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Global Tax Alert

News from Transfer Pricing

Taiwan amends Transfer Pricing Regulations

Executive summary

In response to global transfer pricing (TP) trends and effective anti-tax avoidance measures for cross-border related party transactions, the Taiwan Ministry of Finance (MOF) issued Tai-Tsai-Shuei- Zi Ruling No. 10904654700 (the Ruling) on 28 December 2020 which amends the Regulations Governing the Assessment of Profit-Seeking Enterprise Income Tax on Non-Arm's-Length Transfer Pricing (TP Regulations). The amended TP Regulations apply to 2020[1] Taiwan corporate income tax filings and future years.

This Tax Alert summarizes the key details of the amendments.

Detailed discussion

Updating the definition of intangible assets (Article 4 amendment)

Intangible assets are defined by the amendment as non-tangible assets and rights that can be owned or controlled for use in commercial activities and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances.[2]

Use of uncontrolled transactions as a comparable for controlled transactions (Article 7 amendment)

If a comparable uncontrolled transaction satisfies one of the following conditions, it may be used to determine a single reliable arm's-length result for the controlled transaction:

- There are no differences between the controlled transaction and the comparable uncontrolled transaction, and between a related party engaged in the controlled transaction and a non-related party engaged in the comparable uncontrolled transaction that has a significant impact on the open market price.
- If there are significant differences, reasonable adjustments can be made to eliminate the significant impact caused by such differences.

The economic substance of the controlled transaction (Article 8 amendment)

The amendment follows the Organisation for Economic Co-operation and Development (OECD) TP guidelines and the substance over form principle under Article 7 of the *Taxpayer Rights Protection Act*. When determining the comparability of a controlled transaction, an enterprise is required to base the comparability on the existence of the actual economic relationship and its economic beneficial ownership.

Evaluating the comparability of the risks born by the enterprise under a controlled transaction (Article 8-1 amendment)

The amendment follows the OECD TP guidelines to: (i) emphasize the importance of risk analysis and strengthen the analysis framework; (ii) prescribe the steps for evaluating the comparability of risk factors; (iii) evaluate the risk assumed and management functions of the participants in the controlled transactions; and (iv) allocate profit based on the level of risk assumed and management functions during the re-pricing process.

Comparability analysis of the development, enhancement, maintenance, protection, and exploitation (DEMPE) activities in the valuation of intangible transactions (Article 9-2 amendment)

In addition to following the OECD Base Erosion and Profit Shifting Action Plan in determining the arm's-length nature of profit allocation for intangible transactions, a comparability analysis of the DEMPE activities is required to ensure that profit allocation is consistent with the DEMPE activity (including the functions performed, assets used, and risks assumed) and is at arm's length.

Addition of the Income-based Approach as a TP method for the valuation of intangible assets (Article 11 amendment) and corresponding regulations and considerations (Article 19-1 amendment)

The amendment includes: (i) the addition of the Income-based Approach as a TP method in evaluating the arm's-length nature of intangible asset transactions; (ii) corresponding Income-based Approach regulations; and (iii) factors to be considered when applying the approach.

Penalties for undisclosed controlled transactions (Article 34 amendment)

The penalties under Article 110 of the *Income Tax Act* are imposed if: (i) the profit-seeking enterprise failed to comply with the requirements to disclose its controlled transactions in its income tax return and TP documentation; and (ii) the increase in taxable income of the controlled transactions adjusted and assessed by the tax collection authorities is more than 5% of the annual taxable income of the enterprise and more than 1.5% of the annual net operating revenue.

Implications

The MOF has illustrated that research and development and marketing expenses incurred by an enterprise for the development of intangibles should be recorded as expenses rather than capitalized for financial accounting purposes. However, from a TP perspective, the creation of an intangible asset of significant economic value can be deemed to exist (despite such intangible asset not being recorded on the balance sheet of the enterprise). Consequently, multinational companies (MNCs) should be aware of intangible assets with significant economic value that are not capitalized in the balance sheet as these intangibles may trigger TP issues. The Taiwan tax authorities have been increasingly focused on intangible asset related issues during recent audits and as a result of the amendments, these audits are expected to become more detailed.

As discussed above, the amendments focus on the consistency between a transactions' actual economic relationships and its related beneficial ownership to meet the arm's-length principle. From a comparability perspective, MNCs who assume and manage risks would be considered as the beneficial owner. Thus, if a transaction involves intangible assets, the comparability analysis should be conducted based on the DEMPE activities to ensure that the profit allocation aligns with each entity's contribution. If the economic substance is not taken into consideration and profit allocation is based on the legal ownership of intangibles, MNCs may be challenged by the tax authorities.

The addition of the Income-based Approach provides another alternative in settling disputes on TP issues associated with intangible assets. However, during TP audits, the tax authorities are likely to pay special attention to the assumptions made. It is recommended that MNCs maintain robust documentation in respect of the underlying assumptions when applying the Income-based Approach.

Endnotes

1. I.e., the year ended 31 December 2020. The taxable year is generally the calendar year, 1 January to 31 December. However, a taxpayer may elect to adopt a different taxable year.
2. Intangible assets include business rights, copyrights, patents, trademarks, business names, brand names, designs or models, plans, secret methods, business secrets, or information and/or expertise related to industrial, commercial or scientific experience, various franchise rights, marketing networks, customer data, and other rights with value.

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