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by William M. Sharp Sr. and Natalie Peter

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PRACTITIONERS' CORNER

More Information for U.S.-Swiss Dual Passport Holders

by William M. Sharp Sr. and Natalie Peter

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The September 23 limited amnesty voluntary disclosure program deadline is rapidly approaching, and as expected U.S. tax practitioners are experiencing a surge in eleventh-hour voluntary disclosure cases. In addition to being concerned about possibly being turned in to the IRS for being on the list of about 4,450 UBS AG account holders, noncompliant taxpayers and other Swiss banks, as well as non-Swiss banks, are heeding the remaining days of the limited amnesty.

For those noncompliant U.S. taxpayers who are U.S. citizens (or green card holders), hold Swiss passports, and are otherwise long-term residents of Switzerland, now is the time to review their U.S. tax filing requirements. Under the limited amnesty voluntary disclosure program, the taxpayer's name and other identifying details must be submitted by the September 23 deadline, and thereafter the customary voluntary disclosure procedures can take place. Based on IRS guidance released in May and modified in June, it is clear that the moderate penalties described in the limited amnesty program will expire after September 23, but it is unknown whether a voluntary disclosure program will be available to noncompliant taxpayers after that date.

This article expands the discussion of hazards as well as opportunities for U.S.-Swiss dual passport holders who use the IRS voluntary disclosure program.[1]

Treaty Relief From Double Taxation

A U.S.-Swiss dual passport holder resident in Switzerland according to Swiss tax law is subject to personal Swiss income tax on his worldwide income and to personal Swiss net wealth tax on worldwide wealth. However, that U.S. citizen is also subject to U.S. income tax on worldwide income since the United States reserves the right to tax U.S. citizens on a worldwide basis, despite any provision to the contrary in the Switzerland-U.S. income tax treaty.

However, to mitigate double taxation of a U.S. citizen taxable on his worldwide income, the foreign earned income exclusion may be used to shelter up to $91,400. That taxpayer may also claim a U.S. foreign tax credit for Swiss taxes paid on the same taxable income. Finally, some qualifying deductions allowed in Switzerland may be allowable as U.S. tax deductions to reduce gross income for U.S. taxable income determination purposes.

Unfortunately, not all deductions allowed in Switzerland are allowable in the United States. Therefore, a reduction of Swiss income tax (and the otherwise creditable tax) through Swiss allowable deductions (but nondeductible from a U.S. viewpoint) will result in a commensurately higher U.S. tax liability. Further, capital gains from the sale of personal property are not taxable in Switzerland but are considered taxable in the United States, which results in a higher U.S. tax liability.

When determining the U.S. taxable income of a U.S. citizen who is a Swiss resident, the different sources of income as well as the deductions declared in Switzerland must be analyzed. Even if at first a person does not seem to have a U.S. tax liability, a substantial tax liability may

[1] *See* W. Sharp and N. Peter, "Representing U.S.-Swiss Dual Passport Holders in IRS Voluntary Disclosure Cases," *Tax Notes Int'l*, Aug. 31, 2009, p. 753, *Doc 2009-19251*, or *2009 WTD 166-15*.

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arise in some situations when U.S. and Swiss tax law disconnect. It is therefore important to review both tax law systems to ensure that all income and deductions are identified and taken into account.

Key Swiss Tax Issues

Marital Status

Swiss law provides for three matrimonial regimes in governing the financial relationship between spouses.

The most common matrimonial regime is known as the ''community of acquisitions,'' which applies unless the parties agree otherwise in a nuptial agreement signed before a notary public. In essence, the spouses' assets are allocated to one of four categories:

- husband's own assets;
- wife's own assets;
- husband's acquisitions; and
- wife's acquisitions.

All assets owned by the spouse before the marriage, as well as personal belongings, inheritances, and gifts during the marriage, are legally considered the spouse's own assets. In contrast, a spouse's employment income, investment income, and income from other assets during the marriage belong to the spouse's acquisitions. A spouse is entitled to receive half of his spouse's acquisitions as well as all his own assets upon termination of the marriage, be it by divorce or death of his spouse.

The less common ''separation of goods'' regime applies if the spouses agree by contract signed before a notary public. Under this regime no property is shared and the spouses have no entitlement to each other's assets.

The third and final regime is the ''community of property'' regime, which is rarely agreed to by the spouses.

From a U.S. tax law perspective, several key issues arise as to whether and to what extent a U.S. citizen spouse married to a Swiss citizen is required to report a jointly owned bank account on TD F 90-22.1, the foreign bank account report (FBAR), as well as to determine the taxability of that account. In general, the U.S. spouse should be accountable only for his one-half interest in the foreign financial account, based on an application of Swiss law for determining the U.S. tax result under this scenario. However, if under Swiss law the account is legally considered the spouse's own asset, the U.S. spouse should not have U.S. tax exposure but still may be required to file an FBAR if the U.S. spouse has signature authority over the account. This is one example of the many fact patterns that arise with jointly owned or non-jointly-owned property between a U.S. citizen spouse and a Swiss citizen spouse, and each case must be analyzed based on the facts of the case as well as applicable Swiss and U.S. law.

