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The Hong Kong - Switzerland DTA

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I. Context

The double taxation agreement between Switzerland and Hong Kong (DTA), a Special Administrative Region of the People's Republic of China, for the avoidance of double taxation with respect to taxes, signed on October 4, 2011, entered into force on October 15, 2012. The DTA is applicable as of January 1, 2012, in Switzerland and from April 1, 2013, concerning Hong Kong taxes.

The commercial and financial importance of Hong Kong is crucial both in Asia and to foreign trading partners like Switzerland and other markets elsewhere in the world. With the current European economical and financial uncertainties, the influence of Hong Kong as a gateway to Asia and an important vector for commercial exchanges is even reinforced towards countries such as Switzerland. Hong Kong is Asia's third-largest stock exchange market, right behind Tokyo and Shanghai. Moreover, on a global scale, Hong Kong's financial place plays an influential role being among the largest markets in the world. As of the end of January 2012, the Hong Kong Stock Exchange had 1,506 listed companies with a total market capitalisation of Hong Kong (HK) $19.233 trillion.[1] Conversely, Hong Kong has a rather limited market, equal to roughly seven million inhabitants, and is therefore bound to trade with foreign countries. In that sense, the benefits of this DTA are profitable to both parties. Tax treaties ease the flux of both inbound and outbound investments, relieving investors from the burden of double taxation.

This DTA does not correspond to the double taxation agreement signed on December 6, 2010, by Hong Kong and Switzerland. Although most of the wording of the initial agreement dated December 6, 2010, remains the same, the clause with regard to the exchange of information has been adjusted to be in line with the latest international standards recommended by the Organization for Economic Co-operation and Development (OECD). In addition to the adjustments in relation to the clause on the exchange of information, the DTA also imbeds another change. While all the provisions of the DTA shall have effect according to the rules laid down in Article 28(2)(a) and 28(2)(b), the situation is different when it comes to shipping and air transport (Article 8 DTA) and gains derived from the alienation of ships or aircraft (Article 13(3) DTA). Article 28(2)(a) of the DTA specifies that its provisions shall have effect in Hong Kong, the first day of April of the calendar year following the entry into force of the DTA. Article 28(2)(b) is the corresponding provision of the text for Switzerland specifying that, for taxes withheld at source, the DTA shall apply on the first day of January of the calendar year following the entry into force of the DTA, while for other taxes, it shall be the taxation year beginning on or after the first day of January of the calendar year following the entry into force of the DTA. Conversely, the rules specified with regards to shipping and air transport and the alienation of ships and aircraft shall have effect in both Hong Kong and Switzerland, immediately from the date when this DTA enters into force. The rationale for this specific taxation timing with regard to shipping and aviation or the gains resulting from the sale of vessels aims at avoiding any gaps in the taxation of such revenues.

Beside these elements, the DTA mainly follows the path suggested by the OECD in its Model Tax Convention (OECD MC). In a nutshell, dividends paid by a company (other than a partnership) to a foreign corporate shareholder holding at least a participation of 10 percent in the said company are fully relieved of withholding taxes levied at source, and a similar result is achieved in relation to institutional shareholders such as pension funds, the Hong Kong Monetary Authority or finally to the Swiss National Bank.

Conversely, if the beneficial owner of the dividends does not fall within the scope of one of the institutions listed above, the withholding levy is limited by the DTA to 10 percent of the gross amount of the dividends. With regard to other passive incomes, the situation is even more favourable, since no withholding tax is levied in principle on interest, while the rate is capped at 3 percent for royalties. Moreover, the arbitration clause (Article 24 DTA) and the clause on the exchange of information (Article 25 DTA) adhere to the latest OECD standards.

II. Definition of resident

Before turning to the operative provisions of the DTA, it is worth examining the definition of resident for the purpose of this DTA. Double taxation agreements expressly specify that they apply to persons who are residents of one or both of the contracting states and this

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DTA follows the same principle. According to the OECD MC, a person is resident of one of the contracting states if, under the laws of the state of residence this person is liable to tax therein based on the nexus existing between the person and its state of residence. The nexus might result either by reason of domicile, residence or any similar criterion. The DTA between Hong Kong and Switzerland is no exception in that sense and imbeds such a provision under Article 4(1)(b) of the DTA.

