Taiwan Tax Update

November 2016

Draft "Regulations Governing Controlled Foreign Companies" and "Regulations Governing Places of Effective Management"

The Income Tax Act was amended in July 2016 to include anti-tax avoidance rules in Article 43-3 (CFC) and Article 43-4 (PEM) of the Income Tax Act. The Ministry of Finance announced on November 14, 2016 draft "Regulations Governing Controlled Foreign Companies" and "Regulations Governing Places of Effective Management".

The final version will be promulgated following invitation for comments within 30 days of issuance of the draft Regulations, based on which relevant adjustments will be made. The aforementioned two anti-tax avoidance mechanisms have been enacted via relevant income tax provisions; for detailed information, please refer to June 2016 "Taiwan Tax Update" issued by PwC Taiwan.

The new draft Regulations will provide details including: definition and criteria of CFC, timing and scope of taxation, taxable income calculation method, and tax filing procedures.

Controlled Foreign Company (CFC) Rules

In general, profits retained at CFC level, which is located in a low tax rate jurisdiction and without commercial substance (please find definition in point 3 below), will be taxed in advance at Taiwan parent company level. In the past, taxation of foreign investment income is deferred until the Taiwan parent company receives dividend income. Going forward, qualified investment income will be deemed distributed and taxable in Taiwan in advance, with details laid out below.

<u>1. Accelerated taxation</u>

Earnings from a CFC will be deemed distributed to Taiwan and taxed accordingly based on the following two scenarios:

Scenario 1	Profits of a CFC located in a low tax rate jurisdiction will be taxed in advance as deemed distribution in the year the CFC recognizes its profit.

After the new tax regime comes into effect, except for investment income generated from non-low tax rate jurisdictions as described in Scenario 2 below, after tax profits earned by a CFC in the current year, even if undistributed, will need to be recognised as taxable investment income by its Taiwan parent company in the same year.

Scenario 2	Profits of a company located in non-low tax rate jurisdictions in Asia Pacific, Europe, or America will become taxable in the year the company declares its dividends.

In the past, a Taiwan parent company that indirectly invests in companies located in non-low tax rate jurisdictions in Asia Pacific, Europe, and America via investment companies located in low tax rate jurisdictions would not need to recognize taxable income if non-low tax rate jurisdiction investee companies does not declare dividends. Under the new tax regime, once investee companies in non-low tax rate jurisdictions distribute dividends, even if the dividends are not further remitted to Taiwan parent company level, such dividends will be treated as taxable income by Taiwan parent company in the year dividends are declared by investee companies in non-low tax rate jurisdictions.

2. Calculation of current year earnings of CFC

When calculating the current year earnings of a CFC, the above mentioned taxable income[1] can be reduced by realized investment loss in non-low tax rate jurisdiction (i.e. investee company in non-low tax rate jurisdiction undergoes capital reduction or is sold/transferred). In the event of current year loss realized by CFC, upon assessment by the tax authority, the loss can be carried forward for ten years and can be deductible against future income generated by the CFC.

Where earnings are generated by CFC in the current year, legal reserve or restricted distribution items should be deducted therefrom. In addition, the aforementioned losses assessed by the tax authority from previous years should also be deducted. The Taiwan parent company should recognize proportionately investment income based on its direct shareholding percentage in the CFC and holding period of the shares. The formula is depicted below:

[1] Or losses

	CFC's after tax profit (per financial statement)
+	CFC's other comprehensive income (equity transferred to retained earnings)
—	investment income (loss) from non-low tax rate jurisdiction using equity method
+	distributed earnings (realized investment loss) from non-low tax rate jurisdiction
	CFC's current year earnings
—	CFC's legal reserve
—	CFC's restricted distribution items
—	CFC's losses assessed by tax office carried forward from previous years
	CFC income taxable in Taiwan

3. Definition of CFC

A foreign investee company immediately held by a Taiwan parent company should follow the below criteria to determine whether it will constitute a CFC.

