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New P.R.C.-Hong Kong Double Taxation Arrangement Offers Planning Opportunities for Intellectual Property

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The new P.R.C.-Hong Kong double taxation arrangement promises to further promote the Hong Kong Special Administrative Region as a gateway to China offering potential tax benefits, including the structuring of China inbound intellectual property (IP). The People's Republic of China and the Hong Kong Special Administrative Region signed a new arrangement for the elimination of double taxation (new DTA) on August 21. The new DTA, which is scheduled to take effect in China on or after January 1, 2007, and in Hong Kong on or after the year of assessment beginning April 1, 2007, will replace the current DTA, which was signed in 1988. (For prior coverage, see *Tax Notes Int'l*, Sept. 4, 2006, p. 805, 2006 WTD 163-2, or Doc 2006-15950; for the new DTA, see 2006 WTD 168-9 or Doc 2006-16347.)

However, to fully take advantage of the benefits offered by the new DTA, companies must approach structuring a Hong Kong IP holding company from a comprehensive perspective. Because there may be competing interests between the objectives of effective IP protection and achieving tax efficiencies, it is necessary to consider the P.R.C. and Hong Kong tax implications and, most importantly, China IP protection strategies.

Withholding Tax Rates

Unlike its predecessor, the new DTA is a comprehensive agreement that reduces maximum withholding tax rates imposed on passive income, including dividends, interest, and royalties. The reduced withholding tax rates under the new DTA rival those available under China's bilateral income tax treaties with its other major trading partners. This will undoubtedly further elevate Hong Kong as the jurisdiction favored by foreign companies from which to invest in China.

P.R.C. domestic tax law already provides relatively low withholding tax rates on P.R.C.-source income. After-tax profits distributed to foreign investors from their foreign invested enterprises do not attract withholding tax under the current P.R.C. tax regime. P.R.C.-source interest and royalty income are generally subject to a ten percent Chinese withholding tax. The rates are relatively low compared to other jurisdictions' rates, which can exceed 20 percent.

However, China's coming tax law reform, which threatens to scale back tax preferences and incentives to foreign investors, could bring an unwelcome increase in domestic withholding tax



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rates. And in the case of royalties, Chinese domestic tax law also levies a 5 percent business tax on top of the ten percent withholding tax. The P.R.C. business tax is a turnover tax levied on gross revenue and is not normally a creditable income tax under bilateral income tax treaties or the domestic tax laws of most countries. Those factors make reducing Chinese withholding tax, especially on income that also attracts business tax such as royalties, an important tax-management objective. Thus, companies that already use a Hong Kong holding company structure, or those that are contemplating one, should consider how best to leverage the favorable withholding tax provisions under the new DTA.

One area deserving special attention is the structuring of cross-border intellectual property transactions into China. The 7 percent withholding tax cap on IP-related royalty payments under the new DTA is lower than the ten percent rate generally provided for under China's tax treaties with its major trading partners.

Taxation of Royalty Income Under Chinese Domestic Tax Law

Chinese domestic tax law levies a ten percent withholding tax and 5 percent business tax on P.R.C.-source royalty payments. Chinese domestic tax law provides some opportunities to obtain exemption from those taxes. However, the exemptions, especially for withholding tax, are often predicated on the condition that the IP is technology that is encouraged by the Chinese government and that the technology be transferred—rather than merely licensed—into China.

PRC Business Tax

Caishuizi (1999) No. 273 provides an exemption from Chinese business tax for royalties paid as consideration for technology transfers, technology development, and the provision of some technology consulting services. Technology transfer refers to the transfer of the ownership of, or the right to use, the patented technology or nonpatented

technology. Technology development refers to the research and development of new technology, new products, or new materials, as well as their operational systems. Technology consulting refers to the provision of feasibility studies for a specific technology project, technology forecasting, and evaluation and analysis of technologies for high technology projects. In the past, all taxpayers had to obtain approval for the business tax exemption from the local and national tax authorities and from the provincial science and technology bureau or other competent authorities, including the local offices of the Ministry of Commerce. However, effective July 1, 2004, Guoshuifa (2004) No. 80 eliminated that requirement of advance approval from the tax authorities regarding technology transfers by foreign enterprises.

PRC Enterprise Income Tax

The opportunities for exemption of withholding tax are more restricted. Under article 19 of the People's Republic of China Foreign Invested Enterprise and Foreign Enterprise Income Tax Law (FEITL) and article 66 of its implementation rules, outbound royalty payments can be exempt from Chinese withholding tax if two conditions are met. First, the technology must be of a type that is specified under Chinese tax laws as qualifying for the exemption. Second, the technology must be "advanced" or provided "on preferential terms."