However, this specific provision applies exclusively to Switzerland,[2] since such criteria are not necessarily sufficient to establish a tax residence nexus in Hong Kong and allow its Inland Revenue Department to levy taxes. Since Hong Kong still abides by the territoriality basis of taxation, only income or profits sourced in Hong Kong are subject to tax in Hong Kong. Conversely, when income or profits are derived from a source outside of Hong Kong, they are in most cases not taxed in Hong Kong although they are perceived by a person residing in Hong Kong.[3] For example, in relation to salary taxes, the charging provision provides that "*salaries tax shall, subject to the provisions of the Ordinance (Hong Kong Inland Revenue Ordinance), be charged for each year of assessment on every person in respect of his income arising in or derived from Hong Kong from the following sources: (a) any office or employment of profit; and (b) any pension.*"[4] Consequently, for the purposes of this DTA, it was necessary to specify further criteria, in order to distinguish between residents and non-resident persons in Hong Kong.

As per Article 4(1)(a) of the DTA an individual is a resident of Hong Kong if such individual ordinarily resides in Hong Kong (4(1)(a)(i) DTA) or such individual stays in Hong Kong for more than 180 days during the year of assessment or for more than 300 days in two consecutive years (Article 4(1)(a)(ii) DTA). When it comes to companies, they are resident of Hong Kong if they have been incorporated in Hong Kong, or if incorporated outside Hong Kong they are normally managed and controlled in Hong Kong (Article 4(1)(a)(iii) DTA). For other juridical persons, the rule applies *mutatis mutandis*, as per the terms of Article 4(1)(a)(iv) of the DTA.

The criterion used under this DTA specifying that companies or other juridical persons are resident in Hong Kong, if they are managed and controlled[5] in Hong Kong, is more stringent compared to other double taxation agreements entered into by Hong Kong. Normally, taxation agreements negotiated by Hong Kong provide that companies are resident in Hong Kong if they are managed or controlled, while in this case both criteria must be fulfilled. In case of dual residency of individuals or companies, a "*tie breaker*" rule is provided, respectively under Article 4(2) and 4(3) of the DTA. Interestingly the protocol to the DTA excludes from the definitions of "person" and "resident of a Contracting Party" trusts or any individual or a company acting as a trustee. Consequently, although a trust is being managed and controlled in Hong Kong, it will not be encompassed by this DTA and cannot claim treaty benefits when investing or carrying on business in Switzerland.

III. Permanent establishment

When it comes to permanent establishments (PE), Hong Kong tends to follow a line which departs partially from the OECD MC, relying on a tax treaty policy inspired from the model developed by the United Nations. Conversely, Switzerland tends to abide by the rules laid down by the OECD. Such diverging interests explain why the permanent establishment of this DTA is a distinctive feature. From the Hong Kong perspective, the number of days required for establishing a PE is higher compared to the 183 day policy adopted by Hong Kong. Conversely from the Swiss perspective, this threshold is lower since normally PE requires a 12-month period of existence to be fulfilled. Thus, according to Article 5(3)(a) of the DTA, a Hong Kong resident will have a PE in Switzerland if a building site, a construction assembly or installation project or supervisory activities last for more than 270 days in Switzerland or *vice versa*. Services rendered with regard to such sites, projects or supervisory activities constitute a PE if they last 270 days or periods aggregating more than 270 days within any 12-month period (5(3)(b) DTA). In other words and more importantly, it is must be noted that there is no specific PE article for the provision of services other than those rendered in relation to a building site, a construction, assembly or installation project or related supervisory activities.

