SWISS INVESTMENT REPORT* 1

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* The Swiss Investment Report is provided by Wenfei Attorneys-at-Law Ltd. ("Wenfei"), a Swiss law firm with its seat in Zurich, which has gained extensive experience in providing services in Greater China.

The Swiss Investment Report is especially designed for Chinese Investors, who are intending to extend their business to Switzerland or Europe or are already doing business in Switzerland.

Of course, the Swiss Investment Report is also addressed to any other person who is interested in obtaining background information on the Swiss investment-related legal framework as well as information on current developments in the Swiss legislation from a foreign investor's perspective.

European headquarters of the Chinese investor in Switzerland – Advantages from a tax perspective

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I. Introduction

The financial crisis has led to a worldwide downturn. The American as well as the European economic markets are struggling. Chinas market has also been affected, mainly due to the decrease of demand for goods by the Western countries. However, many Chinese companies have a solid and healthy financial basis. For these companies the current crisis might also be a chance in order to acquire European companies at attractively low prices and establish a presence in Europe.

Whether being a Chinese family-owned business or a large state-owned enterprise, which intents to enter the European market, the Chinese investor will have to choose an appropriate country to set up its European headquarters. What are the criteria to determine such base? Besides aspects such as a stable political system, well-trained and multilingual employees and good infrastructures, the tax environment of the host country is an essential criterion. European countries' tax rates and the general taxation systems may vary tremendously. Low tax rates, attractive tax structures for foreign investors and double tax agreements in combination with a stable legal system are advantageous criteria for the establishment of a European headquarters.

Switzerland is not only well-known for its diverse culture, high-quality products and stable legal system, but also for its attractive tax regime. Therefore many international companies have chosen Switzerland for the establishment of their European headquarters.

This article aims to provide an introduction of the Swiss tax system as well as a brief overview of Swiss foreign-related tax planning instruments. The latest reform of the Swiss corporate tax law, which entered into force on 1st of January 2009, has also been taken into consideration.

II. General tax system of Switzerland

The tax burden of Switzerland belongs to the lowest in Europe: Depending on the location of the company, the effective overall corporate income tax for ordinarily taxed companies starts at a rate of 13.5%. Switzerland's tax law offers a wide range of tax instruments and structures, which allow particularly foreign investors optimizing their overall taxes. A company, which meets the requirement of a "Holding Company", "Mixed Company" status or is treated as a "Principal Company", can profit from remarkable tax reliefs. Furthermore, tax holidays up to ten years may be granted for new investments of economic importance. Double taxation treaties with 70 countries offer solutions for optimized distribution of dividends and interests, whereas in Switzerland no withholding tax is levied on royalties at all.

In Switzerland taxes are levied on three different levels: the federal (national), cantonal (provincial) and municipal level. On the federal level, direct federal tax is levied on the income of natural persons and on the net profit of legal entities. Additionally, federal withholding tax (tax collected at source) is levied on capital yields and stamp duties are imposed on the issue of securities. Value-added tax (standard rate: 7.6 %) is levied on the sales of goods and provision of services. The cantons tax income and net wealth of natural persons as well as profits and capital of legal entities. Furthermore, on the cantonal level tax on inheritance and gift are levied, although, many cantons have abolished such tax for spouses and children. On the third level, the municipality generally taxes a surcharge on the basic cantonal tax and gains on real-estate.

Whereas the federal corporate income tax rate is set at a flat rate of 7.83% the cantonal and municipal corporate income tax rates vary and – due to a competition amongst the cantons – start at a combined flat rate of 5.66%. This results in a total corporate income taxation of 13.5% for ordinarily taxed companies.

In the international context, income tax is imposed on the worldwide income of a natural person or a legal entity, with the exception of income from a business, permanent establishment or immovable property located abroad.

III. Taxation on Holding Companies

All countries, which tax corporate profits both at the basis of the company and on the basis of the shareholders, have to reduce such double charges. Different systems may apply. With the so-called "Holding Privilege" Switzerland provides at the cantonal level a special tax regime which leads to a complete relief of aggregate incomes. On the federal level corporate income tax can be reduced in proportion of the net income from the investment to the aggregate net profit of the company. This tax relief is called "Reduction on Investments".

1. Holding Privilege (Cantonal and municipal Level)

Cantonal and communal taxation laws offer the Holding Privilege. The Holding Privilege results in a total exemption[1] of corporate income tax and a reduction of tax on capital (e.g. Tax rate of canton of Zurich being 0.015%; the tax rate varies in every canton).

A company can profit from the Holding Privilege, if it meets the following requirements:

a) Purpose in the bylaws of the company being the permanent administration of participations (participations include all types of shares, e.g. shares of joint stock company, limited liability company), and

b) At least 2/3 of total assets consist of participations or at least 2/3 of the company income is derived from these financial participations, and

c) No commercial activity of the company within Switzerland. Only secondary aims which are related to the administration of the participations are allowed.

The first two conditions (a and b) have to be met on the long term. In case a new company is set up, the quota should be met within a year. If the quota drops, the Holding Privilege will only be inapplicable, if the quota will not be met again within a two years-period.

[1] Only exception: earnings related to real estate.

2. Reduction on Investments (Federal Level)

Reduction on Investment means that corporate income tax is reduced in proportion of the net income from the investment to the aggregate net profit of the company. This may lead to a total exemption from federal corporate income tax, if the net income from the investment (generally dividend income and capital gain) corresponds to the aggregate net profit. Income other than dividend income and capital gain will be taxed at 7.83%.

