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NEWSLETTER N°6

Editorial

The real-estate company – which is nothing other than a joint-stock company that owns a piece of real estate – has for several decades been a vehicle for purchasing or owning property. It has been widespread in Geneva and also, to a lesser extent, in other French-speaking cantons. It is true that the advantages of the system were considerable: anonymity of the "owner-shareholder" and flexible and free-of-charge transfer. Investors at the time – both before and after the war – were probably seeking above all to preserve their capital rather than to earn a return which, in the case of the real-estate company, was quite substantially eroded by double taxation (taxation of the profit made by the real-estate company and then again as the shareholder's dividend income).

The increase in property values – at a time when the historic values on the balance sheets of real-estate companies were intangible – has also gradually complicated and rendered more expensive the financing transactions that the shareholder had to enter into when buying a real-estate company. In short, the advantages have lost some of their relative value compared with the disadvantages, and investors are attaching increasing importance to cash flow and no longer merely the hope of a capital gain. The result is that this form of indirect property ownership has become rarer in recent years (partly due to a temporary tax incentive to liquidate these companies).

Quite apart from the real-estate company's current "bad reputation", we thought it would be interesting to conduct an objective and factual comparison of direct real-estate ownership (in a person's name) and ownership through a real-estate company, on the basis of the present tax situation, while emphasizing that the latter has changed in 2009 at the federal level as well as at the level of the cantons of Geneva and Vaud; there has been a marked reduction of the cost of double taxation that characterizes the real-estate company (we will have an opportunity to come back to the topic in a future newsletter).

Thierry Barbier-Mueller
Chief Executive Officer of the SPG Group

Fiscal comparison between acquisition of a property in one's own name and purchase of shares in a real-estate company*

In order to encourage the liquidation of real-estate companies, the federal authorities and certain cantonal authorities, including those of Geneva, had decided to temporarily grant tax relief in favour of real-estate companies and their shareholders until December 31, 2003 in the event of liquidation. Many real-estate owners took this opportunity and thus became the direct owners, in their own name, of their properties. Nevertheless real-estate companies are still present in the market and it is common for a potential owner to wonder about the advantages and disadvantages of buying a property by means of one or other of these forms of purchase.

Our aim here is to give any future property owner the main comparative elements that are necessary to select, from a tax point of view, the option that is best suited to his or her personal situation. We will deal here only with the purchase of a residential property for his/her own use by a private individual subject to the ordinary tax regime. By way of example, we shall take the situation of a Geneva resident who is hesitating between purchasing a property in his/her own name and acquiring it through a real-estate company having a registered office in Geneva. It goes without saying that the information given below is based on current legislation and administrative practice, which are of course liable to change. Some additional individual factors relating to the taxpayer's situation (for example, the location of his/her wealth and whether hisdebts are taken into consideration, the risk of qualifying as a professional real-estate dealer)may have an impact on the choice to be made, so that it will be in the latter's interests to have his or her situation analysed accurately before proceeding to make a purchase.

1 General distinction between direct ownership and ownership through a real-estate company

When purchasing in his own name, the purchaser becomes the direct owner of the property without any intermediate company. As such, he becomes directly liable for all taxes relating to the real estate (income tax, wealth tax, or additional real-estate tax, etc.). On the other hand, when the property is owned through a real-estate company, the purchase relates to the shares of the company, which is in turn the owner of the real estate. Purchase through a real-estate company thus implies the coexistence of two taxpayers: the real-estate company, on the one hand, and its shareholder on the other, who is supposed to be treated in a manner similar to a third party who would rent a property.

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One of the major consequences that result from this is double taxation. This means, in substance, that the income derived from owning the real estate is taxed once in respect of the company (tax on profits), then a secondtime in respect of the shareholder when dividends are paid (income tax). A second significant difference is that in the case of a real-estate company the owner of the real estate remains unchanged and the transfer of a company's shares does not entail the same consequences as a transfer of real estate, as we will see in greater detail below.

2 *At the time of purchasing real estate*

Ownership in one's own name

The purchaser is required to pay a transfer duty, which in Geneva is called a **registration fee**, plus the **fees** of the Land Registry and the notary. These taxes and fees are calculated on the purchase value of the properties, without deduction of any debts (mortgages or unsecured debts). The registration fees on real-estate sales are 3% and the Land Registry fee is 0.3%, which makes a total of 3.3%, not counting the notary's fees which are charged according to a degressive scale.

