Analysis: China – Sweden Income Tax Treaty

See treaty text.
Type of treaty: Income Tax
Model treaty on which based: UN
Signed: May 16, 1986
Entry into force: January 3, 1987
Effective date: January 1, 1987 ;
Subsequent Protocol signed: November 18, 1999
Entry into force (subsequent protocols): August 1, 2000
Effective date: January 1, 2001

Article 1 Personal Scope

See treaty text.
Persons who are resident of one or both States.

Article 2 Taxes Covered

See treaty text.

China

- The individual income tax;
- The income tax concerning joint ventures with Chinese and foreign investment;
- The income tax concerning foreign enterprises; and
- The local income tax.

Sweden

- The national income tax, including the withholding tax on dividends;
- The income tax on non-residents;
- The income tax on non-resident artists and athletes;
- The municipal income tax; and
- The tax on means intended for expansion purposes.

As well as application to the taxes existing at the time the Treaty was signed (listed above) there is a provision applying the Treaty to any identical or substantially similar taxes which are imposed after the date of signing of this Treaty.

Article 3 General Definitions

See treaty text.
"China": The entire territory of the People's Republic of China in which the Chinese tax legislation is effectively applied. It includes its territorial sea and the adjacent areas and the sea bed and subsoil over which China may, in accordance with domestic and international law, exercise sovereign rights for the purpose of the exploration and exploitation of the natural resources of the sea bed and subsoil and the waters above these.
"Sweden": The Kingdom of Sweden including the territorial sea as well as other maritime areas over which Sweden exercises sovereign rights or jurisdiction in accordance with international law.
"Person": An individual, company and any other body of persons.
"Company" is defined to include any body corporate or any entity that is treated as a body corporate for tax purposes.
"National": All individuals possessing the nationality of Sweden or China and all juridical (legal) persons created or organised under the laws of either Sweden or China. Also all organisations without juridical personality treated for the purposes of tax by either Sweden or China as juridical persons created or organised under the laws of Sweden or China. Thus the definition could include a partnership which does not have separate legal personality from its members for some purposes but does for tax purposes.
All terms not specifically defined take their meaning from domestic tax law.

Article 4 Resident

See treaty text.
"Resident": Any person who is liable to tax in one of the Contracting States by reason of his domicile, residence, place of Head Office or any other criterion of a similar nature.

Residence: Individuals

In the case of individuals apparently resident in both Contracting States, the usual tiebreaker tests apply:

- He will be deemed to be a resident of the State in which he has a permanent home. If he has a permanent home in both States, he will be deemed to be resident in the state with which his personal and economic relations are closer (centre of vital interests).

• If unable to determine the State where the centre of vital interests lies, then resident of the State in which he has a habitual abode.
• If he has a habitual abode in both States, then resident in the State of which he is a national.
• If a national of both States or of neither of them, then the competent authorities must settle the question by mutual agreement.

Domestic law

China

In individual is tax resident in China if he habitually resides there. This is taken as presence for more than one calendar year. The precise extent of exposure to and rates of Chinese tax depends on whether the individual has been present in China for more than five years without spending more than 90 days in aggregate or 30 consecutive days per calendar year outside China.

Sweden

Physical presence in Sweden for a period of more than 183 days during the taxable year amounts to residence. An individual is also deemed to be a resident of Sweden if the individual has his principal place of abode in Sweden. Normally, this is the place of a taxpayer's home where the taxpayer's family (spouse or dependent children) is resident and where the taxpayer is registered for various purposes.

An individual who no longer has his principal place of abode in Sweden or who is no longer physically present in Sweden will still be considered to be a Swedish resident if he has maintained essential ties with Sweden. The facts in each case must be weighed to determine with which country a taxpayer has the strongest ties. Relevant elements include the location of real property owned by the taxpayer, the nationality of corporations in which the taxpayer holds stock, the countries in which the taxpayer holds bank accounts and the location of other personal property. The existence of a mere summer residence in Sweden or substantial passive investment income from Sweden, is usually not, as such, deemed to constitute an essential tie with Sweden.

Under the “five-year rule”, a citizen of Sweden or an individual who has had his principal place of abode or has been physically present in Sweden for a period of 10 years, is considered to be resident in Sweden during the five years following the day of his or her departure from Sweden, unless the individual proves that he or she no longer has essential ties with Sweden. After five years, such an individual is deemed not to be a resident of Sweden, unless the fiscal authorities are able to prove otherwise.

Residence: Companies

If a company appears resident in both States, e.g. because one determines residence according to the place of legal incorporation and the other according to place of Head Office, then it will be deemed to be tax resident in the State in which its Head Office is situated. Place of management is not considered as a tiebreaker.

Domestic law

China

Companies incorporated in China are considered tax resident. Additionally, under the Corporate Income Tax Law which became effective as of January 1, 2008, China now determines company residence according to the place of effective management. This is interpreted as the exercise of the overall management and control of production, business, employees, finance and assets of a company (Articles 2 and 3 of the CITL). Thus day to day control as well as strategic management must be considered and the definition is very broad.

Sweden

A company is tax resident in Sweden if registered in Sweden under Swedish law.

Partnerships and fiscally transparent enterprises

Residence is to be determined as for companies.