Married Filing Jointly

The Swiss marital regime as explained above has no effect on the annual tax return declarations but it does affect U.S. tax law treatment of the assets covered by a particular regime. Unlike U.S. tax law, under Swiss law a married couple must file a joint tax return. Swiss law has no married filing separately status. Therefore, the worldwide income and wealth of both spouses are declared jointly on the Swiss tax return. The final personal income and wealth tax is therefore assessed based on the spouses' total taxable income and net wealth.

If one spouse is a U.S. citizen and as such is subject to taxation in the United States, the Swiss income tax must be proportioned between the two spouses for determining the foreign tax credit in the United States. Because Swiss tax rates are progressive, the exact income tax for each spouse cannot always be accurately determined. A pragmatic approach is to proportion the total income tax between the spouses based on an income ratio.

Swiss Real Estate Issues

Notional Rental Value

Income from immovable property includes income earned by owners of Swiss real estate, as well as imputed income attributable to an owner-occupied residential apartment or home. Also, vacation homes have a notional rental value that is determined by the community where the property is located. The value of maintaining the premises, some renovation expenses, and upkeep costs typically are deductible. Also deductible are interest payments made during the tax year, including interest on mortgages, personal credit, and credit cards. When a Swiss resident owns real estate in another country, the deductible amount of interest is reduced in proportion to the amount of gross wealth situated abroad.

The notional rent rules represent a severe disconnect between Swiss tax law and U.S. tax law. The notional income required to be reported under Swiss tax principles would not apply to the reconstruction of the U.S. gross income determination. However, the generous Swiss deduction for maintaining renovations and upkeep usually would not be deductible for U.S. tax purposes. This issue would have to be evaluated within the context of the facts and circumstances in each case, but generally a disconnect will likely occur because of the conflicting legal systems described above.

Swiss Pension Plan Issues

Occupational Pension Plan — Contributions

The Swiss social security system includes various schemes, such as old-age and survivors' insurance, disability insurance, unemployment insurance, occupational pension plan, and accident insurance.

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The occupational pension plan is mandatory for employees already subject to old-age and survivors' insurance if their annual gross income amounts to at least CHF 20,520. The mandatory insurance contribution is limited to a salary of CHF 82,080. Income above this threshold may be insured, provided the employer offers additional insurance.

The occupational pension plan scheme can either be run by a company pension, a state fund, or a private fund. In general, Swiss occupational pension plans are financed by the contributions and split between the insured person and the employer, calculated depending on the insured persons' salary. Total contributions increase with age and amount to about 7 percent to 18 percent of gross salary.

A pension plan can calculate for each individual insured employee at any given time how much capital must be available to ensure all future benefits. If the vested benefits are not sufficient to finance the maximum benefits as defined in the pension plan regulations, an insured person can pay additional voluntary contributions into the pension plan and buy into the full benefits.

Occupational Pension Plan — Benefits

Under Swiss law, the occupational pension is paid out after the insured employee reaches retirement age. Men reach their normal retirement age at 65, women at 64. More employees would like to retire early; although early retirement is not explicitly regulated by law, the regulations of a pension plan can provide for it, typically at age 58.

Pensions are calculated as a percentage of the accumulated credit, which is made up of contributions and interest. If an employee retires early, his pension will be reduced notably, because a lower amount of retirement capital is available because he has had fewer contribution years. However, an insured employee who retires early can purchase the full pension that will fall due at the age of 65. The amount required to finance this purchase can be paid into the pension fund.

Instead of drawing a lifelong pension, the insured person can also draw all or part of his retirement benefits in the form of a lump sum payment. Attention should be paid to the pension plan regulations.

Under some circumstances, it is also possible to draw a lump sum payment before reaching retirement age if the regulations of the pension fund allow it. However, a lump sum payment can be requested only if the insured person:

- abandons Swiss residence;
- becomes self-employed; or
- uses the funds to purchase and own real estate.

Pension Plan — Swiss Tax Consequences

Under Swiss tax law, all contributions paid by the employee, whether mandatory or voluntary, are fully tax deductible. Thus, income tax is calculated on net income after all contributions. Consequently, voluntary payments may significantly reduce the Swiss taxable income from employment, which encourages saving in Switzerland.

The monthly retirement pension is fully taxable to recipients, except for some individuals falling under a special grandfathering clause (for whom only 80 percent of the payments are taxable). A lump sum withdrawal is taxed once at a reduced rate and separately from the remaining nonpension income. Depending on the canton of residence, the tax burden differs. Thereafter, the distributed amount is subject to annual wealth tax, and earnings on such capital must be taxed as income.

