Executive summary

On 25 September 2013, China and Switzerland signed a new Agreement for the avoidance of double taxation with respect to taxes on income and on capital (New Treaty), which will replace the current agreement that was signed in 1990, once it enters into force. The New Treaty still needs to be ratified by both countries before it can come into force. This Alert summarizes key changes in the New Treaty.

Detailed discussion

Withholding tax rates

One of the features of the New Treaty decreases withholding taxes on dividends and royalty payments under certain circumstances. With respect to Swiss companies making investments into China, the New Treaty provides for a reduced withholding tax rate on qualifying dividends.

For companies with a direct shareholding of at least 25%, the dividend withholding tax rate is reduced to 5% from the current 10% rate. Shareholders that do not qualify for the 5% treaty rate may still benefit from a reduced withholding tax rate of 10% (the domestic withholding tax rates are 10% and 35% under Chinese and Swiss domestic laws, respectively). The royalty withholding tax rate is decreased from 10% to 9%. It should be noted, however, that the protocol to the existing treaty provides for an effective withholding tax rate of 6% for royalties that are paid for the use of, or the right to use, any industrial, commercial or scientific equipment. This has been eliminated under the New Treaty and its protocol. Switzerland does not levy any withholding tax on royalties.

The withholding tax on interest payments remains at 10%. Switzerland generally does not levy withholding tax on interest on commercial loans.

The below matrix outlines the major differences in the withholding tax rates for dividends, interest and royalties between the existing treaty and the New Treaty.
Capital gains
Based on the New Treaty, capital gains arising from the disposal of shares may be taxed in the state where the company whose shares are being sold is resident, provided the recipient of the gain has held, directly or indirectly, an interest of at least 25% in the capital of that company during the 12-month period preceding the disposal, or the company derives more than 50% of its value directly or indirectly from immovable property situated in the state of residence of the company whose shares are alienated. However, it should be noted that in a case where shares in a Swiss non-real estate company are disposed of, there is no legal basis for Switzerland to tax the respective gain. The existing treaty is more favorable as a capital gain is only taxable in the country of which the alienator is a resident, unless the company being disposed of derives more than 50% of its value directly or indirectly from immovable property situated in the state in which that company is resident.

Permanent establishment
The time thresholds for building site, construction, assembly or installation projects to be treated as a permanent establishment are increased from 6 months to 12 months in the New Treaty.

The new threshold for the provision of services is 183 days within a 12 month period (6 months within a 12 month period in the existing treaty).

Business tax/value added tax
Under the New Treaty, the international transport services provided by Swiss resident shipping companies and airlines will be exempt from business tax, or will be zero-rated under value added tax in China and the input VAT attributable to such suppliers will be creditable to the same extent as it is to business enterprises resident in China. International transport services provided by Chinese resident shipping companies and airlines will be zero-rated under value added tax in Switzerland and the input tax attributable to such suppliers will be creditable to the same extent as it is to business enterprises resident in Switzerland (special rules with respect to the input tax deduction apply if the Chinese resident shipping company is performing supplies of goods in Switzerland).

Anti-avoidance rules
The New Treaty adds a new article specifying that domestic laws and measures concerning special adjustments of taxation still apply. In addition, the New Treaty contains language under the dividend, interest and royalties articles specifying that the relevant treaty provisions will not apply if the main purpose of the arrangements is to take advantage of the treaty benefits.

Foreign tax credit in China
Under the existing treaty, if a Chinese resident company owns not less than 10% of the shares of a Swiss resident company and derives dividend income from the Swiss resident company, the Chinese resident company can claim credit on the tax payable in Switzerland by the Swiss resident company paying the dividend. Under the New Treaty, the percentage of shareholding is increased to 20%.

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<thead>
<tr>
<th></th>
<th>Dividends</th>
<th>Interest</th>
<th>Royalties</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Existing treaty</strong></td>
<td>10%</td>
<td>10%</td>
<td>6%1/10%</td>
</tr>
<tr>
<td><strong>New treaty</strong></td>
<td>5%2/10%</td>
<td>10%</td>
<td>9%</td>
</tr>
</tbody>
</table>
Implications

It is recommended that taxpayers revisit holding company structures in light of the changes to the capital gains, dividend and royalty articles in the New Treaty. In order to avail a more favorable capital gains article under the existing treaty, a review of the current ownership structure may be necessary to determine whether any structural changes need to be taken into account before the New Treaty enters into force. In addition, the New Treaty could complement the Free Trade Agreement between China and Switzerland signed on 6 July 2013, which is expected to enter into force on 1 January 2014.

With the reduction of the withholding tax rate for dividends under the New Treaty, Switzerland will continue to be one of the primary jurisdictions in Europe, both for investments into China and for investments from China into Europe.

Endnotes

1. Applicable to royalties paid for the use of, or the right to use, any industrial, commercial or scientific equipment.

2. Applicable to dividends paid to a company (beneficial owner) with a direct interest of at least 25% in the capital of the company distributing the dividend.
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EYG No. CM3876

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