CONSTRUCTION & REAL ESTATE REVIEW 2019

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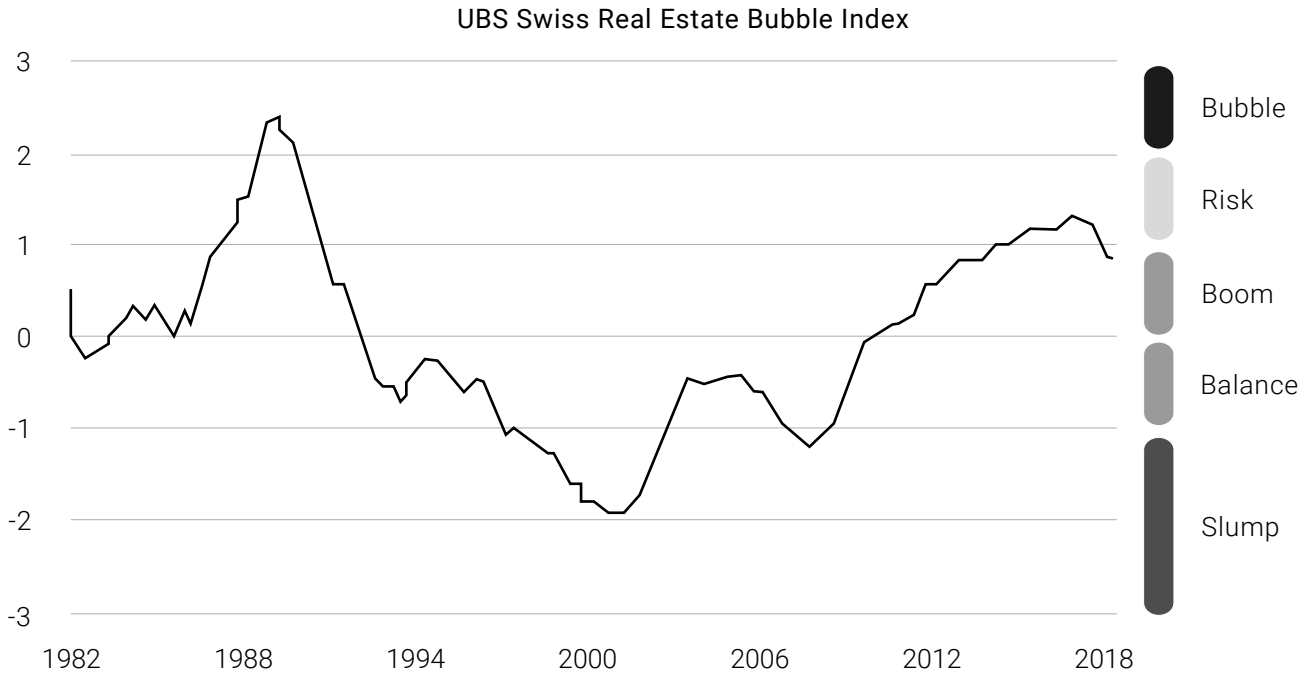
OVERVIEW OF MAJOR ACTIVITY IN THE SWISS REAL ESTATE MARKET IN 2018

The Swiss economy was booming in 2018. Both the Swiss Economic Institute and the State Secretariat for Economic Affairs expect GDP growth of 2.6 per cent in 2018. This boom saw employment growth of 2 per cent in the second half of 2018 compared to the previous year (according to the Federal Statistical Office) and a 2.2 per cent increase in immigration from January 2018 to November 2018, according to the State Secretariat for Migration). At the same time, interest rates remained low and negative interest rates are still present. These economic developments had a positive impact on the Swiss real estate market.

The residential property market has seen various trends in 2018. While not enough owner-occupied apartments were built, rented apartments saw a considerabale increase in vacancies. Meanwhile, every 40th rented apartment is vacant – in some regions outside the centres, the volume is even higher.