Ownership through a real-estate company

The purchase of shares of real-estate companies is not subject to transfer duty unless the transfer has been concluded by an authentic deed, which is very rare in practice. Thus provided that the owner of the real estate does not change, it is not necessary to charge Land Registry fees.

3 *While owning real estate*

3.1 Taxation of income

Ownership in one's own name

A person who owns a property in his own name is taxed on the net **rental value** of the real estate. The rental value represents an income in kind equivalent to the right of use of the real estate, which is added to the taxpayer's other taxable incomes. It is therefore taxed at the rate applicable to the entire global income, that is, a maximum of about 45% in Geneva (including federal, cantonal and municipal taxes).

The rental value corresponds to the amount that the owner would have to pay to rent a property of the same kind or to the income that he would be able to earn from letting his property. In order to align the rental value with market conditions, the Geneva tax administration reviewed the parameters for fixing rental value on January 1, 2007. Said value is in principle determined according to a mathematical formula drawn up by the canton, as a function of different objective criteria (living surface area, type of property, amenities, obsolescence and location), thus generally allowing the owner to estimate, at the time of purchase, his future tax situation with a reasonable degree of accuracy.

For cantonal and municipal taxes, the rental value is **reduced** by 4% for each year of occupancy up to a maximum of 40%. Moreover, if this rental value exceeds a rate of 20% of total gross income, it may be reduced, subject to certain conditions.

In return for taxation based on the rental value, a person who owns a property in his own name is authorized to deduct certain expenses, in particular mortgage interest payments and maintenance expenses. As far as mortgage interest is concerned, it is deductible up to the amount of income earned from the person's wealth, increased by CHF 50,000. As for property maintenance expenses, they can be deducted from taxable income, either on a lump-sum basis or on the basis of the actual amounts by producing all the documentary evidence. If the taxpayer opts for deduction of actual expenses, he may then claim principally the operating expenses, expenses of administration by third parties, insurance premiums and certain expenses incurred in order to economize energy consumption or to reduce environmental impact. It should be noted that the above-mentioned deductions are not limited by the amount of the rental value.

Ownership through a real-estate company

On the one hand, the real-estate company is taxed on its net **profit** at the actual rate of about 24% (including federal, cantonal and municipal taxes). This profit comprises mainly the rents collected from the shareholder-tenant, after deduction of the charges. In accordance with the case law of the Swiss Supreme Court (the Bellatrix ruling, ATF 107 IB 325), the real-estate company is required to collect rents that correspond to market prices. If the rents recorded are lower than what would have been agreed between independent third parties, the difference is designated as a benefit that can be determined in pecuniary terms and is reintegrated into its profit before being assessed for withholding tax and being recovered by the shareholder by way of a concealed dividend. Penalties will generally be charged.

Only the net profit is taxable, so that the company may deduct all the expenses that are commercially justified (maintenance expenses, mortgage interest, taxes, etc.). It should be noted in particular that only actual expenses can be taken into consideration and that they must be duly entered in the accounts.

On the other hand, the shareholder is taxed on the **income paid to him by the company**. It may, for example, be interest received when the shareholder has a remunerated, unsecuredclaim against the company. This interest is then added to his other income and taxed at the maximum rate of about 45%, whereas it is deductible in respect of the company. It may also be the case that the company pays a dividend to its shareholder. This dividend will then be given privileged tax treatment in that it will be taxable only at a rate of 60%, at both the federal and the Geneva cantonal and municipal levels (since January 1, 2009).

If the shareholder has gone into debt in order to purchase shares of the real-estate company, he may claim deduction of the interest up to the amount of the income earned from his wealth, plus CHF 50,000 (on the other hand, the company will not be able to offset the shareholder-tenant's financing costs against therent received from the latter). In addition, if the loan is guaranteed by the company (registration of a mortgage loan on the real estate), this guarantee must be remunerated by the shareholder at the market price.

3.2 Taxation of wealth

Ownership in one's own name

The owner is liable for **wealth tax** at only the cantonal and municipal levels on the net fiscal value of the property at the maximum rate of about 1%. The market value is determining. In practice, it is the purchase value of the property that is taken into consideration. The fiscal value may, however, be re-assessed in the future by the tax authority.