Domestic law

China

The default position is that partnerships are treated as transparent unless an election is made for the partnership to be taxed as a separate entity.

Sweden

With some minor exceptions (for the purposes of real estate tax and tax on pension costs) partnerships are not taxable entities as such. The income attributable to a partnership must, however, be computed separately and disclosed to the tax authorities. Each partner of a partnership is subsequently taxed based on his distributive share of the income of the partnership. The Swedish tax treatment of a foreign partner depends on whether the partnership, or any of the partners, constitutes a permanent establishment (PE) in Sweden. If it does, income attributable to the PE is fully taxable at the corporate income tax rate. In the absence of such an establishment, the income is not subject to Swedish taxation.

Article 5 Permanent Establishment

See treaty text.

This Article defines the term "permanent establishment". The profits of an enterprise of one of the Contracting States can only be taxed on an arising basis in the other Contracting State to the extent that they are attributable to a permanent establishment in that other State.

This Treaty broadly uses the OECD and UN definitions. Three types of permanent establishment are envisaged: A fixed place of business, a service permanent establishment and an agency permanent establishment.

Fixed placed of business

In this context a "permanent establishment" means a fixed place of business through which the business of the enterprise is wholly or partly carried on. The list of types of establishment particularly included follows the UN Model and involves:

- A place of management;
- A branch;
- An office;
- A factory;
- A workshop;
- A mine, an oil or gas well, a quarry or any other place of extraction of natural resources; and
- A building site, construction or assembly or installation project which lasts for more than six months.

Supervisory activities in connection with such activities are also included. Note the departure here from the more usual period of 12 months, reflecting the use of the UN Model Convention.

According to the OECD Commentary, a "fixed place of business" means to be established at a distinct place with a certain degree of permanence, however, it could be a pitch in a market place, or even part of the premises of another enterprise. There is no requirement that the premises be owned. The Commentary offers the example of an employee of Company A who is allowed to use an office at the premises of Company B. This could create a permanent establishment for Company A in the country of Company B if the arrangement persists for long enough and if the employee is carrying out activities which are more than merely "preparatory or auxiliary" (see below).

The OECD considers that to be fixed, a place of business must be at a specific geographic point. However, if the permanent establishment consists of mechanical equipment only, then there is no requirement for mechanical equipment to be fixed to the soil.

As to what constitutes a reasonable period of time to give the necessary degree of permanence, most countries will not consider a presence of less than six months to give rise to a fixed place.

The usual exclusions from the definition of permanent establishment are given so that the following will not constitute a permanent establishment:

a) The use of facilities solely for the purposes of storage, display or delivery of goods or merchandise belonging to the enterprise;

b) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;

c) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

d) The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise;

e) The maintenance of a fixed place of business solely for the purpose of carrying on any other activity of a preparatory or auxiliary character; and

f) Any combination of the above providing that the overall activity of the fixed place of business is of a preparatory or auxiliary character.

To apply this Article, it is necessary to be able to make a distinction between functions that are core to a business and those that are merely preparatory or auxiliary. What constitutes core functions will vary from one business to the next. However, any fixed place of business from which the business is partly managed will constitute a permanent establishment even if its function otherwise appears to be preparatory or auxiliary. Also, if services are rendered to other companies within the corporate group or to third party customers then this would not be preparatory or auxiliary because activities only count as preparatory or auxiliary if they are carried on "for the enterprise" itself.

Note that despite incorporating many features of the UN Model Convention, this Article at paragraph 4(b), unlike the UN Model, excludes "delivery of goods or merchandise" from the definition of what may be considered a permanent establishment. Thus a warehouse would not normally be considered a permanent establishment under this Treaty.

Service permanent establishment

This Treaty follows the UN Model in specifically providing that services provided by an enterprise may result in a permanent establishment, even though there is no fixed place of business.

The furnishing of consultancy and other services, whether through an enterprise's own employees or by other personnel hired for the purpose where a project (and any connected project) will give rise to a permanent establishment where the activities last for more than six months within any 12-month period. There is little guidance available as to what is meant by "same or connected" but Commentary on the OECD Model suggests that commercial connections rather than geographic connections are paramount.

The Protocol states that providing consultancy services in connection with the sale or lease of machinery or equipment through employees or other personnel will not cause a permanent establishment to arise.

Where the services are merely preparatory or auxiliary, as set out above, no permanent establishment will arise.

Agency permanent establishment

Dependent agents may constitute a permanent establishment. Where a person acting on behalf of a resident of a Contracting State has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the resident, that resident is deemed to have a permanent establishment in that other State, unless the activities of the agent are limited to those listed at a) to f) above. Where the activities of the agent are merely preparatory or auxiliary, or where the agent is an independent agent (e.g. a general commission agent acting in the ordinary course of his business) the presence of the agent will not give rise to a permanent establishment unless the agent works wholly, or almost wholly on behalf of the foreign enterprise.

General

The fact that a company has a subsidiary in the other Contracting State does not mean that the subsidiary is a permanent establishment of that company, unless it binds the parent company in contract as per the rule for dependent agents. This rule applies generally to groups of companies.