In order to qualify for such tax reduction, a holding company has to meet the following requirements:

a) Participations being at least 10% of the registered capital of another capital company or participations having a minimum market value of CHF 1 millions (approximately RMB 6,5 millions)

b) Participations must be kept by the holding company for at least one year

IV. Mixed Company

An internationally operative company may also profit from having the status of a so-called Mixed Company.

Mixed companies are companies, which are primarily engaged in activities outside of Switzerland and only perform limited and auxiliary activities in Switzerland (e.g. coordination of business activities). A mixed company is generally existent, if cumulatively at least 80% of the total income is derived from foreign sources and at least 80% of the expenses for services rendered by the company of its own or from third parties are derived from foreign sources.

On the cantonal and communal level, the mixed company's income derived from qualified investments (dividends and capital gains on such investments) is totally exempted from taxes. An investment is regarded as qualified, if the Mixed Company holds at least a 20% stake or participation with a minimum value of CHF 2 millions. Other income derived from abroad is ordinarily taxed in proportion to the extent of business activity in Switzerland. This rule results in a partly taxation of foreign income, whereas the quota of taxation of foreign income is between 10% and 30%, depending on the applicable cantonal regulation. Other income derived from business activities in Switzerland is ordinarily taxed at the locally applicable tax rate.

On the federal level, income derived from Swiss and foreign sources are taxed at the rate of 7.83%. However, also for Mixed Companies, the "Reduction on Investments" tax relief method is applicable, if the requirements as mentioned in paragraph III.2 are met.

V. Principal Company

1. Definition

Recently, internationally operative company groups have started to restructuring their regional structures and setting up cost sharing structures, in which a Principal Company holds a controlling and coordination function and typically assumes risks and responsibilities in areas such as purchasing, planning of production, sales and logistics, providing financial services, planning of research & development, developing of marketing strategies, treasury and finance and administration duties.

The production takes place in a foreign country either by an affiliate company or a third company on behalf and for account of the Principal Company. The manufacturer is paid on a "cost-plus" basis, which means that the manufacturing costs and a certain profit percentage is paid to the manufacturer. The manufactured or purchased goods are sold by an affiliate company (distribution company) on its own behalf, but for account of the Principal Company. The distribution company typically acts as an agent on a commission basis.

2. International profit allocation

The manufacturer and the distribution company are regarded as "dependent agents" pursuant to Article 5 Para 5 of the OECD Model Tax Convention2 by the Swiss federal tax authorities and, therefore, deemed to be a permanent establishment of the Principal Company. The dependent agent is adding

[2] The Double Taxation Agreement between China and Switzerland has adopted the OECD Model Tax Convention.

substantial value to the Principal Company and, consequently, part of the Principal Company's profit has to be attributed to the dependent agent.

The Swiss federal tax authorities attribute 50% of the sales profit to the dependent agent, whereas the other 50% of the sales profit are allocated to the Swiss Principal Company. Hence, only half of the sales profit of the Principal Company is subject to federal income tax. Since the income from a permanent establishment abroad is not taxed under Swiss tax law, this allocation of profits result in an effective federal tax rate of 3.9%.

If the goods are not only traded but also manufactured by an affiliate company or a third company on behalf and for account of the Principal Company, 70% of the net profit derived from sales and manufacture are deemed to be sales profit. In such case, 65% of the sales and manufacture profit are subject to federal income tax, which corresponds to an effective federal tax rate of 5.1%.

The cantonal and communal tax authorities are not bound by the above mentioned international allocation of profit. Most cantons may consider such Principal Company as being a "Mixed Company" and therefore, only 10% and 30% of the business income derived from abroad are subject to cantonal and communal tax, depending on the applicable cantonal regulation.

As a conclusion, the total income tax burden of a Swiss Principal Company would generally be in the range of 5-10%, depending on the particular structure and the location of the Principal Company within Switzerland.

VI. Double Taxation Agreement between China and Switzerland

Swiss tax law provides that a federal withholding tax of 35% is levied on the gross amount of dividends distributed by a resident company to a foreign shareholder and on interest received by a non-resident from bonds issued by Swiss debtors and from deposits with banks. No withholding tax is levied on private and commercial loans (including inter-company loans). There is no withholding tax levied on royalties paid to a resident or a non-resident at all.

Pursuant to the Double Taxation Agreement (DTA) between China and Switzerland dividends distributed from a company of one country to a receiver in the other country are subject to a maximum withholding tax of 10%. Hence, 25% of the withholding tax levied on the dividends will be refunded to the Chinese investor. For international inter-company distribution of dividends, however, Switzerland recently introduced a reduction at source system for dividend payments. For most cross-boarder dividend payments within a group, the company has to pay the non-refundable withholding tax only. The applicability of reduction at source is subject to the application of the tax paying Swiss company to the federal tax administration.

According to the DTA between China and Switzerland, China eliminates double taxation by allowing a deduction of the amount of tax paid in Switzerland on income which may be taxed in China. The total amount is restricted to that portion of the tax in China attributable to the income from Switzerland. For dividends distributed from a Swiss company to a Chinese company, which holds at least 10% of the Swiss company, the total income tax paid by the Swiss company shall be deductible from the Chinese taxes.

VII. Conclusion

Switzerland, which is situated in the heart of Europe, is attractive for Chinese investors. Besides many other advantages, Switzerland offers attractive tax instruments and structures as well as competitive tax rates for internationally operating companies in order to reduce the overall tax burden of their businesses. Upon request, federal and cantonal tax authorities beforehand provide binding opinions, whether a company will profit from being classified as "Holding Company", "Mixed Company" or "Principal Company" or any other preferred tax treatment under Swiss law.

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