If a person is a resident abroad for tax purposes when he retires, the lump sum payment is subject to Swiss withholding tax. However, in cases when the recipient is resident in the U.S. the Swiss withholding tax can be reclaimed based on the double taxation agreement between Switzerland and the United States. The Swiss tax authorities will require proof that the U.S. has been notified of the lump sum payment. Pension payments to a retiree living in the U.S. are not subject to Swiss withholding tax if the retiree is a U.S.-Swiss dual passport holder.

In view of the generous Swiss deduction regime for pension contributions, a disconnect with the U.S. tax system arises because under U.S. tax law, those contributions generally will not qualify for U.S. tax deduction treatment. As a result, assuming a dual passport holder residing in Switzerland has made substantial contributions to a Swiss pension plan that does not otherwise qualify for deduction treatment for U.S. purposes, the taxpayer will face a substantial omitted income calculation in connection with a U.S. voluntary disclosure submission.

Further, the nonqualified pension arrangement for U.S. tax law purposes would most likely be treated as a foreign financial account (depending on the specific facts of the arrangement), and thus any investment income is usually treated as taxable income for U.S. purposes (whereas in Switzerland the income would be tax deferred). Because of complications involved under Swiss tax law, determining this investment income may not be overly practical. Ownership of this account would also give rise to an obligation under U.S. law to file the TD F 90-22.1.

Swiss Life Insurance Issues

Overview

Swiss life insurance is commonly used as a tax planning vehicle, often allowing significant relief from Swiss income, capital gains, or inheritance tax, provided the life insurance policy complies with the applicable Swiss tax regulations (for example, a minimum

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duration or an amount of life insurance coverage besides the investment component).

Two main groups of life insurance are available: (i) ''risk cover'' policies, with guaranteed benefits in the event of death or disability, and (ii) ''capital accumulation'' policies, with additional targets for systematic savings. Mixed life insurance is the most common solution and is used to provide both insurance coverage and targeted savings.

Whole life insurance policies generally serve as specific protection against financial risks in the event of death. If the insured person dies during the term of the policy, the insured capital is paid out immediately to the named beneficiaries. With personal pension insurance, the insured person receives a guaranteed income stream for life. A life insurance policy can be financed either by regular premium payments on a monthly or yearly basis or with a one-time payment.

Fixed and variable life insurance plans are available. The term ''fixed'' means that the life insurance company guarantees the principal and a predetermined return on the investment. Because fixed life insurance is subject to preferential tax treatment, the flexibility is rather limited. The law determines the investment a life insurance company is allowed to make. Also, fixed life insurance is available only for individuals resident in Switzerland and conducting gainful business in Switzerland.

More scope and flexibility is offered by a variable life insurance contract. The policyholder may change between various investment strategies during his lifetime. The policyholder also has more flexibility in determining the beneficiaries of the insurance than with a fixed life insurance policy.

Swiss Taxation of Life Insurance

Monthly premiums for fixed life insurance are tax deductible as long as the insured person has employment income. The tax-deductible amount is limited to a certain amount depending on whether the insured person is employed or self-employed.

Premiums paid for variable life insurance are deductible up to a certain amount. These limits differ from canton to canton and are usually lower than the deductions available for fixed life insurance.

Fixed life insurance is not taxed during the term of the policy. The later payment of the capital, including accumulated investment income, is taxed on a one-time basis at a reduced rate and separate from the remaining income.

The taxation of variable life insurance depends on the scope of the insurance. Some life insurance has a repurchase value that is subject to wealth tax, while others do not. Capital payments from variable life insurance with a repurchase value are taxable in some circumstances at reduced rates and separately from other income. For variable life insurance with no repurchase value, a capital payment may be subject to income tax or may be tax free depending on the scope of the insurance.

Similar to the disparity between Switzerland and the U.S. tax treatment of pension contributions, what would otherwise be fully deductible life insurance premiums for Swiss purposes may not necessarily qualify for U.S. tax deduction treatment. The nature and extent of any particular life insurance premium payment in the context of the applicable U.S. tax rules must be carefully reviewed, but overall, the two systems do not work well together and typically end up with a significant portion of disallowed deductions at the U.S. level depending on the particular facts and circumstances of a given case.

Conclusion

Given the cross-border complexities, U.S.-Swiss dual passport holders residing in Switzerland should consult with not only Swiss tax counsel but also U.S. tax counsel to most effectively maximize tax planning benefits and mitigate some of the traps noted above. Finally, if a U.S. citizen who is also a Swiss passport holder is not in compliance with U.S. tax law, he should review his situation with U.S. counsel and consider whether it is appropriate to participate in the soon-to-expire limited amnesty voluntary disclosure program. ◆

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