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The New Double Taxation Agreement between Switzerland and China

I. Introduction

On 15 November 2014, the new double taxation agreement between Switzerland and China (“DTA”) went into force after the ratification procedure in both countries was completed. As of 1 January 2015, the provisions of the new DTA are applicable and effective.

The DTA replaces the previous agreement in force since 1991 and contains provisions on the exchange of information in accordance with the currently applicable international standard. The new DTA will, along with the free trade agreement that went into force on 1 July 2014 and the social security agreement that is planned to be signed in the course of 2015, contribute to the further positive development of bilateral economic relations between Switzerland and China. At the same time, it will enhance Switzerland’s position to become a hub for Chinese companies doing business in Europe.

This publication shall give an overview of the new legal framework under the DTA and elaborate on some of the consequences for Swiss investments in China.

II. Overview of the New Provisions

A. Withholding Tax

1. Dividends

Switzerland and China have agreed to reduce the maximum rate of withholding tax on dividends from 10% to 5% if the company receiving the dividends holds directly at least 25% of the capital of the company paying the dividends. As previously, in all other cases, both countries may levy withholding tax of no more than 10% on gross dividend amounts.

2. Royalties

The withholding tax rate for royalties has been reduced from 10% to 9%.

3. Interest

The applicable maximum withholding tax rate on interest payments remains at 10% of the gross amount.

B. Permanent Establishment

The thresholds for permanent establishments have been adjusted from previously six months to twelve months for building and construction sites, assembly or installation projects and supervisory activities in connection therewith, as well as from previously six months in a twelve-month period to 183 days in a twelve-month period for the provision of services.

C. Other provisions

Two further revisions of the DTA are particularly relevant for Swiss companies:

China will not be entitled to levy any business tax or any value added tax on international transport services provided by Swiss shipping companies and airlines.

Capital gains deriving from the alienation of shares of a company are taxed in the country where the company of which the shares are being sold is resident, provided that the recipient of the gains at any time during the twelve-month period preceding such alienation had a participation, directly or indirectly, of at least 25% in the capital of such company.

D. Exchange of information

The DTA contains an OECD administrative assistance clause, based on the internationally applicable standard regarding the exchange of information in tax matters as set out in Article 26 of the OECD Model Convention with respect to Taxes on Income and on Capital. It will cover information exchange requests referring to tax years beginning on or after 1 January 2015 (see section 10 of the Protocol to the DTA).

1. The administrative assistance procedure

In the case of Switzerland, the procedure for the exchange of information with foreign tax authorities is set out in the Ordinance on Administrative Assistance under Double Taxation Agreements of 1 September 2010.

Based on this procedure, Chinese tax authorities have to submit a request for administrative assistance to the Swiss Federal Tax Administration, which must contain among other things a clear identification of the company or person to which the information is related, a clear identification of the holder of information (e.g. banks or other financial institutions), a description of the requested information and the reasons why it is requested, as well as the relevant taxation period. The new OECD standard lowers the requirements for the identification of the relevant tax subjects and the information holder: for example, while a specific name, address and account number were required before, the Federal Tax Administration can now also grant assistance where just an account number is furnished. Also, requests covering groups of tax subjects are now admissible. However, the Federal Tax Administration will still reject requests for assistance that appear to be "fishing expeditions", i.e. requests that contain no specific information regarding their targeted subjects and no evidenced grounds for suspicion against such subjects. Equally, an automatic or spontaneous exchange of information with foreign tax authorities is still prohibited by law in the case of Switzerland (although the DTA itself does not expressly prohibit an exchange of information that goes further than the minimum standard).

If a preliminary review shows that the request may be processed, the affected person is informed of the request for administrative assistance. If after a detailed examination of the request and the information to be transmitted, the Federal Tax Administration comes to the conclusion that administrative assistance may be granted, it issues a decision to the affected person, which can be appealed at the Federal Administrative Court within 30 days. If no appeal is filed or the deadline passes, the information will be transmitted to the Chinese tax authorities.