Domestic law

China

The definition of an agency permanent establishment has been widened by Article 3 of the CITL to include business activities carried out for the principal other than purchases and sales. Storage or delivery of goods will also give rise to an agency permanent establishment. Regarding a fixed place of business, the Implementation Rules, effective January 1, 2008 provide that the definition of a permanent establishment (stated as being an establishment or site) will encompass:

- Any establishment from which management or business operations are conducted;
- A representative office;
- An establishment conducting management or business operations;
- A factory, farm or site for exploration of natural resources;
- A site from which services are provided;
- Construction, installation and assembly sites;
- Sites for making or repairs;
- Exploration sites;
- Other engineering projects;
- Other establishments and sites for conducting production and business operations.

The general rules is that a permanent establishment will exist if a site or project lasts for more than six months in a 12-month period.

Under Circular 403 Interpretation and implementation notice for HK's Double Tax Arrangement a permanent establishment will exist if services have been provided in China for more than six consecutive months in any 12-month period. Counting starts from the arrival of the first employee in China and only ceases when the last employee leaves the country.

Article 6 Income From Immovable Property

See treaty text.

The general rule is that income derived by a resident of a Contracting State from immovable property in the other State may be taxed in that other State. Thus, for instance, if a resident of one State owns a building in the other State and receives rent, that rent may be taxable in the other State. This treatment also applies to income from immovable property used by an enterprise and to income from immovable property used for the performance of independent personal services.

Immovable property is defined as per the domestic law of the State in which the property is located but it will include livestock and equipment used in agriculture, forestry, general property rights and rights for the working of natural resources.
There is no extension giving the Situs State any right to tax income from movable property of a permanent establishment.

Article 7 Business Profits

See treaty text.

Only profits actually arising from a permanent establishment may be taxed by the source State. If an enterprise has both a permanent establishment in a State and also derives other income, say, dividends or interest unconnected with the permanent establishment, then the dividends or interest may only be taxed in accordance with Articles 10 and 11 of the Treaty and not this Article.
The profits to be attributed to the permanent establishment are the profits that would be expected if the permanent establishment was a distinct and separate enterprise. The starting point for the computation will be the branch accounts. Provided there is symmetry in the amounts recorded and in the methods of valuation applied in recording the transactions in the books of the different parts of the enterprise, the accounts will normally be an acceptable basis for attributing profit to the permanent establishment. However, any assumptions used in maintaining branch accounts, for instance, an assumption that the branch acts as principal in all cases, when in fact it only acts as intermediary would lead to a downwards adjustment in profit allocated to the branch.
Although this Treaty uses elements of the UN Model as well as the OECD Model, the recent OECD work on attribution of profits to permanent establishments is relevant to this treaty. The aspects of Article 7 of this Treaty which are based on the UN Model are those concerned with the deductibility of expenses in arriving at the taxable profits. The Commentary on the UN Model relating to the rules on deductibility of expenses makes it clear that the extra provisions are present so that all necessary definitions and clarifications on this matter are set out in the text of the treaty rather than merely in a Commentary. The central aim of Article 7 in this Treaty is identical to that in the OECD Model Convention: The profits attributable to a permanent establishment are those which would be earned by the establishment if it were a wholly independent entity dealing with its head office as if it were a distinct and separate enterprise operating under conditions and selling at prices prevailing in the regular market (per paragraph 2 of Commentary on Article 7, UN Model).
The usual provision providing for the deduction of expenses from the profits of the permanent establishment in accordance with the rules laid down by domestic law is present. Deductions for executive and general administrative expenses are permitted whether incurred in the State where the permanent establishment is situated or elsewhere.
As per the UN Model Convention, no deductions are permitted for certain payments by the permanent establishment to the Head Office or any of the enterprise's other offices, unless they represent reimbursement for actual expenses:

- Royalties, fees and other similar payments in return for the use of patents;
- Commission or fees for specific services performed or for management; and
- Interest on money lent to the permanent establishment except in the case of a banking enterprise).

On the other hand, no amounts charged by the permanent establishment to the Head Office, or any other office of the enterprise for these items are to be included in the taxable profits of the permanent establishment.
The OECD, in 2008, published its final report on the attribution of profits to permanent establishments (July 17, 2008) and updated the Commentary on Article 7 of the Model Treaty. When interpreting a tax treaty, it is generally agreed that the latest version of the OECD's Commentary on the Model Treaty should be used. These notes follow the 2008 version of the Commentary. The "authorised OECD approach" to attributing profits to a permanent establishment now requires that there is a two step process.
Firstly, a functional and factual analysis should be carried out, along the lines set out in the OECD's transfer pricing guidelines, to establish the economically significant activities and responsibilities undertaken by the permanent establishment. This will involve establishing the rights and obligations arising out of transactions between the permanent establishment and third parties, e.g. the sales revenue arising from independent customers generated by the permanent establishment as opposed to by the head office. If the permanent establishment takes the form of a factory, then it would assume the obligation to pay for the raw materials which it uses. The OECD then recommends that "significant people functions" relevant to the attribution of economic ownership of assets are identified to support the attribution of economic ownership of assets of the enterprise to the permanent establishment. Economic ownership is defined as the right to income from an asset or the right to