The technologies that qualify for the withholding tax exemption are narrow in scope. They include:

- Technology used in production activities relating to agriculture, forestry, animal husbandry and fisheries
- Technology provided to scientific academies, institutions of higher learning, and other scientific research institutes, to aid scientific research and experiments
- Technology used in the exploitation of energy resources and the development of communications and transportation

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- Technology used in energy conservation and the prevention and control of environmental pollution
- Technology used in the development of important fields of science and technology, including the production of electro-mechanical equipment, nuclear energy, large integrated circuits, super computers and optical telecommunications.

After the first condition is met, the royalty payment must meet a second, more subjective requirement. Under article 19 of FEITL, the licensed technology must be “advanced” or provided on “preferential terms.” Those terms are not defined under the Chinese tax laws and regulations. In practice, the Chinese tax authorities should defer to other competent authorities such as the Ministry of Commerce in making that determination. To obtain the withholding tax exemption, the withholding agent making the royalty payment must file a withholding tax exemption application with the local tax bureau that has jurisdiction over it; that bureau gives the application its preliminary approval and submits it to the State Administration of Taxation. The application procedures will vary depending on the practices of the local tax bureau. The final approval will be issued by the State Administration of Taxation or the local tax bureau.

Hong Kong Profits Tax Implications of IP Holding Company Structures

Because the prospects of obtaining withholding tax relief on royalty payments under Chinese domestic tax legislation are rarely promising, the new DTA will provide a more practical method of reducing Chinese withholding taxes. However, any savings in Chinese withholding taxes must be balanced against the taxation of the royalty payments at the offshore IP holding company level.

Unlike offshore financial centers such as the Cayman Islands, the British Virgin Islands, and the like, Hong Kong is not a zero-tax jurisdiction. However, its 17½ percent profits tax rate is relatively low compared to the rates of other jurisdictions in Asia. And Hong Kong taxes residents and nonresidents only to the extent that they derive Hong Kong-source

income from the carrying on of a trade, profession, or business in Hong Kong. This territorial tax regime provides an opportunity to design the IP holding structure to reduce exposure to Hong Kong profits tax. If that is achieved, structuring an IP holding company in Hong Kong not only realizes Chinese and Hong Kong tax efficiencies, but also positions valuable IP in a jurisdiction with a good reputation and established rule of law.

Hong Kong’s profits tax system taxes royalty payments received by a Hong Kong company only if (1) the Hong Kong company is considered to carry on a trade or business in Hong Kong, and (2) the royalty income is considered to arise in, or be derived from, that Hong Kong trade or business. However, as discussed below, avoiding the Hong Kong profits tax net is not as easy as it appears, especially given the enforcement practices of the Hong Kong Inland Revenue Department (IRD). However, if properly structured, Hong Kong’s territorial tax regime can provide favorable tax planning opportunities.

Hong Kong Taxation of Royalty Income

Whether a company is considered to carry on a trade or business in Hong Kong is a question of fact for which there are no safe harbors. Hong Kong case law provides that a business is carried on where the activities, or part of the activities comprising the business, take place. The threshold of the activities that may constitute the carrying on of a business in Hong Kong is low, especially under current IRD practice. A company may be considered to carry on business in Hong Kong even though minimal activities of an administrative nature are undertaken there. For example, the maintaining of corporate or accounting records in Hong Kong may be considered to comprise the carrying on of a business in Hong Kong, especially when combined with the presence of other Hong Kong contacts.

That a Hong Kong-incorporated company does not have its management and control in Hong Kong should not prevent it from qualifying as a tax resident under the new DTA. Article 4(2)(iii) of the new DTA provides that a Hong Kong company qualifies as a tax resident under the new DTA as long

New P.R.C.-Hong Kong Double Taxation Arrangement Offers Planning Opportunities for Intellectual Property

as it is incorporated in Hong Kong. This treatment is an improvement over the practice under the current DTA, where by a Hong Kong company generally must demonstrate that it has central management and control in Hong Kong (which, if proven, weakens the arguments for nonchargeability from profits tax) in order to obtain a tax residency certificate from the IRD.

Even if a company were found to carry on a trade or business in Hong Kong, profits are subject to profits tax only if they are sourced from Hong Kong. Where profits are sourced is also factually driven. Profits must be examined on an item-by-item basis to determine which factors are relevant to the sourcing of profits. Guidance from the Hong Kong tax authorities indicates that the guiding principle in determining the source of profits is to analyze what the tax payer has done to earn the profits and where the activities took place.