According to section 9 of the Protocol to the DTA, requests for assistance sent by Switzerland to China have to meet the same minimum requirements, i.e. information regarding the person under investigation and the information holder, regarding the tax purpose of the request, and the relevant tax period. The Protocol states that both Contracting States shall not engage in "fishing expeditions" or request information that is unlikely to be relevant to the tax affairs of a given taxpayer. In China, unlike in Switzerland, the person under investigation has no guaranteed right to be informed or heard about an impending exchange of information: under certain circumstances, the tax subject may be informed, but there is no obligation on the part of the tax authorities. Furthermore, in the case of China, the law does not expressly prohibit a spontaneous exchange of information (and, as mentioned above, the DTA does not either). However, Chinese authorities do not resort to such actions in practice firstly because of the principle of reciprocity and secondly because there is as of yet no standard process or legal basis regulating a spontaneous or automatic exchange of information (however, this is likely to change in the medium term: see below).

2. A look ahead: automatic exchange of information

In the medium term, the exchange of information is likely to become more extensive. To date, almost 100 countries, including Switzerland and China, have declared their intention to adopt the new global OECD standard for the automatic exchange of information ("AEOI"), which will allow for an exchange of information without specified requests for administrative assistance.

On 14 January 2015, the Swiss Federal Council launched two consultations on the legal foundations for introducing the future international automatic exchange of information in tax matters, which will run until 21 April 2015. The question regarding the countries with which Switzerland should establish the automatic exchange of information will be presented to Parliament separately at a later stage. The Swiss Parliament is expected to discuss the draft legislation from autumn 2015. This means that the legal foundations could come into force from the beginning of 2017, even with a possible referendum. Switzerland's first automatic exchange of information with a foreign country could then take place from 2018 onwards. China has also publicly committed to an implementation of the new AEOI standard by 2018.

III. Consequences for Swiss Investments in China

The new DTA between Switzerland and China should also prompt Swiss investors to re-think possible structures for investing in China. To understand how to best make use of the various options in light of the tax frameworks of Switzerland, China and Hong Kong and the interplay between them, one must have a look at the double taxation rules between China and Hong Kong, and Hong Kong and Switzerland respectively.

A. Double taxation framework between Switzerland, China and Hong Kong

Under the DTA between China and Hong Kong ("PRC-HK DTA"), dividends are subject to a withholding tax of 10%, or 5% if the dividend recipient is a company holding at least 25% of the capital of the company paying the dividends. Royalties and interests are both subject to a withholding tax of 7%.

Under the DTA between Switzerland and Hong Kong („CH-HK DTA“), dividends are subject to a withholding tax of 10%, or 0% if the dividend recipient is a company holding at least 10% of the capital of the company paying the dividends. Royalties are subject to a withholding tax of 3% and interests can be disbursed tax free.

B. Comparison of possible investment structures

Even though for each investment project the situation has to be evaluated on a case by case basis, the following possible set-up structures can be compared to point out some general observations: (i) a PRC company owned by Swiss company through Hong Kong holding company (“Set-up 1”) and (ii) a PRC company directly owned by Swiss holding company (“Set-up 2”).

Under the old DTA, dividends paid from a Chinese company to a Swiss holding company were always subject to 10% withholding tax. As such, the advantage of Set-up 1 was that the withholding tax on dividends distributed from the Chinese company to the Hong Kong company was only 5% (if recipient holds at least 25% of the capital of distributing company) while Hong Kong did not levy any withholding tax on dividends. This advantage disappears with the entry into force of the new DTA between Switzerland and China because under the new DTA, the withholding tax on dividends distributed from a Chinese to a Swiss holding company has been reduced to 5% (if the dividend recipient is a company holding at least 25% of the capital of the company paying the dividends).

With regard to interest payments from a subsidiary to its parent company, Set-up 1 provides the advantage that the withholding tax is lower if it is distributed via Hong Kong company (7%), compared to a 10% withholding tax on interests paid from a PRC company to Swiss company.

