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Introduction
Article 43-1 of the Income Tax Act (ITA) was intended for dealing with situations where special transactional arrangements are made between related parties not complying to arm's-length principle, thereby reducing tax liabilities in Taiwan, when it was included in ITA in 1971. However, because the provision failed to explicitly specify standards to determine non-arm’s-length business operations or transactions and related (tax) adjustment methods, it had been practically difficult to follow.

On 28 December 2004, the Ministry of Finance (MOF) promulgated Regulations Governing Assessment of Profit-Seeking Enterprise Income Tax on Non-Arm’s-Length Transfer Pricing (TP Assessment Regulations), which set forth detail of the arm’s-length nature of related party transactions that should be assessed, and the relevant documentation requirements.

Statutory rules
TP Assessment Regulations consist of seven chapters and 36 articles, with detail in the following aspects:

• Scope of related parties.
• Codification of arm's-length principle.
• Accepted transfer pricing methods.
• Documentation requirements
• Advance pricing agreements.
• Transfer pricing investigation and assessments.

Burden of proof
Under the transfer pricing assessment regulations, the taxpayer is obligated to conform to relevant regulations in disclosing information on related party transactions and to prepare relevant transfer pricing documentation to comply with the laws and regulations while filing the annual income tax return.

Documentation
When filing income tax returns, profit-seeking enterprises, except for those which have a turnover amount and controlled transaction amount less than the disclosing threshold established by the MOF, shall disclose information regarding their related parties and the controlled transactions with their related parties in prescribed formats. The information required in the prescribed disclosure formats is as follows:

• Related-party organisation chart.
• Detailed list of related parties.
• Summary table of related-party transactions.
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- Detailed declaration of related-party transactions.

A profit-seeking enterprise should prepare the following documents when it files its income tax return, and submit them to the tax authority when requested within the submission deadline if it is under a transfer pricing investigation:

- A comprehensive business overview.
- A description of organisation structure.
- A summary of related party transactions.
- A transfer pricing report.
- A statement of affiliation (in the case of a subsidiary) and a consolidated business report of affiliated enterprises (of a parent company), as stipulated in Article 369-12 of the company act.
- Other documents concerning related parties or controlled transactions that affect pricing.

The transfer pricing report should include the following items:

- Industry and economic analysis.
- Functional and risk analysis of all the participants of the controlled transaction.
- Compliance status of the controlled transaction with the arm's-length principle.
- A description of the search for comparables and relevant information of the comparables.
- A comparability analysis.
- A description of the selection of the most appropriate transfer pricing method and the related comparability analysis.
- The result of the transfer pricing analysis.

Profit-seeking enterprises conducting controlled transactions are generally required to prepare transfer pricing reports. However, to alleviate taxpayers’ burden and compliance costs, MOF established a safe harbour rule on 30 December 2005, and subsequently revised the safe harbour thresholds on 6 November 2008. Profit-seeking enterprises whose controlled transactions meet the requirements regulated under the safe harbour rule may replace their transfer pricing report with other evidentiary documents which can sufficiently prove that the results of such transactions are at arm’s length.

The applied transfer pricing methods specified by the MOF available for each transaction type are as follows:

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<thead>
<tr>
<th></th>
<th>Tangible asset transactions</th>
<th>Intangible asset transactions</th>
<th>Provision of services</th>
<th>Use of funds</th>
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<tbody>
<tr>
<td>Comparable uncontrolled price method</td>
<td>✓</td>
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<td>✓</td>
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<tr>
<td>Resale price method</td>
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<td>Cost plus method</td>
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<td>Comparable profit method</td>
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<tr>
<td>Profit split method</td>
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</table>
If the taxpayer intends to apply a transfer pricing method other than one of the previously mentioned methods specified by the MOF, pre-approval by the MOF is required.

**Audit targets**

On 2 August 2005, the MOF announced key criteria for its selection of audit targets. These criteria include any of the following:

- Profit-seeking enterprises with a gross profit margin, operating margin or return on sales ratio that is lower than that of other enterprises in the same industry.
- Profit-seeking enterprises that make a loss or a profit far less than that of other overseas affiliated entities, while the worldwide enterprise’s group makes a profit as a whole.
- Profit-seeking enterprises whose profitability in the year under review and the previous two years fluctuates abnormally.
- Profit-seeking enterprises that do not disclose controlled transactions in the prescribed forms.
- Profit-seeking enterprises that do not evaluate whether the result of a controlled transaction is at arm’s length in compliance with Article 6 of the transfer pricing assessment regulations or do not prepare the required evidentiary documents.
- Profit-seeking enterprises that have controlled transactions with related parties but without a reasonable arm's-length price.
- The previous and subsequent years of income tax filing of profit-seeking enterprises that do not provide required evidentiary documents of controlled transactions in compliance with Article 22 of the transfer pricing assessment regulations upon tax authorities' transfer pricing investigation and assessment adjustment.
- Profit-seeking enterprises that are involved in significant or frequent controlled transactions with affiliated entities located in tax havens or in countries with a low tax rate.
- Profit-seeking enterprises that are involved in significant or frequent controlled transactions with affiliated entities that enjoy tax incentives.
- Profit-seeking enterprises that are involved in other arrangements that intend to avoid or reduce tax liabilities in Taiwan.

