Taiwan’s draft amendment to TP rules places emphasis on actual risks assumed and intangible assets

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In brief
Taiwan Ministry of Finance (MOF) released on August 18 a draft amendment to the Rules Governing Assessment of Profit-Seeking Enterprise Income Tax on Non-Arm's Length Transfer Pricing (TP Assessment Rules). Once the notice period is over, the amendment will be effective from January 1, 2020.

The amendment is drafted based on BEPS Action Plans 8-10's Final Report: Aligning Transfer Pricing Outcomes with Value Creation, and on the 2017 amendment on Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. The focus of this amendment includes the disclosure of a step-by-step risk analysis, the alignment of functional analysis of intangible assets with profit attribution, and the application of a lower threshold penalty for a failure to disclose.

In detail
Risk analysis
The MOF takes the view that risk analyses conducted by enterprises and tax authorities place heavy reliance on contractual agreements and documentations to determine the outcomes of risks assumed by associated enterprises and thus actual behaviors of assuming risks are overlooked. The new amendment delineates steps required for conducting risk analysis and the method for determining the risks assumed.

Under the amendment, the risk analysis should be performed in accordance with the prescribed steps and be included in the transfer pricing report:

1. **Steps to risk analysis**: Emphasis on the actual conduct of the parties and their capacity to assume and manage risks.

2. **Determination of the risks assumed and managed**: Determining the risks assumed requires considering whether the associated enterprise bears the upside or downside consequences of risk and possesses the financial capacity to undertake such risks. In terms of risk management functions, the associated enterprise’s ability to control and mitigate risk is to be evaluated. If there is discrepancy between the risks contractually assumed by the associated enterprise and the conclusion reached based on its ability to control and mitigate risks, the risk should be reallocated to an associated enterprise that exercises control and has the financial capacity to assume the risk. The profit then shall be reallocated to the associated enterprise that assumes such risk.
Steps to Risk Analysis

- Establish Steps to Risk Analysis
  1. Identify economically significant risks.
  2. Determine the significant risks contractually assumed by the associated enterprises.
  3. Determine how the associated enterprise in the transaction operates in relation to assumption and management of the risks, and which of the associated enterprises has the functions of assuming and controlling risks.
  4. Determine whether the contractual assumption of risk is consistent with the conduct of the associated enterprises (via analysis of whether the associated enterprises adhere to the contractual terms and have the financial capacity to assume the risk).
  5. Reallocate risks based on the actual transaction accurately delineated, and give reasonable renumeration to associated enterprises assuming the risks.

Determination of Risk Assumption

- Functions of Risk Assumption:
  1. Bear the consequences of risk outcomes (upside or downside)
  2. Have the financial capacity to take on or lay off the risk, pay for the risk mitigation functions, and bear the consequences of the risk if the risk materializes.

- Functions of Risk Management
  1. Exercise control over risks, including the capability of making decisions to take on, lay off, or decline risk-bearing opportunities, the capability to make decisions on whether and how to respond to the risks, and the performance of that decision-making function.
  2. Ability to mitigate risk, including the ability to apply measures expected to affect risk outcomes and to reduce the uncertainty, or measures that reduce the consequence if the downside impact of risk occurs.

- If an associated enterprise provides funding but does not in fact control the associated financial risks, it will be only entitled to a risk-free return.
- Pricing should be reapplied taking into account if risk allocation and associated enterprises are compensated appropriately based on the levels of risk management.

Observations

With the view that the actual risks assumed in a transaction may be overlooked in current audit practices and the tendency of risks is easily movable, the draft amendment emphasizes that the risks assumed by a related party cannot be determined merely based on contractual agreements or documentation. Rather, the party’s actual conduct and its capacity to assume and manage the risks also should be examined.

Tax authorities are to conduct audits using this approach after the amendment takes effect. Therefore, it is recommended that companies re-evaluate which related party can control and mitigate risks based on the actual conduct of the parties in order to be consistent with the contractual agreements. If there is any discrepancy, companies should examine the decision-making party with the capacity to control and manage risks and make changes or adjustments to its decision-making function if necessary. In addition, companies should evaluate the financial capacity of each related party and reallocate risks and re-price controlled transactions accordingly.

Intangible assets

The draft amendment provides a clearer delineation of the definition of intangibles, intangibles-related functions, and risks, as well as an analysis involving the use of intangibles. Moreover, the draft amendment adds the Income-Based Approach as one of the Transfer Pricing Methods.

