

Thin Capitalization Rule

Understanding Taiwan Tax Regulations

Excess interest shall not be considered as an expense or loss if the proportion of related party debt to equity of a profit-seeking enterprise exceeds a specified ratio.

Taiwan Thin Capitalization Rule

Article 43-2 of the Taiwan Income Tax Act states:

"Beginning from the year 2011, excess interest shall not be considered as expense or loss if the proportion of related party debt to owner's equity of a profit-seeking enterprise exceeds a specified ratio."

The Taiwan Ministry of Finance has set the specified ratio of debt to equity ratio to be 3 to 1. Please note that this regulation does not stop businesses from granting excess loans to Taiwan Companies, but the interest on excess loans shall not be tax deductible for tax purposes.

Article 4 of Regulations Governing Assessment of Interest Expenditure on the Debts Owed by a Profit-seeking Enterprise to a Related Party in Accordance with the Condition that the Related Payments Shall Not be Considered as Expenses or Losses defines Owner's Equity as follows:

"The term "Owner's Equity" mentioned in the Regulations for a profit-seeking enterprise having its head office within the territory of the ROC means the net amount of owner's equity in its balance sheet. However, if the net amount of the

owner's equity in its balance sheet is less than the sum of the paid-in capital and the capital reserve derived from the issuance of new shares at a premium in accordance with Subparagraph 4 of Article 30 of the "Guidelines for Examination of Profit-Seeking Enterprise Income Tax," the owner's equity shall be equal to the sum of the paid-in capital and such capital reserve. The owner's equity mentioned in the Regulations for a profit-seeking enterprise having its head office outside the territory of the ROC with a branch office within the territory of the ROC means the actual paid-in working capital on which no interest is bound to be paid."

Example

Company A borrowed TWD 400 million from a related party. Company A's equity is TWD 100 million. This means the debt to equity ratio is 4:1 which exceeds the thin capitalization rule. Assuming interest expenses for the year are TWD 20 million, interest on excess loans can be computed as follows:

Interest expenses for related party loans $\times (1 - \text{standard debt to equity ratio} / \text{actual debt equity ratio}) = \text{non-tax deductible loan amount}$.

20 million * (1-3/4) = 5 million.

For the example quoted above, a TWD 5 million interest expense would not be tax deductible.

Safe Harbor Rule

In order to reduce the cost of compliance for taxpayers and also reduce the cost of tax collection, the Taiwan tax office announced a safe harbor rule as per below.

Companies able to meet any one of the following criteria can be exempted from the thin capitalization rule.

- Total annual sales together with none-operating income is less than or equal to TWD 30 million.
- Interest expenses for related party debt and interest expenses for none-related party debt both fall under TWD 4 million per annum.
- Taxable income, excluding interest expenses, is less than zero for the year.

Grant Thornton Taiwan's tax team can help companies stay compliant with related regulations as well as capitalize on planning opportunities to reduce tax burdens. If you have

any questions regarding the thin capitalization rule, please do not hesitate to contact us.

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