In our assessment, importing these items from China would not pose any threat to Taiwan national security or any potential damage to the domestic economy. On the contrary, lifting the ban on these items would rebuild Taiwan's credibility to its WTO commitments and buttress Taiwan's reputation as an attractive location for investment, spurring long-term job creation and business expansion. If a decision is made to retain these items on the banned list, we would expect that decision to be accompanied by concrete economic assessments supporting that determination.

Issue 3: Reform the regulatory framework for cosmetics products.

The current regulatory regime established by the Department of Health (DOH) calls for pre-market registration of medicated cosmetics for acne, suncare and hair dye; pre-broadcast advertising approval for all cosmetics, and submission of Certificates of Free Sales (CFS) for imported products (certifying that the items are sold freely in the exporting country). All of these requirements are unnecessary to ensure product safety.

Cosmetics are not subject to pre-market approval in most leading markets around the world, including the United States, European Union, and the ASEAN countries. The regulators in those areas set strict rules on safety and quality, and they subject products to testing if they have any doubts about whether the products meet those regulations.

A similar principle is followed in the advanced countries for cosmetics advertising; pre-broadcast approvals are not conducted, as that would hinder companies' ability to communicate relevant and necessary information to consumers. Although DOH has developed positive and negative claim lists, the result is that the official reviewers pay excessive attention to revising the wording, rather than examining whether the claims are supportable. We recommend that DOH host periodic meetings with industry representatives, dermatologists, and media scholars to develop clearer and more solid guidelines to reduce false or misleading advertising and better accomplish the objective of consumer protection.

Another problem faced by the industry is the Taiwan regulators' attitude toward trace levels of chemicals that are prohibited from direct use on the body. For technical reasons, it is unavoidable that certain chemicals may be present in trace levels in finished products, but the amounts are so minute as to be well within a safety tolerance. This fact is recognized and accepted in the United States, Japan, and the European Union, where it is made explicit in the EU Cosmetic Directive. But Taiwan's cosmetic regulations do not take such provisions into account, leaving the door open to cases of consumer concern or panic when reports cite the discovery of trace levels.

The Committee recommends revamping the current cosmetics regulations by benchmarking them against the most scientifically based regulatory regimes – for example, those of the EU and ASEAN. Such reform would be an opportunity to eliminate the pre-market registration requirement for medicated cosmetics, waive pre-broadcast approval for advertising as well as the CFS requirement, and state explicitly that the prohibition of ingredients on the negative list does not apply to unavoidable trace amounts.

TAX

Creation of a competitive and reasonable tax system, though only one factor in improving a country's investment environment, is a vital step in enabling a government to solidify a recovering economy. The Committee therefore commends the government for taking the appeals from the foreign business community into consideration over the past several years, and for acting on them to rationalize policy on a range of tax issues. To settle various longstanding tax questions, for example, the Ministry of Finance (MOF) in the past year released its "Recognition Rules of Taiwan-sourced Income" and "Assessment Rules on the Eligibility for Income Tax Treaty Benefits," milestone measures that resolved issues of concern to both domestic and foreign investors.

Several additional important issues relevant to attracting foreign investment still require attention, however, and are outlined below. The Committee would appreciate the MOF's continued efforts on those issues, and we look forward to further cooperation with the Ministry so as to create an investment environment that is more compatible with international tax practice. If these issues could be addressed in the near future, it would be highly beneficial in enhancing Taiwan's international competitiveness.

Issue 1: Rectify imbalances in the income tax structure.

The recent decision to decrease the corporate tax rate will help boost Taiwan's attractiveness as a place for doing business by bringing that rate in line with those of other countries in the Asia-Pacific region, including Singapore's 17% rate and Hong Kong's 16.5%. The change will enable businesses to reduce their operating costs in Taiwan. But undertaking this reform without simultaneously dealing with its impact on other elements in the current income tax system has caused the continued existence of certain imbalances with serious implications for Taiwan's competitiveness. We urge the authorities to consider the following:

1. After the corporate income tax rate drops to 17%, the withholding tax rate on most types of income of foreign entities will remain at 20%, which is not a reasonable situation. We urge that the withholding tax rate on the income of foreign entities be reduced to 17% or lower;
2. Taiwan's personal income tax rate reaches up to 40% for the top bracket, considerably higher than elsewhere in the Asia-Pacific region. Such a steep individual income rate makes it difficult for Taiwan to attract and retain the high-level talent needed for robust economic growth. In addition, the large disparity between the corporate and

individual income tax rates will mean that salary earners will now contribute more to tax revenue than corporate taxpayers. That condition would be extremely unusual in other countries of the world, and is not considered a healthy phenomenon for a national tax structure.