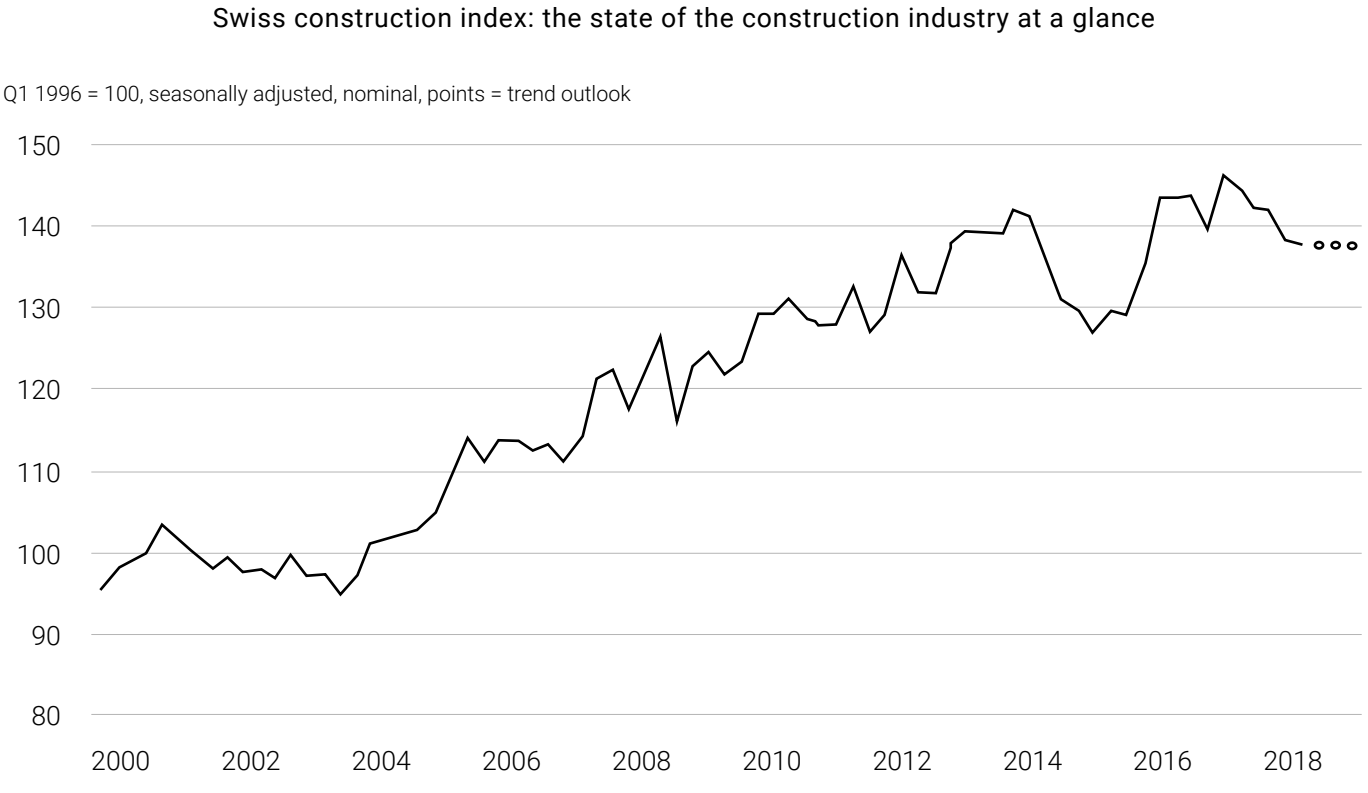
The UBS Swiss Real Estate Bubble Index fell to a value of 0.87 index points in the third quarter of 2018 and remained there in the fourth quarter of 2018. Thus, the risk of a real estate bubble in the market for owner-occupied homes declined further. The index was below the risk zone for the first time since mid-2012, and now shows few signs of a real estate bubble.



Source: UBS

This economic growth fuelled demand for office space. Therefore, in most city centres (with the exception of Geneva) vacancies decreased. In Zurich, vacancies decreased in 2018 for the fourth time in a row and are now 36 per cent lower than in 2014. However, vacancies rose considerably outside the city centres, with an overall increase of 6 per cent compared to the previous year (according to Credit Suisse's report, "Swiss Office Property Market 2019").

Construction activities remain at a high level, though considerably below the previous year. The construction index, prepared by Credit Suisse and the Swiss Contractors' Association, is set at 138 points in the fourth quarter of 2018, down 7 per cent compared to the fourth quarter of 2017. In the building construction sector the turnover for 2018 is expected to decrease by about 5 per cent compared to 2017; and in the underground civil engineering sector, the turnover is expected to decrease about 3 per cent compared to 2017.



Source: Credit Suisse, Swiss Contractors' Association

Switzerland will remain an attractive real estate market for investors in 2019. While the negative trend in certain asset classes (in particular retail spaces) and regions will continue, there will be opportunities in other markets (such as logistics properties) and relating to innovative concepts (such as co-working spaces) or products in the affordable housing sector (such as micro-apartments and serviced apartments).