IV. Business profits

Article 7 of the DTA deals with business profits derived by an enterprise from its business activities. Paragraph 1 of Article 7 specifies that profits of an enterprise arising in one of the treaty countries shall be taxable only in that country unless the enterprise carries on a business in the other country through a permanent establishment set up there. One must bear in mind that only profits attributable to the permanent establishment are taxable in that other country. In the current globalised economy, the importance of Article 7 might seem, at first glance, somewhat outdated since most of the multinational enterprises operate cross-border businesses through subsidiaries and not branches.[6] Based on this, the importance of Article 7 (business profits) should be lower compared to Article 9 (associated enterprises). However, since the 2006 publication by the OECD of its reports on the attribution of profits to permanent establishments much attention has been paid to Article 7.[7] The rise of electronic commerce, the importance of financial services and global trade, conducted often via branches and the proliferation of tax planning using PE structures, are somehow related to Article 7, attracting therefore much of the attention of the international tax community in relation to Article 7.[8]

When it comes to Article 7 of the DTA, it is mainly in line with the recommendations of the OECD (based on the OECD MC of 2008) and the other state has the right to tax profits only if there is a permanent establishment in it. Once it has been determined that there is a permanent establishment in that country (as per the terms of Article 5 DTA), it is necessary to apportion an amount of taxable income to that permanent establishment. Principal methods used for the allocation of taxing powers are the direct and indirect methods. Under the direct method the permanent establishment is considered as a separate entity. The income of the permanent establishment is therefore established on the basis of separate accounts. The indirect method provides that income of the permanent establishment is a portion of the total profits of the enterprise. Thus there is a need to determine the contribution of the permanent establishment to the total income of the company. This is achieved by applying certain coefficients such as a comparison of assets or the turnover. Paragraph 4 of Article 7 of the DTA provides that recourse may be made to other methods, as further prescribed in the law.[9]

V. Associated enterprises

It is not uncommon to find a time bar provision in Swiss double taxation agreements with regard to primary transfer adjustments under the article dealing with associated enterprises (Article 9 DTA). In fact, double taxation agreements concluded between Switzerland and Finland, Argentina, Russia and Canada embed a similar provision. In substance, the six-year time bar for transfer pricing adjustments between associated enterprises resulting from the Hong Kong-Switzerland double taxation agreement provides that profits cannot be adjusted after six years from the end of the taxable year in which the profits would have been made, even though the domestic law provides otherwise. It goes without saying that this time limitation does not apply to cases of fraud or wilful default.

VI. Passive incomes

Hong Kong does not levy in principle a withholding tax on dividends and interests, while a limited burden is suffered with regard to royalties. Royalties and license fees paid to non-residents for the use of certain intellectual properties in Hong Kong and payments to non-resident entertainers or sportsmen for their performance at commercial occasions or events in Hong Kong are subject *ipso facto* to a withholding tax on their assessable profits. Conversely, Switzerland does not levy any withholding tax on royalties but perceives one on bank interest and interest on bonds, as well as on dividends. Considering the specifics of the Hong Kong taxation regimes, notably its strong territoriality principle based conception and the fact that only profits arising from Hong Kong or derived from Hong Kong activities are taxed in Hong Kong, stringent limitation on benefits provisions have been introduced with regard to Article 10 (dividends), Article 11 (interest) and Article 12 (royalties). Such limitations aim at tackling issues where taxpayers residing outside Hong Kong would be tempted to invest in Switzerland through Hong Kong based companies, solely for the purpose of taking advantage of the benefits of this DTA.

VII. Dividends

Article 10 of the DTA provides that the withholding rate is conventionally limited to 10 percent on dividends. Such a rate might even be reduced to nil, if the beneficial owner is a company having a share participation of 10 percent, at least. Further exemptions are also imbedded with regard to institutions such as pension funds, pension schemes, the Hong Kong Monetary Authority and the Swiss National Bank.

VIII. Interest

Treaty benefits, laid down in Article 11 of the DTA, are self-explanatory. While Switzerland normally levies a 35 percent withholding tax on bank interest and interest on bonds, such a rate is reduced to nil by the treaty. The situation does not change for regular loan agreements in Switzerland since they are not subject to tax, nor does it change anything for interest plying from Hong Kong to Switzerland, since Hong Kong does not levy any withholding tax on such passive incomes.

