SWISS AMERICAN WEALTH ADVISORS™

Swiss American Wealth Advisors Guide for Americans in Switzerland – 2021

Twelve Common Tax Return Errors and How to Avoid and/or Correct Them

One of the many joys of being an American abroad, is having to file not one, but two tax returns every year: the tax return in your country of residency, Switzerland in this case, and the US tax return in your country of citizenship. It's the American dream!

Did the sarcasm come through a little too strongly? We apologize!

The uniqueness of American citizenship-based taxation, regardless of the country of residence of the US citizen, is the cause of many a headache for Americans living overseas.

When a US citizen moves abroad, they expect to be required to file a tax return in their new home country and pay taxes there. That's understandable. You are likely a member of this group.

But having to continue to file US tax returns while leaving abroad? Not everyone is aware of this requirement. After the initial shock, the next shock is understanding the level of complexity of the US tax filing as an American living overseas.

Why is this?

The first challenge is that US tax laws impose a second layer of taxation on top Swiss taxation, which creates the risk of double taxation.

A second challenge is that the US tax rules are written with US income and assets in mind, and many times it is not clear how these US taxation rules apply to Swiss income and assets that doesn't really conform to US definitions.

Two common examples can help us visualize this issue:

Switzerland pays a monthly stipend to Swiss resident families with children. This stipend is taxable income for Swiss tax purposes, but no equivalent payment exists in the USA. The closest thing in the USA to it would be the child tax credit, which is, as it name implies, a tax credit, not a monthly supplement income stipend and definitely not income. Is the family allocation taxable income for US tax purposes? You will not find the answer to this question in the US tax code!

Another example is the mietwert or valeur locative, the deemed rental income Switzerland imposes on Swiss residents living in a Swiss home owned by them. The concept of "deemed" income does not exist in the USA, income either is or it isn't. Deemed income is not a thing. So, is the deemed rental income that is reported on the Swiss tax return income that needs to be reported on the US tax return? Unlike the family allocation, this deemed rental income only exists on paper.....

I think you are starting to understand how things can get tricky quickly.

On top of this, you must deal with having to convert income from Swiss francs to US dollars, classify Swiss financial assets according to US definitions (rental deposit account, Pillar 3, etc.), file a joint Swiss tax return with your Swiss spouse who is not required to file a US tax return and then having to decide how much of the Swiss income tax belongs to each spouse...... and on and on and on.

On the Swiss side, for the US expat, reporting issues are sometimes the consequence of poorly understood differences in tax rules between the USA and Switzerland, combined with the language barrier that make it hard for the US expat to communicate efficiently with their Swiss advisor or local tax authorities. Things sometimes get lost in translation.

In the same manner that the US expat needs to figure out how to classify Swiss income and assets under US tax rules, the Swiss advisor, or the Swiss expat who is brave enough to attempt to self-prepare their Swiss tax return, need to make their US assets and income fit under Swiss tax rules in order to correctly report them on their Swiss tax returns.

Given these challenges, we can't image you are surprised that errors take place.

What are the most common errors US expats make on their US and Swiss tax returns?

Let's begin with exploring common Swiss tax return errors:

Error #1: Overpaying Wealth Tax

Unlike the USA that taxes the capital gains resulting from the sale of appreciated investment and personal assets, Switzerland imposes a wealth tax that taxes the value of certain investment and personal assets while they are owned (not sold) by the Swiss tax resident. Some assets, such as retirement accounts, are exempt from Swiss wealth tax. Many US citizens living in Switzerland are participants in US 401ks, contributory IRAs and other types of qualified US retirement accounts. These US retirement accounts are generally accorded the same exemption from wealth tax that is afforded to Swiss Pillar 2 and Pillar 3 accounts. However, many times, we find that US retirement accounts are being reported for Swiss wealth tax purposes and that Swiss wealth tax is imposed on their balance.

Suggestion: if you have paid wealth tax on the value of your US retirement accounts, have a discussion with your Swiss tax advisor to find out if it would be possible to file a claim for refund for this tax overpayment, and do not continue to report those accounts in future tax years.

Error #2: Underpaying Wealth Tax

In our years reviewing Swiss tax returns, we have also found similar errors in the opposite direction. Since the US does not impose a wealth tax, and therefore, the concept of such a tax is hard to understand for US citizens who are filing their first Swiss tax return, sometimes this leads to under reporting issues. The Swiss wealth tax is imposed on a Swiss resident's worldwide assets, with very few exceptions. One of those exceptions, for example, is real estate located outside Switzerland and owned directly by the Swiss resident. However, although the value of this real estate is not taxed, it still must be taken into consideration when determining the rate at which the remaining Swiss resident's wealth is taxed.