OVERVIEW OF THE LEGAL AND REGULATORY FRAMEWORK

The Swiss real estate regulatory framework is based on transaction law; rental law; planning and zoning law; and construction law. As of 1 January 2019, no particularly important changes have been introduced to this regulatory framework. However, political discussions will continue to result in amendments to the regulatory framework. For example, the political decisions to be taken with respect to the Energy Strategy 2050 will have a significant impact on the construction industry.

The optimal use of available land, which is a limited resource, is being discussed at length between dissenting interest groups. On 10 February 2019, the Swiss people voted on and disapproved the initiative against new construction zones, while the initiative for more affordable apartments will be debated in the Swiss parliament this year. The abolition of the imputed rental income and the revision of rental law are also expected to cause heated debates in Switzerland.

Furthermore, the revision of the Swiss financial markets system and the planned entry into force (on 1 January 2020) of the new Financial Services Act and Financial Institutions Act, including the respective ordinances, will have some effect on the indirect holding of real estate – namely for real estate funds and real estate companies.

CERTAIN RECENT DEVELOPMENTS

Planned amendment of the Ordinance on the Rent and Lease of Residential and Business Premises

The Zurich Tenancy Court clarified in its judgment of 9 February 2017 (MG16009) that providing accommodation to paying guests via Airbnb qualifies as subletting, as defined by article 262 of the Swiss Code of Obligations (CO).

Under the current law, tenants who wish to sublet their apartment must always obtain the consent of the landlord (article 262 para. 1 CO). As this provision has repeatedly given rise to arguments in relation to Airbnb, the Ordinance on the Rent and Lease of Residential and Business Premises (VMWG) is to be amended (ie, supplemented) with regards to subletting.

To supplement article 262 CO (subletting), article 8a should be included in the revised VMWG. The new article 8a VMWG is intended to make it possible for the landlord, upon the tenant's request, to grant general consent for repeated short-term sublets. To this end the tenant must send an application to the landlord containing information on the subletting conditions (amount of rent, rooms that are affected, number of persons to be accommodated, etc), whereby the tenant always has to provide the maximum figures. Provided that this general consent from the landlord is given, the tenant should therefore be able to sublet the rented apartment at his/her discretion and in compliance with the subletting conditions set out in the application. According to the explanatory report of the Federal Housing Office, this general consent can also be given for a limited period.

Unfortunately, the amendment to the law of subletting does not seem to satisfy the need for better regulation of subletting via platforms such as Airbnb

In return, however, the landlord should also have the right not to give consent if he or she will suffer material disadvantages from the use of a booking platform or the resulting effects. Such material disadvantages include indirect disadvantages – for example, if the landlord can objectively prove that repeated short-term sublets via a booking platform have a negative impact on the other tenants. A material disadvantage associated with the use of a booking platform can include, for example, the publication of photos of the building in question, or the constant delivery of a building's keys or access codes to unknown persons. The high rate of guest fluctuation can also have a negative impact on the living space (wear and tear), the communal areas of the apartment building and the other tenants. Landlords who refuse to give consent because of material disadvantages arising from the use or resulting effects of a booking platform must objectively substantiate their refusal.

On the one hand, the new article 8a VMWG will take account of the increased use of platforms such as Airbnb by reducing the red tape and making it easier to sublet rooms via a booking platform. When a booking request is posted on Airbnb, the host generally has 24 hours to accept the request, which is hardly enough time to obtain the landlord's consent in accordance with the current law. On the other hand, however, the introduction of article 8a VMWG will also make it possible for landlords to put a ban on repeated short-term sublets by refusing to grant this consent.

The option to obtain general consent from the landlord for repeated sublets, and to keep the administrative input small, could mean that tenants will inform their landlords more often about plans to regularly sublet their apartments. This would provide a better overview of sublets via booking platforms, as there is reason to suspect that rooms are currently being sublet via booking platforms without the landlord's permission and contrary to the law. This is despite the fact that the rules of business management without a mandate mean the landlord would have the right to demand that the tenant surrender profits earned from abusive subletting.