depreciate it. Tangible property should be attributed to the location where it is in use. Economic ownership of intangibles rests with the location in which the risks associated with the intangibles is borne: For instance, if an enterprise owns a patent for a particular drug which is sold by distributor companies in many countries, the economic ownership would rest in that part of the enterprise responsible for commissioning the research to develop the drug and which would bear the losses if medical trials failed. A further set of "significant people functions" are then to be identified: This time, those relevant to the assumption of risks so that an allocation of risks borne by the enterprise can be made to the permanent establishment. For instance, road building equipment may be economically owned by a permanent establishment in Country A but the head office, located in Country B, may have the power to determine on which road building projects the equipment is used and hence the head office bears the risk associated with profits or losses arising from the equipment. The more risks that are managed by the permanent establishment, the higher the share of the profit of the enterprise to be attributed to it. The OECD's 2008 Report looks for the place of active decision taking rather than mere "rubber stamping". Note that no such distinction between asset management and risk assumption functions is required in the case of enterprises in the financial sector, because it is considered highly likely that these functions would be carried out by the same people.

Secondly, taking into account the picture built up in the functional and factual analysis, the profits of the permanent establishment must be determined. Although this is relatively simple in the case of transactions with third parties, transactions and dealings with other parts of the enterprise must be determined using the rules laid down in the OECD's Transfer Pricing Guidelines. This means that goods and services provided by head office must carry an arm's length mark up. Pricing policies should be properly documented, which in practice may prove troublesome as firms may not take the same care in documenting the terms of transactions within the firm as they would with third parties. In determining the profits attributable to the permanent establishment, part of the enterprise's interest costs on its borrowings should be allocated to the permanent establishment. The amount of capital needed to support to functions carried out by the permanent establishment on the assumption that it is a separate entity must be calculated. Then, this total theoretical capital must be broken down into debt and equity (or "free capital" in OECD terms). The greater the risks undertaken by the permanent establishment, the higher the proportion of its notional capital that will be regarded as "free capital". Several methods of establishing the split between "free capital" and debt capital are suggested, including the use of thin capitalisation practices in the State in which the permanent establishment is located. Once the amount of notional debt capital has been determined, an allocation of the enterprise's interest liabilities can be made to the permanent establishment. Note that only actual interest liabilities can be allocated. If the enterprise as a whole has paid no interest to external lenders, then there can be no allocation of interest liability to the permanent establishment. The only exception to this rule is where the permanent establishment is involved in treasury dealings with other parts of the enterprise. Whilst this may well be the case in banking enterprises, it would be unusual in other enterprises. Generally, the interest rates used and the terms of the notional loans to the permanent establishment must be such as would be found between parties dealing at arm's length. This aspect of the AOA ought to be acceptable in interpreting a treaty such as this one which uses elements of the UN Model: in the introductory remarks to the Commentary on Article 7 of the UN Model, at paragraph 4 "...an allocable share of such payments, e.g. interest and royalties, paid by the enterprise to third parties should be allowed."

When deciding what transactions should be recognised between the permanent establishment and other parts of the enterprise, the OECD recommends that the only internal transactions which can be recognised in arriving at the permanent establishment's profits are those which relate to real and identifiable events. These would include the physical transfer of goods, the provision of services, the use of intangibles and the transfer of financial assets. Whilst the internal records (e.g. the branch accounts) are the starting point for identifying these transactions, the true test is whether there has been an internal dealing of economic significance. The OECD's 2008 report suggests the following tests are used when considering whether an internal dealing should have any effect on the profits of a permanent establishment:

1) Is the documentation consistent with the economic substance of the internal dealings?

2) Are the arrangements such that they are not too different from dealing which one group company might have with a fellow group company? For instance, credit periods should be similar in similar circumstances.

3) Are the dealings consistent with the OECD principles for attributing profits to permanent establishments?

Allocations of head office expenses, e.g. for strategic management or centrally managed support functions such as payroll may be set against the profits of the permanent establishment, but the arm's length principle must be observed.

The allocation of profits to dependent agent permanent establishments

A dependent agent is not part of the taxpayer enterprise and will file his tax returns independently. Normally the enterprise will make payments to the agent for his services. The question is: Should the host State merely tax the profits of the agent (the "single taxpayer approach" or should there be an additional charge on the enterprise which is using the services of the agent? The amount of the charge would depend on the excess of the enterprise's profits over the amount paid to the agent which was attributable to the activities of the agent. For instance, a dependent agent may be paid for the sales he procures on a commission bases, but the selling enterprise may make a profit on those sales even after taking into account the (arm's length) commission paid to the agent. The OECD recommends that States should always consider whether the enterprise has made a profit in respect of business transacted via the agent which is in excess of amounts paid to the agent. Hence the host state may tax both the dependent agent and the foreign enterprise.

Alternative method of attribution of profits

This Treaty permits an allocation of the profits of the enterprise to a permanent establishment based on an apportionment of the total profits of the enterprise. This is sometimes known as the unitary, or indirect method of apportionment. It is only acceptable to use this method if it has been customary to do so and in any case, the outcome must be in accordance with the result which would be obtained by using the Authorised OECD Approach (AOA) as set out above.

As is usual no profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.

The same method of attribution is to be used year by year unless there is good and sufficient reason to the contrary.

Domestic law

China

The general rule is that permanent establishments are taxed on Chinese source income only. The rules of the Enterprise Income Tax Law are applicable to permanent establishments. The term used in domestic law is "establishments or sites". It has been the practice to limit the use of permanent establishments by foreign enterprises in favour of corporate forms and joint ventures although this appears to be changing. Note that representative offices have been widely used and there are detailed rules for determining the taxable profits of such an office.