Issue 2: Treat true-up and true-down adjustments consistently in accordance with Transfer Pricing Rules.

Under the Taiwan Transfer Pricing Rules, taxpayers are required to submit contemporaneous documentation to prove that related-party transactions were conducted at arm's length, as well as to make any necessary and appropriate true-up and true-down adjustments on their corporate income tax returns. In practice, the factors that multinational companies must take into consideration in setting their transfer pricing structures are extremely complicated, and given the many market variables, it is extremely difficult to accurately estimate actual operational results in advance. Hence, at the end of a tax period, it is necessary to conduct a one-time adjustment in accordance with the results of the transfer-pricing study.

But the practice adopted by the Tax Office is to treat true-up adjustments as taxable income, while denying tax deductions for true-down adjustments. This practice conforms with neither Taiwan's own Transfer Pricing Rules nor the tax practices commonly adopted in OECD countries. Although downward adjustment was accomplished in some cases in the past by obtaining advance approval from the MOF, the advance approval process may not be suitable for multinational companies operating under strict time constraints. The Committee urges the MOF to look into this inconsistent and inequitable taxation treatment on transfer pricing adjustments and to provide clear guidelines for both the Tax Authorities and taxpayers to follow. Furthermore, in order to reduce tax uncertainties and create a more favorable investment environment for international companies, penalties should not be imposed due to a difference in interpretation when the tax authorities disagree with the transfer-pricing adjustments taken by the tax-payer.

Issue 3: Mitigate the adverse tax impact from applying the AMT Law to expatriates in Taiwan.

The current Income Tax Law defines a foreigner staying in Taiwan for more than 182 days in a calendar year as being a Taiwan resident. As the Taiwan Alternative Minimum Tax (AMT) Law refers to that definition of Taiwan residency, the application of the AMT regime to individual overseas income will also extend to foreign nationals whose stay in Taiwan has exceeded the 182-day threshold. This change will subject expatriates in Taiwan to 20% AMT on their non-Taiwan-source investment income, such as interest, dividends, and capital gains from the disposal of overseas investments (stocks, real estate, etc.), although this income is unrelated to their work assignment in Taiwan.

The adverse tax impact on expatriates stationed in Taiwan is expected to discourage international companies from sending senior executives and other talented personnel to Taiwan – inevitably undermining the government's policy of trying to attract talent to the island and to promote Taiwan as an operations center.

The Committee urges the MOF to carefully re-assess the definition of "Taiwan resident" for AMT purposes to exclude foreign nationals without dual citizenship who stay in Taiwan for a period of over of 182 days in a tax year.

Issue 4: Re-consider taxing foreign enterprises for drop-shipment transactions in Taiwan.

Taiwan's success in developing the high-tech sector has led many foreign companies to contract with Taiwan enterprises for manufacturing, testing, assembly, or other activities before the finished product is delivered to buyers overseas. It is common in this business model for the foreign companies to ship semi-finished goods to the Taiwan contract manufacturers for further processing, after which the products are shipped directly to the buyers outside Taiwan in what is known as a "drop shipment." When it comes to whether the value added in the drop-shipment process should be taxed in Taiwan, the MOF takes the position that it depends on whether the sale was completed in Taiwan.

As there is no clear definition of "sales completed in Taiwan" in tax laws and regulations, the MOF has interpreted it to mean that the buyer and the sales terms have already been determined and the sales orders received before the products leave Taiwan. If the sales are considered to be completed in Taiwan, the foreign enterprises will be deemed to have Taiwan-sourced income, which is calculated according to the proportion of contribution to the transaction attributable to activities in Taiwan (for example, procurement, testing, and/or storage functions). To calculate the business profit attributable to Taiwan, the taxpayer needs to provide the enterprise's global transfer pricing report analysis or other documentation.

The overall tax rate for drop shipments will therefore be: Contribution rate x actual profit x 17% corporate tax rate. But the definition of "sales completed in Taiwan" that has been applied seems unreasonable in the context of the drop-shipment business model. In practice, foreign enterprises will not place orders with Taiwan contract manufacturers for further processing before having already secured the buyers to whom those processed products will be delivered. Thus, drop-shipment transactions inherently fall within the definition of completion of sale.

In addition, the definition that has been applied would tend to encourage foreign enterprises to insert their overseas warehouses as intermediary stops in the delivery process, even though the buyers had been identified from the beginning. "Completion of sale" should actually refer to the moment at which delivery is made, and under the drop-shipment business model, it takes place overseas, not in Taiwan. Since the sales are not completed in Taiwan, there is then no convincing basis for treating the added value made by Taiwan contract manufacturers as Taiwan-sourced income.

