New tax treaty provisions between China and the Netherlands to promote investment

On 31 May 2013, a new tax treaty was signed between the Kingdom of the Netherlands and the People’s Republic of China (the New Tax Treaty). When it enters into force it will replace the current tax treaty, which was introduced in 1987.

The New Tax Treaty contains certain updated and improved provisions, which are expected to further promote investment and trading between the two countries.

Dividends

The New Tax Treaty provides for a reduced source country tax on dividends of 5%, an improvement as compared to the current tax treaty which was fixed at 10%. This 5% applies in situations where the beneficial owner of the dividends is a resident company of one of the Contracting States and directly holds at least 25% of the capital of the company paying the dividends in that other Contracting State.

It is noted that this reduction of source country tax on dividends especially benefits Dutch groups with Chinese subsidiaries, as in the reverse situation there are usually a number of alternatives to mitigate Dutch tax on dividends altogether.

As a consequence, Dutch groups (and other MNCs) may want to reconsider the structure of their investments into China, i.e., it may be worthwhile to rationalize existing holding structures. In those situations, Chinese income tax on capital gains and internal reorganization rules should be carefully considered as well.

In addition, under the New Tax Treaty, the source tax on dividends would not be imposed on dividends paid by a company, which is a resident of one of the Contracting States, if the beneficial owner of the dividends
is the Government of that other Contracting State or one of its institutions or a company the capital of which is wholly owned directly or indirectly by the other Contracting State. This provision would be especially relevant to a limited number of Chinese State Owned Enterprises that are wholly owned by the Chinese government, even for portfolio interests in Dutch companies.

In all other circumstances than described above, the source country tax on dividends is limited to 10%. The New Tax Treaty does not specify the holding period with regard to the abovementioned 25% of holding percentage. Nevertheless, pursuant to relevant interpretations provided in Guoshuihan [2009] No. 81 and Guoshuifa [2010] No. 75, to qualify for the intended treaty benefit, it seems the resident of the contracting state shall directly hold at least 25% of equities of the company paying dividends in the other contracting state for no less than consecutive 12 months prior to the distribution.

Capital gains on shares

**Immovable property**

Capital gains derived by a resident of the Contracting State from the alienation of shares deriving more than 50% of their value directly or indirectly from immovable property located in the other Contracting State, may be taxed in that other Contracting State.

**Shareholdings of at least 25%**

Gains derived by a resident of a Contracting State from the alienation of shares of a resident company of the other Contracting State, may be taxed in that other Contracting State if the recipient of the gain had, at any time during the twelve month period prior to the alienation, directly or indirectly, a participation of at least 25% in the capital of that company.

**Other**

Gains derived by a resident of the Contracting State for the alienation of shares in the two categories mentioned above may only be taxed in the Contracting State of which the alienator is a resident, if the alienated shares are:

- Quoted on a recognized Stock Exchange, provided that the total of the shares alienated by the resident during the fiscal year in which the alienation occurs is not more than 3% of the quoted shares; or

- Held by the Government of one of a Contracting State, any of its institutions or any other entity the capital of which is wholly owned by that Contracting State, provided that such institution or entity is a resident of that Contracting State.

It is important to note that under certain circumstances, based on Guoshuihan [2009] No. 698, China claims the right to tax indirect capital gains.

**Permanent establishment definition**

Under the New Tax Treaty, a permanent establishment will also include a building site, or construction, assembly or installation project or supervisory activities in connection therewith, but only if such site, project or activities last more than 12 months. In the current tax treaty, this period is six months. By extending the time period, the New Tax Treaty will make it more flexible for companies in the Netherlands to carry on such activities in China without creating a permanent establishment and vice versa.

With respect to the taxation of so called service permanent establishments under Chinese domestic rules, the New Tax Treaty will allow China to levy tax only if and when the activities continue for more than 183 days within any twelve month period. The current treaty provides a threshold of more than six months within any twelve month period. In practice this leads to disputes on whether presence in China only for one day would taint a whole month in determining whether the six months threshold has been met. The New Tax Treaty therefore provides a welcome clarification.

**Determination of the profit of a permanent establishment**

The current tax treaty determines that the remuneration for the provision of technical services (such as examinations of geological or technical nature, engineering activities and consultancy or supervisory services) will only be taxed as profit of a permanent establishment, implying that a Contracting State can tax this remuneration for income tax purposes only if the provider of the technical services is considered to have created a permanent establishment in this Contracting State. On the other hand, basing on Guoshuiwaizi [1989] No. 38 regarding an interpretation of certain articles of the current tax treaty, such revenue shall not be classified as royalty for withholding tax purposes. Instead, it would be treated as business profit of the permanent establishment in
the Contracting State and may be subject to statutory corporate income tax rate. The aforesaid provision has been cancelled in the New Tax Treaty. As a result, it may need to be considered whether the current payments for technical services might be taxed at royalties pursuant to the Royalties article.

Interest
The Netherlands does not levy interest withholding tax. The new tax treaty still provides for a 10% interest withholding tax rate on interest paid from China and received by the beneficial owner, which is resident of the Netherlands.

However an interest withholding tax exemption applies to interest paid from a Contracting State to, or on loans guaranteed or insured by, the Government or a local authority, the Central Bank, or any financial institution wholly owned by the other Contracting State.

In addition, article 23 of the treaty, interestingly called the “Miscellaneous rule,” mentions that the treaty and its provisions shall not prejudice the right of each Contracting State to apply its own domestic anti-abuse rules. In this respect, the Guoshuihan [2009] No. 601(Circular 601) as well as further clarifications thereto is relevant as it provides guidelines to determine whether the recipient of the dividend/interest/royalty is to be considered the beneficial owner and consequently should receive treaty benefits. One should be careful to assume that a seemingly clear cut case would for example benefit from the reduced 5% dividend withholding tax rate without considering all the factors mentioned in Circular 601.

Elimination of double taxation
Under the New Tax Treaty, China should provide a tax credit for the underlying Dutch corporate income tax and dividend withholding tax in the case of a dividend distribution made by a Dutch company to a Chinese company, in cases where the Chinese company owns 20% or more of the Dutch company. This ownership threshold has been increased as compared to the current treaty (10%) and is in line with current Chinese domestic tax law.

Exchange of information
The New Tax Treaty contains a revised exchange of information clause, which is in line with the current OECD standard. It should be noted that China is not an OECD member, but it does have a working relationship with the OECD.

Assistance in the collection of taxes
A provision for assistance in the collection of taxes has been included in the New Tax Treaty with respect to the taxes to which the New Tax Treaty applies.

Entry into force
At the moment of the publishing of this Tax Alert it is not certain yet when the New Tax Treaty will become effective; both the Netherlands and China should notify each other through the relevant diplomatic channels that the formalities required by their domestic law for the bringing into force of the tax treaty have been complied with. Subsequently, the New Tax Treaty shall enter into force on the last day of the month, which follows on the date of the last notification. The New Tax Treaty will then become effective for the income year, which begins on or after 1 January following the year in which the New Tax Treaty has entered into force. The current tax treaty will be terminated at the time when the new treaty enters into force.
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