New China-Switzerland tax treaty enters into force

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 replaces the agreement that was signed in 1990. The New Treaty entered into force on 15 November 2014 and is effective for income derived on or after 1 January 2015. This Alert summarizes key changes in the New Treaty.

Detailed discussion
Withholding tax rates
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 (other than partnerships) 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.

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<tr>
<th></th>
<th>Dividends</th>
<th>Interest</th>
<th>Royalties</th>
</tr>
</thead>
<tbody>
<tr>
<td>Existing treaty</td>
<td>10%</td>
<td>10%</td>
<td>6%/10%</td>
</tr>
<tr>
<td>New Treaty</td>
<td>5%/2/10%</td>
<td>10%</td>
<td>9%</td>
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**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 Switzerland does not levy a nonresident capital gains tax on the transfer of shares except for disposal of shares in a Swiss real estate company. 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 shares being disposed of derive more than 50% of their value directly or indirectly from immovable property situated in the state in which that company is resident, or if the disposal has had directly or indirectly at least 25% in the capital of the disposed company at any time during the 12 month period preceding the dispositions.

**Permanent establishment**
The time threshold for building site, construction, assembly or installation projects to be treated as a permanent establishment is 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 and value added tax**
Under the New Treaty, the international transport services provided by Swiss resident shipping companies and airlines will be exempt from Chinese business tax, or will be zero-rated under value added tax (VAT) 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 VAT 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.

**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 royalty 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%.

**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 addition, the New Treaty complements the Free Trade Agreement between China and Switzerland that was signed and entered into force on 6 July 2013 and 1 July 2014, respectively.

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.

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**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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