IX. Royalties

While royalties are free of any withholding tax in Switzerland, Hong Kong levies a *de facto* withholding tax. Under Article 12 of the DTA, the withholding tax is restricted to 3 percent. In other words, this treaty does not add any benefits to Hong Kong companies receiving royalties from Switzerland, since royalties are not subject to a withholding levy, while Swiss investors, repatriating royalties from Hong Kong to Switzerland get more leeway under this DTA.

X. Limitation of benefit

The discussion as regards the concept of beneficial owner has been extremely prolific over the last year since the OECD Committee on Fiscal Affairs has tried to lay down various proposals geared at clarifying the meaning and the interpretation that should be given to the concept of beneficial owner in the context of the OECD MC.[10] Since the notion of "beneficial owner" found in Articles 10, 11 and 12 of the OECD MC has never been defined, it has given rise to multiple and diverging interpretations by courts and tax administrations, increasing the risk of legal uncertainty and lack of foreseeable nature on how such a notion will be applied to taxpayers.

While this is an interesting and crucial debate, it goes beyond the scope of this paper. However, it is important to mention with regard to the DTA at stake, that the concept of beneficial owner is present in all three articles mentioned above, namely dividends, interest and royalties. In other words, the recipient of dividends, interest and/or royalties must be the beneficial owner to get the full benefits specified under the corresponding provisions of this DTA. Moreover, in addition to the concept of beneficial owner, this DTA imbeds anti-abuse provisions targeting conduit companies used for channelling dividends, interest and royalties abroad and leveraging treaty benefits in an inadequate way. Under Articles 10, 11 and 12 of the DTA, treaty benefits can be denied if:

i) a Hong Kong company is simply interposed between a Swiss subsidiary and its parent company located in a third country, while the Hong Kong entity remits all or a substantial part of the dividends, interest or royalties to such a third country company and the same company would not be entitled to the same benefits in respect of that income under this DTA; and

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ii) the purpose of the whole structure is to get purely and simply treaty benefits.

In addition to this, it is also specified under this DTA that both Hong Kong and Switzerland can apply their domestic laws and measures concerning tax avoidance.

XI. Independent personal services

The article on independent personal services has not been a part of the OECD MC since the year 2000, following the publication of the report called "*Issues Related to Article 14 of the OECD Model Tax Convention*".[11] Article 14 of the OECD MC has been removed since many tax scholars and practitioners felt that this article worked in a way which was comparable to business profits. Thus, it was perceived that dealing separately with both types of incomes was somewhat artificial and might ultimately lead to a situation of potential confusion. While business profits can only be taxed in the state of source, if the company has a permanent establishment in that country, Article 14 provides that professional services and other activities of an independent character may only be taxed in the state where such independent personal services are rendered if the person has a fixed base regularly available in the other state. The notion of "independent personal services" is not defined as such under this DTA nor is it the case in any of the commentaries released by the OECD until the year 2000, while this provision was still imbedded in the OECD MC.

However, there is some guidance under Article 14(2) of the DTA to what might be considered and perceived as independent personal services. It is notably the case when it comes to independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants. Moreover, the concept of "fixed base" is not defined either in the OECD MC, or in this DTA. However, it will probably cover a physician's consulting room, or an architect's or lawyer's office.[12]

While many countries have adhered to the views of the OECD and removed Article 14 from their taxation treaties, Switzerland considers that the provision on independent personal services is necessary to warrant the effectiveness and clarity of double taxation conventions. Thus, this provision has been included in the DTA entered into by Switzerland and Hong Kong. It is the policy of Switzerland to ratify tax agreements granting taxing rights to the state of source, in relation to independent personal services only if there is a fixed base in that country. This DTA goes a step further. In addition to the criterion of the fixed base, the source country may tax independent personal services if the person rendering such services stayed in the state of source for an aggregate period of 183 days in the fiscal year concerned. As such, this a specificity that goes beyond the standard wording of Article 14 and the tax treaty policy usually adopted by Switzerland.