With regard to licenses or management services provided between the parent company and its subsidiary, it may be better to conclude license and/or management agreements directly between the Swiss company and the PRC company even in case of Set-up 1, as royalties paid from Mainland China to Hong Kong are subject to a 7% withholding tax and royalties paid from Hong Kong to Switzerland are subject to a 3% withholding tax while there is no favourable treatment for management services provided by a Hong Kong company. In contrast, the withholding tax on royalties paid directly from Mainland China to Switzerland only amounts to 9% under the new DTA between the two countries.

C. The impact of the new Sino-Swiss Free Trade Agreement

Another advantage of Set-up 1 that will tend to lose its edge in the years to come is the fact that the Closer Economic Partnership Agreement between Hong Kong and the People’s Republic of China (“CEPA”) on the one hand, and the Free Trade Agreement between Hong Kong and the EFTA States (“EFTA-HK FTA”) on the other hand facilitate the trade of goods and services between Mainland China and Hong Kong and between Hong Kong and Switzerland, respectively. With the new Sino-Swiss FTA, such a free trade framework will also exist between China and Switzerland. However, it is clear that the liberalizations under the Sino-Swiss FTA do not go nearly as far as those between Switzerland and Hong Kong as well as those between Hong Kong and Mainland China. While 0% tariff rates generally apply in the latter case, the tariff reductions for imports from Switzerland into Mainland China are only partial in most cases and subject to transition periods of several years. Equally, trade in services via a Hong Kong entity is subject to significantly less restrictions than services provided by Swiss entities in the PRC, even under the new Sino-Swiss FTA. For service providers in particular, Set-up 1 hence offers significant advantages and a far broader market access than a direct investment in the PRC.

Furthermore, Hong Kong not only offers a low and stable corporate income tax, it also allows for a free flow of capital and a free convertibility of currency while the exchange and transfer of RMB into and out of the PRC is still heavily restricted and subject to administrative burden.

With regard to the Free Trade Zone in Shanghai, the regulatory framework there offers only limited benefits to foreign-investors as of now; in particular, it is still very far apart from the benefits offered by Hong Kong. However, the situation in the Shanghai Free Trade Zone is highly dynamic and should be closely watched as it may present increasingly interesting advantages to Swiss companies looking to do business in the PRC.

One of the major disadvantages of an investment through a Hong Kong company by way of Set-up 1 compared to Set-up 2 is the additional set-up and administration costs for the entity in Hong Kong and the 3-5 years of prior substantive business operations that are required in order to apply for a Hong Kong Service Supplier (HKSS) certificate, without which the company cannot benefit from preferential treatment under CEPA.

D. Conclusion

Of course, the ideal set-up structure for any investment into PRC has to be determined on a case by case basis, taking into account the prospective nature of the investment (production, import and distribution of goods, services etc.), the flow of capital, the provisions applicable to the intended investment in the relevant FTAs and DTAs as well as the administrative costs involved in the various options.

In conclusion, however, it can be generally stated that an investment through Hong Kong (Set-up 1) still offers many advantages. While the benefits of such a set-up in terms of taxation of dividends and interests are diminishing with the new DTA between Switzerland and China, Hong Kong still offers a very low corporate income tax rate as well as no VAT or sales tax, unlike the PRC. Furthermore, market access in Mainland China via a Hong Kong Service Supplier is still significantly broader and easier since CEPA offers significant advantages over the general GATS framework in the PRC while trade barriers with regard to trade of goods, services and cross-border investments have been mostly abolished under the EFTA – HK FTA. This is particularly true for Swiss companies looking to provide services in Mainland China, as the trade in services between Switzerland and China is still subject to high barriers despite the new Sino-Swiss FTA. However, depending on the field and scope of activity of the prospective company, a set-up through a direct investment in Mainland China, without a holding company in Hong Kong, is viable option that should be seriously considered in an increasing number of cases following the entry into force of the new double taxation framework.

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