to purchase a holiday home in a place designated by the respective cantonal authorities as a holiday resort. But every authorisation must be deducted from the annual quota assigned to the cantons by the Federal government for holiday homes and hotel condominium units. The cantons and communes may also apply their own restrictions, which may be even more stringent. Holiday homes and hotel condominium units may only be acquired by physical persons under their own name, and under no circumstances by a company. These restrictions also mean that tax and estate planning options with regard to Swiss holiday homes owned by foreigners are very limited.

However, foreigners who hold a Swiss residence permit can now acquire real estate easily and without restrictions. Since 1997, foreigners holding a Swiss residence permit may purchase a reasonably sized house or apartment for their personal use with no further need to seek prior approval. Even if a foreigner subsequently leaves the country, he or she is not forced to sell again and can therefore keep their property. As financially independent EU citizens are easily able to obtain a Swiss residence permit, they also gain the right to acquire Swiss residential real estate for their own personal use.

While these provisions concern only residential real estate, the acquisition and holding of purely commercial real estate by foreigners or foreign entities is no longer restricted in Switzerland. As a result, there is again ample scope for tax planning by foreigners and foreign entities wishing to invest in Swiss commercial real estate.

which came into effect on 1st June 2002, have removed the restrictions imposed by Swiss immigration law on residence permits for financially independent EU citizens. As the lump-sum taxation regime remains unaffected by these changes, it will be possible for all EU citizens who can show sufficient financial means to become resident and benefit from lump-sum taxation in all cantons throughout Switzerland.

## EU citizens can now easily benefit from lump-sum taxation

The combination of the new immigration rules for financially independent EU citizens and the unchanged lump-sum taxation regime means unrestricted access to Switzerland for EU citizens, while giving them the option of benefiting from lump-sum tax arrangements anywhere in the country, regardless of the canton in which they wish to settle.

Under the lump sum taxation regime, the Swiss tax authorities generally require the assessment of a minimum taxable income that amounts to at least five times the annual rental payments for the apartment or house in which the foreigner will reside in Switzerland. In case of owned real estate, the annual rental value is taken as the basis for this calculation. An important aspect of the lump-sum taxation regime is also that if taxed on this basis, you are not asked to declare your worldwide income or assets, which offers wealthy individuals considerable privacy with regards to their financial affairs. The amount of tax effectively payable, however, must exceed the income tax that would be due on certain expenses in Switzerland. It must also exceed the tax that would be due on Swiss-source income as well as income for which a partial or total reduction of foreign taxes is requested by virtue of an international tax treaty.

## The modified lump-sum tax

In several double taxation agreements concluded by Switzerland, including the treaties with Belgium, France and Germany, it has been agreed to limit treaty benefits to foreign-source income which is taxed in Switzerland at the regular tax rates. Because these treaty clauses would normally exclude persons who are taxed under a lump-sum arrangement, modified lump-sum taxation has been introduced. Under this regime, the income derived from the respective treaty country will be included in the assessed tax base. In order for the tax authorities to determine the correct tax rates at which the foreign source

income should be taxed, the total worldwide income would have to be taken into account. However, if the worldwide income is not declared, then the highest tax rates apply on the respective foreign-source income for which treaty relief is sought.

### Limited or no gift and inheritance taxes

Besides offering a unique lump-sum taxation regime that effectively caps the income and net wealth tax for qualifying foreigners, Switzerland is also an attractive place of residence with regard to inheritance and gift taxes. The country has no federal inheritance or gift taxes. Instead, the cantons levy inheritance and gift taxes in their own competence, which means that there are 26 different inheritance and gift tax regimes. The Canton of Schwyz, for example, dispenses entirely with inheritance or gift taxes, and many cantons do not levy inheritance taxes between spouses or between parents and children, or levy only a very modest tax of less than 10 per cent for descendants. According to the cantonal inheritance and gift tax laws, the relevant cantons are competent to levy these taxes on real estate situated in the canton and on the worldwide estate of deceased persons or donors who had their last domicile in that canton. Where inheritance and gift taxes apply, there is usually a progressive scale depending on the relationship and size of the donated property or estate. The highest tax rates apply to gifts and inheritances between persons who are not related to each other and in such cases tax rates may reach up to about 50 per cent in certain cantons. So it is also important to pay attention to the applicable cantonal gift and estate taxes when choosing one's place of residence in Switzerland. The absence of inheritance and gift taxes, or the very low tax rates, naturally provide interesting possibilities for succession planning. Besides this scope for tax planning, Swiss international private law also allows foreigners who live in Switzerland to choose whether to apply the inheritance law of Switzerland or of their country of origin, a situation that offers further flexibility for estate planning.

