BUNDESMINISTERIUM
FÜR FINANZEN

Abteilung IV/4

GZ. I 1/10-IV/4/00

Himmelpfortgasse 4-8
Postfach 2
A-1015 Wien
Telefax: +43 (0)1-513 98 61

Sachbearbeiter:
Dr. Loukota
Telefon:
+43 (0)1-51433/2754
Internet:
post@bmf.gv.at
DVR: 0000078

Betr.: **Plant-construction in China (EAS.1680)**

With reference to your inquiry of 13 June, 2000 the following response is given under the Ministry's Express Answering Service (EAS):

If an Austrian plant-constructor has entered into a contract with a Chinese customer for the construction of an electric arc furnace and a single slab continuous casting machine and the construction period exceeds 6 months then a permanent establishment has been created on the territory of China; as a result, Chinese taxing rights accrue to the extent as such taxing rights are chargeable on profits attributable to such permanent establishment (Article 5 para. 3 in conjunction with Article 7 of the Austro-Chinese Double Taxation Convention/ DTC). According to Article 24 subpara.b of the DTC Austria is obliged to exempt that part of the profits from its tax.

The allocation of profits to the Chinese permanent establishment has to be made in accordance with the provisions of Article 7 of the tax treaty: these provisions require the application of the "arm's length principle" according to which functional analysis has to be carried out. Therefore, in a first step, it has to be ascertained which functions are actually performed by the Austrian head office and which are rendered at the site in China. In a second step it has then to be evaluated what amount an independent enterprise might have earned in China if it had rendered exactly the same functions as had been performed by the permanent establishment of the Austrian company. For that purpose the Austrian tax administration accepts a method as described in the enclosure where a split of total profits is made between

the two countries on a ratio determined by the functions performed. But also a cost plus approach can be used.

If under the construction contract the activities of the Austrian plant constructor are confined to the design, engineering and technical documentation, the supply of equipment and spare parts, the performance of technical service comprising supervision of erection, commissioning, testing and training at site, als well as training at reference plants in Austria then such activities by its very nature are obviously not covered by Article 12 of the DTC.

Admittedly, Article 12 of the Austro-Chinese DTC, which in its substantial parts reflects the concept of the OECD-Model Tax Treaty, covers remuneration for "information concering industrial, commercial or scientific experience", which is commonly understood as remuneration for the supply of know-how. But as explained in para. 11 of the OECD-Commentary to Article 12, only information "that is necessary for the industrial reproduction of a product or process ....." falls within the scope of Article 12. In other words, if a company uses its own know-how for the supply of construction services, which constitute "active services" of such company, then the remuneration for such services is to be dealt with under Article 7 rather than under Article 12. If, however, under the terms of the respective contract the recipient of the industrial or scientific information has obtained a permission (which constitutes a "passive service") to use the technology developed by his contracting party for his own commercial or industrial purposes (for the purpose of "reproduction") and if his payment is therefore made for having obtained such allowance to use the intellectual property owned by his contracting party then such payment constitutes a "royalty" in the sense of the convention.

Therefore, if the Austrian constructor of the plant has to disclose production technology to the future operator of the plant then any remuneration derived for such entitlement to use such technology in the future production may constitute a royalty in the sense of Article 12. However, if the value of such transfer of technology constitutes only a small part of the total construction price and therefore has not been found worthy of forming the subject of a separate know-how-contract then para. 11 of the OECD-Commentary does not require that such negligeable parts of the total remuneration should be carved out from Article 7 and be taxed under Article 12 in the source country. This is clarified by the Commentary as follows: "if, however, one part of what is being provided constitutes by far the principal purpose of the contract and the other parts stipulated therein are only of an ancillary and largely unimportant character, then it seems possible to apply to the whole amount of the consideration the treatment applicable to the principal part".

If on the basis of the above explanations a cross-border tax conflict should emerge between the Austrian and Chinese tax authorities then a resolution must be sought through a mutual agreement procedure under Article 26 of the Double Taxation Convention.

29. Juni 2000
Für den Bundesminister:
Dr. Loukota

Für die Richtigkeit
der Ausfertigung: