

# CONSTRUCTION & REAL ESTATE REVIEW 2018

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Although the general economic outlook for the world economy in 2018 is seen as very positive by most economists, the Swiss real estate markets are fighting vacancies in the housing and office space markets.

As of mid-2017, 2.4 per cent of all rental apartments were vacant according to UBS (Real Estate Focus 2018), the highest rate since 1998. However, rent decreases have been moderate to date and, as a consequence, UBS estimates the correction potential for asking rents to amount to 10 per cent to 15 per cent.

Despite the positive economic outlook (KOF Swiss Economic Institute forecasts GDP growth of 0.8 per cent in 2017 and 2.2 per cent in 2018) and the growth of the number of office employees in recent years, it is estimated by Credit Suisse in its recent office space market study that there is a vacancy rate of about 4 per cent in the overall Swiss office space market.

As a consequence, rental apartment and office space owners have increasingly started to offer special arrangements, such as lease-free time or vouchers in order to improve the attractiveness of their spaces for lessees.

Besides the fact that a typical market in favour of lessees exists in Switzerland at the moment, the discussion regarding an interest rate turnaround is becoming increasingly important. At the end of 2017 and the beginning of 2018, interest rates for mortgages have increased significantly, in line with the increase of the interest rates of 10-year US treasuries and 10-year Swiss Confederation bonds. Also, consumer prices are generally expected to increase in 2018.

The UBS Swiss Real Estate Bubble Index relating to housing was at 1.32 in the fourth quarter of 2017, a slight decrease compared to the past quarters, and thus remained in the risk zone. On

the one hand this development was driven by the relatively strong economic and income growth in Switzerland in 2017, and on the other hand by the relatively low increase of the household mortgage debt volume with banks of only 2.6 per cent in 2017. This is the lowest increase since 1999 and far below the 10-year average of 3.8 per cent (however, the figures do not include mortgages granted by insurers and pension funds, which have become increasingly significant recently). Therefore, the respective UBS sub-index mortgage volume relative to disposable household income was at about zero.

Construction activities still remain at a high level and the construction index prepared by Credit Suisse together with the Swiss Contractors' Association (SCA) is set at 142 points in the first quarter 2018. However, this is a decline of 3

points compared to the previous quarter and a decline of 2 points compared to the fourth quarter in 2016, which seems to indicate a certain change in trend. This decline is mainly attributable to the civil engineering sub-index, which declined by 6 points or 2.9 per cent compared to the fourth quarter in 2017 and by 12 points or 6.6 per cent compared to the third quarter in 2017. In contrast, the building construction sub-index nearly remained at the record level of the previous quarter (122 points compared to 123 points).

Despite difficult conditions, the returns to be earned in the Swiss real estate markets remained attractive in 2017. The top returns for office space in Zurich and Geneva remained at 2.7 per cent and 3 per cent respectively, according to the 2018 office market study Switzerland of JLL, resulting in a positive spread of 250

UBS SWISS REAL ESTATE BUBBLE INDEX



Source: UBS

## SWISS CONSTRUCTION INDEX: THE STATE OF THE CONSTRUCTION INDUSTRY AT A GLANCE

QI 1996 = 100, seasonally adjusted, nominal, points = trend outlook



Source: Credit Suisse, Swiss Contractors' Association

to 300 base points compared to Swiss treasury bonds. Owing to real estate markets, which currently favour lessees, investors are increasingly focusing on top real estate in terms of location, tenancy status and building quality.

**THE SWISS 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 2018, no particularly important changes have been introduced to this regulatory framework. Political discussions will continue to result in amendments to the regulatory framework though. For example, the political decisions to be taken with respect to the Energy Strategy 2050 will continue to have a significant impact on the construction industry. The optimal use of the available land, which is a limited resource, is heavily discussed between dissenting interest groups. In this respect, we will review below the planned revision of the Zurich Planning and Construction Act. The possible revision of the Swiss Federal Act on Acquisition of Real Estate by Persons Abroad (the Lex Koller) will remain a hot topic and is also reviewed below. And, of course, the digitalisation of the economy, sometimes also called industry 4.0, is heavily affecting the real estate sector. For example, crowd investing in Swiss residential real estate is becoming more and more popular. In this review, we will also assess some important court decisions in the area of landlord and tenant law, and touch on some new

developments in the area of tax law that are important for the real estate sector.