Sweden

A Swedish branch of a foreign company is taxable on net income attributable to the branch. The definition of a taxable branch is the same as that of a permanent establishment. As a matter of both domestic law and treaty law, a branch is taxed as if it were a separate entity distinct from the Head Office of which it is a part. As a consequence, the existence of a branch in Sweden does not prejudice, from a tax standpoint, the existence of another activity of the foreign company in Sweden. After the properly allocable deductions are taken, the net income is subject to tax at the corporate income tax rate.

Article 8 Shipping And Air Transport

See treaty text.

Not analysed.

Article 9 Associated Enterprises

See treaty text.

This contains the usual OECD provisions regarding transfer pricing. Associated enterprises must adopt the arm's length principle in their dealings with each other, and to the extent that they do not, a Contracting State may make an upwards adjustment to taxable profits.

Paragraph 2 provides for a corresponding downwards adjustment to taxable profits by the other State providing that the tax authorities in the two States reach agreement. There is express provision for consultation between the tax authorities.

Article 10 Dividends

See treaty text.

This Article allows the source State to levy withholding tax on dividends paid to a resident of the other Contracting State at rates which may be below those charged under domestic law.

To qualify for the withholding tax rates set out in this Treaty, the recipient should also be the beneficial owner of the dividend.

Withholding tax rates under this Treaty:
5%: If the recipient is a company (but not a partnership) owning at least 25% of the capital of the paying company.
10%: All other cases.
Paragraph (3) defines the term "dividends" to include income from shares or other rights (which are not debt-claims) which participate in profits. Also included is income from other corporate rights which is treated as income from shares under the law of the State in which the distributing company is tax resident. Other amounts treated under domestic law as dividends or distributions are included in the definition of dividends as well.
Paragraph (4) provides that where, say, a Chinese company receives a dividend from a Swedish company, and that dividend is effectively connected with a permanent establishment which the Chinese company has in Sweden, then the dividend income will be deemed to be part of the income of the permanent establishment and the provisions of Articles 7 or 14 dealing with the attribution of business profits will apply.
Paragraph (5) contains the usual provision that a State does not have the right to levy any tax on a dividend unless either the dividend is paid by a resident company or received by a resident shareholder. Thus the fact that a dividend paid by a Chinese company may be sourced from profits earned by a permanent establishment which that Chinese company has in Sweden, does not give Sweden any taxing rights over that dividend, unless of course, it is received by Swedish shareholders.
Domestic law
China
Per Article 4 of CITL which came into effect on January 1, 2008: 10% withholding tax
This replaces the previous exemption from withholding tax for dividends.
Sweden
With effect from January 1, 2000, dividends from direct investments are subject to 0% withholding if certain conditions are met. The recipient must either be resident in a state with which Sweden has a tax treaty or be subject in its country of residence to corporate income tax comparable to the tax imposed by Sweden on Swedish resident corporations which qualify for the withholding tax exemption. Also, the recipient must own at least 10% of the voting power of the paying company and have been owned for at least 12 months unless the paying company is unquoted. The minimum holding period does not apply where the recipient is a company resident in a fellow EU Member State.
In the case of other types of shareholding, withholding tax of 30% applies.

Article 11 Interest

See treaty text.
This Convention provides for withholding tax rates below those which would be applied by virtue of domestic law.
Rates are:
0% for interest paid to the Swedish or Chinese Governments, their central banks and certain other government agencies. This treatment also extends to interest on any debts guaranteed, insured or indirectly financed by either of the governments, their central banks and certain other government agencies. It can also apply to interest paid to any financial institution agreed upon by the tax authorities of Sweden and China. The various institutions qualifying for 0% withholding tax are listed in this Article in detail.
10% in all other cases providing the recipient is also the beneficial owner of the interest.
Interest is defined as income from debt-claims of every kind whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits. The term includes income from government securities, bonds and debentures and premiums and prizes attaching to these securities as well as other bonds. Penalty charges for late payment are excluded from the definition.
There are the usual provisions such that interest received by a non-resident but which relates to a permanent establishment which that non-resident has in the other Contracting State is taxed under Article 7 and thus escapes withholding tax. Also, interest paid by an enterprise which is borne by a permanent establishment is deemed to arise in the State in which the permanent establishment is situated. Hence, if the permanent establishment and the recipient are in the same State, no withholding tax can arise.
As is usual under the Model Conventions, there is a provision limiting the treaty benefit to an arm's length amount of interest where there is a special relationship between the payer and the beneficial owner.
Domestic law
China

Withholding tax of 10%, unless paid in connection with a permanent establishment which the recipient has in China. Interest on certain governmental loans may be exempt.
Sweden
No withholding taxes on interest payments.

