Newsletter

Tax Department
New China – Italy Double Tax Treaty

On 23 March 2019, the Chinese and Italian Governments signed a new agreement for the avoidance of double taxation and the prevention of fiscal evasion (the "**Agreement**"). The Agreement, once in force and effective, will replace the current double taxation treaty between the two countries, concluded on 31 October 1986 (the "**1986 DTT**").

The Agreement, the implementation of which aims at promoting and developing the bilateral cooperation between The People's Republic of China and Italy, will strengthen the communication and coordination on fiscal, financial and structural reform policies to create and foster a favorable economic and financial environment.

Contrary to the majority of the double tax treaties concluded by Italy, the Agreement shall apply to taxes on income only (including taxes on capital gains), and does not apply to taxes on capital.

I Implementation of the MLI minimum standards

The analysis of the Agreement suggests that the new provisions are aligned to the OECD BEPS standards and to the OECD Multilateral Convention ("**MLI**"), which both China and Italy signed on 7 June 2017 (although still not ratified) and for which both Countries have included the 1986 DTT as a covered tax agreement under Article 2(1)(a)(ii).

In this respect, in compliance with the MLI minimum standards for the protection against the abuse of tax treaties, a new statement has been introduced in the preamble of the Agreement; according to such statement, the Countries expressly represent that their common intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty-shopping arrangements.

Still on the MLI minimum standards' subject, the Agreement includes a Principal Purpose Test (**PPT**) clause (Article 24 of the Agreement), which consists of a general anti-abuse rule patterned along the lines of Article 6, paragraph 1 of the MLI. Pursuant to the PPT, a benefit under the Agreement shall be denied where the principal purpose or one of the principal purposes of any arrangement or transaction, or of the parties to an arrangement or transaction, was to obtain those benefits.

II Permanent Establishment

In line with the 2017 OECD Model Convention, the Agreement provides for a new definition of permanent establishment which contains the BEPS anti-fragmentation rule as well as a new definition of "independent agent" under the agency permanent establishment provisions.

It is noteworthy that, contrary to the corresponding definition under Italian domestic tax legislation, no provisions have been included in order to tackle the digital permanent establishment issue.

III Dividends, interest, royalties and capital gains

The provisions concerning the allocation of taxing powers with respect to cross-border passive income (*i.e.,* dividends, interest, royalties) and capital gains undoubtedly represent the most significant change brought by the Agreement. Indeed, the main innovative elements can be summarized as follows:

III.I Dividends

The withholding tax rate applicable to dividends has been reduced to 5 per cent in all cases where the beneficial owner directly holds at least 25 per cent of the capital of the company paying the dividends and such a condition is met for a minimum holding period of 365 days. The current 10 per cent rate will continue to apply in all residual cases.

In this respect, it is worth highlighting that, embracing the MLI blueprint embedded in the new Agreement, the 365-day period shall include the day of the payment of the dividends and that, for the purposes of computing that period, no account shall be taken of changes of ownership that would directly result from a corporate reorganization, such as a merger or de-merger of the company that holds the shares or that pays the dividends.

III.II Interest

Similarly to the provisions laid down by the 1986 DTT, the taxation in the source State of the interest cannot exceed 10 per cent of its gross amount; moreover, the Agreement introduces a reduced 8 per cent withholding tax in case the interest income is paid to financial institutions of the other State in relation to loans (i) having a minimum maturity of three years and (ii) destined to financing investment projects. Although there is no punctual definition of "investment projects" for the purposes of the Agreement, it is arguable that this notion should encompass projects in the field of infrastructure which were also part of the umbrella deal entered into by the two Countries under the Silk Road project.

More importantly, the Agreement widens the scope of the exemption from taxes on interest already granted under the 1986 DTT, stating that no tax shall be levied on interest paid to, *inter alia*, public entities. This provision directly addresses certain Italian financial institutions, such as *Cassa Depositi e Prestiti*, which otherwise would have been excluded from such exemption under the wording of the 1986 DTT.

Furthermore, the Agreement introduces a specific exemption on interest income paid by certain Italian financial institutions to Chinese resident beneficial owners in relation to the issuance of debt securities known as the *Panda Bonds*. In brief, Panda bonds are *Renmimbi* (RMB) denominated bonds issued in mainland China by foreign financial institutions.

III.III Royalties

The Agreement provides for a further reduction of taxation applicable to royalties deriving from the use or the right to use of industrial, commercial or scientific equipment. While the 1986 DTT provides for a 10 per cent withholding tax levied on 70 per cent of the gross amount of the royalty (effective 7 per cent rate), the Agreement now states that such tax shall be applied only on 50 per cent of gross amount, resulting in an effective tax rate of 5 per cent.

III.IV Capital Gains

The Agreement has significantly restructured the provision on the allocation of taxing rights in case of capital gains.

Source State taxing rights are confirmed with regards to capital gains deriving from the alienation of (i) immovable properties, (ii) movable properties part of the business property of a permanent establishment; and (iii) shares representing a participation of at least 25 per cent to the share capital of an entity resident in a contracting State.
Finally, and perhaps more importantly, the Agreement provides that all cases of capital gains not expressly governed by the paragraphs of article 13 shall be taxed only in the State of residence of the alienator. This is a change of paramount importance also considering that the 1986 DTT, together with only a few other double tax treaties entered into by Italy (such as the one with France and Israel), provided for concurrent taxation as a general rule applicable to all the residual cases.

IV Entry into force

According to the general principles of public international law, following the authorities' signatures occurred on 23 March, the Agreement will be enforceable after the ratification by each of the two signatory countries (Italy will need an *ad-hoc* ratification law) and the completion of the exchange of ratification instruments. It seems unlikely that the Agreement may come into force before 2021.

V Final remarks

It is worth highlighting that the Agreement is amongst the first ones signed by Italy after the ground-breaking introduction, in the context of the global tax environment, of the MLI. Despite both Italy and China had reserved the right not to apply almost all the provisions aside from the minimum standard ones, a significant number of provisions contained in the MLI have been anyway transposed in the Agreement.

This said, given that the Agreement, once in force and effective, will replace the 1986 DTT, it cannot be considered as a covered tax agreement for the purposes of the MLI unless Italy and China update the list of covered tax agreements as per article 2 of the MLI.

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Depending on each particular case it may be more appropriate to consider planning alternatives for corporate restructuring before the Agreement comes into force.

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