Are We Having Funds Yet?

Using Pension Money To Finance Home Property—Watch For A New Rule...And New Tax Trap

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The Swiss social security system is built upon three fundamental pillars. The first pillar, AVS-AI (old age, survivor, and disability insurance), is designed to cover an individual's basic needs. The second pillar, a supplement to the first with a view to ensure a decent standard of living in case of accident or death, was introduced in 1985. The third pillar is based on voluntary private insurance arrangements selected by those who want to improve their personal situation. The contributions made under the first and second pillars are deductible whereas the tax deductions for the third pillar are limited. This article is about the second pillar, which offers interesting tax-planning possibilities with relation to the financing of a main residence.

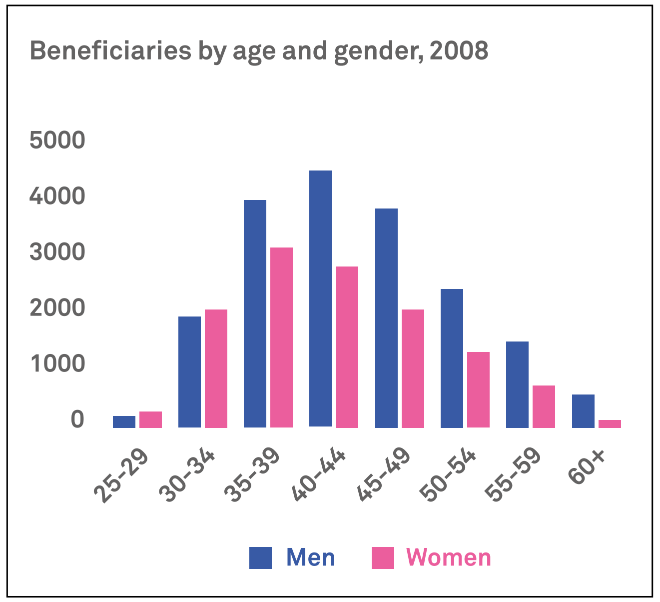
An easy and efficient way to mitigate taxes is to make voluntary contributions (i.e., supplementary contributions on top of the annual statutory contributions) into the second pillar. Subject to certain limits and conditions, these contributions are fully deductible against taxable income. This is relevant to top expatriate managers who join a Swiss pension arrangement in the middle of their professional careers without having accumulated a significant retirement fund in the past. Self-employed people can also benefit from tax incentives for voluntary contributions into their plans, especially if they decide to join the pension arrangement set up for their employees.

Homeownership of one's principal place of residence is highly encouraged in Switzerland, to the point that the Swiss constitution itself contains a specific provision to that effect. Owning a place to live constitutes a basic need—one that consumes a substantial portion of an individual's living expenses. A homeowner is generally protected from real estate market fluctuations, and rent increases become moot. An owner, however, incurs a financial risk associated with the mortgage; this is why the possibility of using funds accumulated in the second pillar was introduced into the legislation.

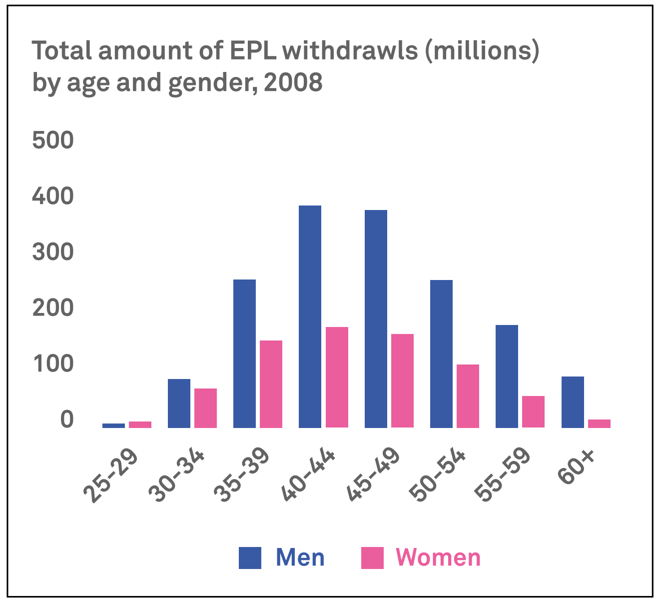
There are two possibilities to make use of the funds accumulated in the second pillar to finance one's main residence. The funds can either be drawn upon in advance (prepayments) or pledged as backing in order to secure a mortgage.

How does it work?

1. The system is restricted to the principal residence and is not applicable to the purchase of secondary or holiday homes nor to investment in an undeveloped parcel of land on which future construction is planned.
2. Access to second-pillar funds is also permitted for application to home improvements on a main residence and for refinancing a mortgage.
3. A prepayment or a pledge can only occur once every five years.
4. For people under 50 years old, the level of prepayment can vary from CHF 20,000 up to the total amount of vested benefits. For those over 50 years old, the maximum amount is equal to the vested benefit accumulated to the age of 50.
5. A prepayment is treated for tax purposes as taxable income but benefits from a reduced rate of taxation.
6. A special annotation will be entered into the Land Registry providing for a sale restriction. This is intended to ensure the funds withdrawn from the second pillar are not used for another purpose.
7. Repayments to the pension plan can occur at any time up to three years before retirement age provided no claim for benefits has been made in the meantime.



Beneficiaries by age and gender, 2008



Total amount of EPL withdrawls (millions) by age and gender, 2008

What is the new rule ?

The vast majority of private-home acquisitions are financed through mortgage loans granted by banks and insurance companies. These financial institutions require that purchasers contribute to the purchase price through a personal cash payment (the "equity"). The equity is usually equivalent to a minimum of 20% of the purchase price. Until 1 June 2012, it was possible for the clients to finance their equity contributions by using funds accumulated in their pension plans. This is no longer possible; as a result of a modification to the banking regulations, at least 10% of the equity must have a source other than the second pillar.

This new rule is independent from the ongoing discussion regarding the future of the second pillar. The capacity of the second pillar system to honour its financial commitments in the long run raises major concerns in Switzerland, as it does in other countries. Beneficiaries are living longer and therefore collecting benefits over a longer period of time while income generated by assets owned by pension funds is decreasing. Prepayments made to beneficiaries before their retirement adds to lower return on investments. For this reason, it has been suggested—among other modifications—to change the age limit from 50 to 40 years old. Unsurprisingly, this suggestion has not met with a lot of support and this new limitation is far from any official introduction into legislation.

What is the tax trap?

Voluntary contributions into the second pillar are normally tax deductible. On the other hand, funds withdrawn from the second pillar in the form of prepayments are taxable at a privileged low rate. As a result, there is a temptation to channel funds through the second pillar (by making voluntary contributions followed by prepayments) without any purpose other than to mitigate taxes. Under a tax-authority anti-abuse policy supported by the Federal Supreme Court, any prepayment that occurs within three years following a voluntary contribution is considered abusive. As a consequence, the contributions made during the previous three years will be reclassified retroactively as non-deductible expenses; tax assessments for those years will be reconsidered and new tax bills will be issued.

It is an abuse, according to our Supreme Court, to operate the second pillar as a current account, i.e., contribute funds on a voluntary basis into the second pillar and then withdraw money as a prepayment without other any purpose than to mitigate taxes. The matters that came under the review of the federal court did not concern a prepayment for the acquisition of the main home; rather, they were related to beneficiaries who were leaving Switzerland or reaching the retirement age and taking their pension capital in cash without using it to finance a main home. It was rather clear, according to the facts summarised by the Federal Court, that these situations were abusive and the beneficiaries could benefit from an undue tax advantage.

The situation is very different if the prepayment is made for financing a main home. The legislation already provides anti-abuse rules in this specific case: the prepayment amount must be allocated to the main residence and cannot be paid back to the beneficiary, and a special annotation is entered into the Land Registry to secure this. Any subsequent voluntary contribution is treated as reimbursement of the prepayment and is not tax-deductible. It is possible that the position of the Federal Court will be clarified in the future. But, in the meantime, extreme caution is recommended and pledging the second pillar capital will be, in most cases, the preferred solution compared to prepayment. «««

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