

APPENDIX

A GENERAL DESCRIPTION OF THE IMPUTATION SYSTEM IN THE ROC

I. Introduction

The income tax system of the ROC consists of a profit-seeking enterprise income tax and an individual income tax. Profit-seeking enterprise income tax is imposed on the profits of profit-seeking enterprises, including corporations, partnerships, proprietorships, and other organizations such as co-operatives, foundations, or societies. The individual income tax is imposed on the consolidated income, including dividends, of an individual.

Before the 1997 tax reform, business profits were first taxed at the corporate level at a rate of 25%, and the distributed after-tax profits, which were received as the dividend income of an individual, were subject to individual income tax according to the individual shareholder's tax rate, ranging from 6% to 40%. The combined tax rate on distributed profits could be as high as 55%.

As a result, enterprises would tend to retain earnings to avoid being taxed twice and prefer debt rather than equity financing to reduce their income tax burden. The distortion caused by inadequate financing could have an adverse effect on the financial soundness of a corporation and also hamper the development of the stock market.

To improve the efficiency and fairness of the income tax system, the MOF modified the relevant tax law and regulations. The revision received legislative approval and came into effect on 1st January, 1998.

The most substantial modification contains an integration system for dividend taxation which allows shareholders a credit for profit-seeking enterprise income tax against the individual income tax liability on the dividends they receive. The system is based on the following principles:

- A. The income shall be taxed once rather than being taxed twice or not being taxed at all.
- B. The imputation credit is not extended to non-resident shareholders.
- C. The tax incentives extended to a corporation will not be passed on to its shareholders, and which amount will only be taxed as individual income tax.
- D. The amount of the imputation credit is calculated only on business income tax paid within the ROC.

In addition, a 10% profit-seeking enterprise income surtax is charged on undistributed earnings in order to curb tax deferment by the retention of earnings.

Generally speaking, the modification takes into consideration both the fairness and efficiency of the taxation. It will reduce the tax burden of taxpayers on investment income, from a maximum of 55% to a maximum of 40%, which is the highest marginal individual income tax rate. It is also expected to improve the overall economic environment by providing a lower tax burden with fewer obstacles and to promote the competitive ability of the economy.

II. Major Amendments Regarding the Imputation System

An essential feature of the imputation scheme is a mechanism for ensuring that the imputation credits are granted correctly, and only for the profit-seeking enterprise income tax paid in the ROC, not including any foreign tax paid. Only resident shareholders are eligible for the imputation credit. An account-based approach is adopted as a means of limiting credits to the amount of profit-seeking enterprise income tax paid within the ROC. Under this approach, companies should keep an “imputation credit account” to keep track of the tax paid and the imputation credit that they have allocated to shareholders. The credits will be allocated in a uniformly pro-rated way so that they will not be exhausted right away.

A. For Corporations

Corporations shall set up an imputation credit account, and record the amount of profit-seeking enterprise income tax paid in the ROC. When the earnings are distributed, the company shall calculate the imputation credit available to its shareholders. The withholding tax on dividends is no longer required on the dividends paid to resident shareholders.

The credit available to shareholders is calculated by multiplying the net dividend received by a creditable ratio, which is the maximum credit available for companies to allocate to shareholders. The creditable ratio shall be calculated as follows:

$$\text{Creditable Ratio} = \frac{\text{Balance of Imputation Credit}}{\text{Accumulated Retained Earnings since 1998}}$$

The balance of the imputation account in turn is determined by the amount of profit-seeking enterprise income tax paid by the company, plus the amount of credit passed on from dividends received from reinvestments, plus the surtax paid on undistributed earnings, minus credits which have been allocated to shareholders and other designated items. However, such ratio should be subject to the ceilings arising from the specific formula. Because of the reduction in the tax rate of the profit-seeking enterprise since 2010, the ceilings are revised as follows:

1. 33.33% if the accumulated retained earnings before 2009 have been not subject to 10% surtax. And 20.48% if the accumulated retained earnings after 2010 have been not subject to 10% surtax.