Unfortunately, the amendment to the law of subletting does not seem to satisfy the need for better regulation of subletting via platforms such as Airbnb. For example, there is intentionally no provision to limit the period for which living space can be rented via internet platforms. Such a limitation would therefore have to be applied by communal law. The city of Berne, for example, intends to manage this problem by including stricter rules regarding residential use of the Old Town in its revised building regulations. According to the intended revision, temporary residential use should in future be limited to parts of buildings for which the building regulations prescribe "residential use", and for which no other use is permitted. It should be impossible to establish second homes as defined by article 2 of the Federal Act on Second Homes if they are regularly rented for a maximum of three months. This would also mean that the conversion of a primary home into a second home intended for regular short-term subletting to third parties would constitute a change of purpose, for which a building permit is required. Second homes that are currently already being rented out for short periods should, however, have grandfathering rights. In this way the city of Berne is trying to introduce a solution via public law, even though subletting is

governed by private law. It must be noted that there will not be a regulatory body to control the subletting activities. It is therefore doubtful whether the intended amendment to the building regulations will have the anticipated effect.

The active use of booking platforms, and the fact that anybody – even tenants – can suddenly become (paid) hosts, demonstrate that the law should be adapted to account for this trend. The consultation process regarding article 8a VMWG ended on 3 July 2018.

Latest developments in Geneva concerning online rental platforms

On 7 March 2018, the Council of State for the Canton of Geneva added the new article 4A to the regulation for the application of the law on the demolition, transformation and renovation of residential houses (RDTR). According to this article, the renting of an apartment for more than 60 days in a year is considered a commercial activity. As such a change in use requires approval; breaches are subject to sanctions.

After a resident of Geneva filed an objection to this new rule with the court, the Constitutional Chamber decreed by judgment of 15 August 2018 (ACST/19/208) that this does not qualify as an excessive restriction on the guarantee of ownership or an infringement of the landlord's economic freedom, particularly in view of the persistent shortage of residential accommodation in Geneva.

The judges were of the opinion, however, that the 60-day limit is too short when compared to other countries, and therefore seems too strict. The Constitutional Chamber checked the rules that apply in cities such as Paris, Tokyo and Toronto, all of which apply longer maximum periods (120 to 180 days). Only Amsterdam applies a limit of 60 days per year, while San Francisco's limit is 90 days per year. Based on these comparisons, the Constitutional Chamber concluded that a limit of 90 days per year is acceptable under the principle of proportionality, and amended article 4A RDTR accordingly.

As the Constitutional Chamber's decision was appealed to the Federal Supreme Court, our highest court now has to decide on the lawfulness of this restriction. In the meantime, it is unlikely that landlords who offer their apartments to rent for a longer period will be punished, as there is no clear legal basis for this at the moment.

Revision of the Ordinance on Air Pollution Control – impact on heating costs

The new Ordinance on Air Pollution Control (OAPC) came into effect on 1 June 2018. Several provisions of the OAPC primarily aim to avoid unnecessary emissions of air pollutants and damage caused by exhaust gases, and to reduce fine dust emissions. Stricter rules apply for heating emissions, which is why buildings should be checked to see if the heating system in use still complies with the law or whether it needs to be replaced. The standard time limit for retrofitting is five years, but the authorities grant time limits of 10 years for retrofitting installations that become subject to mandatory retrofitting under the amendment of 11 April 2018, but which already comply with the preventive emission limits based on the existing provisions.

The new law also introduces a number of incentives that can be used by municipalities to advance and promote the building of non-profit apartments

If retrofitting is necessary, it should be noted that a property owner who rents out premises may not pass on the costs of replacing the heating system to tenants via the ancillary costs; and the depreciation costs for the heating system must be included in the rent. The actual heating costs can, however, be passed on to tenants via the ancillary costs. As a result, the revision of the OPAC should not lead to an increase in the ancillary costs. The situation will be different if the price of heating oil should continue to rise, as these costs can be passed on to tenants.

No revision of Lex Koller

At its meeting of 20 June 2018, the Federal Council decided against a revision of the Lex Koller, ie, the Federal Act on the Acquisition of Real Estate by Persons Abroad. This is the outcome of the consultation process, which confirmed that most participants do not see any need for action. This is the logical end for a proposal that was flawed from the outset and has resulted in lengthy discussions since its announcement by the Federal Council in 2015.

New legal provisions to combat housing shortage adopted in Vaud

On 1 January 2018, the new Vaudois Law on the protection and promotion of rental property (LPPPL) entered into force. The objective of this law is to advance the renovation of existing properties and to promote the construction of new apartments that meet the needs of the population.