As for rental value, the value of the property may be reduced by 4% per year of occupancy up to a maximum of 40%.

Provided that wealth tax relates to the taxpayer's net wealth, mortgage debts may be deducted from it.

Ownership through a real-estate company

First, the real-estate company is liable, at the cantonal and municipal levels, for the **tax on capital**, the actual rate of which is, in principle, about 0.4%. This tax is levied on the company's equity capital (the real estate itself is not taxable).

Second, the shareholder is liable for **wealth tax**, which is a maximum of about 1% (cantonal and municipal tax) of the fiscal value of the shares of the real-estate company. This value is determined according to the market value of the company's net assets. In practice, it concerns mainly the fiscal value of the real estate, without any reduction being allowed. In addition, if the shareholder has an unsecured claim against the company, that claim also forms part of his taxable wealth. On the other hand, debts contracted in order to purchase the shares of the company are deductible.

3.3 Additional real-estate tax

Ownership in one's own name

A person who owns a piece of real estate in his own name has to pay additional real-estate tax, which amounts to 0.1% of the gross value of the real estate, without any reduction. The additional real-estate tax may be deducted from one's taxable income, but only in respect of federal tax.

Ownership through a real-estate company

The additional real-estate tax is levied on the real-estate company. Its rate amounts to 0.2% of the gross value of the real estate. It is an expense that may be deducted from taxable profit, in respect of federal as well as cantonal and municipal taxes.

4 *At the time of selling the real estate*

4.1 Capital gains tax

Ownership in one's own name

In Geneva, the sale of a piece of real estate held in one's own name entails the levying of a capital gains tax, which is called **tax on real-estate profits and gains**. In contrast, no tax is levied on the capital gain at the federal level.

The taxable capital gain corresponds to the difference between the selling value of the real estate and its purchase value. The tax rate decreases the longer the period of time for which the real estate is owned. According to current Geneva law, it varies from 50% for a duration of ownership of less than two years to 0% when the property has been owned for more than 25 years. The rate of taxation amounts to 40% when the vendor has owned the property for a duration of two to three years, 30% for a duration of ownership of between four and five years, 20% between six and seven years and 15% for a period of between eight and nine years. Thereafter, for any sale made after having owned the property for at least 10 years but less than 25 years, the rate of taxation is 10%.

When the vendor re-invests the proceeds of the sale in a new dwelling, he may request, subject to certain conditions, partial or total reimbursement of the tax paid. This is known as **re-use of the real-estate gain**. The gain is not tax-exempt in the sense that the reimbursed tax becomes payable when the substitution property is sold. To meet the conditions for re-use, the gain must, in particular, have resulted from the sale of an owner-occupied dwelling and it must be re-invested within a maximum time-limit of five years, for the purchase of a property of the same kind.

In the event that the owner makes a loss on the sale of his property, he may not claim any corresponding deduction.

Finally, in the event of the real estate being transferred by means of donation or inheritance, the tax on real-estate profits and gains is deferred. This means that it is not collected at the time the property is transferred, but will only be collected when the next taxable transfer is made. In order to calculate the tax due by the donee or heir when the property is subsequently sold, the Tax Administration will take into consideration the purchase price paid by the donor or the deceased and the duration of possession since the real estate was acquired by the latter. As far as **taxes on donations and inheritances** are concerned, they are determined according to the kinship tie between the donor or the deceased and the beneficiary, on the one hand, and to the market value of the property at the time of the transfer, on the other hand. No tax is charged, however, for inter vivos donations or transfers by way of inheritance, in favour of the spouse and the direct descendants. On the other hand, in the absence of any kinship tie, the maximum tax rate can reach 54.6%.

Ownership through a real-estate company

The sale by the shareholder of the shares of a real-estate company also entails, at the cantonal level only, the levying of the **tax on real-estate profits and gains** on the portion of the selling price that corresponds to a real-estate capital gain. When the sole asset owned by the real-estate company is the property, the entire gain made is taxable. The capital gain liable for tax then corresponds to the difference between the selling value of the shares and their purchase value. The tax rate, which is set according to the duration of holding, is identical to the rate applicable in the case of ownership in one's own name (see above "Ownership in one's own name").

