The new China-Switzerland Double Taxation Agreement

Regulations discussed in this issue:

- *Agreement Between the Swiss Federal Council and the Government of the People's Republic of China for the Avoidance of Double Taxation with respect to Taxes on Income and on Capital*

The new double taxation agreement (DTA) between China and Switzerland provides investors from both countries a potentially more beneficial withholding tax (WHT) rate on dividend and royalty income. Further, the threshold period of a 'Construction' PE has been expanded while the threshold period for a 'Service' PE has been revised to 183 days to align with other new DTAs recently concluded or re-negotiated by China. On the other hand, the ambit of DTA relief on sales of shares has been reduced under the New DTA.

Background

Following the signing of a landmark free trade agreement in July 2003, China and Switzerland have signed a revised double taxation agreement and protocol ("New DTA") on 25 September 2013, which should facilitate closer economic ties and avoid any incidence of double taxation between the two countries.

The New DTA replaces the existing DTA, which had been in force since 1990. The New DTA shall apply to income derived from 1 January of the year following its entry into force, upon ratification by both countries. As such, the earliest possible effective date of the DTA would be 1 January 2014, although 1 January 2015 would likely be the more realistic time frame subject to the timetable from ratification in the two countries.

Key features of the new DTA

Overall, the New DTA accords with the general direction of the recent DTAs that China has concluded or re-negotiated with European countries in recent years, including Belgium, Finland, the U.K., Denmark and the Netherlands.

WHT rate on passive income

The New DTA introduces more favorable WHT treatment on dividends and royalty income (subject to 'limitation of benefit' clause). By way of comparison, the principal features of the New DTA are as follows:

	Existing DTA	New DTA
Dividends	• 10 percent in all cases	• 5 percent if the beneficial owner of the dividends is a company which directly holds at least 25 percent of the capital of the company paying the dividends; • 10 percent in all other cases • Exemption specifically granted to 'institution or fund wholly owned by that State': in the case of China, the China Investment Corporation (CIC) and the National Council for Social Security Fund • Specific 'limitation of benefit clause' introduced
Interest	• 10 percent • Exemption for government, government related entities or official agencies is available	• 10 percent • Exemption for government, government related entities or official agencies is available • Specific 'limitation of benefit clause' introduced
Royalties (on licenses and rental of industrial/ commercial/ scientific equipment, etc.)	• 10 percent	• 9 percent • Specific 'limitation of benefit clause' introduced

Tax exemption for gains from disposal of shares curtailed under New DTA

Regarding capital gains, it is important to note that the New DTA limits the scope of capital gains tax exemption relief applicable on share disposals.

Under the existing DTA, Switzerland has the sole taxing right when a Swiss investor disposes of its shares in a PRC tax resident enterprise (TRE) and such gains are not taxable in China (unless the TRE is 'land rich').

The 'blanket' relief on PRC tax on gains on disposal of shares in a 'non-land rich' PRC TRE is no longer available under the new DTA. Instead, under the new DTA, China will have a right to impose a 10 percent tax on gains derived by a Swiss investor from the disposal of shares in a PRC TRE if:

- the PRC TRE is a considered 'land-rich' (i.e. more than 50 percent of the value of the company is derived directly or indirectly from immovable property situated in China); *or*
- the Swiss investor, at any time during the twelve-month period preceding the disposal, had held directly or indirectly of at least 25 percent of the capital of PRC TRE.

It is observed that compared with other recently re-negotiated DTA's with Belgium and the Netherlands, the New DTA between China and Switzerland does not contain any specific relief for disposal of listed shares.

Anti avoidance measures

In keeping with China's recent focus on introduction of tax anti-avoidance measures both domestically and in an international context, the New DTA also introduces/strengthens anti-treaty shopping and tax abuse provisions through the following:

- A specific 'limitation of benefit' clause in the dividend, interest and royalty articles is introduce d to deny the beneficial tax treatment accorded under the New DTA, where the main purpose of the income recipient is to take advantage of the reduced withholding tax rate or a tax relief on capital gains derived
- A catch all article allowing both countries to invoke their domestic anti-avoidance rules to combat perceived tax avoidance cases
- A more comprehensive 'exchange of information' (EoI) mechanism.

Permanent Establishment (PE) article changes

The New DTA also contains the following key changes to the definition of PE with regard to a Swiss tax resident deriving income from China:

- 'Construction' PE: the threshold period for carrying out construction/ installation type activities in China that would constitute a PE in China is extended from six months to 12 months

- 'Service' PE: the threshold period for furnishing of services (including consulting services) in China that would constitute a PE in China is amended from six months to 183 days (within any 12 month period).

Further, under the New DTA (as specified in the Protocol), PRC business tax is now specifically exempted and VAT is zero-rated on international transportation income derived by Swiss airlines and shipping companies from China.

KPMG observations

As mentioned above, the New DTA provides investors from both China and Switzerland with a potentially lower WHT rate on dividend and royalty income. The threshold period of a 'Construction' PE has also been expanded while the threshold period for a 'Service' PE has been revised to 183 days to align with other new DTAs recently concluded or re-negotiated by China.

That said, the ambit of DTA relief on sales of shares has been reduced under the New DTA. The New DTA also introduces new clauses and articles to strengthen the anti-treaty shopping and anti-tax avoidance measure, including specific 'limitation of benefits' clauses and a more comprehensive information exchange article.

Investors from China and Switzerland should evaluate the impact of the New DTA on their existing investment holding structure to assess whether the intended tax effectiveness would be sustainable going forward, and take into consideration the same when structuring future investments in both countries.

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