

China Tax Update

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China's Tax Incentives for Technology Transfer: Latest Clarifications

Chinese companies have enjoyed an enterprise income tax incentive on technology transfer¹ since 1 January 2008 (“**EIT Incentive**”). A taxpayer may enjoy a 100% EIT exemption on qualified technology transfer income up to RMB 5 million, and 50% on the excess amount. But the lack of detailed rules on getting tax authority approval means that few companies have enjoyed this incentive.

Two circulars were issued since 2009 to clarify the EIT Incentive. The State Administration of Taxation (“**SAT**”) issued Circular 2122 in April 2009, and in December 2010 SAT and the Ministry of Finance (“**MOF**”) jointly issued Circular 1113. In this update, we summarize the main contents of these two circulars.

Who benefits from the EIT Incentive? Only Chinese Tax Residents

The circulars clarified that only Chinese tax resident enterprises may enjoy the EIT Incentive. A Chinese tax resident enterprise is either established:

- within China pursuant to Chinese law; or
- outside China but with its effective place of management in China⁴.

So foreign companies that are not Chinese tax resident do not enjoy the EIT Incentive. However, both these foreign companies and China tax resident companies, enjoy a 5% business tax exemption (“**BT Incentive**”) for technology transfer pursuant to Circular 273⁵.

¹ *The Implementing Rules of the Enterprise Income Tax Law of the People's Republic of China*

² *Circular on EIT Exemption and Reduction to Incomes from Technology Transfer* (Guo Shui Han [2009] No.212)

³ *Circular on EIT Policy on Technology Transfer by Resident Enterprises* (Cai Shui [2010] No.111)

⁴ *Enterprise Income Tax Law of the People's Republic of China*

⁵ Circular Cai Shui Zi [1999] No. 273

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What Technology Qualifies?

The EIT Incentive applies, with conditions, to a limited scope of technology (“**Qualifying Technology**”), namely:

- Patents: only inventions, utility models, and appearance design (excluding simple change of product pattern) with exclusive rights granted by law;
- Copyright of software;
- Layout design right of integrated circuit;
- New variety of plants or of bio-medicine;
- Any other technology specified by the MOF and SAT.

Notably Qualifying Technology does not include know-how, which applies to the BT Incentive under Circular 273.

What Forms Can Technology Transfer Take?

Under the EIT Incentive regime, “technology transfer” means the transfer of the ownership of the Qualifying Technology **or** the worldwide exclusive license right to use the Qualifying Technology for at least 5 years. So a Chinese tax resident enterprise may enjoy EIT Incentive if it either:

- transfers ownership of the Qualifying Technology it owns;
- licenses Qualifying Technology for worldwide exclusive use for at least 5 years.

This requirement also complies with Circular 273, which however grants business tax exemption for a qualifying technology licence in general, rather than for “a worldwide exclusive license for no less than 5 years”.

No EIT Incentive for Technology Transfers to 100% Affiliates

A taxpayer cannot enjoy the EIT Incentive if it directly or indirectly holds 100% of the shares in the transferee/licensee.

This requirement is designed to prevent the abuse of the EIT Incentive by transferring profits via a technology transfer contract to a wholly owned subsidiary who then enjoys the EIT Incentive.

How to Calculate the Incentive?

The taxpayer must use the following formula to separately calculate the technology transfer income and reasonably allocate relevant

expenses:

Technology Transfer Income = Revenue from Technology Transfer – Cost of Technology Transfer – Relevant Taxes and Fees

“Revenue from Technology Transfer” refers to the revenue obtained by performing the technology transfer contract, excluding the items below:

- Non-technology revenue such as sale or transfer of the equipment, apparatus or raw material etc.;
- Revenue from technical consultation, technical service and training etc., which are NOT inseparable from the technology transfer.

“Cost of Technology Transfer” is the net value of the intangible asset to be transferred, i.e. the balance of the original value of the intangible asset and amortized amount.

“Relevant Taxes and Fees” include all taxes (excluding EIT and deductible VAT) that are actually incurred in the course of technology transfer, expenses for contract conclusion, legal fees, etc..