Intangible assets can be defined by their capability of being owned and controlled for use in commercial activities. The use or transfer of an intangible asset would be compensated had it occurred in a transaction between independent parties. The amendment dictates that the renumeration for use of intangibles should be in accordance with the analysis conducted in respect to the assets used, functions performed, and risks assumed in connection with the development, enhancement, maintenance, protection, and exploitation (DEMPE) of intangibles.

The analysis is to conducted according to the risk analysis steps mentioned in the earlier section, with its analysis process and conclusion disclosed in the transfer pricing report. Moreover, the Income-Based Approach, stipulated in the No. 7 valuation standards published by Taiwan’s Accounting Research and Development Foundation, has been added to the
existing list of Transfer Pricing Methods for Intangible Transactions: Comparable Uncontrolled Transaction Method (CUP), Comparable Profit Method (CPM), and Profit Split Method (PSM).

**Observations**

- The draft amendment yields a clearer definition of intangibles. However, this means that some intangibles may not fall under the TP Assessment Rules’ prescribed scope of intangibles under the following circumstances: intangibles not owned, controlled, or used by the companies in their commercial activities, or intangibles not remunerated under comparable uncontrolled circumstances (e.g., market characteristics that are not controlled or owned by the companies). Such transactions will not be viewed as controlled intangible transactions, but rather a factor to be considered in comparability analysis. This therefore may become a challenge if the country of the opposing related party in the transaction takes a different perspective.

- The purpose of DEMPE analysis is to determine the contribution of all related parties in a company. The benefits derived from the intangibles (e.g., royalty benefits derived from products or services, or other forms of benefits) should be allocated based on the actual contributions made by the related parties. It should not be solely determined based on the legal ownership or contractual agreements.
  
  - Multinational enterprises should examine which member is responsible for making DEMPE-related major decisions (including decisions over significant risks), whether the actual conduct is in line with contractual agreements, and whether the profit is allocated based on contribution. Changes and adjustments should be made to lessen any potential disputes in the future.
  
  - Companies should first compile and analyze the expenses borne by their related parties for their
contribution toward the intangible and determine if any adjustments need to be made. If projection of future benefits is available, a Cost- Contribution Agreement can be considered to reduce overall tax levied.

- In response to Taiwan’s controlled foreign corporation (CFC) rules reportedly expected to take effect in 2022 and the amendment on TP assessment rules, IP holding companies need to examine whether decisions are made by capable personnel and where the decisions are made, and make any necessary adjustments.

- The introduction of the Income-Based Approach as a Transfer Pricing Method is welcome. However, a comparability analysis still is required under that approach. Because the information utilized by the Income-Based Approach differs from that of the other existing TP methods, the proof of comparability also will differ from that of other TP methods.

- The amendment requires that the comparability analysis should be done based on actual economic circumstances and the allocation of the economic benefits. Inconsistency between the economic circumstances and the actual conduct in intangible transactions may cause the comparability analysis to distort the results of profit allocation (e.g., a related party performing contract R&D service makes significant DEMPE-related decisions. However, contract R&D service is used in comparability analysis).

Addition of penalty threshold
In consideration of some taxpayers’ failure to fulfill the obligation of disclosing related-party transactions as required, the draft amendment adds a lower penalty threshold to be applied to those who do not comply with the disclosure requirements. Companies not disclosing their related-party transaction in the transfer pricing disclosure form attached to the income tax return or transfer pricing documentation, and whose income adjusted by the tax authorities reaches 5% of assessed annual income and 1.5% of assessed annual net operating revenue, will be deemed as have an under-declaration or omission of their taxable income. As such, a fine of no more than twice the amount of the tax shortage shall be applied in accordance with Article 110 of Taiwan’s Income Tax Act.

**Observation**

It is common that companies may fail to receive appropriate consideration in a related-party transaction, e.g., not receiving a service fee for the support performed by its expatriated employees, a royalty for the use of intellectual property by a related party, etc. If the transactions are not disclosed in the transfer pricing documentation or income tax return, the taxpayer may be subject to the lower of the penalty thresholds.

**The takeaway**

The draft amendment gives more guidelines on both risk and intangible analyses so that tax authorities and taxpayers have a better opportunity of finding common ground on transfer pricing matters. At the same time, it is reasonably anticipated that tax authorities will pay more attention to both analyses. Taxpayers should review their contracts and documentation to determine whether they are in line with actual conduct before the amendment becomes effective. Also, taxpayers should check whether all controlled transactions are disclosed in TP disclosure forms or TP documentation.
Let’s talk

For a deeper discussion of how this issue might affect your business, please contact:

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