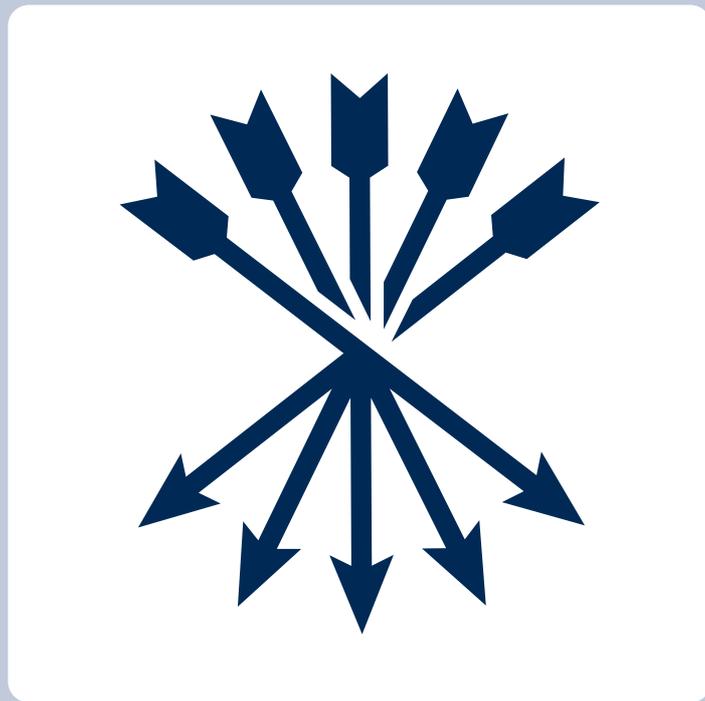


Rothschild Trust

Review



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Welcome to the sixteenth edition of the Rothschild Trust Review which again contains an interesting mix of reviews on international trust, taxation, estate planning, matrimonial issues and related matters.

There are articles on how to live in Spain and Switzerland on a tax efficient basis and others on important technical developments and ideas relating to New Zealand, Bermuda and Guernsey for assistance of financial planners. Also we have included a focus on India for the first time. Private trust companies are now very much in vogue and readers will find an objective assessment on their pros and cons. By way of balance, we have also included an article on big money divorce cases where the disputed assets are held in the Bermuda trust.

Finally, in acknowledgement of the significant increase in trust litigation (both domestic and international), this edition includes a review of some recent cases in the Channel Islands and the UK.

David Harris

New Court, February 2008

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Expenditure Taxation in Switzerland



Oliver Arter
Froriep Renggli

Oliver Arter explains the basis for living in Switzerland subject only to a modest tax regime based upon living expenses in Switzerland.

Nature of Expenditure Taxation

Under certain conditions, Swiss tax law offers the taxpayer the possibility to opt for so-called taxation according to expenditure, also referred to as expenditure taxation or lump-sum taxation, instead of the ordinary income or wealth (net worth) taxation. Expenditure taxation is levied not on the taxpayer's income and assets but on living expenses in Switzerland. The main advantage of this type of taxation is that the basis of assessment diminishes as a consequence of the ordinary tax rate only being applied to a portion of the taxpayer's worldwide income and assets. The result is a regular and significant reduction in the individual tax burden.

Taxation based on expenditure involves a simplified assessment procedure. The tax authorities base their assessment on criteria as set out below and carry out a control valuation (*Kontrollrechnung*) on the basis of domestic source income and domestic assets.

Applicable Statutory Basis

Switzerland is a confederation of 26 cantons with about 3'000 municipalities. Taxes are levied not only by the Federation but also at the cantonal and municipal level. Article 6 of the Federal Law on the Harmonisation of Direct Cantonal and Communal Taxes (hereinafter "StHG") obliges cantons to accord natural persons the right, in certain circumstances, to pay tax according to

expenditure instead of income or wealth tax. An essentially identical provision exists at the federal level under Article 14 of the Direct Federal Tax Act (hereinafter "DBG"), which provides for the possibility of taxation based on expenditure under certain conditions. To further specify the details and conditions governing expenditure taxation in relation to direct federal tax, the Federal Council issued a corresponding implementing decree on 15 March 1993 (hereinafter "Decree")¹. Therefore, taxation according to expenditure is provided for by statute at the federal and cantonal/municipal levels.

