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China alert

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# New light shed on technical fees under treaties with India, Pakistan and the UK

## Regulation discussed in this issue:

- Announcement on Relevant Issues regarding Enforcement of Technical Fees Articles under China's Tax Treaties with the UK, India and Pakistan, SAT Announcement [2011] No. 19, issued by the SAT on 16 March 2011, effective from 16 March 2011

### Background

The State Administration of Taxation (SAT) has further clarified the income tax treatment of technical fees under China's tax treaties with the UK, India and Pakistan ("Relevant Treaties") respectively in Announcement 19 issued on 16 March 2011. Announcement 19 has given more clarity and certainty to an area where there have been a lot of local variations in interpretation and enforcement. It is encouraging to note that SAT has started taking the steps to the address this issue. Announcement 19 is effective from 16 March 2011.

The key points of Announcement 19 and our comments on them are set out below:

**1. What is a technical fee?**

Announcement 19 does not provide a generic definition to the term, "technical fee". The Relevant Treaties and the circulars issued by SAT in the past in respect of them state what should or should not be included in the scope of technical fees, but do not provide a holistic meaning to the term.

Under the Relevant Treaties, technical fees include technical fees, supervisory fees, consulting fees or managerial fees, as the case may be. These sub-terms are generally not further defined either. As technical fees and fees for other services can have very different Chinese tax implications, it is important to distinguish between technical fees and fees for other services.

Part II of 2002 Reports related to the OECD Model Tax Convention (2002 Report,) which deals with the treaty characterisation issues arising from e-commerce can provide some guidance in this regard. According to the 2002 Report, the services can be understood as follows:

- **Technical services**: A service is regarded as being of a technical nature when special skills or knowledge related to a technical field are required for the provision of such service. However, it is crucial to determine at what point the special skill or knowledge is used. Developing or creating inputs to a service business does not necessarily amount to the provision of technical services. A service is not technical in nature unless a special skill or knowledge is required when the service is *provided* to the customers.

- **Managerial services**: Services of a managerial nature are services rendered in management functions. The concept of managerial services should take on a normal business meaning. Managerial services should be about functions related to *how* a business is run rather than functions involved in carrying on that business.

- **Consultancy services**: These are services constituting in provision of advice by someone such as a professional who has a special qualification allowing them to do so.

- **Supervisory services**: The concept of supervisory services should take on a normal business meaning. However, supervisory activities of a company in connection with its building site, construction, assembly or installation projects are normally not regarded as supervisory services in the technical fee context.

As SAT generally does not simply adopt the technical guidance provided by OECD, the above notes are for general reference purposes only.

**2. How should a technical fee be treated under the domestic law?**

The Corporate Income Tax (CIT) Law and implementation rules do not mention the term, "technical fees". Neither did the Foreign Enterprise Income Tax (FEIT) Law and implementation rules (which ceased to be in force on 1 January 2008).

If a non-resident enterprise is required to carry out activities in order to earn the technical fee i.e. active income, then the question is whether the activities will give rise to an establishment under CIT Law or permanent establishment (PE) under the Relevant Treaties. In that case, the non-resident enterprise will be liable for CIT on the technical fees in accordance with the rules on business profits only if the activities create a PE in China.

If the non-resident enterprise does not need to carry out any activities in order to earn the technical fee i.e. passive income, then it should not be liable for any CIT. "Technical fees" do not fall within the scope of passive income items that are subject to Withholding Tax like royalties. Both CIT Law and FEIT Law and related implementation rules refer to "other income" in the context of income derived by non-resident enterprises / foreign enterprises from China. However, the scope and source of such "other income" should be officially defined by the Ministry of Finance (MoF) and SAT. We are not aware of any circulars that explicitly or implicitly state that "other income" includes technical fees.

Therefore, unless the activities underlying a technical fee give rise to an establishment under the domestic law or a PE under a tax treaty in China, such technical fees should not be subject to CIT in China.

**3. How should a technical fee be treated under the Relevant Treaties for CIT purposes?**

Before the issuance of Announcement 19, SAT had issued a number of circulars setting out the circumstances under which China has the taxing rights over the technical fees arising in China under the Relevant Treaties. Please see Appendix A for a summary of the rules in the related articles of the Relevant Treaties and the rules in the SAT circulars in connection with these articles.