Why is this?

Because in most Cantons, wealth tax is taxed at progressive rates, and a higher rate will apply on the Swiss taxable wealth based on the overall wealth, whether taxed or not.

A common example of this is the former principal home of a US expat who moves temporarily to Switzerland. The home is not sold, instead it is converted into a rental property while the US expat lives in Switzerland. If the value of this property is not disclosed to the advisor preparing the Swiss tax return or to the Swiss tax authorities for the calculation of the Swiss wealth tax, this will cause Swiss wealth tax to be calculated incorrectly, because the wrong progressive tax rate will be used.

Suggestion: if you believe that you may have underpaid Swiss wealth tax, contact your Swiss tax advisor or your local Swiss tax authorities to confirm if this is indeed the case, and if so, to find out how they recommend that you remedy the situation.

Error #3: Underpaying Swiss Income Tax

Very much like the USA, Switzerland imposes income tax at progressive tax rates on the worldwide income of its residents, with limited exemptions. One of those exemptions is rental income earned from property located outside Switzerland. Even though foreign rental income is not taxed by Switzerland, it is still considered in the determination of the progressive tax rate that applies to the income subject to Swiss income tax. Many US citizens hearing that foreign rental income is not subject to Swiss income tax, do not take it into consideration in any manner, which results in the application of the incorrect Swiss income tax rate, typically leading to understatement of Swiss income tax.

Suggestion: if you believe that you may have underpaid Swiss income tax, contact your Swiss tax advisor or your local Swiss tax authorities to confirm if this is indeed the case, and if so, to find out how they recommend that you remedy the situation.

Error # 4: Failing to File Form DA-1 to Claim Refund on US Dividend Income Under the US-Swiss Tax Treaty

This is a very common error that we believe may be due to a misconception: does withholding tax apply to US dividend income earned by a US citizen living in Switzerland? Many Swiss advisors think it doesn't, and in the literal sense this is correct. But in practical terms, US dividends earned by US citizens are subject to US income tax not through withholding tax but rather via tax return. The USA does not withhold tax on its citizens because it imposes an obligation to file a tax return annually. The US dividend income is reported and taxed on that tax return. The US-Swiss Income Tax Treaty limits the tax that can be imposed on US dividends earned by Swiss residents to 15%. Conversely, it limits the Swiss tax that can be imposed on Swiss dividends earned by US residents to 15%. When a US citizen living in Switzerland files their tax returns, the US dividend income is reported on both the US and Swiss ones, and it is taxed by both countries at their resident tax rates.

This can lead to double taxation.

The way Switzerland remedies this risk is by providing a 15% refund on US dividend income through the filing of Form DA-1. The US citizen is then allowed to apply a foreign tax credit, on the US tax return and under the resourced-by-treaty category, on the excess tax imposed by Switzerland (the Swiss marginal rate net of the DA-1 refund).

Suggestion: if you have US dividend income and have not filed Form DA-1 in the past, it may be worth consulting a Swiss tax advisor to understand how to go about this going forward, the size of the potential missed Swiss refunds, and whether it is cost effective to file late Forms DA-1s to claim the refunds that may still be open. Bear in mind that if you used the foreign tax credit to reduce US income tax on those dividends, filing past Form DA-1s may result in you having to amend your prior year US tax returns too.

Let's now switch to US tax returns, and discuss the most common errors made by Americans in Switzerland:

Error #5: Failing to File FBAR and/or Form 8938

US citizens are required to report their foreign (from a US perspective) bank and other financial accounts to the US government every year. When US citizens live abroad, they will most likely have foreign financial accounts because they need them to conduct their lives in the foreign country: bank accounts, retirement accounts, investment accounts, etc.

Two potential forms are required to report these foreign accounts: Form FinCEN 114, commonly referred to as the FBAR, and Form 8938, also referred to as the FATCA form.

The FBAR is a standalone filing that is required even when the US expat has no income and does not file a US tax return. The FBAR filing threshold is very low: $10,000 in the AGGREGATE. Once the aggregate balance is met, all and any foreign accounts owned by the expat must be reported, even if those accounts have no balance. Form 8938 has much higher reporting thresholds , and pensions are specified foreign financial assets for Form 8938 purposes. It doesn't take that many years for a US citizen working in Switzerland to accumulate enough savings in their Pillar 2 accounts to meet the Form 8938 filing threshold. The FBAR filing threshold is typically met the very first year of Swiss residence for any adult US citizen.