One of the most important new provisions introduced by this law is the right of pre-emption granted to municipalities by articles 31 to 38 LPPPL, although this right of pre-emption will only take effect from 1 January 2020. Under certain conditions, this will allow municipalities suffering a housing shortage to acquire undeveloped and developed land within the borders of the municipality, in order to build non-profit apartments.

The LPPPL also makes provision for a new category of non-profit apartments, ie, affordable apartments (LLAs). These apartments, which will not be subsidised by the canton, are aimed at middle-class residents. The canton will control rents and make sure that a property's annual rental income does not exceed the statutory upper thresholds, which differ according to the size and location of the apartments. The new law also introduces a number of incentives that can be used by municipalities to advance and promote the building of non-profit apartments (including LLAs). Municipalities are in particular authorised to set quotas for the construction of non-profit apartments, and to give owners who voluntarily build such apartments a bonus of up to 10 per cent on the gross living area.

Constitutional restriction on the construction of new second homes

In 2018, the Federal Supreme Court had to decide for the first time whether the constitutional restriction on the construction of new second homes, as introduced by article 75b of the Constitution (approved by the referendum of 11 March 2012) could also grant a claim to compensation to owners of land in the relevant municipalities, ie, municipalities with more than 20 per cent second homes.

In the first judgment (1C_216/2017 of 6 August 2018), confirmed by a second judgment issued a few weeks later (1C_364/2017 of 21 September 2018), the Federal Supreme Court decided that the restriction on the construction of second homes is not an encroachment on the guarantee of ownership that would justify material expropriation, for which the municipalities would have to assume responsibility. Based on case law, according to which construction prohibitions arising from general and

abstract norms constitute specifications of ownership, the federal judges considered the restriction to be a spatial planning measure, applying directly at the constitutional level which redefines the option of building such apartments. They therefore decided that this does not qualify as a restriction on the right of ownership.

Although our highest court accepts that an amendment to the law can lead to the loss of some rights, it is of the opinion that the affected party in this case is obliged to accept this loss without compensation. The Federal Supreme Court did, however, leave open the option of compensation in special cases – eg, if the transition from the old law to the new law should lead to glaring inequalities that have dire consequences for some owners, and if the legislator did not consider this fact.

Left to right: Wolfgang Müller, Alexander Vogel and Denise Läubli

New SIA standard 150 on arbitration proceedings

A new version of SIA standard 150, issued by the Swiss Society of Engineers and Architects ("Provisions for procedures at a court of arbitration"), entered into force on 1 January 2018. Provided that the arbitration agreement makes reference to this, and regardless of the date of the arbitration agreement, this new standard applies to all arbitration proceedings initiated after this date that concern a legal dispute in the architectural, engineering and construction sectors. The most important amendments introduced by the revision include the following:

- the option for the arbitration court to appoint a technical expert;
- the increased importance given to the mediation process, which can be requested at any time – particularly in the context of the case management conference (article 15) and the instruction hearing (article 19), which are now compulsory;
- the introduction of a compulsory case management conference to establish a procedural timetable and determine the compensation payable to the members of the arbitration court (the case management conference can also serve as a venue to freely discuss the matter in dispute or to find an amicable settlement);
- double submissions to the court of arbitration are no longer the norm –it will decide on the need for a second round of legal briefs after the instruction hearing (article 20);
- the introduction of a simplified procedure for amounts in dispute of up to 250,000 Swiss francs, and for cases where the parties have agreed on a settlement (article 41) – unless otherwise agreed by the parties, the simplified procedure is decided by a sole arbitrator who bases his or her decision on a single round of submissions and a single evidentiary hearing within six months of receipt of the file (the parties can also agree that the arbitrator should base his or her decision solely on the file); and
- the Annexe to the SIA standard concerns the urgent determination procedure, which allows the parties to request a declaratory decision (positive or negative) regarding certain exhaustively listed cases that require a quick solution (emergency situation) within 30 days –this procedure has the effect of a final award which is limited to the questions covered by the urgent determination procedure.

Other new features worth mentioning include the new rules on the taking of evidence, which aim to soften the adversarial principle (article 24); the introduction of a rule regarding default by a party (article 26); and the inclusion of a chapter on the costs of the proceedings (article 36 to 40).

Tax law – recent developments relevant to real estate

Compensation paid for the withdrawal of an objection against a building project is taxable

In its judgment 2C_267/2018 of 17 September 2018, the Federal Supreme Court passed a decision on whether compensation paid to settle negotiations between the parties involved in a disputed building project is taxable.

