

China's New Tax Treatment for Royalties

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Introduction

The China State Administration of Taxation ("SAT") issued Circular Guoshuihan [2009] No.507 "*Notice of the State Administration of Taxation about the Issues Relevant to the Execution of the Royalty Clauses of Tax Treaties*" ("Circular 507") on 14 September 2009 clarifying some issues on implementation of the Royalty Clauses under the tax treaties concluded between the People's Republic of China and foreign parties on the avoidance of double taxation (including the tax arrangements between the Mainland and Hong Kong Special Administrative Region and Macao Special Administrative Region, hereinafter referred to as the tax treaties) in respect of the definition and scope of royalty payments and the related tax treatments.. This Circular 507 took effect from 1 October 2009.

On 26 January 2010, the SAT issued a notice, Circular Guoshuihan [2010] No.46 "*Notice of the State Administration of Taxation about the Issues Relevant to the Execution of the Tax Treaties*" ("Circular 46"), to address the relevant issues raised by some local-level tax bureaus, supplement the implementation of Circular 507, and clarify the transitional tax treatments in relation to the technology-transfer-related services.

Main Points of Circular 507

1. Income from Lease

Tax treaties did not give a clear explanation of income from lease, but divide the lease income into two kinds: real estate income and royalty use income.

According to Circular 507, if the definition of the term "royalty" in a tax treaty expressly includes the payments charged for the use of industrial, commercial and scientific equipment (namely the income from lease in Chinese tax law), the relevant incomes shall be governed by the royalty clause of the tax treaty. If the tax rate prescribed in the said tax treaty is lower than that prescribed in the tax law, the tax rate prescribed in the said tax treaty shall apply. However this does not apply to the use of real estate

Generally speaking, agreement tax rate apply to tax treaties is 10%, sometime lower than 10%.

2. Information concerning Industrial, Commercial or Scientific Experience

According to Circular 507, information with respect to industrial, commercial or scientific experience stipulated in Circular 507 on royalties shall refer to proprietary technologies, generally means the information or other data required to produce a certain product, or to replicate a certain process, that is not disclosed to the public and is proprietary in nature.

Royalty related to proprietary technologies always refers to the payments made by a licensee to the owner of the proprietary technologies where the licensor does not participate in the use of the proprietary technologies or guarantee the results thereof. Such proprietary technologies generally would already exist, but it also can be the proprietary technologies developed by the licensor at the licensee's request which is subsequently licensed to the licensee under certain restrictions.

3. Difference between Transfer or License of Technology and Provision of Service

Royalty stipulated in tax treaties means the profits the residents of one country received from the others of the contracting states for the use of his property, especially intangible property, such as patent, proprietary technology, trademark, copyright, design and plan (machinery equipment). It may cause some confusion when people are handling with the tax of property use, especially the income from transfer or license of technology. For the reason that provision of service always exists during the transfer or license of technology, sometimes it is difficult for people to distinguish between the two.

According to Circular 507, if the service provider uses certain specialized knowledge and technology in the course of the provision of services, but such knowledge and technology are not licensed to the service recipient, then such payments for this shall not be considered as royalty payments; if the result of the service provided by the provider falls in the scope of royalties under the royalties article of an applicable tax treaty, and the service provider retains ownership of the result, the service recipient is only granted a right to use the result, then such payments for this can be considered as royalty payments.

This provide a good guidance for treating technical service fee as royalties, only when the service provider keeps the ownership of the proprietary technologies, and the recipient of services merely has the right to use the technology, the income derived from such services can be considered as royalties.

4. Related Technical Assistance and Guidance Fee

According to Circular 507, if the licensor assigns personnel to provide services, such as support and guidance relating to the use of the licensed technology, and charges service fees, no matter whether the service fees are included in the total amount of the royalties or invoiced separately, such fees will be subject to the royalties provision in tax treaties. However, if the service provided by the above said personnel is considered as a permanent establishment (PE) in China, then the service fee shall be considered as business profit and will subject to the clauses of income tax of business profit stipulated in the tax treaties.

5. Service Income no Considered as Royalty

According to Circular 507, the following payments will not be considered royalty payments but service income instead:

- 1) Payments for after-sale services in connection with the trading of goods;
- 2) Payments for services provided under a product warranty;
- 3) Payments derived from services provided by an institution or individual that provides professional services, such as engineering, management and consulting services; and
- 4) Other similar payments as stipulated by SAT.

Unless otherwise stipulated in the applicable treaty, the clauses of business profit stipulated in tax treaties shall apply to the above said service income.

6. Beneficial Owner Requirement

According to Circular 507, the royalties of the tax treaties only applies to residents of the other contracting state that are beneficial owners of the royalties. If the Permanent Establishment (PE) of a resident of a third country or jurisdiction located in the other contracting state derives royalties from China, the tax treaty between China and this other contracting state will not apply, instead the tax treaty between China and the third country or jurisdiction shall apply. The PE of a Chinese tax resident in the other contracting state is not a resident of the other contracting state, and therefore can not take advantage of the tax treaty between China and the other contracting state in respect of the royalties received from China.

Main Points of Circular 46

Circular Guoshuihan [2010] No. 46 is a supplement to the implementation of the

earlier Circular 507 mentioned above.

According to Circular 46, technology-transfer-related services are considered as part of the technology transfer, the relevant service income shall fall under the scope of royalties and shall be treated in accordance of the provisions of royalties stipulated in tax treaties. However, if the foreign technology-provider has sent personnel to China to support the adoption the use of the technology being transferred, and the time spent by the foreign personnel in China have constituted a PE for the foreign technology-provider, then the service income belong to the PE shall be treated as business profit, and the foreign personnel shall be treated in accordance with the relevant dependent personal services article of tax treaties.

Conclusion

The provisions stipulated in Circular 507 and Circular 46 clearly clarify some actual issues concerning the execution of the royalty clauses of the tax treaties which may easy to cause divergence or different understanding among some local tax departments when executing relevant clauses. As the issuance of Circulars 507 and Circulars 46, some multinational corporations may need to adjust their technology license and technical service contracts accordingly.