**Audit procedure**

When a profit-seeking enterprise is perceived to enter into controlled transactions that are not consistent with the arm’s-length principle, the collection authorities in charge may initiate an investigation. A profit-seeking enterprise must present the evidential documentation as listed here within one month of receiving a written notice of an investigation from the competent tax authority. Those who cannot present such documentation within the prescribed period under special circumstances must apply for an extension before the original due date. The extension may not exceed one month and is limited to one time only.

Should the tax authority deem it necessary to request additional supporting documents subsequent to its first review, the profit-seeking enterprise should provide the additional supporting documents within one month.
Audit procedures, assessment and corresponding adjustments
The MOF is principally responsible for setting policies and issuing statutory interpretations; the various regional bureaus of the National Tax Administration undertake the task of concrete implementation.

The tax authorities may choose from two approaches to conduct the investigation based on whether the enterprises being audited provide the transfer pricing documentation as required.

If an enterprise provides adequate transfer pricing documentation, the authorities may assess its taxable income based on such documentation.

If an enterprise fails to provide the mandated documentation, the authorities may assess the taxable income based on the information gathered from internal and external sources.

In either case, the taxable income of the taxpayer is assessed in accordance with the regulations. However, where there is a failure to provide information regarding comparables, the authorities in charge may assess tax on adjusted taxable income based on the standard profit margins regulated by MOF.

If an arm’s-length adjustment, approved by the MOF, is made by a collection authority in charge, that authority shall also make a corresponding adjustment to the taxable income of the counterparty of the transaction if the counterparty is subject to income tax obligation in Taiwan. If the arm’s-length adjustment results from an income tax assessment of a foreign tax jurisdiction under the tax treaty framework, the collection authority in charge shall also make a corresponding adjustment to the taxable income of the counterparty which is liable for the income tax obligation in Taiwan, if such adjustment is perceived as reasonable by the Taiwanese tax authorities.

Revised assessments and the appeals procedure
If a taxpayer refuses to accept the tax authority’s decision as final, the taxpayer may attempt to protect its interests by filing for administrative remedy and litigation.

Additional tax and penalties
If an enterprise is engaged in related party transactions, it must determine the transaction results in accordance with the transfer pricing assessment regulations and use the results as its basis to determine its taxable income.

Where a profit-seeking enterprise fails to comply with the regulations, thereby resulting in a reduction of tax liability in Taiwan, and the collection authority in charge has made adjustments and assessed the taxable income of the enterprise in accordance with the Income Tax Act and the transfer pricing assessment regulations, a fine may be imposed. Article 110 of the Income Tax Act stipulates that in addition to the tax liability assessed, a fine will be imposed at two to three times the tax amount underreported, depending on the circumstances, for any of the following:

• The declared price of a controlled transaction is no less than two times the arm’s-length price as assessed by the tax administration, or no more than 50% of the assessed arm’s-length price.
• The increase in taxable income of the controlled transaction as adjusted and assessed by the collection authority in charge is 10% or more of the annual taxable income of the enterprise, and 3% or more of the annual net business revenue.
• The profit-seeking enterprise fails to submit a transfer pricing report and is unable to provide other documents evidencing that the results of the transaction are at arm’s length.
• In other cases where evidence of tax shortfall discovered by the collection authority in charge leads to significant amount of tax omission or underreporting.

**Advance pricing agreements (APAs)**
The transfer pricing assessment regulations also provide rules for advance pricing agreements (APAs) and specify the following particulars:

- The criteria and time period for applying for an APA.
- Materials that must be provided in an application for an APA.
- Notification of significant changes in conditions and agreement termination.
- Period for audit and evaluation by the tax authority.
- Signing procedures and application period of an APA.
- Content of an APA.
- Submission of annual APA reports.
- Efficacy of an APA.
- Handling of changes in factors affecting prices or profits.
- Extension of an APA.

