China: defining intangibles

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The author proposes an alternative definition of intangibles to solve the problems of the existing definition in the Chinese regulations

Transfer pricing is relevant to the majority of enterprises with foreign investment in China. Transactions between foreign investors and their Chinese associated enterprises are covered by the Chinese transfer pricing regime, which is rapidly developing. Particular attention should be paid to associated transactions to make sure that they are consistent with the arm's length principle and thus reduce the risk of triggering transfer pricing audits. Cross-border associated transactions involving intangibles are becoming common and have drawn the attention of Chinese tax authorities. However, compared with the accumulated experiences of auditing transactions involving tangible goods, the Chinese tax authorities have far less experience in dealing with intangible assets. This can be seen from the ambiguous definition of intangibles included in the 2009 Special Tax Adjustments Measures.

In this article, the definition of intangibles used for Chinese transfer pricing purposes will be analysed. The problems existing in the current definition are described in terms of duplicate enumeration of concepts and inappropriate use of vague concepts.

In the first section, the relevance of transfer pricing to enterprises with foreign investment in China is discussed. In the second part, problems of the existing definition of intangibles will be analysed, including those arising from the clause relating to royalties usually included in double taxation agreements. In the conclusion, an alternative definition of intangibles will be suggested.

I. FDI and transfer pricing

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According to statistics revealed by the People's Republic of China (PRC) Ministry of Commerce, in 2010, non-financial Foreign Direct Investment (FDI) in China was utilised by different vehicles as shown in Table 1:

Use of Foreign Direct Investment

	Number of projects by year		
	2009	2010	% change
Total FDI	23,435	27,406	16.9
Equity joint ventures (EJVs)	4,283	4,970	16.0
Co-operative joint ventures (CJVs)	390	300	-23.1
Wholly foreign-owned enterprises (WFOEs)	18,741	22,085	17.8
Foreign-invested shareholding ventures	21	51	142.9

Table cited from the US-China Business Council, which is available on www.uschina.org/statistics/fdi_cumulative.html, accessed on 23/03/2012, source: PRC Ministry of Commerce

The table clearly demonstrates that wholly foreign owned enterprises (WFOEs) make the greatest use of non-financial FDI utilisation in China. The ratio of WFOEs set up has soared from 41.8 percent in 1998 to 76.4 percent in 2004.[1]

According to the definition of associated relationships in the Special Tax Adjustments Measures, one enterprise is associated with another enterprise, organisation or individual, in terms of shareholding, where "one party directly or indirectly holds a total of

25 percent or more of the shares in the other party, or 25 percent or more of the shares of both parties are directly or indirectly held by a third party".[2]

WFOEs are clearly associated with their foreign investors. Chinese EJVs and CJVs trading within special categories[3] defined by Chinese government require a minimum foreign investment of 25 percent of the registered capital.[4] This means these CJVs and EJVs and their foreign investors are destined to be related parties for Chinese transfer pricing purposes. Foreign investment utilised in other forms of shareholding ventures is rare compared with the above three forms. It can be predicted that if the restrictions on foreign investment trading in special industries are eased in the future, more WFOEs will be incorporated.

As a result, a majority of foreign investment vehicles in China are related parties to their foreign investors for transfer pricing purposes. Transactions between them will be governed by transfer pricing regulations.

II. Transfer pricing of intangibles

As China is known for its manufacturing industry, it is relatively easy to identify comparables for transactions of tangible property. However, the emergence of other low labour cost countries has depressed somewhat the profitability of manufacturing in China with a resulting negative effect on the profit margin made from related transactions of tangible goods. Nevertheless, transactions involving intangibles are becoming more popular and they continue to bring significant profits to technology owners, who are usually foreign investors.

Due to a lack of indigenous technology, Chinese enterprises have to pay large royalties for the use or transfer of technology owned by foreign enterprises in related transactions. In the perception of the Chinese tax authorities, transfer pricing has been used as a main mechanism of shifting profits out of China.

Therefore, developing a comprehensive approach to intangibles for transfer pricing purposes is crucial to prevent such misuse. The first question is: what are intangibles?

III. Definition of intangibles

Chinese transfer pricing regulations have seen rapid development in recent years. The Special Tax Adjustments Measures start to separate regulations over transactions involving tangible property and intangible property, although unlike the United States, there is no special section regulating transfer pricing of intangibles.

The definition of intangibles included in Article 10 of "associated transactions" states:

> the transfer and use of intangible property, including assigning ownership of or providing the right to use licences of items, such as land use rights (leasehold rights), copyrights, patents, trademarks, client lists, marketing channels, Pai Hao, trade secrets, and proprietary technology as well as industrial property rights such as industrial product designs or utility models.