If a Taiwan parent company simultaneously holds several CFCs, each CFC's income should be calculated separately. In other words, losses from one CFC cannot be used to offset income from another CFC, nor can losses of CFCs be deducted from operating income of Taiwan parent company.

CFC definition	A foreign company in a low tax rate jurisdiction that is held directly or indirectly by a Taiwan company and its affiliates, with collective shareholding percentage at year end larger than or equal to 50%, or less than 50%, but with Taiwan company exercising material influence over the foreign investee company.
Low tax rate jurisdiction	Each of the below constitutes a low tax rate jurisdiction: • jurisdiction where CFC is located has a tax rate that is less than or equal to 70% of Taiwan's corporate income tax rate (i.e. 11.9%) • jurisdiction where CFC is located does not impose tax on offshore income (e.g. Hong Kong and Singapore)
CFC exemption criteria	A foreign company that meets any one of the criteria below will not be deemed a CFC: • The foreign company has commercial substance and operations (i.e. simultaneously fulfills the two criteria below)

	1. The foreign company has a fixed place of business in the jurisdiction where it is domiciled, and hires employees to operate its business; and 2. The foreign company's passive income is less than 10% of total income. • The foreign company does not have commercial substance and operations, but its current year profit is less than or equal to TWD 7 million (Note 2)

Note 1: In June 2016, the Executive Yuan proposed that if a Taiwanese individual together with his/her spouse and second degree relatives collectively hold more than 10% of the shares of a CFC, the said Taiwanese individual is required to report CFC income proportionately based on his/her shareholding percentage in the CFC, and to include such offshore income in his/her calculation of alternative minimum tax.

Note 2: The current year profit of each CFC held by the same Taiwanese company will need to be added together to determine whether the threshold of TWD 7 million is exceeded.

Place of Effective Management ("PEM") Rules

Under the new tax regime, if a foreign company meets all three criteria triggering PEM definition, including 1) decision making location, 2) record keeping and maintenance location, and 3) actual operating location are all in Taiwan, the foreign enterprise will be deemed as having its head office in Taiwan, and will be subject to tax assessment in accordance with Taiwan Income Tax Act and other tax regulations.

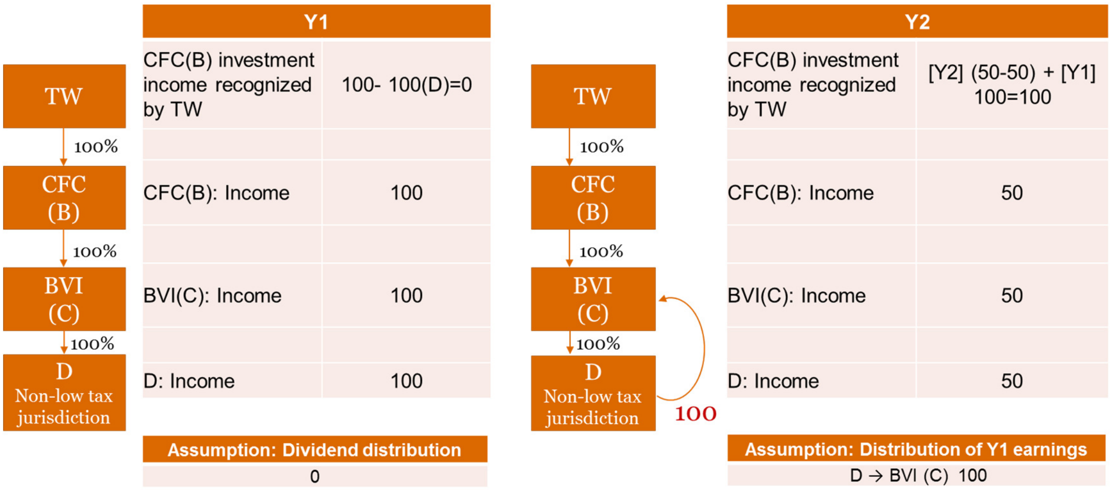
A foreign enterprise may voluntarily apply to be subject to the PEM taxation mechanism, or the tax authorities may determine whether PEM taxation mechanism should apply after conducting appropriate audits. Within 3 years of the effective date of the Regulations Governing Places of Effective Management, the tax authority will need to report to the Ministry of Finance ("MOF") for approval, a list of all foreign enterprises deemed to have its PEM in Taiwan. The MOF may extend such approval for 3 additional years when necessary.

