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NEWSLETTER

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Severance payments and taxes in Switzerland

Dear Ladies and Gentlemen,

The termination of employment is always a sensitive issue, so severance payments can at least be a nice consolation. In Switzerland, according to Art. 339b of the Swiss Code of Obligations, a severance payment is mandatory if the employment relationship of an employee who is at least 50 years old is terminated after 20 years or more of service. The amount of compensation can be determined by written agreement, standard employment contract or collective employment contract, but must be at least two months' wages. Otherwise, it is to be determined by the judge at his discretion, but may not exceed the amount of eight months' wages.

A distinction must be made between this compensation under the Swiss Code of Obligations and severance payments which are paid out as part of social plans. Since January 1, 2014, companies with more than 250 employees are obliged to draw up a social plan in the event of mass redundancies. A collective redundancy is when companies intend to lay off at least 30 employees within 30 days for economic reasons.

Of course, there is the question of taxation of such benefits and whether these benefits are subject to social security contributions. There are different solutions depending on country. Germany has the so-called "fifth rule" for severance payments, the severance payment is taxed, but only one fifth of the severance payment is taken into account for the tax rate or the progression. Severance payments are not subject to social security contributions. In France, severance pay is in principle taxable, but there is an allowance of EUR 246,816. Severance payments as part of a social plan or a protection against dismissal plan are exempt from tax. Executive employees are exempt up to three times the annual amount of the social security limit (EUR 123,408 in 2021), but only in the event of a forced termination of employment. The severance payments are usually not subject to social security contributions up to an exemption limit. In the UK, severance pay is partially tax-exempt, the first £ 30,000 is not taxed, but the excess is fully taxed.

The right to tax severance payments in cross-border relationships (the employee only receives the severance payment after moving abroad) must be differentiated. According to the explanations of the renewed OECD Model Tax Convention, depending on the nature of the severance payment, taxation is allocated either to the place of work or to the place of residence. In the case of a Swiss resident who received a severance payment as a result of a reorganization for 29 years of service (26 years in the UK and 3 years in Switzerland), the Cantonal Court of Basel has ruled that this should be taxed at the place of residence in Switzerland because the severance payment only arose after and as a result of the dismissal and therefore had no connection to the place of work. If the severance payment were to be considered similar to a bonus payment, pro rata taxation would have been appropriate. Since the employer is liable for the withholding tax, he will deduct the withholding tax in case of doubt. Depending on the practice in the country of residence, double taxation cannot be ruled out and this would have to be clarified by a mutual agreement procedure. Individual Swiss cantons require proof of taxation from the other country. Compensation for premature contract termination is fully subject to AHV in Switzerland. An exemption of CHF 129,060 is granted in cases of hardship such as company closures, company mergers and company restructuring. In 1998, the Swiss Federal Court ruled that social security contributions are also owed by people living abroad. In the case of taxes, a distinction is made according to the character of the severance payment. Severance pay of a pension nature serves to mitigate the financial consequences of the risks of old age, death and disability. This includes, in particular, compensation to close the gaps in the pension fund that have arisen as a result of early departure. However, the following requirements must be met cumulatively:

- Resignation may only take place from the age of 55
- There must be a definitive cessation of main employment
- Future pension gap (ordinary employer and employee contributions up to the ordinary retirement age), calculation of the portion of the pension gap by the pension fund
- No compensation for purchases required for missing contribution years from the past

If these criteria are met, the compensation is taxed separately from other income at the pension rate (maximum approx. 10% in most cantons).

Severance payments without a provision character can have the following reasons:

- Compensation for dismissal
- Risk premium for personal and professional future
- Loyalty bonus for years of service
- Compensation for missed wage payments

So-called lump-sum benefits for recurring benefits, which are used to compensate not only future but also accrued partial benefits, i.e., partial benefits based on the past, are taxed at the so-called pension rate. Although the lump sum is fully taxed, the tax rate is calculated by dividing the lump sum by the number of years in the period being settled. This so-called taxation based on economic ability has a similar effect as the German one-fifth rule. Where other income is high, the already high tax rate will be a little higher for all income due to the gradual progression in Switzerland. In Germany, with luck, you stay in the same progression class based on the level progression.

The other severance payments are taxed in full. The taxation of severance pay is therefore very different depending on the character, the most advantageous is of course the severance pay with pension character.

Severance payments of a pension nature to persons resident in Switzerland are taxed according to the ordinary procedure, i.e., no withholding tax is to be deducted. Severance payments to persons not resident in Switzerland are taxed according to the standard withholding tax rates. The taxpayer has the right to apply for a recalculation of the withholding tax or a subsequent ordinary assessment by the end of March of the following year. Depending on the nature of the severance payment, this deadline should be observed, otherwise the entire severance payment will be fully taxed!

Since taxation in cross-border relationships must be examined more closely in individual cases, buying into the pension fund in the same year is the best way to reduce the tax burden. Here, however, the 3-year blocking period must be observed, during which no capital can be withdrawn from the pension fund within this period, otherwise the tax savings of the purchase for the paid-out capital will be taxed. Some employers pay the severance pay before the end of the employment relationship, but others only pay it after the end of the contract. Furthermore, the regulations of the respective pension fund should be observed, since, for example, lump-sum payments may be stipulated in the regulations in the event of early retirement. If the employer offers different options for compensation, the tax implications should always be considered before choosing the option in order to avoid having to regret the choice later. When it comes to severance payments, there is no universal patent solution for tax planning, each individual case must be clarified individually in order to find the best possible solution based on the individual situation and preferences, so that the consolation doesn't get a too bitter aftertaste.

We will be happy to help you to work out the optimal solution for you and will also be happy to accompany you through the entire process.

Best regards
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