Reviewing the intangibles definition from the perspective of Chinese intellectual property law, several problems can be identified, including the use of overlapping concepts and inappropriate use of vague concepts.

A. Patent

According to the PRC Patent Law, three kinds of patent rights are conferred to "inventions-creations": patents for inventions, utility models and designs.

The difference between patents for inventions and utility models lies in the extent of inventiveness of the inventions, where

> "the invention has prominent substantive features and represents a notable progression and that the utility model has substantive features and represents progress".[5]

Designs refer to

> "any new design of a product's shape, pattern or a combination thereof, as well as the combination of the colour and the shape or pattern of a product, which creates an aesthetic feeling and is fit for industrial application".[6]

Different from countries which protect inventions, utility models and designs in separate legislation, patent rights are conferred to inventions, utility models and designs under the same Chinese patent law. The term "patent" in China includes all three aspects, inventions, utility models and designs, unless otherwise indicated. However, in the intangibles definition, "patents" and "industrial product designs or utility models" are presented at the same time. In this case, should it be inferred that the patents referred to are patents for inventions only?

A similar problem exists with trade secrets, as well as client lists and marketing channels.

B. Trade secret

Trade secrets are protected by the Anti-Unfair Competition Law of the People's Republic of China. They are defined as

> "any technology information or business operation information which is unknown to the public, can bring about economic benefits to its owner, has practical utility and about which the owner has adopted secret-keeping measures".[7]

According to the definition, trade secrets can be divided into two groups: business secret information (or operation information) and technical secret information. There is no further definition of these two subcategories, so their specific forms can only be identified in the relevant business or technical context.

Client lists[8] and marketing channels are two kinds of trade secrets under the subcategory of business

secret information. However, specific forms of trade secrets are far more than client lists and marketing channels. No particular reason is given why these two kinds of trade secrets are listed specifically with no mention of other forms.

For the existing definition, if specific forms of trade secrets cannot be exhausted, it is not helpful only to list two possible trade secrets, client lists and marketing channels.

C. Pai Hao (trade name)

Although the above two problems may lead to confusion to some extent, they still can be understood generally. The term "Pai Hao" is not used in Chinese domestic legislation and its meaning cannot be easily identified either.

After searching the term on official websites, the use of Pai Hao is identified in two documents. In a Chinese version of Article Two of the Convention of Establishing the World Intellectual Property Organisation, "designations" is translated to "Pai Hao", as used in the context of "trademarks, service marks, and commercial names and designations".[9] Similarly, in a Chinese version of the "Model Law for Developing Countries on Marks, Trade Names and Acts of Unfair Competition", "Pai hao" is identified as the translation of "designation" in its Article One subsection (4), "trade name means the name or designation identifying the enterprise of a natural or legal person".[10]

Accordingly, the author infers that "Pai Hao" indicates the name for identifying an enterprise. In a World Intellectual Property Organisation (WIPO) document on Understanding Industry Property, "a commercial or trade name" is explained as "the name or designation that identifies an enterprise".[11] Pai Hao is therefore synonymous with trade name.[12]

> "There should be a legal definition of 'trade name'"

Trade name is usually called "Zi Hao, Shang Hao" in Chinese or "Pai Hao" as used in the intangibles definition. It is the special combination of at least two characters as part of an enterprise name,[13] which is used to distinguish it from other enterprises when all the other aspects are the same in two enterprise names (e.g. administrative division, business or operation feature and form of organisation). Enterprises usually use their trademark as their trade name.

Pai Hao as used in the intangibles definition is not a formal legal concept. It should be replaced by a legal concept of "trade name" which denotes the reputation and value set up by the enterprise.

D. Industrial property

A less obvious informal legal term within the Chinese intangibles definition is the use of "industrial property".

Although the concept of "industrial property" is understood generally in the intellectual property protection context, this concept is not adopted in Chinese domestic intellectual property legislation.

One of the major international agreements of industrial property protection signed by China include the Paris Convention for the Protection of Industrial Property (Paris Convention) which came into force for China on March 19, 1985. Its Article One states: "the protection of industrial property has as its object patents, utility models, industrial designs, trademarks, service marks, trade names, indications of source or appellations of origin, and the repression of unfair competition".

This definition of industrial property has an extremely broad range. So what is the scope of the "industrial property" used in the Chinese intangibles definition? Should it be understood as widely as that used in the Paris Convention? If yes, it means the items in Article One of the Paris Convention should also be included, which will lead to further duplication of concepts. If not, "industrial property" may only include industrial designs and utility models, which would be a misuse of the term.