Announcement 19 goes beyond the question of taxing rights and addresses the issue of how the CIT liability of the non-resident enterprises should be calculated under the Relevant Treaties. The rules governing the calculation of the CIT liability can be summarised as follows:

| Circumstances | CIT Treatment |
|---|---|
| **Service arising in China according to CIT Law** (Note 1) | |
| • Service creating PE in China according to Relevant Treaties (Note 2) | Non-resident enterprise will be liable for CIT on income attributed to PE. |
| • Service not creating PE in China according to Relevant Treaties (Note 2) | Non-resident enterprise will be liable for CIT on income attributed to services arising in China, but its CIT liability will be subject to a cap as prescribed in the Relevant Treaties. |
| **Service not arising in China according to CIT Law** (Note 1) | |
| • Technical fees are taxable income according to CIT Law (Note 3) | Not clear (Note 4) |
| • Technical fees are non-taxable income according to CIT Law (Note 3) | Non-resident enterprise will not be liable for CIT. |

Notes

1. According to Article 7(2) of the Implementation Rules for CIT Law, a service is regarded as arising in China if the service is performed in China. However, if a technical fee is regarded as a passive income, it might be regarded as arising in China if the payer is in China. The former position would seem more reasonable. Whereas under the article on technical fees in the China-UK double tax agreement (DTA) and China-India DTA, a service will be treated as arising in China if it is paid by a Chinese resident enterprise.

2. Under the China-India DTA, a service will give rise to a permanent establishment if the activities continue in China for a period or periods aggregate more than 183 days. However, It is not clear from the wording of the China-India DTA if technical services can also enjoy the 183-day threshold. For the China-UK DTA and the China-Pakistan DTA, there is certainly no such threshold protection.

3. Technical fees are not one of the categories of taxable income under Article 3 of CIT Law and Article 6 of Implementation Rules for CIT Law. In principle, technical fees can come under the category of "other income". However, procedurally the scope of "other income" should be formally defined by MoF and SAT. We are not aware of any regulations that state that other income covers technical fees.

4. It is not clear from Announcement 19 as to how the CIT liability of the non-resident enterprise will be determined if technical fees are taxable income.

In other words, a non-resident enterprise performing the services in China will still be liable for CIT on technical fees even if the services do not create a PE under a Relevant Treaty. However, in that case, the tax liability of the non-resident enterprise will be capped using the reduced tax rate and calculation method prescribed by the Relevant Treaty. As such, the technical fee article will operate to deny the non-resident enterprise the treaty relief in respect of permanent establishment, but limit the tax burden of the non-resident enterprise to certain level.

**4. How to identify onshore and offshore portions of technical fees if some services are performed in China and some outside China?**

Announcement 19 does not address the issue of identifying onshore and offshore portions of technical fees under such circumstances. It is certainly an important issue going forward for non-resident enterprises from the UK, India and Pakistan. As can be seen from Point 3 above, the onshore fees will be taxable one way or the other while the offshore fees will not be taxable at all.

However, reference can be made to the circular, Guo Shui Fa [2010] No. 19 (Circular 19), which deals with the deemed profit methods for calculating the CIT liability of PEs of non-resident enterprises. According to Circular 19, where a non-resident enterprise sells equipment or goods to a resident in China and at the same time provides services such as installation, assembly, technical training, guidance, supervisory services, the Chinese tax authorities may refer to prices of the same or similar industries to determine the service fees if the service fees are not separately identified in the sales contract or the service fees so identified are unreasonable. Where there are no readily available referential prices, the Chinese tax authorities can deem the service fees to be not lower than ten percent of the total contract price.

In addition, where some services are provided in China and some outside China, the Chinese tax authorities will require the non-resident enterprise to produce authentic and valid evidence in identifying the onshore and offshore fee portions. The non-resident enterprise will have to take into account factors such as work volume, work hours, costs and expenses, etc in determining the apportionment. If the non-resident enterprise cannot produce authentic and valid evidence, the Chinese tax authorities can assume that all the services are performed in China and tax the non-resident enterprise accordingly.

