**Expenditure-based taxation**

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Introduction

For over a century, Switzerland has used a system of expenditure-based taxation – also known as lump-sum taxation – which allows foreign nationals not engaged in gainful activity in Switzerland to be taxed not on the basis of their income and wealth but on their expenditure.

This system – largely supported by the Swiss people who rejected an initiative aiming to abolish it by a majority of 60% on 30 November 2014 – underwent major reform on 28 September 2012. This resulted in this tax being enshrined in Swiss legislation on a long-term basis.

The conditions

To be eligible for expenditure-based taxation, the taxpayer is required to fulfil the following conditions:

1. They must not be a Swiss national. This requirement excludes as potential beneficiaries: Swiss citizens; foreign nationals having opted for lump-sum taxation who acquire Swiss nationality; a person having dual citizenship who is a Swiss citizen and also a citizen of another country; couples in a common household in which one partner is Swiss and the other is a foreign national.
2. They must have an unrestricted right to remain in Switzerland granted either for the first time or after an absence of ten years or longer. This rule brings with it a two-fold requirement. First of all, the taxpayer must have an unrestricted right to remain in Switzerland (which in practice means they must be resident there) and must, therefore, be in possession of a residence permit. Secondly, the legislation requires the taxpayer to have an unrestricted right to remain in Switzerland either for the first time, or following an absence of ten years or more.
3. The taxpayer must not conduct any gainful activity in Switzerland.

How the tax is calculated

As a guiding principle, both direct federal tax and cantonal tax (including communal tax) are calculated based on the taxpayer’s annual expenditure. To determine a basic threshold, and, by extension, the total payable tax, a distinction should be made between the requirements set out by the Federal Act of 14 December 1990 on Direct Federal Taxation (DFTA), which relate only to income tax, and those set out by the Federal Act of 14 December 1990 on the Harmonisation of Direct Taxation at Cantonal and Communal Levels (DTHA), which relate to income tax as well as wealth tax.

According to DFTA, direct federal tax which replaces income tax should be calculated based on the taxpayer’s total annual expenditure, which should not be less than the highest of the following amounts:

1. CHF 400,000.
2. For taxpayers who are the head of a household, seven times the annual rent paid or rental value of a property, and, for other taxpayers, three times the annual expenditure on accommodation and food.
3. The revenue taken into consideration as part of the control calculation.

Cantonal tax which replaces income tax should be calculated based on the taxpayer’s total annual expenditure, and should not be less than the highest of the following amounts:

1. A sum determined by individual cantons, and which stands as follows in the French-speaking cantons: Bern, Geneva and Neuchâtel: CHF 400,000; Vaud: roughly CHF 360,000; Fribourg and Valais: CHF 250,000; Jura: CHF 200,000 Readers should note that higher amounts may be applicable to non-European nationals.
2. For taxpayers who are the head of a household, seven times the annual rent paid or rental value of a property, and, for other taxpayers, three times the annual expenditure on accommodation and food.

Once this amount has been calculated, the amount of cantonal tax intended to cover wealth tax will need to be added. The two amounts together will constitute the amount of expenditure-based taxation due. Each canton is free to tax flat-rate taxpayers’ assets as it wishes. For example, the cantons of Vaud and Geneva have opted for a solution which involves increasing the taxpayer’s total expenditure by 10%. Thus, if somebody taxed based on expenditure rents an apartment in the cantons of Vaud or Geneva for a monthly sum of CHF 6,000, they will be taxed on minimum expenditure of CHF 504,000 (CHF 6,000 x 12 x 7), an amount which is increased by 10% as a basis for cantonal wealth tax.

Once the tax has been calculated, based on the principles outlined above and using the standard tax scale, this amount should be compared on a yearly basis with an amount determined as part of a calculation known as the “control calculation”, based on the following elements and with the highest amount being due:

1. Real estate assets situated in Switzerland and revenues thereof;
2. Moveable objects situated in Switzerland and revenues thereof;
3. Movable capital situated in Switzerland including debts secured by the pledge of a property and the revenues thereof;
4. Copyrights, patents and similar rights being used in Switzerland and the revenues thereof;
5. Pensions, unearned income and annuities from Swiss sources;
6. Revenues for which the taxpayer requires either temporary or full foreign tax relief under a double taxation treaty entered into by Switzerland.