PwC Observation:

As illustrated below, we assume after tax profit of the CFC in Year 1 is 100, all of which is derived from its investee Company D situated in a non-low tax rate jurisdiction, and Company D does not distribute any dividends in Year 1.

Because Company D is not situated in a low tax rate jurisdiction, and it does not distribute any dividends, CFC investment income of the ultimate Taiwan holding company for Year 1 is 0 (100-100=0).

Assuming in Year 2, after tax profit of the CFC is 50, all of which is derived from its investee Company D situated in a non-low tax rate jurisdiction, and Company D does not distribute dividends from earnings generated in Year 2. Instead, Company D distributes dividends entirely from earnings generated in Year 1 (i.e. 100) to the CFC. Because Company D is not situated in a low tax rate jurisdiction, and the decision to distribute 100 of its Year 1 earnings is made in Year 2, the ultimate Taiwan holding company shall recognize in Year 2 its CFC investment income as 100 ([50-50+100]=100) based on its shareholding percentage (100%).



Kindly note that the above "cash basis" recognition of taxable income only applies to companies which are not situated in low tax rate jurisdictions. If Company D is situated in a low tax rate jurisdiction (including those that only impose taxes on domestic income, such as Hong Kong or Singapore), even if Company D has commercial substance and actual operations, the Taiwan holding company will recognize taxable investment income in the year the income is recognized by Company D, as if such income were distributed immediately, even though Company D has not distributed dividends corresponding to earnings derived in that year. In other words, the Taiwan holding company has to recognize CFC investment income of 100 and 50 in year 1 and year 2 respectively, if Company D was situated in a low tax rate jurisdiction.

Currently, input for CFC and PEM rules are being sought by the tax authorities from interested parties. PwC will closely monitor the status and provide timely updates.

Taiwan and Poland signed tax treaty in October 2016

Taiwan and Poland has officially signed Agreement on the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income ("TW-PL Tax Treaty") on October 21, 2016. The two countries must notify each other in writing after completing domestic formalities, after which the TW-PL Tax Treaty will come into effect on January 1 of the following year. The TW-PL Tax Treaty is Taiwan's 34th comprehensive agreement on avoidance of double taxation on income, and the 15th concluded with a European country. The salient points of TW-PL Tax Treaty are summarized below:

Scope	Taxpayer	Resident: includes resident individuals and enterprises defined under domestic tax law.
	Applicable tax	Income tax
Primary tax benefits	Business profit	"Business profits" of an enterprise of a territory shall be taxable only in that territory unless the enterprise carries on business in the other territory through a "permanent establishment" situated therein.
	Passive income	1. Dividends: 10% reduced withholding rate
		2. Interest: 10% reduced withholding rate; specific types of interest are exempt from income tax
		3. Royalties: 3% reduced withholding rate for payment received as consideration for the use of, or the right to use, any industrial, commercial, or scientific equipment; 10% reduced withholding rate for circumstances other than the above.
	Capital gain	Capital gain on transfer of shares is exempt from income tax in general.
Transfer pricing		1. Provides corresponding adjustment mechanism to resolve double taxation issues arising from related party transactions.
		2. Provides mechanism for application of Bilateral Advance Pricing Agreements ("BAPA") with authorities in both territories to reduce subsequent audit risk, and increase tax certainty for related party transactions.
Dispute resolution	Mutual agreement	If a resident of a territory encounters any issues in applying the tax treaty dispute resolution clause, dispute in regards to transfer pricing corresponding adjustment mechanism, or other double taxation issues, mutual agreement may be applied for with the authority in such territory within a specific time frame to resolve such issue.

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