

China: SAT clarifies application of royalty article under tax treaties

The Chinese State Administration of Taxation (SAT) issued a circular (Circular 507) on 23 September 2009 that clarifies the application of the royalties article in China's tax treaties and sets out the types of payments that are considered royalties and those that are not. Circular 507, which became effective on 1 October 2009, is the latest in a series of rules aimed at strengthening the administration of nonresident enterprises claiming treaty benefits.

Highlights of Circular 507

Information concerning industrial, commercial or scientific experience – Circular 507 provides that the phrase "information concerning industrial, commercial or scientific experience," as used in the royalties article, should be regarded as "proprietary know-how." The circular notes that the phrase generally refers to 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. Payments for proprietary know-how will be considered royalty payments where the payments are made by a licensee to the owner of the know-how and where the licensor does not participate in the use of the know-how or guarantee the results thereof. Interestingly, the SAT comments in the circular that proprietary know-how generally would already exist, but it also would include proprietary know-how developed by the licensor at the licensee's request and that is subsequently licensed to the licensee under certain restrictions (e.g. confidentiality).

Service contracts – The circular distinguishes between the following payments:

- **Payments not considered royalty payments** – 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.
- **Payments considered royalty payments** – Focuses on the "end result" of the contract, when: (1) payments for the "end result" would be considered royalties under the royalties article of an applicable tax treaty; (2) the service provider retains ownership of the "end result"; and (3) the service recipient is only granted a right to use the "end result." It is important to note that the term "royalties" as defined in the OECD model treaty refers to payment of any kind received as a consideration for the use of, or the right to use, such assets as any copyright of literary, artistic or scientific work, including cinematograph films, any patent, trademark, design or model, plan, secret formula or process, or "proprietary know-how." The "end result" should be any of the assets mentioned in the definition of "royalties" in an applicable treaty.

Technical assistance – Where the licensor assigns personnel to provide services, such as support and guidance relating to the use of the licensed technology, and charges service fees, regardless of whether the service fees are included in the total amount of the royalties or invoiced separately, the fees will be subject to the royalties provision in an applicable tax treaty. However, if as a result of the services provided by the assigned personnel, the service provider is considered to have a permanent establishment (PE) in China, the business profits article rather than the royalties article will apply to the services income. In this regard, the SAT clarifies a position taken in Circular Guoshuihan [2007] No. 1141 where it did not seem to consider the question of whether a PE might have been created as a result of provision of service.

In practice, PEs are often taxed on a deemed profit basis at a deemed profit rate ranging from 10% to 40%. As such, royalties attributable to a PE would be subject to Enterprise Income Tax at an effective rate of 2.5%-10%, rather than at the 10% withholding tax (in most circumstances) if the royalties were not attributable to a PE.

Payments specifically not considered royalty payments – Notwithstanding the above, Circular 507 clarifies that the following payments will not be considered royalty payments:

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.

Such payments will be considered services and will be subject to the business profits article unless otherwise stipulated in the applicable treaty (e.g. the “technical fees” article in the China-U.K. treaty).

Application to PEs – The royalty article in a treaty will apply only to resident beneficial owners of the treaty partner country. For example:

1. Where China-source royalties are paid to a PE in Country X of a company residing in Country Y, the tax treaty between China and Country Y applies.
2. Where China-source royalties are paid by a Chinese PE of a foreign entity (e.g. of Country X) to a tax resident of another contracting state (e.g. Country Y), the tax treaty between China and Country Y applies.
3. A PE of a China tax resident entity in Country Y does not qualify as a “resident” of Country Y and as such should not benefit from the tax treaty between China and Country Y.

Comments

Circular 507 provides welcome guidance concerning payments that constitute royalty payments, and the SAT’s position broadly accords with the position of the OECD.

However, the SAT appears to take a broader view of what constitutes royalties in the case of information concerning industrial, commercial or scientific experience (proprietary know-how). The SAT acknowledges that, in situations where payments for proprietary know-how are considered royalty payments, the proprietary know-how is generally already in existence. The SAT also appears to take the position that payments for proprietary know-how that is created at the request of the service recipient, is owned by the service provider, and in respect of which the service recipient only has a right of use, also would be considered royalty payments. According to the OECD, the proprietary know-how must already be in existence for such payments to be royalty payments.

Payments for technical services have frequently been an area where taxpayers can expect a challenge from the tax authorities; for example, payments are made to a service provider to modify an existing design where the ownership of the modified design belongs to the service recipient. Circular 507 makes it clear that payments for technical services generally should not be regarded as royalty payments merely because they relate to “technical” services. Such payments will be regarded as royalty payments only if the “end result” of the services provided is owned by the service provider and the recipient is paying for a license to use that “end result.”

In a final welcome clarification, Circular 507 provides that payments for after-sales services, services provided under a product warranty and payments for the provision of professional services are not “royalties.”

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