

China Law Update

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China's State Administration Of Tax Clarifies Treaty Treatment for Technical Know-How

On January 26, 2010, the State Administration of Tax (the "SAT") issued another *Notice on Issues Concerning Implementing Royalty Clauses in Tax Treaties* (Guishuifa [2010] 46, also referred to as "Circular 46"), further clarifying treaty treatment for technical know-how.

Main Points

According to Circular 507 issued by the SAT in 2009, "technical know-how" is "nonpublic information or data that is needed for the production or reproduction of a manufacturing process for a product". Circular 46 states that income generated from technical services provided in the course of transfer of usage rights of technical know-how is regarded as royalties for the purpose of taxation. However, if the licensor of the technical know-how assigns personnel to provide service at the location of the licensee for a duration of time that qualifies as a permanent establishment, according to the applicable tax treaty, the income arising from such permanent establishment will be subject to Article 7 of the treaty concerning taxation of business profits. In addition, the personnel providing such services is subject to the dependent personal service provisions of the tax treaty. The income that is not attributable to the permanent establishment, or that arises from services that don't constitute a permanent establishment, will still be treated as royalties for taxation purpose.

Sometimes the licensee of a technology transfer agreement pays the royalties and fees for the associated technical service in advance when concluding the contract. In that case, according to Circular 46, the rules of royalties shall apply temporarily if it is unclear whether a permanent establishment has been created. Once it is determined that a permanent establishment exists according to the duration of the service the tax treatment of income that arises from the permanent establishment will be adjusted. The business profits attributable to such permanent establishment will be subject to the enterprise income tax, and the income of the personnel to personal income tax.

For technology transfer agreements concluded before October 1, 2009, if the related technical services are performed beyond October 1, 2009 and that income has not yet been taxed, such income will be subject to both Circular 46 and Circular 507. The duration of technical services performed before October 1, 2009 will be used to determine whether such services constitute permanent establishments if they extend beyond October 1, 2009. However, income tax that had

been imposed on technology transfers and related technical services before October 1, 2009 under the royalties rules will not be subject to adjustment.

Conclusion

Circular 46 should be read in tandem with Circular 507. According to Circular 507, royalties rules in a tax treaty only apply to resident beneficial owners of a treaty partner. Royalties generated in China by a permanent establishment created by a third-country resident and located within a treaty partner will be subject to the tax treaty between China and the third country. Royalties paid by a permanent establishment or establishment of a third-country resident located within China to a treaty partner resident will be subject to the tax treaty between China and the treaty partner. A permanent establishment created by a Chinese resident within a treaty partner cannot benefit from the royalties clause of the tax treaty between China and the treaty partner, because the Chinese resident located in a treaty partner is not regarded as a resident of the treaty partner state.

Whether the income from technology transfer and the related technical service is deemed business profit or royalty is very important. Business profits from China derived by a foreign enterprise that does not have a permanent establishment in China are actually not taxable according to China's tax treaties. However, royalties earned in China by a foreign enterprise are always subject to taxation (usually around 10%). Guishuifa[2006] No. 35 provides guidance on how to determine whether a permanent establishment exists, and Caishuizi (1999) No. 273 addresses situations where business profits from technology assignment and related technical services are exempt from income tax.

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