**PLANNING AND CONSTRUCTION LAW: REVISION OF THE ZURICH CANTONAL ACT ON PLANNING AND CONSTRUCTION**  
The Zurich Building Department sent a revision of the Zurich Cantonal Act on Planning and Construction (APC) for consultation on 12 May 2017. The consultation process closed on 11 August 2017 with 32 appeals filed. This “low” number was considered a success by the city council. However, it is important to note that the Zurich Heimatschutz Association appealed not only against specific proposals but against the complete package, which makes it impossible to set undisputed parts of the revision in force.

The revision intends to abolish the unpopular basement, which is partly built into the ground, and instead allows an additional floor to be built above ground. Moreover, the revision introduces new rules regarding near-shore building projects in urban areas. According to the draft submitted for consultation, all lake towns should, in future, draw up near-shore development plans to supplement their building and zoning regulations.

What sounds relatively harmless could have far-reaching consequences in practice, because, until now, the canton, through the Office for Waste Management, Water, Energy and Air, had the say about building projects along the lake. The background to this was that almost the entire Zurich lakefront was artificially raised during the 19th and early 20th centuries. As the canton

was the sovereign of the lake, it often reserved far-reaching rights when granting onshore building permits, with the result that the properties along the lakefront were seriously confined. Those who wanted to build on the shore needed not only a permit from the municipality, but also a cantonal permit. The canton exploited this situation to protect the public's interest in the lakefront and to limit building development along the shore. For example, it pruned hedges that obscured the public's view of the lake, limited the number of floors of buildings and traded building permits against a right of way in the front garden. The Federal Supreme Court eventually intervened and declared that this “special building code” was not permitted. The highest court found that there are now so many rules that the public interest can be sufficiently protected by the APC, the Waters Protection Act and the Protection of Nature and Cultural Heritage Act, even without a special cantonal permit.

As a result, the revision can lead to liberalisation in many areas, but opinions differ about whether this is good or bad.

**LEX KOLLER: FROM BADRAN'S FAILED MOTION TO THE NEW LEX SOMMARUGA?**  
The Federal Council wants – in its own words – to adapt the Lex Koller “to today's realities”, which restricts the acquisition of Swiss residential and other non-commercial real estate by foreign (non-Swiss) persons. This is in spite of the fact that a revision recently initiated by National Councillor Jacqueline Badran was rejected by the Swiss parliament. The Federal Council led by Federal Councillor Simonetta Sommaruga now wants to get a mostly very similar revision off the ground. At its meeting on 10 March 2017, the Federal Council finally launched the consultation that had been postponed several times. The consultation process closed on 30 June 2017.

In the “interests of a return to the purpose of the law”, the Federal Council was putting forward for discussion, during the consultation process, stricter rules for the purchase of commercial real estate and an obligation to obtain approval for the acquisition of residential real estate companies. It remains to be seen whether discussing the above during the consultation process is permitted by the law, and what the legal consequences of such a discussion would be. However, it was clear that the proposed revision once again met with vigorous opposition from the real estate sector.

The Federal Council was also proposing that the acquisition of property serving as their principal residence by nationals of states that do not belong to the European Union or the European

Free Trade Association (EFTA) should require approval and the permit owners should be obliged to sell the property again when it is no longer used as the principal residence, which is usually after two years.

The transitional provisions also fuelled debate, as the adjusted law should be applicable to legal transactions that were finalised but have not yet been executed or have not yet become legally binding before the amendments entered into force. This set-up could lead to interesting complications.

It is no surprise, therefore, that the feedback of the consultation was mostly negative. Many participants rejected the proposals of the Federal Council altogether, arguing that they are not necessary, not constructive and harmful for the Swiss economy. In particular, the proposals to restrict the acquisition of commercial properties and to prohibit the acquisition of participations in non-listed Swiss real estate funds and listed real estate companies holding residential properties by foreign (non-Swiss) persons was strongly criticised.

As a result, it seems likely that the Lex Koller will not be revised for the time being. However, it has not been determined when the proposals will be debated and decided by the Swiss parliament.

LANDLORD AND TENANT LAW:  
IMPORTANT COURT DECISIONS AND  
REFERENCE INTEREST RATE

*Consensual rent adjustments*

In its decision 4A\_637/2016 of 3 March 2017, the Federal Supreme Court confirmed its previous practice that a rent increase that is agreed between the parties without using the official form is null and void if the tenant was unaware of the possibility of an appeal.