Moreover, Taiwan contract manufacturers have already paid or will pay income tax for the added value by reporting their remuneration – that is, the service fees obtained from their foreign customers – on their tax returns. To tax the foreign enterprises for the same value added creates double-taxation issues, and deviates from international tax practice.

If other countries were to apply the same tax treatment on the drop-shipment business model as Taiwan does, Taiwanese companies would certainly complain of unfairness.

In the interest of reciprocity, the smooth promotion of international trade, and Taiwan's reputation as a competitive place with which to do business, the Committee urges the MOF to revise its method of taxing foreign enterprises under the drop-shipment business model.

Issue 5: Clarify whether the transfer of securities for purposes other than sale is subject to securities transaction tax.

According to Article 1 of the Securities Transaction Tax Act (STT Act), the sale of Taiwan securities is subject to securities transaction tax (STT). Accordingly, the transfer of securities as a gift, inheritance, or capital contribution, or for any purpose other than sale should not be subject to STT.

In addition, the Mergers and Acquisitions Act (M&A Act) prescribes that the transfer of securities in a merger, de-merger, or a qualified business and assets transfer in an M&A transaction is exempt from STT. However, because the M&A Act applies only to M&A transactions in which at least one party is a Taiwan company, the tax authorities seem to be of the opinion that the transfer of Taiwan securities in an M&A transaction between two foreign companies should be subject to STT. Moreover, a transfer of Taiwan securities, such as the transfer of securities as capital contribution or the distribution of residual assets to shareholders upon a company's liquidation, must be conducted in accordance with the Company Act in order for such transfer to be exempt from STT.

Because of the different opinions between the tax authorities and taxpayers over which transfers of Taiwan securities are subject to STT, the Committee urges the MOF to issue a directive to explicitly confirm that the transfer of Taiwan securities for purposes other than sale should not be subject to STT.

Issue 6: Clarify "hire of work" contracts under the Stamp Tax Act.

Under the Stamp Tax Act, the parties to a "hire of work" contract signed within Taiwan are subject to stamp tax. A contract for "hire of work," according to the Civil Code, is a contract under which a party agrees to complete a specific piece of work for the other party in return for remuneration. As the Stamp Tax Act does not include a definition of "hire of work," the tax authorities have tended to treat the majority of contracts as contracts for "hire of work," as most contracts involve one party completing certain work for the other party. An example is the MOF tax ruling issued September 22, 1999 concerning a contract for cleaning and maintenance as well as security services. The MOF stated that because the contract stipulated the items to be cleaned and maintained, and provided that the remuneration would be paid only if certain work was completed, the contract (except for the portion dealing with security services) constituted a "hire of work" contract and was thus subject to stamp tax.

The tax authorities' broad definition of "completion of specific work" has led to difficulty in distinguishing "mandate" contracts from "hire of work" contracts in terms of substance. Both types of contracts involve one party performing certain work for the other party in return for remuneration. Under the tax authorities' interpretation, virtually all contracts would be deemed "hire of work" contracts and thus subject to stamp tax if signed within Taiwan.

In view of the increasing confusion regarding whether or not a contract is subject to stamp tax, the Committee urges the tax authorities to issue a clear and specific definition of "hire of work" contracts under the Stamp Tax Act. As cases in point of "hire-of-work" contracts, the authorities may refer to three examples cited under Item 4, Article 5 of the Stamp Duty Act: contracts for construction, printing, and contract manufacturing.

Issue 7: Remove obstacles to income payers' following the tax ruling on Taiwan-source income.

The Committee appreciates the tax ruling issued by the MOF on September 3, 2009 to clarify the scope of Taiwan-source income. Although the tax ruling provides guidelines for determining Taiwan-source income, in tax practice income payers have not been following this tax ruling to determine the Taiwan-source income on payments to foreign entities. Instead, the income payers have continued to take a very conservative approach in treating the payment as Taiwan-source income, withholding 20% on the gross payment. This practice is mainly due to the income payers' fear of incurring a tax penalty if it is considered to have under-withheld tax.

If the income payer follows the tax ruling and judges that any payment (or a portion of it) is not Taiwan-source income and therefore does not withhold tax upon the payment, but the tax office later disagrees with the income payer's decision, the income payer will be regarded as having failed to withhold tax and will be subject to a severe penalty. As a result, the income payers, notwithstanding the tax ruling, are still deducting the 20% withholding tax on the payment.