Conditions for Expenditure Taxation

General remarks

If a person meets all the conditions for expenditure taxation, they have a legal right to be taxed accordingly. The competent tax authorities do not have any discretion in this respect. However, if the conditions are not wholly met, expenditure taxation is not possible. Expenditure taxation is available *only to natural persons*. The lump-sum taxation of legal persons is not provided for. In order to fall under Switzerland's tax regime, individuals wishing to be taxed according to their living expenses must furthermore *acquire tax domicile or residence status in Switzerland*. Expenditure taxation is only available to persons taking up domicile or residence in Switzerland *for the first time or following a ten year absence*.

No professional activity on Swiss soil

The key requirement for the permissibility of expenditure taxation is that the taxable person does not engage in any gainful occupation. Gainful occupation is any main



activity or part-time occupation that is exercised for the purpose of earning an income, whether in an independent capacity or as an employee. The activity must be remunerated to qualify as gainful. There must be a pecuniary gain. This is lacking if a wage is to be qualified as compensation for costs or in the case of work performed in a wholly voluntary capacity. The concept of gainful occupation further includes a quantitative aspect – a few business calls made from a private domicile in Switzerland do not suffice.

According to the case law of the high courts, the applicant must *not be engaged in any professional activity on Swiss soil*, that is to say within the geographical area of Switzerland. This means that a taxpayer applying for expenditure taxation may not physically engage in gainful activity in Switzerland. It is immaterial whether or not the professional activity is related to the Swiss economy. The whereabouts of the domicile/registered office of the employer or the “value” assigned to the work are equally of no importance. The decisive criterion is physical presence. In contrast, *gainful employment abroad does not preclude taxation according to expenditure*, irrespective of whether the employer is foreign or Swiss.

The absence of a gainful occupation has further implications outside tax law: Non-EU/EFTA foreign nationals under 55 years of age are granted a regular residence permit only if they are eligible for a work permit. This is somewhat in contradiction to expenditure taxation requirements. In practice however it is possible to circumvent this discrepancy by, for example, taking up employment in Switzerland with a newly formed company which carries out all its activities exclusively abroad. This type of gainful occupation, which is not physically carried on in Switzerland, is not incompatible with expenditure taxation.

Basis of assessment

The basis of assessment for expenditure taxation is the *living expenditure of the taxpayer and the taxpayer’s family members*. For expenditure taxation purposes, family membership is not based on family relationships. To

qualify, a person must be a dependent of the taxpayer and live in Switzerland. Thus any person residing in the family circle of the taxpayer is considered a relevant family member, not only spouse and children.

The aggregate amount of the annual living expenses paid by the taxpayer for himself or herself and the persons mentioned above qualifies as taxable expenditure. Living expenditure comprises all of the following:

- subsistence and clothing expenses;
- accommodation expenses, including expenses for heating, cleaning, garden maintenance, etc;
- all expenses (cash remuneration and benefits in kind) for the taxpayer’s staff;
- expenditure on education, entertainment, sport, etc;
- expenses for travelling, holidays, health cures, etc;
- upkeep costs of expensive domestic animals (riding horses, etc);
- maintenance and operating costs of automobiles, motorboats, yachts, planes, etc;
- all other living costs, including direct taxes.

Out-of-pocket living expenses of the spouse and dependent children, provided they live in Switzerland

The Decree of the Federal Council on Expenditure Taxation provides for further conditions in relation to direct taxes. The total calculated living expenses must meet a *minimum aggregate expenditure level*. Pursuant to Article 1 para 1 of this decree, the *total living expenditure must be equivalent to at least five times the rent or the rental value of the lived-in area of a house owned and occupied by the taxpayer*. In all other cases living costs must be at least double the board and lodging expenditure. At the cantonal level there are some variations regarding this minimum requirement – the majority of cantons follow the requirements imposed in relation to federal direct tax.

So, the taxpayer must submit two amounts for every tax period for the purpose of determining the basis of assessment: the actual annual living expenditure and the rent, rental value or annual board and lodging



expenditure, multiplied by the relevant factor. Subject to verification that it complies with the required minimum value, the result shall constitute the assessment basis.

