New China-Netherlands tax treaty improves capital gains protection for Netherlands investors

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In brief

China and the Netherlands entered into a new double taxation agreement (DTA) and protocol on May 31, 2013. This replaces the existing DTA, which has been in force since January 1, 1989. The new DTA follows the general trend of DTAs that China has concluded or renegotiated in recent years. However, it includes a new provision that will benefit Netherlands investors in China, including Netherlands subsidiaries of US multinational corporations (MNCs).

Under the standard Chinese DTA, China can tax gains from the disposal of property-rich company shares and, when a 25% shareholding threshold is met, Chinese non-property-rich company shares. The new DTA provides additional treaty protection when, among other conditions, the disposed shares are quoted shares listed on a recognized stock exchange.

This treaty protection for quoted shares is new for Chinese DTAs. It puts Netherlands investors in China in a better tax position than investors from other jurisdictions.

In detail

After both countries ratify the new DTA, it will apply to income derived from January 1 of the year following its entry into force, replacing the existing China-Netherlands DTA. Therefore, the earliest possible effective date is January 1, 2014. We highlight key changes in the new DTA below.

Treaty protection for gains from quoted shares

Under the existing China-Netherlands DTA, China retains taxing rights with respect to gains derived by a Netherlands tax resident from the disposal of Chinese company shares. In general, the new DTA adopts the standard capital gains clauses on the taxation of shares found in China's recent DTAs.

As a result, China may only tax:

- gains from disposal of property-rich company[1] shares; and
- gains from disposal of Chinese non-property-rich company shares, but only when the recipient of the gains held at least 25% of that company's capital (either directly or indirectly) at any time during the 12 month period preceding the disposal.

The new capital gains article adds protection for gains derived from the disposal of quoted shares. This provision is not included in other Chinese DTAs.

[1] A property-rich company refers to a company deriving more than 50% of its value, directly or indirectly, from immovable properties situated in China.

Under the new DTA, only the residence state (i.e., the Netherlands) may tax the gains from the disposal of shares quoted on a recognized stock exchange. Furthermore, the total number of shares disposed of during the fiscal year in which the disposal takes place may not exceed three percent of the quoted shares.

This protection is similar to a provision in the new China-Belgium DTA (concluded in 2009 but not yet effective). This was the first Chinese DTA to include such a clause. However, under the China-Belgium DTA, the treaty protection applies only to quoted shares of Chinese non-property-rich listed companies. The quoted shares protection under the new China-Netherlands DTA is more favorable because it also covers quoted shares of property-rich listed companies.

Other key changes

Some of the other key changes for a Netherlands tax resident deriving income from China are:

Permanent establishment (PE)

- *Construction PE:* The DTA extends the period required for construction activities to constitute a PE from 6 to 12 months.
- *Service PE:* The DTA amends the time threshold when furnishing services will create a PE from 6 months to 183 days.

Passive income

- *Dividends:* The DTA reduces the withholding tax (WHT) rate for dividends to 5% provided that the dividends' beneficial owner (BO) directly holds at least 25% of the capital of the company paying the dividends. A 0% WHT rate applies if the BO is the Netherlands government or a state-owned enterprise.
- *Interest and royalties:* The WHT rate for interest and royalties remains unchanged at 10% on interest and royalties in general and 6% on royalties from equipment rental.
- *Tax sparing credit for interest and royalties:* The tax sparing credit for interest and royalties under the existing DTA is no longer available.

Anti-treaty shopping and abuse

- *Limitation of Benefits (LOB)*: A LOB paragraph denies the preferential treaty rate for dividends, interest, and royalties when the main, or one of the main, purpose of the structure is to take advantage of the treaty benefits.
- *General anti-avoidance rules (GAAR*): The DTA adds an article allowing both countries to invoke their respective domestic GAAR.

Persons covered

- A new article in the protocol provides that a person who is established in the Netherlands and treated as a tax-exempt investment institution under the Netherlands company tax law is not entitled to DTA benefits.

  Observation: We believe this provision was added to address global concerns of double non-taxation.

The takeaway

In recent years, China has concluded or renegotiated new DTAs with several European countries, including Belgium, Finland, the United Kingdom, Denmark, and the Netherlands. These new DTAs have generally followed the trend of China's recent DTAs. The capital gains protection for quoted shares in the new China-Netherlands DTA reflects this trend and offers more protection to residents of the Netherlands investing in quoted shares of Chinese listed companies (and similarly for Chinese investors into the Netherlands).

US MNCs with affiliates in countries that have recently concluded new DTAs with China should study the impact of these new DTAs. The new DTAs reflect the Chinese State Administration of Taxation's desire to equalize treaty treatments for most overseas jurisdictions in order to reduce treaty shopping.

MNCs also should consider the anti-treaty-shopping and abuse elements in these new China DTAs and should revisit existing investment and business structures to assess whether they will continue to qualify for treaty benefits.

Let's talk

For a deeper discussion, please contact:

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