A profit-seeking enterprise may apply for an APA if it meets all of the following requirements:

- The total amount of the transactions being applied for under the advance pricing arrangement shall be no less than 1 billion New Taiwan dollars, or the annual amount of such transactions shall be no less than TWD 500 million.
- No significant tax evasions were committed in the past three years.
- Documentation required for an APA application, such as a business overview, relevant information of the related parties and controlled transactions, transfer pricing reports, etc. shall be provided within the prescribed time limit.

Taxpayers deemed qualified to apply for an APA should file an application before the end of the first fiscal year covered by the APA. The collection authority in charge shall notify the taxpayer in writing within one month whether the application is accepted. Once the application is accepted, the taxpayer should provide all required documents and report within one month from the date the notification is received, with a possibility to ask for an extension of the deadline for another month.

The collection authorities in charge shall review and reach a conclusion within a year. Under special circumstances, the evaluation period may be extended by six months, and if necessary, by an additional six months. There is no deadline for bilateral APA cases.

The collection authorities in charge will carry out discussions with the applicant in the six months following the date the conclusion is reached. An APA shall be signed between the collection authority in charge and the applicant upon an agreement being reached.
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reached between both parties. Once an agreement is signed, both sides are obligated to follow its terms.

During the applicable period of the APA, the applicant must submit an annual report on the execution of the APA to the tax authority during the annual tax filing period. The applicant also must retain evidential documentation and reports as required.

OECD issues
Although Taiwan is not a member of the Organisation for Economic Co-operation and Development (OECD), the MOF nonetheless consulted the OECD Transfer Pricing Guidelines and the legislation of other countries including US, UK and Japan, in drafting Taiwan's transfer pricing regulations.

Liaison with customs authorities
Although there is certain mechanism for exchange of information between the inland tax authority and the customs authority, since the method used to determine arm's-length transfer prices of imported goods for custom purpose may not necessarily follow that for income tax purpose, transfer pricing adjustments for income tax purpose do not bind the custom authority in calculating the import duties of those imported goods. Because the assessment period of custom duties is six months from importation, the custom authority generally would not allow any price adjustment after the said assessment period. For transfer price adjustments within the said assessment period, a recalculation of custom duty based on the said adjustment is possible in theory, but not often accepted by the custom authority in practice if it leads to a reduction of custom duties on the imported goods.

Thin capitalisation
Thin capitalisation rules were included in ITA on 26 January 2011 and took effect from 1 January 2011. The rules are designed to disallow the deduction of excessive related party interest expense pertaining to the portion of related-party debt that exceeds a certain prescribed debt-to-equity ratio.

A special assessment rule stipulates the scope of related parties, the determination of the debt and equity position, the safe harbour ratio and disclosure documentation requirement, promulgated on 22 June 2011 and applicable to the income tax returns for year 2011 onward. The prescribed debt-to-equity ratio is set at three-to-one for non-financial enterprises. Enterprises in the financial industries are currently not subject to thin capitalisation rules.

Special topics
Transfer pricing on permanent establishment
On 11 January 2007, the MOF issued a ruling which specifies application of transfer pricing assessment regulations when determining operating profit attributable to the permanent establishment (PE) of a foreign enterprise in Taiwan in accordance with a double taxation agreement (DTA).

If under a DTA between Taiwan and a foreign country, an enterprise of the other contracting state has a PE in Taiwan, the profit attributable to the PE is subject to income tax in Taiwan, and should be determined in the following manner:
The PE shall be deemed as carrying out business transactions with the enterprise of the other contracting state in a capacity of a completely independent enterprise, under same or similar conditions for the same or similar activities. The income attributable to the PE shall be determined in accordance with transfer pricing assessment regulations. Sufficient documentation proving that the attribution of income to the PE is in compliance with transfer pricing rules must be ready for audit by a collection authority in charge. Where an enterprise of the other contracting state deducts for income tax purpose the expenses incurred for carrying out the business of the PE, it should apply the Taiwan Income Tax Law, profit-seeking enterprise income tax assessment regulations, transfer pricing assessment regulations and other relevant rules.

If the enterprise of the other contracting state attributes all income from sale of goods or provision of services in Taiwan to its PE, it is not subject to transfer pricing documentation requirements.

**Management service fees**

Management service fees charged to Taiwan entities have come under scrutiny by the tax authorities. The tax authorities have challenged (1) the necessity of management services and (2) that the Taiwan entity realised actual benefits. The burden of proof has been heavily placed on the taxpayer to persuade the tax authorities that management expenses are necessary. There is no specific outline of acceptable evidence, but detailed records of all expenses charged should be kept in the event the tax authorities challenge management charges.