Article 12 Royalties

See treaty text.
Withholding tax is limited to 10%. The recipient of the dividends must also be the beneficial owner. There is an exception for the use of or right to use industrial, commercial or scientific equipment: withholding tax on these is only to be levied (at the 10% rate) on 60% of the gross income giving an effective rate of 6% (per the Protocol).
Royalties are defined as payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work (including cinematograph films, and films or tapes for radio or television broadcasting), any patent, trade mark, design or model, plan, secret formula or process, or for information (know-how) concerning industrial, commercial or scientific experience.
There are the usual provisions such that royalties received by a non-resident but which relate to a permanent establishment which that non-resident has in the other Contracting State are taxed under Article 7 and thus escape withholding tax. Also, royalties paid by an enterprise which are borne by a permanent establishment are deemed to arise in the State in which the permanent establishment is situated. Hence, if the permanent establishment and the recipient are in the same State, no withholding tax can arise.
Where the payer and beneficial owner are connected and the amount of royalties exceeds an arm's length amount, the excess amount paid will not enjoy the treaty benefits and will be liable to tax in the payer's State at the normal domestic rate of withholding tax.
Domestic law
China
Withholding tax of 10%.
Sweden
Unusually, the receipt of royalties by a non-resident gives rise to a deemed permanent establishment in Sweden. This enables Sweden to tax the royalties at normal income tax rates. Where a treaty, such as this one, provides for a particular rate of withholding tax, that rate is applied to the gross royalty income before expenses.

Article 13 Capital Gains

See treaty text.
Generally this Treaty grants the right to tax capital gains to the State in which they arise.
This reflects the UN Model Treaty which this Article follows closely and the nature of Chinese domestic law on the taxation of capital gains but is a departure from the more usual rule, that a State may tax gains of non-residents by exception only. There is an exception for gains on international transport assets.
The term “alienation” is used in connection with events giving rise to capital gains. This will include normal disposals of assets and also events such as exchange of assets, expropriation, gifts and the passing of assets to another on death. Not all States levy tax in all these situations, but the meaning of the term “alienation” is sufficiently wide to give them the right to do so if their domestic law provides for a charge to tax in a particular situation.
Some particular cases where the general rule applies are set out:
• There is the usual rule that gains on alienation of movable property forming part of the assets of a permanent establishment may be taxed by the Contracting State where the permanent establishment is situated, including gains from the alienation of the permanent establishment, whether or not as part of the alienation of the whole enterprise. Thus, for example, the sale of a wholly owned company resident in State A and owned by a resident of State A could give rise to a tax charge in State B if that company has a permanent establishment in State B. This would be covered by the general rule giving the situs State taxing rights but is set out for completeness.
• Gains from the disposal (alienation) of shares in a company whose underlying assets consist mainly (whether directly or indirectly) of immovable property situated in the other State may be taxed by the State in which the property is located.
• Gains from the disposal (alienation) of shares in any other company where the shares disposed of represent a participation in the company of at least 25% may be taxed in the State in which the company is resident.

Paragraph 6 states the general rule under the UN Model Treaty, that gains derived from any property other than that dealt with specifically above may be taxed in the State where the property is situated. This does not oblige the situs State to tax the gain but gives it the right to do so if it chooses.

Domestic law

China

Non-residents are taxed on gains on the disposal of Chinese property via a withholding tax.

Sweden

The Swedish tax treatment of capital gains depends on the nature of the capital asset concerned. If a non-resident receives income in the form of a capital gain from the sale of Swedish situs real property, the income is subject to Swedish tax. Capital gains on the sale of assets used in a Swedish permanent establishment are taxable in Sweden.

Income received by a non-resident from the disposal of shares issued by a Swedish corporation is subject to Swedish tax only if the non-resident is an individual that has been a resident of Sweden at any time during the 10-year period before the date of the transfer. Any gain realised by a non-resident who has never been a resident of Sweden on the occasional sale of shares in Swedish corporation, whether the corporation is listed on the stock exchange, a family-owned company, or a Swedish subsidiary, is not subject to Swedish taxation.

Article 14 Independent Personal Services

See treaty text.

This Treaty has separate Articles governing the taxation of income from permanent establishments (see Articles 5 and 7) and income from professional services. This Article provides that where a resident of one of the States has a "fixed base" in the other State, income in respect of professional services attributable to that fixed base may be taxed in the country in which it is situated. Thus a Swedish accountant with an office in China will be taxable in China on profits attributable to the Chinese office. The attribution of profits is dealt with in the same way as for other business profits under the provisions of Article 7.

This treatment will also apply to professional services performed in the other State by individuals present in the other State for more than 183 days in aggregate in the calendar year concerned.

The term "professional services" is defined to include especially independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants.

Article 15 Dependent Personal Services

See treaty text.

Salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of employment are taxable only in that State unless the employment is exercised in the other State. If so, remuneration derived from the other State is taxable in the other State. However, the other State (the source State) will not tax provided:

- The recipient is present in the other State for no more than 183 days in aggregate in the calendar year concerned;
- The remuneration is paid by, or on behalf of, an employer not resident in the other State; and
- The remuneration is not borne by a permanent establishment or a fixed base which the employer has in the other State.

The purpose of this Article is to ensure symmetry in taxation. If the employer is not taxable in a State, because it is neither resident there nor has a permanent establishment there then it will not receive any tax deduction in that State for wages and salaries paid. Wages and salaries paid by the employer in respect of short term employment postings of employees to that State are correspondingly exempted from tax in that State in the hands of the employee.