The Registration and Approval Procedure

Before the tax authority approves the EIT Incentive, the tax payer must register with and obtain approval from other authorities. If the technology is:

- Transferred/licensed to a domestic party, the contract must be registered with the science and technology bureau at provincial level, or above;
- Exported to a foreign party, the contract must be registered with the commerce bureau at provincial level, or above⁶ ;
- Produced with government financial support, its transfer/licensing must be approved by the science and technology bureau at provincial level, or above.

Every year the taxpayer should submit its EIT Incentive application documents with the tax authorities for filing/approval before making its annual EIT filing for that tax year.

⁶ The technology cannot fall into the “Catalogue of Technologies Prohibited or Restricted from Export”. Otherwise the Ministry of Commerce will not register the technology transfer contract and TT Incentive cannot apply.

Salans Comments:

China has given tax incentives for technology transfer activities since the 1990s. This policy was strengthened in 2008 with the EIT Incentive. Now with the newly issued Circular 212 and Circular 111, most of the ambiguity of implementing it has disappeared. Since these circulars have retrospective effect to 1 January 2008, relevant tax payers should check if they are eligible for the EIT Incentive and apply to the tax authority before 31 May 2011 if they are. They should also engage in discussion with the tax authorities on technical issues such as how to allocate expenses in calculating the technology transfer income.

Taxpayers should also be aware that compared with BT Incentive, the EIT Incentive has a narrowed scope of application in some respects. For example, know-how is excluded and a technology license must be under a worldwide exclusive license for at least 5 years. Moreover, the EIT Incentive is prohibited for technology transfers to directly or indirectly wholly-owned subsidiaries. Although this may not prevent the abusive use of incentive in all cases, it reflects the determination of China's tax authorities to enhance their technique in attacking tax avoidance.

On the other hand, because the tax authorities have implemented the BT Incentive for many years and have issued additional circulars to interpret it, such interpretation may also be used for the EIT Incentive in practice. We provide a comparison of both incentives for your reference.

Lastly, EIT and BT Incentives, though subject to different conditions, may be applicable to a single technology transfer. Multinational companies should make comprehensive plans on how to optimize the tax effect in their China-related technology transfer operations.

Annex: Comparison of EIT and BT Incentives

	EIT Incentive (Circular 212 & Circular 111)	BT Incentive (Circular 273)
Applicable Parties	Only Chinese tax resident enterprises	Any entities and individuals including foreign invested enterprises, foreign invested R&D Centers, foreign enterprises and foreign individuals
Scope of Technology	<ul style="list-style-type: none"> - Patents; - Copyright of software; - Layout design right of integrated circuits; - New variety of plants or of bio-medicine 	<p>The technology is in the natural science field and generally include:</p> <ul style="list-style-type: none"> - Patents; - Know-how
Forms of Technology Transfer	<ul style="list-style-type: none"> - Transferring the ownership of qualifying technology; or - Licensing qualifying technology for a worldwide exclusive license for no less than 5 years. 	<ul style="list-style-type: none"> - Transferring the ownership of qualifying technology; or - Licensing qualifying technology
Income Calculation	- Exemption is based on technology transfer income after deduction of costs, fees and taxes	Exemption is based on technology transfer revenue without deductions.
	- Non-technology revenue such as sales or transfer of the equipment, apparatus or raw material etc. is excluded.	Same as EIT Incentive.
	- Revenue from technical consultation, technical service and training etc., which are NOT inseparable from the technology transfer are excluded.	Similar to EIT Incentive plus a requirement that if the income for technical consultation or service qualifies for technical transfer income, then the consultation or service fee should be charged in the same invoice for the technology transfer fee
Special Restriction	A taxpayer may not enjoy an EIT Incentive if the transferor/licensee is a related party in which it directly or indirectly holds 100% shares	N/A
Registration/approval	<ul style="list-style-type: none"> - If the technology is transferred to a domestic party, then the relevant contract must be registered with the science and technology bureau; - If the technology is exported to a foreign party, the contract must be registered with the commerce bureau 	Same as EIT Incentive

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