Tax

1. Application of thin capitalization rules to the financial services industry
2. Unfavorable withholding tax rate for foreign entities
3. Guidelines on CPA audit reports for withholding tax refund purposes

Introduction

The committee recognizes the government's decision to reduce the corporate income tax rate to 17% in order to enhance Taiwan's competitiveness and attract more foreign investors. Although most of the issues raised in last year's paper remain unresolved, they are not addressed this year in order to highlight other issues which are of a more urgent nature. Committee members sense there is still room for improving the current tax environment which is considered less friendly than other countries in the region.

1. Application of thin capitalization rules to the financial services industry

Currently, there are no thin capitalization rules in Taiwan. The government has proposed an amendment to the Income Tax Act to introduce thin capitalization provisions. Thin capitalization rules would disallow the deduction of interest expenses on debts when the debt to equity ratio exceeds a certain prescribed threshold. This provision is intended to prevent companies from massive borrowing from related parties to take advantage of interest deductions rather than raising funds through increasing capital. The proposed debt to equity ratio is likely to be three to one, which would limit a company's interest expense deduction on debt to three times its capital.

Due to the unique characteristics of the financial services industry, the scope of the proposed thin capitalization rules will have a seriously adverse impact on companies in the industry, especially banks. Given the fact that financial institutions tend to borrow significant amounts during their normal course of business, they would likely breach the debt to equity ratio prescribed under the proposed thin capitalization rules. Furthermore, financial institutions are already subject to stringent standards set by the Financial Supervisory Commission (FSC) related to capital adequacy and the FSC has expressed hopes for exempting financial institutions from the thin capitalization rules.

Most countries including Japan, the United States and the United Kingdom, specifically exclude the financial services industries from the scope of thin capitalization rules. It is generally recognized that the financial services industry is highly leveraged and thus should not be subject to the same rules as other industries with regards to thin capitalization.

RECOMMENDATION

Considering the unique characteristics of the financial services industries, the government should exclude financial institutions from the scope of thin capitalization rules.

2. Unfavorable withholding tax rate for foreign entities

Starting from the 2010 tax year, Taiwan's corporate income tax rate has been reduced from 25% to 17%. However, the withholding tax rate on payments made to foreign entities without permanent establishments in Taiwan has not been correspondingly reduced and remains at 20%. This results in unfavorable tax treatment of foreign entities.

RECOMMENDATION

The government should consider reducing the withholding tax rate on payments made to foreign entities to 17% or lower.

3. Guidelines on CPA audit reports for withholding tax refund purposes

The committee acknowledges the government's initiative to address the issues raised in previous position papers regarding withholding tax (WHT) by announcing the 'Principle for Determining Taiwan Sourced Income under Article 8 of the Taiwan Income Tax Act' on 3 September 2009. This principle allows foreign companies to claim actual costs and expenses incurred in deriving Taiwan sourced income and to seek refunds for excess withholding tax paid. According to the principle, WHT applicants are required to provide supporting documents including relevant books and records and CPA audit reports.

Unfortunately, in practice, the exercise to gather and present the relevant books, records and other documentation to substantiate the actual costs and expenses can be so complex that it is simply not feasible. This is as a result of the divergence in record keeping requirements of each country, the complexity of accounting systems of multinational corporations (MNCs) and foreign language requirements, among other issues.

As an alternative to the requirements listed above, MNCs can provide CPA audit reports to support their applications for WHT refunds. However, obtaining the CPA audit reports is time consuming and costly. Moreover, the principle does not provide guidelines on the specifications for the CPA audit reports. Without explicit guidelines on the format and content of CPA audit reports, it is uncertain whether the CPA audit reports would be acceptable to the Taiwan tax authorities. Lacking certainty in this respect, foreign companies are unable to initiate WHT refund applications by claiming cossts and expenses.

RECOMMENDATION

The government should provide explicit guidelines on the format and content of CPA audit reports for WHT refund purposes to allow companies to submit reports that comply with the guidelines and thereby preempt unnecessary disputes between taxpayers and the tax authorities.