As such, it is more important for non-resident enterprises from the UK, India and Pakistan to keep good records in respect of their activities in China.

**5. How will the CIT liability of non-residents be calculated under Announcement 19 where services are provided in China without creating a PE?**

Announcement 19 does not spell out the tax calculation method. The announcement simply states that if the CIT liability as calculated in accordance with the domestic CIT Law is higher than the tax amount as calculated using the ratio prescribed in the article on technical fees in the Relevant Treaties, then the technical fee shall be eligible for treaty relief.

In practice, one possibility is to simply calculate the tax payable of the non-resident enterprise as the gross amount of the technical fees (adjusted where appropriate in accordance with the Relevant Treaties) times the reduced tax rates prescribed by the Relevant Treaties.

For example, an Indian resident enterprise performs services in China, however the activities in China do not continue long enough to create a PE in China. The Indian resident enterprise receives a technical fee of RMB 2 million. Its CIT payable will simply be:

| CIT Payable |
| --- |
| = RMB 2,000,000 x 10% (Tax rate under Article 12 of China-India DTA) |
| = RMB 200,000 |

Another possibility is to calculate a hypothetical CIT liability of the non-resident enterprise first as if the non-resident enterprise had a PE in China and then compare that hypothetical tax liability with the CIT liability using the method prescribed in the article on technical fees under the Relevant Treaty and take the lower amount. According to Circular 19 mentioned in Point 5, for the taxable income of the PE of a non-resident enterprise, the deemed profit rates for calculating the taxable income are as follows, depending on the nature of the services:

| Services | Deemed profit margin rate |
|---|---|
| Contracted projects, design and consulting services | 15% - 30% |
| Management services | 30% - 50% |
| Other services or activities other than services | 15% |

If, say, the technical fees fall within the category of consulting services, at a CIT rate of 25 percent, the CIT payable may be:

| CIT Payable |
|---|
| = RMB 2,000,000 x 15% (deemed profit margin rate) x 25% (CIT rate |
| = RMB 75,000 |

In that case, the Indian resident enterprise will not have to avail itself of the tax treaty under Article 12 of China-India DTA and pay CIT of RMB 75,000 instead based on the hypothetical method.

If, say, the technical fees fall within the category of management services, at a CIT rate of 25 percent, the CIT payable may be:

| CIT Payable |
|---|
| = RMB 2,000,000 x 50% (deemed profit margin rate) x 25% (CIT rate) |
| = RMB 250,000 |

In that case, the Indian resident enterprise can avail itself of the tax treaty under Article 12 of China-India DTA and pay CIT of RMB 200,000 instead of RMB 250,000.

SAT may issue further circulars to clarify the tax calculation method for technical fees under the Relevant Treaties.

**6. How will Announcement 19 interact with Circular 507?**

According to the circular, Guo Shui Han [2009] No. 507 (Circular 507), when the owner of proprietary technology transfers or licenses the technology to another party and assign its personnel to provide services in China such as support, guidance in respect of the use of that technology in return for service fees, those fees shall be treated as royalties for tax treaty purposes. This is regardless of whether those fees are charged for separately or included in the price of the technology. Therefore, in considering whether the technical fee article in the Relevant Treaties will apply, it is useful to see first if the fee in question will fall within the category of royalties. However, given that the tax relief provisions on royalties and technical fees under the Relevant Treaties are similar, the distinction between royalties and technical fees may have limited practical implications. Nevertheless, each case should be examined based on its own merit.

Under Circular 507, certain payments are specifically excluded from the scope of royalties such as considerations for after-sale services under contracts for pure supply of goods, services provided by sellers to buyers during product warranty periods and services provided by professional institutions or individuals specialising in projects, management and consulting. The non-resident enterprises that provide such services are generally liable for CIT in accordance with the rules on business profits under tax treaties. However, some of them may fall within the scope of technical fees.