The problems within the intangibles definition indicate the tax authorities' confusion about the intellectual property items included in the definition. In practice, except for the obvious intangible assets, such as patents and trademarks, which are registered for legal protection, there are various forms of specific intangible assets being transacted, especially in the categories of trade secrets and proprietary information. If tax authorities do not have a correct understanding of what comprise intangibles in the first place, it will be more difficult for them to identify the consideration paid for the less obvious intangible assets involved in associated transactions.

IV. Royalties in double taxation agreements

It is important to have a clear understanding of what comprise intangibles involved in associated transactions; it is also important to identify the consideration paid for the intangible assets which form the tax base. When deciding the withholding taxes on international royalties, reference should be made to the royalties article in the tax treaties signed between China and other countries.

By the end of May 2011, China had officially signed 96 double taxation avoidance agreements with foreign governments, 93 of which are already in force. Two

further arrangements have been agreed with the Special Administrative Regions of Hong Kong and Macao respectively.[14]

A comparison of the articles on royalties included in the agreements signed with the top 10 originators of non-financial FDI to China in 2009[15] demonstrates that the royalties articles are similar to each other, with only minor exceptions.[16]

The common statement of the royalties article is

> "the term royalties as used in this Article means payments of any kind received as consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, or films or tapes for radio or television broadcasting, patent, trade mark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific equipment or for information concerning industrial, commercial or scientific experience."

This statement is the same as the royalties article included in the United Nations Model Double Taxation Convention between the Developed and Developing Countries (UN 2001). The UN model of double taxation agreement is known to favour source countries compared with the model tax convention made by OECD which favours residence nations. When drafting tax treaties, the Chinese tax authorities should take into account the difference between the two models, especially when China is the source country within international trade.

In order to qualify for the treaty benefits of limited withholding taxes on royalties (a reduced tax rate), intangible assets involved in associated transactions should be covered by the scope of intangibles in the royalties article.

Although the intangible assets included in the royalties article are not identical with those included in the intangibles definition in the Special Tax Adjustments Measures, the intangible items mentioned in the treaties should be understood in the context where they are applied. A noticeable difference is the additional statement of "for the use of, or the right to use, industrial, commercial or scientific equipment or for information concerning industrial, commercial or scientific experience".

According to a Circular concerning royalties issued by the State Administration of Taxation, payment for the "the use of, or the right to use, industrial, commercial or scientific equipment" (which is a kind of rent) is deemed as royalties.[17] "Information concerning industrial, commercial or scientific experience" is categorised as proprietary technology which is interpreted in the Circular as "the information or materials which are necessary to the production of a product or process replication, unknown to the public, with the proprietary nature".[18]

Because trade secrets and proprietary information are not protected in the same way as traditional intellectual property, such as patents, trademarks and copyrights, the identification of trade secrets and proprietary information is mainly from contract secrecy clauses. The confidentiality of trade secrets and proprietary information complicates the issue of transfer pricing.

Because the provision of trade secrets and proprietary information is usually accompanied by technology consultancy or assistance services, to avoid paying withholding taxes on royalties, related parties may conclude service contracts instead of technology transfer contracts. By concluding service contracts, the consideration paid to foreign enterprises for the actual use or transfer of relevant information is converted to service fees and subject to taxes on business profits under the double taxation agreement. As long as the foreign enterprise does not have a permanent establishment (PE) in China, there will be no withholding taxes on the "business profits" at all.

The State Administration of Taxation holds a fairly strict view on fees paid for services during the process of transferring or licensing the right to use proprietary technology:

> "The technology licensor provides instructions or guidance services for the use of proprietary technology and charges a service fee, which, whether it is a separate charge or included in the technology price, shall be deemed as a royalty. If the services provided are qualified to be a PE in China, the service fees should be included in the business profits of the PE".[19]

Therefore, a clear understanding of the difference between trade secrets and proprietary information and their auxiliary services will help tax authorities distinguish fake service contracts and separate payments for intangible property and services so as to charge taxes accordingly.

V. Conclusion

With reference to the royalties article included in tax treaties, and bearing in mind the problems of the existing intangibles definition in Chinese transfer pricing regulation, the author proposes an alternative definition of intangibles to solve these problems:

> "The transfer and use of intangible property, including assigning ownership of or providing the right to use licences of
> 1. land use rights,
> 2. copyrights,
> 3. patents (inventions, utility models and designs),
> 4. trademarks, trade names,
> 5. trade secrets and proprietary technology (know-how) and
> 6. other similar intangible items which are identifiable, non-monetary assets, capable of bringing economic benefits to the person who owns or controls the intangible assets."