Treatment of stock options

The treatment of employee stock options is not expressly dealt with and can be difficult as entitlement to the benefit taxable as a result of the option may have accrued partly whilst the employee was working temporarily in one of the States but there may be no taxable event, such as exercise of the option until the employee returns to the other State. A State is permitted to tax that part of the taxable benefit that can be related to the portion of the entitlement period spent working in that State.

Determining the extent to which an employee stock option benefit is derived from employment exercised in a particular State has to be done on a case by case basis, taking into account all relevant facts and circumstances. Whether a period of employment would be considered in allocating taxing rights between two States would depend on whether the entitlement to exercise the stock option was

contingent upon continuing employment during that period. If an option was granted with a right to exercise, say, in three years' time, regardless of continuing employment then time elapsing between grant and exercise would not count towards an apportionment of the taxing rights over the benefit in the absence of any other factors.
Periods of employment before the option was granted may be considered in the apportionment of taxing rights if the grant of the option was contingent upon a minimum period of employment or attainment of performance objectives.
Once the option is exercised, any further benefit to the employee, normally in the form of a capital gain on a disposal of the shares at a profit, will be dealt with under Article 13 and so probably only taxable in the State where he is resident.
If the shares do not vest irrevocably on exercise of the option (e.g. because they are liable to forfeiture upon certain conditions) then the increase in value of the shares until they do vest irrevocably will also be dealt with as employment income and subject to the same considerations as the benefit arising between grant and exercise.
The method of apportioning stock option benefits recommended by the OECD is by reference to the proportion of the number of days during which the employment was exercised in one State to the total number of days of employment from which the entitlement to the stock option benefits were derived. Thus if an employee was required to work for an employer for 520 days in total during a particular time period to qualify for the benefits of the stock option and was sent to work in the other State for 260 days out of that period, then half of the stock option benefits would be taxable in each State.

Domestic law

China

The extent of the taxation of expatriates depends on whether the stay is more than a year and whether it is more or less than five years. If the stay is for less than 90 days, then Chinese source income is taxable, except that employment income not borne by the Chinese employer is not taxed. (This corresponds to the rules set out in the Treaty, where the period is 183 days.) If the stay is for more than 90 days but less than a year, then Chinese source income, but not foreign income, is taxed in China. If the stay is for less than five years, then foreign income is usually exempt from Chinese tax. Only for stays of more than five years does full Chinese taxation apply.
Employer provided accommodation, travelling expenses, removal costs, and general household costs for expatriates are tax free.
China also permits an enhanced personal tax allowance.

Sweden

Foreign experts, researchers, executives and other "key persons" such as senior managers on temporary assignment to Sweden qualify for certain income tax benefits under a special regime. These benefits are:
• 75% of earnings are subject to personal income taxation in Sweden;
• The 75% of earnings basis is also the basis for social security charges; and
• Relocation costs, school fees and tuition (up to and including *baccalaureate* and the cost of two round trips to the country of origin for the entire family), paid for by the employer, are not taxable and do not constitute benefits in kind.
The exempt income is not subject to social security contributions.
Otherwise, the key person is treated as a Swedish resident taxpayer, taxable on worldwide net income subject to zero bracket amounts and available deductions.
The special regime is aimed at foreign experts, scientists, executives and other key persons on temporary assignment to Sweden, provided they are not Swedish nationals and provided they have not been residents of Sweden any time during the five-year period prior to taking up the temporary assignment. Generally, the regime will apply where there are difficulties in recruiting staff with similar expertise within Sweden. The Swedish assignment may not exceed five years and the special regime is limited to the first three years of the assignment.
Qualifying employers are Swedish private or public employers or non-Swedish undertakings with a branch or other fixed place of business in Sweden. An application for the special regime must be filed with the Research Tax Board (*Forskarskattenamnden*) within three months of taking up the Swedish assignment, at the latest.
The special regime provisions became effective January 1, 2001. Key persons who already were on assignment in Sweden on or before January 1, 2001, may also apply for the regime.

Article 16 Directors' Fees And Remuneration Of Top-level Managerial Officials

See treaty text.

These fees and other similar payments may be taxable in the country in which the company is resident as well as that in which the director is resident.
This rule also applies to salaries, wages and similar remuneration derived in a capacity as an official in a top-level managerial position of a company resident in the other State.

Article 17 Artists And Athletes

See treaty text.

The usual OECD Model rule is followed: Income derived by a resident of one State as an entertainer, such as a theatre, motion picture, radio or television artist, or a musician, or as an athlete, from their personal activities as such exercised in the other State may be taxed in the other State. This also applies where the income accrues not to the entertainer or athlete himself, but to another person, e.g. a management company or a troupe, team or orchestra forming a legal entity or to an artist company. This rule does not apply if the activities of the artist or athletes whose visit to the other State is made under a cultural exchange between the two States.

Article 18 Pensions

See treaty text.

These are taxable only in the State where the recipient is resident. However, as per the UN Model, pensions paid from a State's social security system are taxable only in the paying State.

Article 19 Income From Government Service

See treaty text.

Not analysed.

Article 20 Students And Trainees

See treaty text.