**7. What if it cannot be decided in advance whether a PE will arise under a technical fee transaction?**

Announcement 19 does not address this issue. If the service is not performed in China, the non-resident enterprise should not have any tax filing or payment obligations. However, if the service is performed in China, but it is not clear if the activities will continue long enough to create a PE for the non-resident enterprise in Chna, it is possible, in practice, that the non-resident enterprise will be required to pay CIT on the onshore portion of the technical fee in accordance with the CIT Law, but the CIT payable shall not exceed the tax amount as calculated using the ratio prescribed in the article on technical fees in the Relevant Treaties. However, if it turns out that a PE will arise, the non-resident enterprise can no longer enjoy the treaty relief and will have to make up the tax difference retrospectively. A similar principle is adopted in the circular, Guo Shui Han [2010] No. 46, in relation to the CIT treatment of services relating to transfer of technology under tax treaties.

**8. What should be the tax filing and payment deadlines for technical fees?**

The tax filing and payment deadlines will depend on the nature of technical fees. The situation will be clear cut if the activities underlying the technical fees give rise to a PE in China. In that case, CIT returns will be due on a quarterly basis, and tax will be payable within fifteen days of the end of each quarter. However, the situation will not be so clear where the service is performed in China, but the activities do not continue long enough in China to create a PE in China. It would be reasonable to adopt the quarterly filing basis in that case on grounds that although there is no PE in China, the technical fees are active income in nature.

An alternative would be to treat technical fees as passive income, like royalties, under those circumstances. In this case, the payer of technical fees will file a withholding return and pay the tax within the seven days of the technical fees becoming due and payable.

SAT may issues further circulars to clarify the tax filing and payment deadlines.

**9. Should the non-resident enterprise follow the prior approval procedure or the record lodgement procedure when applying the tax treaty relief on technical fees?**

Under the circular, Guo Shui Fa [2009] No. 124, a non-resident enterprise that would like to enjoy tax treaty relief for dividends, loan interest, royalties and capital gains, should apply to the tax authority in charge for prior approval. On the other hand, a non-resident enterprise that would like to obtain relief in respect of permanent establishment, should lodge a record with the tax authority in charge for reference purposes.

In the case of technical fees, when the non-resident enterprise uses the tax calculation method prescribed in the article on technical fees under the Relevant Treaties, it is not clear which procedure it should follow. This is an area that calls from further clarification from SAT.

**10. What does Announcement 19 mean for non-resident enterprises from countries or territories other than the UK, India, Pakistan and countries or territories with similar treaties with China?**

Announcement 19 should not have any implications for the other countries or territories as technical fees are peculiar to those treaties. However, Announcement 19 raises the general issue of complexity where tax treaties deal with the taxation of income items that are not covered by the domestic law.

**11. What is the effective date of Announcement 19?**

According to Announcement 19, the rules in the announcement shall be applied from the date of its issuance. However, it is not clear if the rules will apply to transactions that took place before the issuance of the announcement where the tax position of those transactions is still open. Even if the tax liability in respect of past transactions has been settled before the issuance of the announcement but in a way different from those rules, the tax authority or the taxpayer may seek to re-open the case within the statute of limitation.

## KPMG observation

Announcement 19 is another sign that SAT is intent on driving alignment among the state and local tax bureaux at the local level in the application, interpretation and enforcement of the rules contained in tax treaties. The circular, Guo Shui Fa [2010] No. 75 (Circular 75), that was issued in July 2010, was a major milestone in that direction. Circular 75 contains a comprehensive set of guidance on the interpretation of all the major articles in the prevailing China-Singapore DTA. Announcement 19 should serve to keep the momentum going.

Announcement 19 tackles some challenging issues of technical fees. It seems that in developing the rules in Announcement 19, SAT has considered important matters of principle such as whether tax treaties should create new tax obligations that do not exist under the domestic law and whether tax treaties should only apply if and to the extent that they are beneficial to the taxpayers. Balanced against such consideration would be the concern about base erosion in the sense that no tax is collected on income like technical fees while resident enterprises in China claim full deduction on such payments.

In India, there was a Tribunal case in May 2010, which dealt with the question of whether the services rendered by a Chinese company from outside India was a fee for technical services under the provision of the Income Tax Act of India and under the China-India DTA (*Ashapura Minichem Ltd. v. ADIT [ITA No.2508/Mum/08] dated 21 May, 2010*). The decision of the Tribunal was that the Chinese company was liable for withholding tax at 10 percent on the technical fees because, under the China-India DTA, it was sufficient that the services were utilised in India, irrespective of the situs of rendering of the services. It is, however, important to note that unlike the Chinese CIT Law, India's Income Tax Act had been amended to facilitate the taxation of technical fees within the domestic legal framework. For details, please refer to the KPMG Flash News issued by KPMG India on 9 June 2010.

