China alert

Tax and regulatory developments

TAX

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Tax treaty treatment of royalties clarified

In Brief

- The State Administration of Taxation (SAT) recently clarified tax treaty treatment of royalties.

Relevant regulation discussed in this issue:

Notice on Issues with Respect to Implementing the Article of Royalties, Guoshuihan [2009] No. 507 (Notice 507), issued by the State Administration of Taxation on 14 September 2009, effective 1 October 2009.

Background

To help interpret royalty articles in bilateral tax treaties signed between the PRC government and other jurisdictions, the SAT recently issued Notice 507 to clarify the definition of royalties and the applicability of the relevant articles.

Key items

- Royalties for "use of industrial, commercial or scientific equipment" do not include income from use of immovable properties.
- "Information concerning industrial, commercial or scientific experience" refers to proprietary technologies.
- If the service provider applies technology or know-how during the course of providing services, whether the income shall be regarded as "royalties" shall be determined based on the following factors:
  - If the service provider applies technology or know-how without transferring the technology or know-how, the income for these services shall not be characterised as "royalties".
  - If, during the course of the services, certain intellectual property is formed, and the service provider owns the intellectual property of the service outcome, while the service recipient only has a right to use the service outcome, the income for these services shall be characterised as "royalties".
- For transfer or licensing of technologies, if support services are also provided, the tax treatment should be as follows:

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- If the aforementioned services do not constitute a permanent establishment as defined in the tax treaties, the service fees shall be treated as royalties regardless of whether the service fees are charged separately or included in technology fees.

- If the aforementioned services constitute a permanent establishment as defined in the tax treaties, the income for these services shall be treated as business profit.

- The income derived from the following activities shall be regarded as service fees instead of royalties and the article of business profits shall apply, unless the specific tax treaties provide otherwise:

  - After-sales services for pure trading activities
  - Services provided by sellers to buyers during warranty period
  - Professional services
  - Similar remuneration as stipulated by the SAT.

Important Notes

In summary, Notice 507 does the following in terms of the definition and scope of royalties described under the Corporate Income Tax Law and the tax treaties:

- Clarifies that royalties shall include the income for the use of movable properties (i.e. rental income as is defined in the PRC tax regulations), while excluding income for the use of immovable properties

- Clarifies the differences between royalties and service fees and sets out four types of income which do not fall within the scope of royalties

- Clarifies the tax treatment for services provided during the course of technology transfer.

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