Payments which a student, business apprentice or trainee, who is, or was immediately before visiting a Contracting State, a resident of the other Contracting State and who is present in the visited State solely for the purpose of his education or training will not be taxed in the visited State on:

- All remittances from abroad for the purpose of is maintenance, education, or training;
- All scholarships, grants and awards from governmental, scientific or educational organisations for the purposes of his maintenance, education or training; and
- Income from personal services in an amount not exceeding 18,000 Swedish Kroner or equivalent in Chinese Yuan for any year of assessment. This exemptions lasts only as long as reasonably necessary to complete the education or training and in any case, no longer than seven consecutive years.

Article 21 Teachers And Researchers

See treaty text.

Professors and teachers normally resident in one State can work in the other State for a period of up to three years and remain taxable only in the State of residence. The work must consist of teaching or engaging in research in a university, institute, school or teaching institution, or Government recognised research institution. Research must be public research and not primarily for the benefit of private persons, including companies.

Article 22 Other Income

See treaty text.

Any income not dealt with in the preceding Articles is taxable only in the State of residence but if it arises in the other State then the other State may tax it according to domestic law. Thus the default position regarding the two States is that the State of source has primary taxing rights. Income not arising in either State may only be taxed by the State of residence. These rules follow the UN Model Treaty.
There is an express provision that income in respect of rights or property which is connected to a permanent establishment is taxed under Article 7 as the income of that permanent establishment. Income from immovable property remains taxable under Article 6 in the State in which the property is located.

Article 23 Elimination Of Double Taxation

See treaty text.

Sweden

Sweden uses the credit method However, Sweden will nevertheless take into account any income or gains taxable only in China in determining rates of Swedish tax to be applied to income or capital remaining in charge to Swedish tax (exemption with progression).
Sweden will also apply its domestic participation exemption to foreign dividends where appropriate (see notes under Article 10). There is a “subject to tax” test: The income used to pay the dividends must have been subject to the normal rate of corporation tax in China or to a comparable income tax

in China or elsewhere. Thus dividends paid out of profits which have enjoyed Chinese investment incentives will not qualify for the Swedish participation exemption.
There is no relief for underlying corporation tax in respect of dividends.

Tax sparing

Tax sparing is granted by Sweden during the years 1997 to 2006. This period may be extended by mutual agreement but no extension has been reported.
Tax sparing is applied to business profits: Sweden will give a credit for any Chinese tax which has not been charged by China under a time-limited exemption or reduction granted under inwards investment incentive provisions designed to promote economic development. This only applies to industrial, manufacturing, agricultural, forestry, fishing or tourism profits from activities carried out in China. The minimum tax credit given in these circumstances by Sweden is 15% of profits computed according to Swedish tax rules.
Whatever the actual rate of withholding taxes charged by China, Sweden will give credit as follows:
Interest: 10%.
Royalties: 5% minimum, or actual paid to China plus an extra 5% of the gross amount of royalties. This provision applies only to royalties for the use of or right to use patents, know-how, design or model, plan, secret formula or process or for information concerning industrial, commercial or scientific experience.

China

The credit method is used, but with credit for underlying tax on Swedish dividends where the dividend is received by a Chinese company owning at least 10% of the shares of the paying company.

Article 24 Non-discrimination

See treaty text.

The usual OECD provisions, that nationals of one of the States shall not be subjected in the other State to any taxation or any requirement connected with tax, which is other or more burdensome than the taxation and connected requirements to which nationals of the other State in the same circumstances are or may be subjected.
There is an extension so that the principle of non-discrimination also applies to persons not residents of either Sweden or China. It applies to all taxes, not merely those listed in Article 2.

Article 25 Mutual Agreement Procedure

See treaty text.

The usual provision found in the OECD Model is used but with different time limits. Where a person considers that the actions of one or both of the States result or will result for him in taxation not in accordance with the provisions of this Treaty, he may present his case to the competent authority of the State of which he is resident or if not resident in either Sweden or China, to the competent authority of which he is a national. This is so irrespective of the remedies provided by domestic law. The time limit for bringing a claim is three years from the date of first notification of the disputed tax liability.
The two tax authorities will try to resolve the case by mutual agreement. They will also try to agree on definitions of terms not specifically defined in the Treaty and on general matters of interpretation of the Treaty.
Thus this Article removes the need for the tax authorities in each State to go through diplomatic channels, they may simply contact each other directly. The mutual agreement procedure is commonly used to decide matters concerning income and expense allocations and transfer pricing.

Article 26 Exchange Of Information

See treaty text.

The scope of this Article is quite wide ranging in that it provides for exchange of such information as is "necessary for carrying out the provisions of this Convention", for the purposes of domestic law of the two States and also for the prevention of tax evasion. The exchange of information is not limited to that only concerning persons who are residents of one of the States.
The Article includes the usual provisos relieving the States from any obligation to:

- Carry out administrative measures at variance with the laws or administrative practices of either State;
- Supply information which is not obtainable under the laws or in the normal course of the administration of either State; and
- Supply information which would disclose any trade, business, industrial commercial or professional secret or trade process, or information the disclosure of which would be contrary to public policy (*ordre public*).

There is no requirement to supply any information that the requested State would not need for its own tax purposes. Neither is there any bar on declining a request solely due to secrecy concerns.

Article 27 Diplomatic Agents And Consular Officers

See treaty text.

Not analysed.

Article 28 Entry Into Force

See treaty text.

Not analysed.

Article 29 Termination

See treaty text.

Not analysed.