On the assumption that the planned expansion of a shopping centre would have a negative impact on the immediate neighbourhood, a married couple took action against the building project and took the case all the way to the Federal Supreme Court. During the negotiations, the owners of the land on which the shopping centre was to be built offered to pay them compensation on the balance of all claims if they withdrew the objection. The relevant agreement stated that the couple would receive compensation "for the reduction in value of their property as a result of the building project".

The question then arose as to whether this compensation payment has to be taxed as income. Article 16 para. 1 of the Direct Federal Taxation Act implies that compensation paid for damage suffered is not an addition to net assets, and therefore does not have any relevance for the purposes of income tax. The salient issue, as regards the taxability of the compensation payment, was whether this payment compensated the couple for a reduction in the value of their land and thus for damage suffered by them.

The couple had to provide legally acceptable proof of the reduction in value. They also had to prove that the price per square metre had dropped, and state how

much it had dropped by, as a result of the expansion of the shopping centre.

In this case, and in spite of the leading formulation in the agreement between the parties, the couple could not prove that the payment was compensation for the reduction in value of their land, which is why the compensation payment was finally deemed to be taxable. They should therefore have taken account of the tax to be paid when negotiating the compensation amount.

Real estate capital gains tax in the Canton of Zurich

On 1 January 2019, an amendment to the Zurich tax law came into effect that allows companies based in the Canton of Zurich to deduct business losses from their real estate capital gains if they sell property. Until now, this was only possible for companies domiciled outside Zurich.

The monistic tax regime applies to real estate capital gains tax in Zurich. Under this regime, gains from the sale of a property classified as a business asset are subject to a separate real estate capital gains tax – the same as for natural persons. In accordance with the Federal Supreme Court's rulings regarding the prohibition of inter-cantonal double taxation, companies that sell a property in the Canton of Zurich, but which are domiciled in another canton, can deduct their business losses from the real estate capital gains up to the present date, unlike Zurich companies. The new rule is now in line with the approach of most cantons applying the monistic tax regime.

INDUSTRIES THAT ARE PARTICULARLY ACTIVE IN THE REAL ESTATE SECTOR

It appears that 2018 was the year of real estate transactions. We have never advised on more transactions than we did in 2018, including several sale and lease-back transactions. A very unusual transaction, not often seen in the European real estate market, was an important asset swap with a deal value of several hundred million Swiss francs. According to the Ernst & Young "Trendbarometer Real Estate Investment Market – Switzerland 2019" report, institutional real estate investors are expected to streamline their portfolios with strategic divestitures and selective acquisitions in 2019. It is quite possible that there will be a lot of activity in the Swiss real estate transactions markets as well during 2019.

In the past decade, Swiss real estate has outperformed most other asset classes. Low interest rates, combined with the central bank's extremely expansive monetary policy, have propelled the real estate market to an extent that would previously have been considered unthinkable

We were also active in the field of real estate area development projects, particularly in the western part of Switzerland – including one very extensive court dispute where we represented the general contractor.

FORTHCOMING DEVELOPMENTS IN THE SWISS REAL ESTATE MARKET

In the past decade, Swiss real estate has outperformed most other asset classes. Low interest rates, combined with the central bank's extremely expansive monetary policy, have propelled the real estate market to an extent that would previously have been considered unthinkable. In the current late phase the Swiss real estate cycle, market participants expect the transaction volume to move sideways at a high level (see the abovementioned Ernst & Young report). As a consequence, Switzerland will remain an attractive real estate market for investors in 2019. It is widely expected that interest rates will remain low and that the Swiss National Bank will not raise interest rates prior to the European Central Bank which, according to the Swiss Economic Institute, should not occur earlier than in autumn 2019.

Based on the abovementioned Ernst & Young report, Swiss market participants expect that in the next five years the most important trends in real estate will be demographic change, interest rate policy and digitalisation. Those trends will, as stated earlier in this article, offer many opportunities, for example in logistics properties and relating to innovative concepts (such as co-working spaces) or products in the affordable housing sector (such as micro-apartments and serviced apartments).

Property technology companies are starting to shape the real estate industry. To date, these innovative companies have focused on three topics, namely: transactions; new valuation methods; and the organisation of the workspace. Although digitalisation is expected to result in major efficiency gains, its influence is still slower in real estate than in other sectors. It will be interesting to see how the Swiss real estate industry will catch up.