Defining intangibles in this way will remove the confusion found in the current definition of intangibles caused by the lack of clarity in understanding of intellectual property. It is important to include an article such as show in 6. above, which refers to the US regulations and also takes account of Chinese accounting principles in terms of intangible asset recognition. Furthermore, it gives discretion and flexibility

to the Chinese tax authorities in capturing taxes on the consideration paid for the use or transfer of intangibles.

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[1] Hui Li, 'Correlation Analysis on Intellectual Property Rights Protection and China's FDI Utilising' International Commerce: The Journal of University of International Business and Economics China, 2008, Issue 2, p93

[2] PRC State Administration of Taxation, 'Circular of the State Administration of Taxation on the Issuance of the Implementation Measures of Special Tax Adjustments (Provisional) Circular Guoshuifa [2009] No.2' www.chinatax.gov.cn/n8136506/n8136593/n8137537/n8138502/8784619.html

[3] 'Catalogue Guiding Foreign Investment in Industry (2010 Revised)' www.gov.cn/flfg/2011-12/29/content_2033089.htm accessed May 5,2012

[4] The US-China Business Council, 'Equity Joint Venture Fact Sheet ' (February 2011) www.uschina.org/public/documents/2011/02/equity-joint-venture-fact-sheet-2011.pdf, accessed March 5, 2012

[5] 'Patent Law of the People's Republic of China (2008 Amendment) (English translation)' (*Standing Committee of the National People's Congress*) en.pkulaw.cn/display.aspx?cgid=111782&lib=law, accessed March 31, 2012, Article 22

[6] Ibid, Article 2

[7] 'Anti-Unfair Competition Law of the People' Republic of China (English translation)' (*WIPO*) www.wipo.int/wipolex/en/details.jsp?id=849, accessed April 5, 2012, Article 10

[8] "Client list" is defined in a Judicial Interpretation as "special customers' information different from publicly known information, which is comprised of customers' names, addresses, contact details and trading habits, intentions, content, etc., including client roster of a number of clients, and specific clients with whom long-term stable relations have been set up."

[9] 'Convention of Establishing the World Intellectual Property Organisation (Chinese translation)' (*State Intellectual Property Office of PRC*) www.sipo.gov.cn/zcfg/flfg/qt/gjty/200804/t20080403_369215.html, accessed April 6, 2012, Article 2 (viii)

[10] 'Model Law for Developing Countries on Marks, Trade Names and Acts of Unfair Competition (Chinese translation)' (*State Intellectual Property Office of PRC*) www.sipo.gov.cn/zcfg/flfg/sb/wgf/200804/t20080403_369298.html, accessed April 6, 2012, Article 1 (4)

[11] World Intellectual Property Organisation, 'Understanding Industrial Property' www.wipo.int/export/sites/www/freepublications/en/intproperty/895/wipo_pub_895.pdf, accessed March 31, 2012

[12] Evidence to support the translation of Pai Hao as trade name rather than enterprise name is identified in an English translation of "Regulations on the Protection of the World Exposition Symbols". The translation of its Article Five subsection (6) states "using the World Exposition symbols in a *trade name* to apply for the registration of an *enterprise name* may mislead or confuse the market".

[13] 'Provisions on Administration of Enterprise Name Registration' (*State Adminitration for Industry & Commerce of the People's Republic of China*) www.saic.gov.cn/qyj/djfg/gz/199107/t19910722_59609.html, accessed April 6, 2012, Article 10

[14] PRC State Administration of Taxation, 'Complete List of the Avoidance of Double Taxation Agreement by China ' (March 28 2011) www.chinatax.gov.cn/n8136506/n8136593/n8137537/n8687294/index.html, accessed March 28, 2012

[15] The 2009 Data was calculated by the US-China Business Council using sources from PRC Ministry of Commerce, available on https://www.uschina.org/statistics/fdi_cumulative.html, accessed March 28, 2012. The top ten originators are Japan, Singapore, the United States, South Korea, the United Kingdom, Germany, Canada, Hong Kong, Macao and Taiwan. There is no double taxation arrangement between Mainland China and Taiwan, so only nine agreements and arrangements are reviewed.

[16] The royalties article included in the agreements signed between China and Japan, Germany and arrangements with Hong Kong and Macao is identical to the above common statement. For agreements with the United States, South Korea, Canada, and the United Kingdom, there is one more item beyond the common statement: "know-how". For the agreement with Singapore, the item beyond the common statement is "any computer software".

[17] PRC State Administration of Taxation, *Circular on Implementation of the Royalties Article in Double Taxation Agreement* (2009) Guo Shui Han [2009] 507

[18] Ibid

[19] Ibid