China Clarifies Tax Treatment for Royalties

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On 14th September 2009, the State Administration of Taxation (SAT) issued a tax circular Guoshuihan [2009] No.507 Notice on Certain Issues Concerning the Implementation of Articles on Royalties in Tax Treaties (Circular 507), which clarifies a few issues in Double Tax Treaties (DTT) between China and other jurisdictions in respect of the definition and scope of royalty payments and the related tax treatments. Circular 507 shall come into effect from 1st October 2009.

Highlights of Circular 507

- In cases subject to a DTT, royalties are defined as including charges for the use of industrial, commercial or scientific equipment (i.e. rental income as is defined in the PRC tax regulations), the corresponding withholding tax (WHT) rate shall apply to the payment of such charges. The articles on royalties do not cover charges for the use of immovable properties.
- The phrase “information concerning industrial, commercial or scientific experience” used in the article on royalties shall refer to proprietary technologies.
- The key attributes of proprietary technologies are clarified as:

  - The licensor authorizes the licensee to use undisclosed technologies, and the licensor is not involved in the implementation process and does not guarantee the result;

  - The technologies are existing, or specifically developed as requested by the licensee restricted by confidentiality provisions.

- To distinguish royalty payments from service fees, the following factors should be considered:

  - If the technology used by the service provider during the course of provision of services is not transferred or licensed to the service recipient, the income arising from the provision of such services shall not be treated as royalties.

  - If certain intellectual property is developed as a result of the provision of services, which falls in the definition of royalty under the applicable DTT with the ownership being kept by the service provider, furthermore, the service recipient is only granted a right to use such intellectual property, the income arising from the provision of such services shall be treated as royalties.

- In the case where support services are provided during the course of transfer or licensing of technologies, the tax treatment should be:

  - If the support services do not constitute a permanent establishment (PE), the service fees shall be treated as part of the royalty, no matter whether the service fees are billed separately or not.

  - If support services constitute a PE, the service fees arising from the PE and the royalty shall be separately assessed. The article on business profits of DTT shall be applied to the service income part, and if the profit attributable to the PE in respect of the service portion cannot be clearly

indentified, the Chinese tax authorities can determine it according to the principle set forth under the DTT.

- The following four types of income must be regarded as service incomes instead of royalties.

  - Payment for after-sale services for pure trading activities;

  - Payment for services provided by sellers to buyers under a product warranty;

  - Payment for provision of professional services, such as engineering, management, and consulting services; and

  - Other similar payments as stipulated by SAT.

- The royalty article in a DTT shall apply only to resident beneficial owners of the contracting party, in particular:

  - If China-sourced royalties are paid to a PE in Country A of a tax resident of Country B, the tax treaty between China and Country B applies.

  - The PE of a China tax resident entity residing in Country A does not qualify as a resident company of Country A, so it should not benefit from the DTT between China and Country A.

  - If China-sourced royalties are borne and paid by a Chinese PE of a tax resident of Country A to a tax resident in Country B, the DTT between China and Country B applies.

LehmanBrown Observations

On 20th February 2009, the State Administration of Taxation issued Guoshuihan [2009] No.81, which provides guidance relating to the implementation of the dividends article of DTT, and on 24th August 2009, SAT issued Guoshuifa [2009] No.124, which provides further guidance for non-residents claiming DTT benefits.

Now Circular 507, as the latest regulation in a series of rules aimed at strengthening the administration of non-resident enterprises claiming DTT benefits, provides clearer guidance on the applicability of articles on royalty in a DTT, which would be helpful for non-tax residents to more accurately assess the tax implications when deriving royalties from or providing related services to China.

We understand that some MNCs take royalty payments as an effective way for repatriating profits or cash from China in light that royalty is only subject to WHT and the applicable DTTs may also provide a beneficial tax rate. These MNCs, particularly the ones, which provide services associated with the transfer and/or licensing of technologies, are advised to immediately review their royalty transactions, and to accordingly prepare any documentation to support their claims for the DTT benefits in connection with royalty payments. MNCs should consider engaging professionals for assistance in provision of advisories, documentation preparation and dispute resolution on this issue.