

Royalty or Business Profit?

By David Yu and Clare Lu

In late 2009, the State Administration of Taxation (the SAT) issued Circular Guoshuihan [2009] No.507 (Circular 507), which provides for the applicability of royalty articles in Double Taxation Treaties (DTTs) to technical service fees. In addition, at the beginning of 2010, the SAT further issued Circular Guoshuihan [2010] No.46 (Circular 46), which further elaborates on the tax assessment of technical service fees under DTTs. Considering that the royalty payments are common to cross-border transactions, the new tax treatment rules on technical service fees may affect the structure of such transactions from a taxation, foreign exchange (forex) and customs standpoint.

New Tax Treatment Rules on Technical Service Fees

➤ Definition of 'royalties'

'Royalty' under DTTs generally refers to fees that are charged by a resident of a contracting state for licencing rights to intangible or tangible property to a resident of another contracting state. For contracts that include both technology licencing and ancillary technical services, the application of royalty articles on the technical service fee portion could be determined by whether the licence constitutes the principal purpose of the contract based on the OECD Model Tax Convention commentaries. Under Circular 507 and Circular 46, if the technology licensor assigns personnel to provide technical services (e.g. support and instruction), the service fee charged shall be regarded as part of royalties regardless of whether it is charged independently from, or is covered within, the royalties. As such, we understand that under both DTTs and the PRC tax regime, technical services could be considered a part of the technology licence, in which case technical service fees are a part of the royalties.

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➤ Circular 507 and Circular 46

Despite the above, Circular 507 stipulates that if the provision of technical services causes the licensor to be deemed a Permanent Establishment (PE) in Mainland China, the fee collected for the technical services may be taxed as ‘business profit’. Circular 46 further clarifies that, where the licensor constitutes a PE in Mainland China and the service fees are regarded as effectively connected with the PE, corporate income tax (CIT) shall be reassessed and collected on such service fees (as business profit attributable to the PE). Foreign assignees are subject to individual income tax. In other words, provisions of ‘business profit’ will prevail over those of ‘royalty’.

In light of the above, we feel that the determination of whether the service fees will be regarded as ‘business profit’ or as ‘royalties’ hinges on whether the licensor constitutes a PE in Mainland China. Whether a taxpayer constitutes a PE in Mainland China and whether the income is effectively connected to such PE will be determined in accordance with PRC domestic tax regime and DTTs.

➤ CIT treatment on technical service fees

Under the new tax regime, if the licensor’s provisions of technical services constitute a PE in Mainland China, the licensor is subject to CIT at a rate of 25% on the profits attributable to the PE. In practice, local tax authorities prefer collecting taxes on a ‘deemed profit’ basis. As stipulated in the Circular Guoshuifa [2010] No.19 (Circular 19), the deemed profit rates for non-resident enterprises range from 15% to 50%. The tax authority may apply a higher deemed profit rate where it has grounds to believe that the actual profit rates of the non-resident enterprise are evidently higher than the mentioned range. Furthermore, under Circular 19, where the non-resident enterprise cannot prove that the technical service is rendered offshore, the tax authority may treat all services to be performed within China. In this regard, the effective CIT rate might reach 12.5% or even higher. Meanwhile, foreign assignees are subject to IIT for income derived from their services performed during their time in China.

Discussion of Issues

Circular 507 and Circular 64 have changed tax assessment on technical service fees associated with technology licencing. Such changes require the taxpayers and local tax authorities to determine whether a service fee is ‘business profit’ or ‘royalties’ based on the foreign assignees’ duration in China. This will increase the administrative burden on foreign assignees for both taxpayers and local tax authorities. Having said that, as the tax authorities are empowered to tax on a ‘deemed profit’ basis, the new rules mainly add to the taxpayers’ administrative burdens.

Secondly, payments of royalties and service fees are common in cross-border transactions. Based on our previous experience, and for the convenience of tax administration and collection, local tax authorities prefer collecting withholding tax (WHT) at 10% (and business tax at 5%) rather than carefully distinguishing between ‘business profit’ and ‘royalties’. We will keep a close eye on the possible impact that Circular 507 and Circular 64 will have on the practice of local tax authorities.

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Thirdly, royalties and service fees are subject to different forex administrative procedures. In this regard, the new tax treatments on service fees under Circular 507 and Circular 64 might affect the forex payment process for taxpayers.

Lastly, valuation of royalties is consistently emphasised by customs. The new tax treatment on the service fee under both Circular 507 and Circular 64 might also influence customs valuation.

With the announcement of Circular 507 and Circular 64, multinational corporations' cross-border technology licencing and technical service arrangements might need to be adjusted accordingly. More attention should be paid to ongoing changes in the administration and regulation regarding taxation, customs and forex.

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