This could have dire consequences for the landlord: in the case before the court, the landlord had to repay the excess rent inadvertently paid by the tenant for a period of 10 years. This can become very expensive.

*New developments regarding Airbnb*

In its decision MG16009 of 9 February 2017, the Zurich Tenancy Court made it clear that providing accommodation to paying Airbnb guests qualifies as subletting. The tenant therefore has to obtain the landlord's approval for a sublease pursuant to article 262, paragraph 1 of the Swiss Code of Obligations, which the tenant in the relevant case failed to do.

The Court also held that the tenant charged an "unfairly high rent" and did not prevent the Airbnb guests from bothering the other occupants. As a result, the Tenancy Court generally forbade the tenant to sublet any rooms via Airbnb

internet platforms in future and obliged him to hand over the gains earned from Airbnb to the landlord.

It is well known that Airbnb's popularity in Switzerland is growing, which was incentive enough for many people – in particular the hotel sector – to call in the help of the regulator. This particularly concerns the visitor's tax, as the hoteliers felt that it should also be collected from the private Airbnb hosts. Although this is compulsory in many towns (except, for example, in the city of Zurich where the visitor's tax is a voluntary contribution by the hotelier), the authorities have, to date, been hard-pressed to monitor and implement this practice, as private hosts are not included in any official lists.

On 18 June 2017, the first such agreement in Switzerland was announced: from 1 July 2017, Airbnb will automatically collect the visitor's tax from all guests in the canton of Zug and pass it on to Zug Tourism. This will relieve the private hosts from this task while guaranteeing that Zug receives the tax. Other cantons and municipalities are expected to follow.

*Reference interest rate*

The Federal Housing Office reduced the Swiss reference interest rate for tenancies to an all-time low of 1.5 per cent on 1 June 2017. The reference interest rate has remained unchanged, although interest rates have started to rise (as outlined above).

TAX LAW: RECENT DEVELOPMENTS  
RELEVANT TO REAL ESTATE

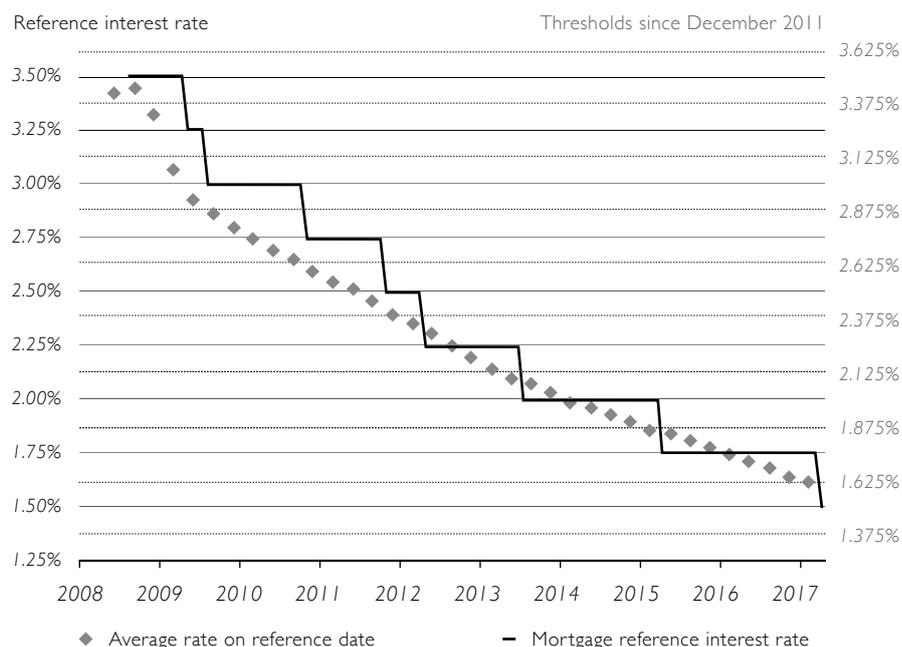
*Real estate capital gains tax in the canton of Zurich*

Companies domiciled in the canton of Zurich that sell a property should be able to set-off business losses against the real estate capital gains tax – like companies domiciled outside the canton can do already. The Governing Council of the canton of Zurich therefore asked the Cantonal Council in 2015 to eliminate this disadvantage for Zurich companies, and the respective amendment of the tax law was approved by the cantonal parliament in October 2017. However, a referendum has been launched and the vote has been scheduled to be held on 10 June 2018.