On the other hand, under the domestic law, the UK tax authority does not impose withholding tax on technical fees, and it is well established that a treaty gives the contracting States the taxing rights, but does not in itself impose tax. In Pakistan, we are not aware of any rulings that specifically address the issues of technical fees under tax treaties.

It is also interesting to note that the China-UK DTA is under re-negotiation. It should not be a surprise if issues such as PE threshold and technical fees have been discussed at length during the negotiation process. In addition, as can be

seen above, there are still a number of unanswered questions about the practical aspects of Announcement 19. Therefore, more circulars on the technical fee issues are expected.

## Appendix A – Summary of articles on technical fees under China's DTAs with UK, India and Pakistan respectively

| | China-UK DTA – Article 13 (Note 1) | China-India DTA – Article 12 (Note 2) | China-Pakistan DTA – Article 13 (Note 3) |
|---|---|---|---|
| **1. Scope of technical fees** | | | |
| Nature | Payments of any kind to any person in consideration for any services of a technical (Note 4), supervisory or consultancy nature | Payments for the provision of services of managerial, technical or consultancy nature | Any consideration (including any lump sum consideration) for the provision of rendering of any managerial, technical or consultancy services (including the provision of the services of technical or other personnel) |
| Exclusion | | | |
| • PE – general services | Payments to a person who carries on business in China through a permanent establishment (PE) in China or performs in China independent personal services from a fixed base situated in China, with which the technical fees are effectively connected | | |
| • PE – specific services | N/A | Payments for furnishing of services other than technical services by an Indian enterprise through employee or other personnel in China | Payments for a building site, a construction, assembly or installation project or supervisory activities in connection therewith |
| • Dependent personal services | Payments made to an employee of the person making the payments for dependent personal services | | N/A |
| **2. Taxing right** | | | |
| Residence based | Technical fees arising in China which are derived by a UK / Indian / Pakistani resident may be taxed in the UK / India / Pakistan. | | |
| Source based | Technical fees may also be taxed in China, and according to the law of China. | | |
| **3. Source** | | | |
| Residence | Arise in China when the technical fees are paid by the payer is the Government of China or a political subdivision thereof or a local authority or a resident of China. | | N/A (Note 5) |
| PE / fixed base | Arise in China when the technical fees are borne by a permanent establishment or fixed base of the person paying the technical fee in China. | | N/A (Note 5) |
| **4. Tax relief** | Tax charged ≤ 10% x 70% x gross amount of technical fees | Tax charged ≤ 10% x gross amount of technical fees | Tax charged ≤ 12.5% x gross amount of technical fees |

Notes

1. Many aspects of this article have been dealt with in the circular, Guo Shui Han Fa [1990] No. 1097 (Circular 1097).

2. Many aspects of this article have been dealt with in the circular, Guo Shui Fa [1994] No. 257.

3. Many aspects of this article have been dealt with in the circular, Guo Shui Han Fa [1990] No. 142.

4. According to paragraph 1(2) of Circular 1097:

a) Technical services do not cover technical services that are specifically provided for the transfer of proprietary technology.
b) Where the activities underlying a contract for the supply of equipment does not constitute a PE for the UK resident in China, and the components of the prices of the equipment can be identified and deducted e.g. long haul freights and insurance premiums, the UK resident shall be taxed in accordance with the rules on technical fees.
c) Where the activities underlying a contract for the mixed supply of software and hardware does not constitutes a PE for the UK resident in China, the UK resident shall be taxed on the licensing fee part of the price in accordance with the rules on royalties and on the technical service fee part that is related to the hardware in accordance with the technical fee rules.
d) Where the activities underlying a contract for the supply of equipment or the mixed supply of software and hardware constitute a PE for the UK resident in China, then the UK resident shall be taxed on the technical fees in accordance with the rules on business profits.

5. According to Announcement 19 where a tax treaty does not provide rules on the source of a technical fee, the sourcing rules in the CIT Law will apply.

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