Suggestion: if you believe that you may have missed filing a required FBAR or Form 8938, you may consider consulting a US tax professional well versed in offshore tax compliance to discuss your options and risks. Unfortunately, both the FBAR and Form 8938 carry potentially high failure to file penalties. Fortunately, there are different IRS programs that may allow you to get back into compliance without having to pay these penalties. These programs have specific requirements that may not be easy to understand by a lay person. Given the potential of significant tax and penalty savings under these programs, it is usually well worth it to work with the guidance of an experienced international US tax advisor.

Error #6: Not Filing a US Income Tax Return When Required

US tax return filing requirements apply above certain levels of income. If your income is below that level, there is no requirement to file a US tax return. However, you need to understand very well what the income thresholds are, and how they apply to your situation before deciding that the US tax filing requirement does not apply to you. Sometimes, US citizens living abroad misunderstand the filing thresholds and reach incorrect conclusions. Let's go over some examples: A US citizen is married to a Swiss citizen where the Swiss citizen is the main income earner in the couple. The US citizen makes just CHF6,000 of income as an independent English tutor. What is the US filing threshold in this situation?

Typically, the filing threshold for a single person under age 65 is $12,400 (in 2020), but when the person is married and files a separate tax return from their spouse, the filing threshold is $5 of income! Just five dollars! In this example, the US citizen with CHF6,000 of tutoring income is required to file. Now let's imagine that the Swiss resident tutor is single, instead of married. They are below the filing threshold, right? Wrong! Although CHF6,000 is less than $12,400, it is self-employment income, because it is independent tutoring income. For self-employment income, the filing threshold is $400 a year, not $12,400. See how tricky these determinations can get?

Suggestion: check the IRS website for detailed tax return filing threshold requirements and make sure that you are looking at the filing threshold that applies to your situation. If you have doubts, the IRS has a neat tool that takes you through a questionnaire to help you make this determination. You can access this tool through this link. If you still have questions after using the tool, it may make sense to consult a professional. If you realized that you should have been filing tax returns and you haven't, an experienced professional can evaluate your situation, explain your options, and help guide you back into compliance.

Error #7: Using the Incorrect Foreign Exchange Rate to Convert CHF to USD

Foreign income and assets need to be converted to USD for US reporting purposes. For FBAR and Form 8938, the December 31st F/X rate is required to be used, regardless of the date of the highest balance of the account measured in foreign currency. Income, however, must be converted at the spot rate on the date the income was earned. For example, if you sell your Swiss home on September 3rd, you must use the foreign exchange rate on September 3rd, not the December 31st rate nor the average annual rate. Average annual rates can be used for income that is received ratably during the year, such as wages that are paid monthly.

Suggestion: The IRS website provides information about converting foreign currency amounts into USD and provides an annually updated table with the average exchange rates for the most common currencies. If you have any doubts about what exchange rate to use, this webpage is a good resource.

Error #8: Overuse of the Foreign Earned Income Exclusion

The foreign earned income exclusion is a provision in the US Tax Code that allows certain foreign resident US taxpayers exclude from US taxation foreign earned income up to a limit of $107,600 in 2020. This amount is adjusted by inflation annually. Qualifying for the foreign earned income exclusion requires meeting certain criteria, including having a tax home in a foreign country and meeting one of two different foreign presence tests: the bona fide resident test or the physical presence test.

The IRS has been paying closer attention to the foreign earned income exclusion in recent years, auditing it at higher rates than before and disallowing it when it was claimed incorrectly by the US expat. While claiming this exclusion may seem straightforward, it requires filling out Form 2555 with care. Even when claimed correctly, the foreign earned income exclusion can have disadvantages, particularly for families with dependent US children that would otherwise be eligible to receive the additional child tax credit, and also for Americans living in cantons with high Swiss income tax rates, which can sometimes be higher than US income tax rates, who would be better off by claiming the foreign tax credit instead.

Suggestion: if you have US citizen dependent children, income below $400,000/year and live in a canton with high income tax rates, you may be better off not using the foreign earned income exclusion. You can test if this is the case by preparing your next tax return with and without the exclusion and comparing the results. If you are required to file a state income tax return, pay attention to the impact of not using the foreign earned income exclusion on both your federal and state returns. If you decide to revoke the exclusion, keep in mind that you cannot claim it again for five years without obtaining IRS express permission, so consider your medium term plans and make sure that the change will work in your favor long term.