Frequently asked questions

We look at questions frequently asked by our clients below:

1. What is meant by “lack of gainful activity” in Switzerland?

In theory, this means that taxpayers subject to expenditure-based taxation may not exercise any gainful activity on Swiss soil, whether as the employee of a Swiss or foreign company, or in a self-employed capacity. They may, however, carry out non-remunerated activity in Switzerland or abroad, as well as any kind of gainful activity outside of Switzerland, whether as an employee or self-employed. However, we wish to draw readers’ attention to the fact that the cantonal tax authorities are becoming increasingly restrictive in their interpretation of this requirement. In particular, some cantons deem that flat-rate taxpayers can only perform a non-operational activity abroad and cannot hold various functions in Switzerland, even without payment, such as the director of a Swiss joint stock company. Flat-rate taxpayers are nevertheless entitled to invest their assets in Switzerland or abroad. If the investment takes place in Switzerland, its value, as well as the revenue generated from it, are taken into account in the above-mentioned control calculation.

1. What does “moveable capital situated in Switzerland and the revenues thereof” mean in the context of the control calculation?

This principle by no means prevents flat-rate taxpayers from having their wealth held and managed by a bank based in Switzerland. The connecting factor is not the currency in which the assets are held or invested but only the headquarters of the debtor company against which the person subject to expenditure-based taxation has a claim. If it is in Switzerland, the amount of the debt and its revenue are included in the control calculation. On a practical level, debts and revenue taken into account are the following:

* Bonds issued in any currency by an issuer based in Switzerland and associated interest.
* Shares in a Swiss company and associated dividends.
* Cash deposits in any currency in a bank with its headquarters in Switzerland (for example, EUR 500,000 in a savings account).

However, the following are not relevant for the purposes of the control calculation:

* Bonds issued in Swiss francs by a foreign issuer.
* Swiss shares and bonds held by a foreign investment fund.
* Swiss francs held by a foreign monetary fund.
* Bonds in Swiss francs issued by a foreign issuer and associated interest.
* Escrow payments in Swiss francs or a foreign currency sent by a Swiss bank to a foreign bank.
1. What are the consequences for flat-rate taxpayers if they purchase a secondary residence in Switzerland or if they invest in real estate on Swiss soil?

Generally, if taxpayers buy real estate in the canton where they are domiciled, its value and revenues are included in the control calculation. However, if the real estate is located in another canton, the control calculation will not be carried out but the owner will be taxed in the other canton based on the value and revenues of the real estate.

If flat-rate taxpayers buy a secondary residence, the tax authority generally takes it into account to determine their minimum level of expenditure. However, if it is an investment, and more specifically a real estate development, it is vital that the person taxed based on expenditure restricts their role to that of investor so that the tax authority does not deem them to be performing a gainful activity in Switzerland.

1. How important is it for flat-rate taxpayers to take advantage of the double taxation treaties concluded by Switzerland?

Taking advantage of the double taxation treaties concluded by Switzerland, especially those with the taxpayer's former country of domicile, presents two-fold benefits. Firstly, the tax levied at source in the other country can be fully or partially reclaimed depending upon the circumstances. Secondly – and most importantly – it allows them to benefit from the criteria set out in the treaty enabling the taxpayer’s place of domicile to be determined which are usually more favourable than those applied by national law.

Many treaties do not stipulate any particular requirement in order for persons subject to expenditure-based taxation in Switzerland to benefit from them. The application of the treaty concluded with France is problematic because, since 1 January 2013, France has deemed that flat-rate taxpayers can no longer benefit from it while Switzerland maintains the exact opposite position. It is vital that the governments of these two states put an end to this legal uncertainty. In our view, the French position is completely unsustainable and erroneous. However, special attention must be paid to the treaties signed by Switzerland with Germany, Austria, Belgium, Canada, the USA, Italy and Norway. In accordance with these treaties, flat-rate taxpayers wishing to benefit from them must be taxed in Switzerland at the normal rate on all income from one of these states as the treaty in question stipulates that such income must be taxed in Switzerland. For example, the dividends paid by a Belgian company must be taxed in Switzerland in contrast to director’s fees as the treaty between Belgium and Switzerland stipulates that the former are taxable in Switzerland while the latter are taxable in Belgium. It should be noted that this income is included in the control calculation and is subject to the same regulations.

Conclusion

Two conclusions can be drawn from the above.

Firstly, after several years of instability, the expenditure-based tax system has been placed on a long-term footing both at a legal and political level by the reform of 28 September 2012 and by the Swiss people’s decision to reject the “End tax breaks for millionaires (Abolition of lump-sum taxation)” initiative by a strong majority on 30 November 2014.

Secondly, even though this form of taxation has the great benefit of simplicity, it is nevertheless vital to adhere to certain provisions which are being controlled increasingly rigorously by the cantonal tax authorities.