One special feature of ownership through a real-estate company is that it involves a **hidden fiscal charge** that is levied on the real-estate company and its shareholder in the event of liquidation (see below, chapter 5). Thus in practice an informed purchaser will take this potential fiscal charge into consideration in order to negotiate

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a reduction of the selling price. Moreover, it should be pointed out that the capital gain made when selling a property acquired in connection with the liquidation of a real-estate company obeys special rules.

When the disposal relates directly to the real estate and is carried out by the real-estate company, the difference between the selling price and the book price of the property is included in the company's taxable **profits**, which are taxable at the actual rate of about 24%. In the event of a loss, this constitutes a deductible expense. Moreover, there are situations in which taxation of the hidden reserves can be postponed, that is, in particular when the company replaces, within a reasonable period of time, the asset disposed of with a property performing the same economic function. In fiscal terms it is then a case of re-use. That being so, re-use will, in principle, not be possible for the real-estate company, according to Genevan practice. Finally, when the gain resulting from the real-estate sale is paid out in the form of a dividend to the shareholder, it is liable for income tax according to the modalities applicable to dividends (see above, chapter 3.1).

It should also be noted that the sale of the real-estate company to a person required to keep accounts may lead to a problem known as "indirect partial liquidation", which generates taxable income. This situation is not described in the present article as it should rarely pose a problem where a real-estate company is concerned.

In the event of a donation or inheritance, the same rules are applicable as in the case of ownership in one's own name (see above "Ownership in one's own name").

4.2 Transfer duty and fees

Ownership in one's own name

The transfer duty (registration fee) and **the Land Registry fees**, that is, 3.3% of the selling price, as well as the notary's fees, are payable by the buyer.

Ownership through a real-estate company

The sale of shares of real-estate companies is not subject to transfer duty unless the transfer has been concluded by an authentic deed. Moreover, no registration at the Land Registry is required.

5 *Special case of liquidation of a real-estate company*

Liquidation of a real-estate company entails fiscal consequences at two levels. Firstly, the hidden reserve inherent in the piece of real estate, viz the difference between the market value of the property and its book value, is realized upon liquidation. It is thus added to the (liquidation) profits of the company and is taxable as such. Secondly, the liquidation surplus is liable for income tax payable by the shareholder. It corresponds to the value of the company's net assets, after deduction of the reimbursement of the sum owed to the shareholder and the face value of the share capital. The liquidation surplus is, in addition, subject to withholding tax, of which Swiss resident shareholders may request a refund, however (on request, the declaration procedure allows one to avoid having the tax levied and then refunded).

In practice, the tax charge that is payable in the event of liquidation of the company is also taken into account when the sale or purchase of a property owned through a real-estate company is being considered. In fact, any informed purchaser, when acquiring a property through a real-estate company, generally asks that all or part of the hidden tax charge inherent in liquidation be deducted from the selling price.

6 *Conclusions*

Each of the two options involves advantages and disadvantages, which may weigh more or less heavily in the balance of interests at stake, depending on the personal situation of each potential buyer. The main advantages of buying a property in one's own name, on the one hand, and of buying through a real-estate company, on the other, can be summarized as follows:

As far as **ownership in one's own name** is concerned, it offers mainly the advantage of (i) avoiding double taxation; (ii) benefiting from the reductions granted both on rental value and on taxable wealth and from reference to the purchase price of the property for wealth tax purposes; (iii) benefiting from a preferential rate with regard to additional real-estate tax and (iv) being able to sell one's property at its market value without having to give up the reduction for the hidden fiscal charge. The solution, of course, generally also has the merit of being simple.

As for purchase of property through a **real-estate company**, it allows one mainly to (i) avoid transfer duties and land registry and notary's fees when buying and selling shares; (ii) deduct, without any limitation, the interest that the company has paid on loans (but not that of the shareholder from the company's income); (iii) resell the property in the short term through the company with taxation of the capital gain subject to a maximum rate of 24% (provided that the gain is paid out in the form of a dividend) and (iv) deduct any possible loss in the event of a loss being made on the sale of the property through the company. This being the case, the existence of a real-estate company engenders obvious complications which, in general, render purchases of real-estate companies much less attractive in the real-estate market than the purchase of properties owned directly in a person's name. ■

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