### Trusts in Switzerland and the use of pre-immigration trusts

Because Switzerland is a civil-law country, trusts are practically unknown in Swiss law, which provides for fiduciary agreements and foundations, but not for trust arrangements. As a result, considerable legal uncertainty surrounds foreign trusts with some connection to Switzerland, for instance in the form of a Swiss trustee, trust assets located in Switzerland, Swiss resident beneficiaries or settlors. This uncertainty exists both with respect to the legal recognition and the taxation of trusts.

Nevertheless, because Switzerland is one of the most important private banking centres in the world, trusts are well known to Swiss bankers, fiduciaries and lawyers who service international private clients and they have been in use in Switzerland for quite a long time. Even the Swiss tax authorities have become familiar with trusts and several cantons have established principles for the tax rules to be applied to trusts linked to Switzerland. As an increasing number of wealthy foreigners are moving their residence to Switzerland, particular questions have arisen with regard to the treatment of trusts which they had established prior to settling in the country, or trusts established while they are resident in Switzerland.

Essentially, two issues need to be considered. The first relates to the legal recognition of trusts. It has been suggested that Switzerland should ratify the Hague Convention on the law applicable to trusts and their recognition, even though such a step would not address fully the many legal uncertainties existing for trusts with a Swiss connection. Although the Swiss government commissioned a report, which was published early in 2001, on whether or not Switzerland should join the Convention, the Swiss Government has shown little interest in proceeding further. In the meantime, lawyers and courts - as well as persons involved in trusts - have to live with the fact that trusts are, in principle, not recognised in Switzerland.

The second issue relates to the tax treatment of trusts. The tax authorities in a number of cantons, for example Zurich and Vaud, have developed principles on how they tax trusts and the persons involved in trust arrangements, such as beneficiaries, settlors and trustees. However, these principles are not consistent and considerable differences exist throughout Switzerland with regard to the tax treatment of trusts. Great care must therefore be taken in drafting the trust deed before a trust with a Swiss connection is established, or before a foreign national moves to Switzerland if he or she is in some way connected to a trust, for example as a settlor or beneficiary. In most cases it is also essential to discuss and obtain a tax ruling from the competent tax authorities in the locality where the person concerned intends to reside.

### Tax rulings are essential with regard to trusts

Not only does Swiss law give no legal recognition to trusts, it also fails to stipulate any clear taxation rules for them, so that their tax treatment is uncertain. Consequently, trusts are liable to general taxation rules, which can lead to inappropriate results, and as these rules

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differ between cantons, a wide range of different scenarios exists with regard to the taxation of trusts. The creation of a trust may lead to gift and estate taxes, which could, in certain situations, be levied again later upon distribution. Wealth and income taxes could be levied from the beneficiaries, trustees or settlors, depending on the trust deed and the opinion of the responsible tax authorities. While these uncertainties with regard to the taxation of trusts make it difficult to gain an overview, Switzerland fortunately allows tax scenarios to be submitted to the tax authorities in order to obtain tax rulings. Individuals and families who live outside Switzerland but who intend to establish their residence in Switzerland have a further advantage: the cantonal authorities are usually quite flexible and willing to grant a favourable tax ruling because they are interested in attracting wealthy foreign residents.

These aspects, but also the possibility of lump-sum taxation arrangements and the high degree of privacy and personal security enjoyed by its inhabitants, already make Switzerland the residence of choice of many

wealthy retirees and international celebrities. In the future, the liberalisation of the Swiss immigration regulations for EU citizens will make Switzerland an even more attractive place of residence for financially independent persons from all over the European Union who wish to relocate to a milder tax climate.

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Tax rulings may be obtained easily

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