Control valuation and Tax Rate

According to express statutory regulation, the assessment basis is subject to a control valuation. *The expenditure tax is set against the taxable amount normally due under ordinary taxation on source income and – at the cantonal level – domestic assets.* Where a person is entitled to relief under a double taxation treaty, the foreign source income and asset values are included in this calculation. The expenditure tax must not be less than the tax that would normally be chargeable on the gross aggregate of these elements as computed by reference to the ordinary rate. If it drops below this value, the expenditure tax is levied on the basis of the control valuation result. The following has to be taken into consideration:

- Immovable assets located in Switzerland;
- Chattels located in Switzerland;
- Moveable financial assets located in Switzerland, including income from mortgage notes (e. g. bonds, serial bonds, serial annuities and debt ledger entries issued or recorded by a local, shares, participations in limited liability companies, participations in corporations, participation certificates and profit-sharing certificates issued by a local, shares in investment funds or similar shares issued by a local or by a local acting together with a foreigner, client assets with local banks and savings banks);
- Copyrights, patents and similar rights exploited in Switzerland;
- Retirement benefits, annuities and pensions from Swiss sources;
- Income on which the taxpayer claims full or partial relief in respect of foreign tax under a double taxation agreement concluded by Switzerland.

The main advantage of this type of taxation is that the basis of assessment diminishes as a consequence of the

ordinary tax rate only being applied to a portion of the taxpayer's worldwide income and assets. The result is a *regular and significant reduction in the individual tax burden.*

Modified expenditure taxation

Some of the double taxation agreements concluded by Switzerland raise particular problems in respect of expenditure taxation. Since the 1970s, certain treaty partners have no longer recognised a taxpayer who is taxed according to expenditure as being “resident” in Switzerland for tax purposes. Under agreements with Belgium, France, Germany, Italy, Norway, Austria, Canada and the USA, relief is available only to persons residing in Switzerland who are subject to the federal, cantonal and communal direct taxes in respect of all income accruing in these countries that is taxable under Swiss law. In all other cases these persons do not qualify as having tax resident status in Switzerland. These treaty provisions rule out all protection under the double taxation treaty and the taxpayer can claim neither full nor partial relief in respect of foreign source tax. A taxpayer who is taxed according to living expenditure and claims relief under one of the treaties mentioned above is, therefore, treated as being subject to ordinary taxation in respect of income accruing in the relevant treaty country.

The consequences in respect of the relevant tax calculation are the following: first, the assessment basis is established according to living expenditure. The control valuation must then be “extended” to include any other income subject to Swiss taxation according to the relevant double tax treaty and liable for tax under Swiss law. Here the taxpayer may differentiate between income accruing in different countries, but not between income accruing in the same country. Finally, the higher of the two assessment bases is applied. This allows for income accruing in a double tax treaty country to be subject to ordinary taxation and thus for taxpayers to make use of relief under the relevant double tax treaty.



Procedure

The assessment procedure is carried out in accordance with general procedural rules. A special tax return form should be completed. Where applicable, the taxpayer must submit a formal table of securities held to make sure they can reclaim tax withheld in the country of source. Living costs should be stated on the form, as well as Swiss source income and domestic assets for control valuation purposes. Foreign income should only be declared in the cases described above. Ultimately, it is the taxpayer's responsibility to prove that all requirements for expenditure taxation are met.

Before the start of every tax period, the tax authority must have the necessary assurance that the taxpayer is entitled to expenditure taxation and, in particular, that the necessary information and evidence has been provided as required. Data related to living expenditure and data required for the control verification must be available. In particular, foreign source income must, where applicable, be fully documented, insofar as this information is not apparent from relief claims. Before an enforceable valuation is made, clarification must be sought as to whether or not and to what extent the

taxpayer wants to make use of the advantages under a double taxation agreement.

Summary

For decades, expenditure taxation has been firmly anchored in the Swiss tax landscape. It offers taxpayers the possibility under certain conditions of being taxed on living expenditure incurred in Switzerland by themselves and their dependents in Switzerland, instead of an income and assets as would normally be the case under ordinary taxation. The minimum requirement is that these costs equal at least five times the annual rent or rental value, or, where the taxpayer neither owns nor rents property to live in, double the board and lodging costs. These living costs are then compared against Swiss source income and domestic assets for control valuation purposes, with the higher result constituting the assessment basis. Peculiarities arise where a taxpayer claims relief from tax on foreign source income under a double taxation treaty.

Footnotes:

1. Expenditure taxation decree in respect of federal tax of 15.3.1993, SR 642.123 (henceforth Decree of the Federal Council on Expenditure Taxation).





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**Oliver Arter, Consultant, Attorney at law, Bellerivestrasse 201,
8034 Zurich, Switzerland, Tel.: 0041 44 386 6000.**