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Investment in real estate

What is the best way of holding from a tax perspective?

Investment in the real estate market is perceived by many as safe and sustainable. In some locations in Switzerland, land prices have been rising continuously for more than twenty years. For these and other reasons, demand for investment properties and residential property remains high.

We are repeatedly asked which way of holding is most tax optimized for an investment in real estate. Should the new holiday home be acquired indirectly via a corporation or directly by the private individual? Is it recommended to structure the establishment of a real estate portfolio indirectly through a corporation? What are the advantages and disadvantages of the various holding forms for the planned construction of a property and the subsequent sale?

In our experience, there is no generally applicable answer to the question whether a private individual should hold real estate directly or indirectly from a tax perspective. Rather, the optimal way of holding should be analyzed on a case-by-case basis. It is important to note that not only tax reasons have to be taken into account. Financing, liability law, succession planning and other factors should be included in an overall plan.

However, the following comments are limited to a comparison of direct and indirect real estate ownership from a tax perspective. How do these two ways of holding differ? To approach the answer to this question, one must first be familiar with the principles governing the taxation of real estate in Switzerland:

- Taxation takes place at the location of the real estate.
- The tax rate is determined by the location of the real estate.
- Taxes are levied annually on the rental income and on the asset value.
- Transaction taxes (real estate transfer tax, real estate capital gains tax) are incurred on the purchase and sale.
- Both individuals and corporations are subject to tax.

The following can be derived from these principles:

- The investing person becomes subject to tax at the place where the Swiss real estate is located and must make an annual tax declaration there.
- The place of residence of the investing person is of secondary importance for the taxation of real estate in Switzerland. Regardless of whether the place of residence is

Wollerau, Dubai or New York, real estate located in the city of Bern is taxed by the city of Bern according to the standards applicable there.

- The transfer of real estate from a private individual to its corporation may result in substantial transaction taxes.
- Indirect real estate ownership sooner or later leads to double taxation: the direct return from the real estate (income or gain) is first taxed at the level of the corporation. A later distribution of the remaining return is subject to income tax at the level of the private individual as dividend income.

Particularly the double taxation outlined last raises the question why indirect real estate ownership can be advantageous over direct ownership. The reason is that private individuals are sometimes taxed differently than corporations. Here are some examples:

- In the case of a corporation, rental income is taxed at a proportional tax rate of, say, 15 percent, whereas in the case of an individual, the progressive tax rate can be as high as over 40 percent, depending on the amount of other income. Therefore, if one plans to reinvest the return, he or she should use a corporation. Because with a net rental income before taxes of 1’000, in this example 850 instead of 600 remain after taxes for the reinvestment.
- A corporation can claim tax-effective depreciation on the building and thereby reduce the taxable profit. This is denied to a private individual who holds the real estate as private assets.
- The majority of cantons tax the gain made by a corporation from the sale of real estate with the proportional profit tax (tax rate e.g. 15 percent). On the other hand, such a gain on sale is always subject to real estate capital gains tax if a private individual has held the real estate as private assets. The real estate capital gains tax rate is generally progressive and can quickly double or triple the profit tax rate.
- Trading in real estate by a private individual results in the individual being considered self-employed for the purposes of income tax and social security contributions. In such a case, both the profits from real estate trading and the rental income from real estate are subject to income tax on the one hand and social security contributions of around 10 percent on the other hand. If, however, the trading in real estate is conducted by a corporation, these social security contributions do not apply.

The differences between the two ways of holding are multi-faceted and complex, depending on the situation. The following questions can help to make the optimal choice from a tax perspective:

- Where is the place of residence of the investing person(s)?
- What is the location of the real estate?
- How long is the real estate to be held?
- Is the focus on current income or on future increase in value?
- Should the real estate return be reinvested or consumed?
- Does the investing person deal in real estate or is this planned?
- How high is the tax progression?
- Should deferred taxes be taken into account?

These explanations indicate why, from a tax perspective, it is not possible to make a general statement as to whether direct or indirect real estate ownership is more advantageous for a private individual. The optimal way of holding should be determined on the basis of the individual circumstances and the investment strategy. In our experience, it is therefore worthwhile to analyse an investment in real estate based on planning figures and model calculations with regard to the way of holding in advance. In addition to the tax comparison, the additional expense of operating a corporation (e.g. bookkeeping, annual financial statements, etc.) and any non-financial factors (e.g. estate planning) should also be taken into account in the overall analysis.

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