XII. Exchange of information

While the wording of this DTA has not been profoundly modified by comparison to the version initially signed on December 6, 2010, the provision on the exchange of information has seen the highest amount of amendments. First and foremost, it is important to mention that the wording of Article 25 of this DTA goes more or less along the lines proposed by the OECD in its OECD MC. Paragraph 1 of this provision states that the exchange of information shall be limited to information as is foreseeably relevant and the protocol signed by both territories specifies that an exchange of information shall only be requested once all regular sources of information under the internal taxation procedure have been exhausted.

The introduction of such limitations aims at avoiding fishing expeditions, while safeguarding the privacy of the taxpayers. While paragraph 1 of Article 25 lays down basic rules with regard to the exchange of information, the second paragraph deals with secrecy of the information disclosed. It must be specified that information exchanged is restricted to corresponding tax authorities and that no disclosure is admitted to oversight authorities. This practice is in line with the Departmental Interpretation and Practice Notes, No. 47, released by the Inland Revenue Department of Hong Kong on the exchange of information under comprehensive double taxation agreements. Further limitations are also available under paragraph 3 of Article 25 of the DTA. All in all, it can be said that the mechanism dealing with the exchange of information, offers good protections and limitations in favour of the taxpayer, while adhering to the latest guidelines suggested by the OECD.

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NOTES

[1] Hong Kong Exchange Market website, visited on February 15, 2012, information available at: *<http://www.hkex.com.hk/eng/stat/statrpt/mkthl/mkthl201201.htm>*

[2] In Switzerland individuals are subject to income tax on their worldwide income regardless of source, provided they have their tax residence in Switzerland. The rule suffers exceptions notably in relation to income generated by foreign businesses, permanent establishments and immovable property. Individuals are Swiss residents either if they are "domiciled" or "resident" in Switzerland (Art. 3(1) Swiss Direct Tax Law and Art. 3(1) Swiss Tax Law on Harmonization). *Oberson, Xavier, Droit fiscal suisse, 4th edition (Basel: Helbing Liechtenhahn, 2012)*.

[3] Currently most jurisdictions impose taxes on the basis of residence. When it comes to individuals some jurisdictions may also opt to tax based on citizenship, domicile or source of income. Hong Kong relies on the concept of source income since 1955. Ultimately, the choice of the taxation nexus is a policy matter.

[4] Section 8(1), Inland Revenue Ordinance, Chapter 112, Laws of Hong Kong.

[5] The place where the central management and control is exercised is not necessarily the place where the main operations of the business are to be found. Usually, it is the place where the directors meet to do the business of the company (Koitaki Para Rubber Estates v FC of T (1940) 6 ATD 42). *Deloitte, Hong Kong Master Tax Guide 2012/13, 21st edition (Hong Kong: Wolters Kluwer business, 2012)*.

[6] Avi-Yonah, Reuven S. and Clausing, Kimberly A., Business Income (Article 7 OECD MC) (Sept. 30, 2007). University of Michigan Law & Economics, Olin Working Paper No. 07-016; University of Michigan Public Law Working Paper No. 91. Available at SSRN: http://ssrn.com/abstract=1017515 or http://dx.doi.org/10.2139/ssrn.1017515

[7] OECD, Report on the Attribution of Profits to Permanent Establishments (December 2006) (the "OECD Report").

[8] Avi-Yonah, Reuven S. and Clausing, Kimberly A., op. cit., p. 2.

[9] Relevant regulations and rulings are:

Departmental Interpretation Practice Note 48: Advance Pricing Arrangement, March 2012

Departmental Interpretation Practice Note 46: Transfer Pricing Guidelines, December 2009

Departmental Interpretation Practice Note 45: Relief from Double Taxation due to Transfer Pricing or Profit Reallocation Adjustments, April 2009.

[10] OECD, Clarification of the meaning of "beneficial owner" in the OECD Model Tax Convention, Discussion Draft, available at: *<http://www.oecd.org/dataoecd/49/35/47643872.pdf>*

[11] Issues in international taxation No. 7, (Paris: OECD, 2000).

[12] Philip Baker, "Double taxation Conventions", Sweet & Maxwell, London, 2010, p.14-2/1 and references quoted.