Error # 9: Underreporting Swiss Wages
Line 11 on your Swiss salary certificate is the wage amount that is reported for Swiss income tax purposes. It's the amount with the big fat arrow pointing at it. Many times, that is the amount of wages that is reported on the wage line on the US tax return, but this is not correct.

Why not?

First off, because that amount is net of Swiss social security (Pillar 1) contributions. US tax laws do not allow a deduction for social security taxes of any kind, not even US social security taxes are deductible for income tax purposes. Secondly, the net wage amount is after taking a second deduction, for Pillar 2 contributions, which are also not deductible for US tax purposes, more on this later. If you are reporting your net wages as your taxable wages for US tax purposes, you are underreporting your income and as a result, potentially understating your US tax. Please make sure to avoid making this mistake.

Error #10: Failing to report Pillar 2 Contributions as Compensation
Not only is line 11 of your Swiss Salary Certificate the incorrect amount of US taxable wages. Even line 1, gross wages, is too low.

Why is that?

Because, unfortunately, the US does not recognize Swiss Pillar 2s as equivalent to US qualified retirements accounts, and as a result, it does not award them the same tax advantages awarded to US retirement accounts such as 401Ks and IRAs. One of those tax advantages is the deductibility of employee contributions. The other is the non-recognition of employer contributions as taxable income until the contributions are withdrawn from the account at retirement. Instead, contributions from your Swiss employer to your Pillar 2 account are US taxable as compensation in the year deposited, and your own contributions are not tax deductible.

Suggestion: the different tax treatment of Pillar 2 contributions between Switzerland and the USA creates a mismatch in timing between the two tax systems that can eventually result in double taxation. It is very important, therefore, for US citizens caught in this situation, to keep close track of every contribution made into their Pillar 2. Since those contributions are not US tax deductible, they are also not US taxable when distributed from the account. Keeping track of contributions will allow you to track your "cost basis", the amount that has already been taxed, and exclude it from US taxation in the year of distribution.

Error #11: Taking a foreign tax credit for Swiss wealth tax

US tax rules allow taking a foreign tax credit to offset the US income tax assessed on foreign source income that has already been taxed by the foreign country. Switzerland, as we already discussed, imposes not just an income tax, but also a wealth tax that is determined as a percentage of the value of the assets owned by a Swiss tax resident at the of the calendar year. Although Swiss wealth tax is calculated on the Swiss tax return, it is not an income tax, because it is not a percentage of income. Since it is not an income tax, it cannot be used for purposes of the foreign tax credit to reduce US income tax on Swiss source income.

Suggestion: when preparing your US tax return, refer to your Swiss tax calculation breakdown between federal, cantonal and local taxes and segregate the portion of cantonal and local taxes that is attributable to wealth tax. This tax is not creditable and should not be used in the US tax return to calculate your foreign tax credits.

Error #12: Not Deducting IRA Contributions

Swiss resident US citizens who do not use the foreign earned income exclusion or who have wages in excess of the foreign earned income exclusion can continue to make US IRA contributions and many of them do. What they do not always do is take the IRA contribution deduction on their US tax return. One of the silver linings of Pillar 2s not being recognized as equivalent to qualified US retirement accounts, is that their contributions do not count as qualified retirement contributions. This means that high income earners working in Switzerland can continue to contribute to their US Individual Retirement Accounts (IRAs) in a tax deductible way regardless of how high their income is. The income limitations that apply to active participants of qualified retirement plans does not apply to Pillar 2 participants.

Suggestion: If you are a high-income earner working in Switzerland and you generally owe US income tax, you may be able to reduce your US tax liability by continuing to make annual IRA contributions. To boot, Contributory IRAs are generally recognized by the different Swiss cantons as US retirement accounts, which means that their growth is not taxable for Swiss tax purposes and their value is not taxable for Swiss wealth tax purposes, potentially providing a triple tax advantage.

Filing tax returns as a US expat in Switzerland can be a surprising challenge! We hope that reading this article helped clarify some of your questions, and that it also helps you avoid making some of the most common unintentional mistakes.

If you have additional questions, do not hesitate to contact us at info@swissamericanwealthadvisors.com or by phone at +1.610.668.1829 (USA) or +41.44.557.39.00 (Switzerland). We have helped many families in Switzerland navigate the complexities of their crossborder financial lives, and we would be delighted to have the opportunity to work with yours.

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