SHEPPARD MULLIN
SHEPPARD MULLIN RICHTER & HAMPTON LLP
China Law Update BLOG
For the Latest Developments in China Law

# China Law Update

Posted at 9:43 AM on October 2, 2009 by Sheppard Mullin

## China Crystallizes Royalty Clause of Tax Treaty

China's State Administration of Taxation ("SAT") issued a Notice on the Issues concerning the Application of Royalty Clauses in Tax Treaties (Circular No. 507, hereinafter referred to as the "Circular") on September 14, 2009. The Circular clarifies the definition and scope of royalty clause involved in tax treaties to avoid double taxation and to prevent fiscal evasion with respect to taxes on income. It will be effective on October 1, 2009.

Highlights of the Circular

The Circular is widely applicable to mainland China's tax arrangements with foreign countries as well as Hong Kong and Macau Special Administrative Regions. In the event that the definition of "royalty" in a tax arrangement covers payments for the use of industrial, commercial and scientific equipment, a lower tax rate specified by the tax arrangement will be applied to income originated from such payments. However, immovable properties will be regulated separately in line with immovable property clauses.

The Circular further confirms that information procured by industrial, commercial or scientific experience will be recognized as technical know-how. In a service contract, if the service provider uses certain technical know-how without transferring or licensing it, service fees will be excluded from the scope of royalties. In contrast, service fees obtained by technical support or guidance in the course of licensing or transferring the technical know-how will be regarded as royalties, provided that such services do not constitute a permanent establishment.

Even more importantly, the Circular enumerates four categories of payments which will not fall in the spectrum of royalties: (i) income derived from post-sale services with respect to sales of goods; (ii) remuneration earned from services provided by sellers to buyers during the product warranty period; (iii) payments arising from an entity or individual who specializes in engineering, management, consultant services and so on; (iv) other similar payments as decided by the SAT.

In addition, the Circular emphasizes that payments from entities, places and permanent establishments set up by foreign companies in China to residents of countries or districts with tax arrangements with China will be deemed as royalties.

## Conclusion

These developments provide more certainty for foreign companies in executing royalty clauses of tax arrangements. The Circular is also of great importance for multinational companies to optimize their tax planning strategies. Both non-resident and resident companies can regard the Circular as guidance in the course of negotiating licensing or transfer contracts.

Authored By

Jingyuan Sun
(212) 634-3094
jsun@sheppardmullin.com