The Inland Revenue Ordinance considers royalty income to arise in Hong Kong from a Hong Kong trade or business if the royalty income was received by or accrued to a person:

- From the exhibition or use in Hong Kong of cinematographic or television film or tape, any sound recording, or any advertising material connected with a film, tape, or recording
- For the use of, or the right to use in Hong Kong, any patent, design, trademark, copyright material, secret process or formula or any other similar property
- For the use of, or the right to use outside Hong Kong, any patent, design, trademark, copyright material, secret process or formula or any other similar property that is deductible in ascertaining the profits of a person for profits tax purposes.

The Inland Revenue Ordinance suggests that royalties received in consideration for the use of IP outside Hong Kong (to the extent the payer is not deducting the payment for profits tax purposes) should not be Hong Kong-source income. However, Hong Kong

case law has held that royalty income, paid for the use of IP outside Hong Kong, is sourced in Hong Kong if the activities are undertaken in Hong Kong to produce the royalty income.

Accordingly, determining the source of royalty income for Hong Kong profits tax purposes can be complicated given the numerous deeming provisions under the Inland Revenue Ordinance that operate as exceptions to general rules, and the exceptions to those exceptions.

Hong Kong Withholding Tax on Royalty Payments

Hong Kong generally does not impose withholding tax on outbound payments. However, for outbound royalty payments, Hong Kong imposes a withholding tax if the amount paid is treated as income that is chargeable to Hong Kong profits tax under the criteria described above. If it is not, no withholding tax is imposed.

If withholding tax is chargeable on royalty payments from Hong Kong, the payment would attract a withholding tax of either 5½ percent or 17½ percent. The higher rate applies if the royalty payment is made to an associate and the intellectual property has been owned, or partly owned, by a person carrying on business in Hong Kong.

Protection of IP Rights

Hong Kong provides a good platform for a foreign enterprise that is planning to license IP to affiliates and others in China. A Hong Kong company can be established to hold the China-bound IP, which can then license the IP to P.R.C. licensees. Given the state of IP protection in China, adopting good IP protection practices is an integral part of executing an IP strategy in China.

China has a full suite of IP legislation that covers patents, copyright, trademarks and unfair competition. The laws and regulations provide for enforcement of IP rights through administrative and judicial proceedings. In practice, however, enforcement remains an issue of concern as IP owners are faced with

New P.R.C.-Hong Kong Double Taxation Arrangement Offers Planning Opportunities for Intellectual Property

limited remedies, local protectionism, and other practical problems. However, it is possible to come up with an effective strategy that uses the existing P.R.C. legal regime to protect IP rights that are being licensed in China.

Companies that license IP into China should keep the following points in mind. As in any jurisdiction, it is important to conduct thorough due diligence and to learn as much as practicable about a potential third-party licensee. Identifying a trustworthy business partner and licensee is particularly important in China because once valuable IP falls into the wrong hands, the risk and scope of infringement is high. After vetting the potential licensee and before entering into the licensing agreement, the licensor should ensure that the scope, term, and territory of the license grant are properly limited and that appropriate termination provisions are included in case early termination of the license becomes necessary.

The licensor should also minimize the disclosure of sensitive IP, although that may compete with P.R.C. tax objectives as discussed above. Where applicable, the license agreement should include comprehensive confidentiality provisions that obligate the licensee to treat the licensor's confidential information and know-how in strict confidence and to mandate the return or destruction of confidential materials upon the termination of the license. The agreement should also require the licensee to require its employees who have access to the licensor's confidential information to enter into confidentiality and nondisclosure agreements that impose the same confidentiality obligation. These measures will help minimize the risk that the licensor's IP and other confidential information could be disclosed by the licensee and its employees.

In addition to the provisions in the license agreement, the licensor should also seek to protect its IP through additional contractual arrangements where practicable. If the licensee is an affiliate of the licensor, for example, non compete agreements between the licensee and its key employees may be used as an additional way to prevent the licensor's IP and confidential information from being acquired by a competitor that lures away the licensee's employees.

Arbitration can often be faster in resolving licensing and related IP disputes than the Chinese administrative bodies and courts. It is advisable to include an arbitration provision in the license agreement. In a license agreement between a Hong Kong licensor and a P.R.C. licensee, because the Hong Kong party is considered a foreign entity, the agreement can designate an arbitration forum outside China. A good choice of non-P.R.C. arbitration forum is the Hong Kong International Arbitration Centre, which offers an experienced group of arbitrators and is usually an acceptable choice of forum for the P.R.C. party.

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