The monistic tax regime applies to real estate capital gains tax in the canton of 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 are domiciled in another canton can deduct their business losses from the real estate capital gains – unlike Zurich companies. This should also apply for companies with their registered office in the canton of Zurich. The new rule, if approved by the vote, will be in

MORTGAGE REFERENCE INTEREST RATE

Development of reference interest rate and relevant average interest rate.



Source: Federal Housing Office, Credit Suisse

line with the approach of most cantons applying the monistic tax regime.

*Value added tax and real estate – changes from 1 January 2018*

The temporary additional financing of the disability insurance from value added tax (VAT) ended on 1 January 2018. Consequently, the current VAT rate of 8 per cent dropped by 0.4 per cent, but then increased by 0.1 per cent on 1 January 2018 under the Financing and Expansion of Rail Infrastructure bill. These two changes combined meant that the normal VAT rate dropped to 7.7 per cent as of 1 January 2018. This rate also applies to VAT-opted real estate transactions.

Even though this change applies to all VAT-opted real estate transactions, it is unlikely to cause any difficulties in practice. Many companies will likely find the new rule regarding the tax obligation of foreign companies in Switzerland a bigger challenge:

Under the law, which was valid until 31 December 2017, the subjective tax liability was determined from a wholly Swiss point of view. A company earning less than 100,000 Swiss francs in revenue in Switzerland was not subject to VAT in Switzerland. Therefore, a worker domiciled outside Switzerland who did work in Switzerland did not have to charge his or her Swiss customers VAT, provided that he or she earned a revenue of less than 100,000 Swiss francs in Switzerland – with the exception of deliveries of materials, which were always subject to Swiss import tax. The Swiss customer on the other hand was obliged by law to pay the acquisition tax on the work performed by the foreign worker if he or she purchased services abroad for more than 10,000 Swiss francs per year. In practice, however, this often did not work the way the legislature intended, because

the worker domiciled outside Switzerland had an advantage over his or her Swiss competitors as he or she could offer his or she services without VAT to the Swiss customers.

As of 1 January 2018, VAT liability in Switzerland will be determined by worldwide revenue: A company earning global revenue of more than 100,000 Swiss francs will become liable for VAT in Switzerland and will have to register for VAT from the first Swiss franc in local sales. This affects many construction companies and workers in the regions bordering Switzerland, who now have to charge Swiss VAT to their Swiss customers. In turn, such companies can also deduct the import tax levied on the materials brought into Switzerland as input tax, and save their customers this expense.

Some of the work done in Switzerland (eg, installations, repairs) is regarded as VATable deliveries by the Swiss authorities. It is therefore likely that many cross-border companies in the construction-related industry will also become liable for VAT in Switzerland when performing work in Switzerland.

**INDUSTRIES OR TYPES OF CLIENT THAT ARE PARTICULARLY ACTIVE IN THE REAL ESTATE SECTOR**

In the past year we advised again on several big real estate area development projects in the west and centre of Switzerland, and in the Zurich area with an investment volume of several hundred million Swiss francs each. In addition, we handled several heavy disputes arising out of area development projects. In the transactional market we represented several institutional clients in acquiring an office building in the industrial zone of Geneva, in the exercise and execution of a purchase right, in the purchase of an

area near Zurich for the development of several hundred apartments and in selling a mountain holiday resort. In addition, in another interesting project, we advised an international insurance company on the issuance of a buyer's warranty and an indemnity insurance policy for the buyer acquiring a portfolio of Swiss properties for a purchase price exceeding 250 million Swiss francs. Buyers' warranty and indemnity insurance is increasingly seen in the Swiss real estate market.

**DEVELOPMENTS IN THE SWISS REAL ESTATE MARKET IN THE NEXT YEAR OR SO**

During 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 has propelled the real estate market to an extent that would have been considered unthinkable before. However, conditions are getting more difficult. As stated at the beginning of this article, the peak of the Swiss real estate market has been reached. Interest rates are increasing and inflation has returned. Competition in commercial and residential segments is rising as a result of oversupply and increasing vacancies. Owners of apartments and office space have increasingly started to offer special arrangements, such as lease-free time or vouchers in order to improve the attractiveness of the space for lessees. However, real estate remains a very stable asset class and the boom in the construction sector has continued, albeit at a slower rate. In summary, the Swiss real estate market still offers many opportunities, some of which will certainly be fuelled by developments in the field of digitalisation, such as crowd investing in Swiss residential real estate, which has been heavily advertised recently.