Further, since the income payer still continues to withhold 20% on all payments to foreign entities, the foreign income receivers may be forced to file tax refund applications and/or seek private rulings from the tax office on specific transactions – creating an administrative burden for both the taxpayer and the tax office. In essence, the above-mentioned income payers' fear of being subjected to a penalty has hindered the application of the tax ruling, preventing the MOF from accomplishing the intended objective of providing clear guidelines for taxpayers and withholding tax agents to follow. To resolve this problem, the Committee suggests that the MOF provide a penalty waiver in cases where the income payer has made a reasonable effort (such as collecting relevant documents, seeking professional opinion, etc.) to determine whether the payment is Taiwan-source income under the terms of the tax ruling.

Issue 8: Classify capital income from registered offshore funds as domestic income.

Registered offshore funds represented in Taiwan by master agents and overseas funds launched by Securities Investment Trust Enterprises (SITEs) are both important investment conduits for Taiwanese investors to participate in worldwide economic growth and diversify their investment portfolios. Considering the identical nature of these two products, the Tax Committee shares the position of the Asset Management Committee that they should receive equal tax treatment, ensuring a fair competitive environment.

But as a result of an MOF circular on September 3, 2009, capital income from registered offshore funds – though not from SITE overseas funds – has been excluded as domestic income and starting this year has become subject to the Alternative Minimum Tax system. As the Asset Management Committee notes in its paper, this interpretation has not only jeopardized the interests of investors purchasing registered offshore funds, but is also inconsistent with the view of the Financial Supervisory Commission (FSC), which has defined both registered offshore funds and SITE overseas funds as "securities" under Article 6 of Securities Exchange Law. Additionally, the MOF has categorized capital gains from foreign exchange-traded funds (ETFs) listed on Taiwan Stock Exchange as domestic income even though, like registered offshore funds, they are launched outside Taiwan. We therefore urge the MOF to revise Article 8 of its circular to specify that capital income from securities listed or launched or registered in Taiwan is regarded as domestic income.

TECHNOLOGY

The Committee would like to express its appreciation for the government's efforts to develop Taiwan as an operations headquarters and to further spur the transition of the economy from a primarily manufacturing base to one emphasizing R&D and the service sector. Investments in technology, services, and intellectual capital will be crucial for Taiwan's transformation into an attractive and competitive location for both domestic businesses and multinational corporations.

One of the necessary measures for achieving this goal is the provision of a comprehensive set of preferential tax incentives to encourage businesses to conduct R&D, design, and other service functions within Taiwan. Although investment tax credits are available, the implementation details need to be further clarified. In addition, the amount of investment currently going into software, services, and training is insufficient to support the desired transformation.

Although Taiwan's R&D expenditure has grown steadily over the past years – from 2.4% of GDP in 2004 to 3% in 2008 – the Committee recommends that the government consider even higher goals, emulating countries that lead the world in R&D expenditures. Israel, for example, has the highest R&D expenditure as a proportion of GDP (4.8%), followed by Sweden, Japan, and Korea. Increasing public expenditures on R&D would facilitate the government's goal of upgrading Taiwan's economy and also help strengthen Taiwan's competitiveness.

Further, the Committee encourages the government to share its long-term plans to boost investment in green energy and energy conservation. That information will allow corporations to work hand-in-hand with the government in developing new solutions in support of those goals.

In line with the objectives of promoting Taiwan's development as an operations and R&D hub and furthering the transition to a services-based economy, the Committee presents the issues below and looks forward to discussing them with the relevant government agencies, offering our assistance in identifying possible solutions.

Issue 1: Increase government spending on software, services, and intellectual capital.

Development of an information society has been widely accepted as the most important tool for meeting the "Millennium Challenge of Human Needs" set by the United Nations (UN). That development must be anchored not only in the availability of relevant hardware, but also of software and technology-related services.

In Taiwan, production of Information and Communications Technology (ICT)-related hardware – currently worth NT$3.6 trillion (US$114 billion) annually – is the major contributor to the export economy. That success has led many observers to assume that Taiwan's software and technology-related service industries, which only contribute NT$200 billion-$300 billion (US$6.3 billion-$9.5 billion) annually to GDP, are also in good shape.

According to an International Data Corp. (IDC) report in 2009, software and services account for up to 61.3% of global IT spending, and each year the growth rate for software and services exceeds that of hardware. The same report, however, shows that Taiwan's expenditure on software and services stands at only 37.7% of total IT spending. In addition, according to Bank of Taiwan data, software made up only 20% of government IT procurement over the past two years. In the Taiwan government's economic stimulus program carried out in 2009, software and services spending represented less than 10% of the total. Taiwan clearly has not caught up with the global trend in