2. 48.15% if all the accumulated retained earnings before 2009 have been subject to 10% surtax. And 33.87% if all the accumulated retained earnings after 2010 have been subject to 10% surtax.
3. For an aggregate amount of undistributed earnings that have been partially subject to 10% surtax and have been partially not subject to 10% surtax: the sum of the creditable ratio to be calculated respectively based on the applicable tax creditable ratios specified in the preceding two items in respect of the different proportions of the aforesaid two parts of undistributed earnings to the aggregate amount of the undistributed earnings.

In this way, the ratio may vary from company to company according to a company's tax liability.

Corporations shall issue a dividend voucher to their shareholders stating the amount of the net dividend paid and the credit imputed thereon before or on 10th February following the year the distribution is made. In the case that three national holidays occur in immediate succession in January, the period of the issuance of dividend vouchers shall be extended to 15th February.

B. For Shareholders

Upon receiving dividends, shareholders will be notified by the company of the imputation credit to which they are entitled. They should include in their assessable income every year the grossed-up dividend income (gross dividend), according to the dividend voucher, which consists of net dividend received and any imputed credit thereon. An individual shareholder's income tax liability for the same year may be offset by the imputation credit received. The imputation credit received by a corporation shareholder shall not be credited against its profit-seeking enterprise income tax liability, and shall be passed on to its shareholders. A cash refund is available to individuals for any excess of the imputation credit, but not for corporation shareholders. There are no longer any withholding taxes on dividends paid to resident shareholders; dividends paid to non-residents, however, are still subject to withholding.

In addition, after the modification, dividends received after 1st January, 1999 will no longer be included in the special deduction for savings and investment, which had granted an exemption on interest and dividend income up to NT\$270,000.

III. Calculation of Corporate Income Surtax on Undistributed Earnings

Due to the discrepancy between the highest marginal profit-seeking enterprise income tax rate and the highest marginal individual income tax rate, an additional 10% profit-seeking enterprise income surtax will be payable on undistributed earnings, consisting of after-tax income retained by a company rather than being distributed as dividends to shareholders in the then current year. After the surtax is paid, the amount of earnings may be accumulated without any limitation. Credit will also be given for the surtax if the after-surtax retained earnings are distributed later on.

Beginning from 1998, the after-tax earnings derived by a company shall incur a 10% surtax if not distributed in the then current year. For example, the profits earned in Year 1 shall be filed in Year 2, and the distribution shall be made in Year 2. If the profits are not distributed by the end of Year 2, the corporation shall calculate the additional tax payable, file the undistributed earnings amount in Year 3 along with the profits earned in Year 2, and make the payment before the deadline.

The undistributed earnings were calculated by adding certain items back into the assessed taxable income before 2005. However, beginning from the year 2005, undistributed earnings have been calculated on the basis of the amount of income after tax as calculated by a profit-seeking enterprise in accordance with the Commercial Accounting Act, less the sums of the following items:

- A. Make-up of the losses in previous years and the next-year-loss which has been duly audited and certified by a certified public accountant;
- B. Net dividends or net earnings which have been distributed from the earnings gained in the current year;
- C. Legally-earned surplus reserve having been set aside from the surplus earnings of the current year in accordance with the Company Act or other acts, the legal reserve and the public interest reserve having been set aside in accordance with the Co-Operative Act;
- D. Sinking fund reserve or restricted distributable surplus earnings which were required to be set aside or restricted from distribution under any treaty signed by the nation with another country, or under any agreement signed in accordance with the economic assistance or loan agreement signed by the nation with any international organization;
- E. Bonus or remuneration paid to directors, governors and employees from surplus earnings in accordance with the provisions of the articles of incorporation of the company or co-operative;
- F. Special reserve or restricted distributable surplus earnings which were required to be set aside or restricted from distribution of the surplus earnings of the current year pursuant to the order given by the competent authority in accordance with the provisions of other laws;
- G. Capital reserve which was required to be transformed from income after tax pursuant to the provisions of other laws; and
- H. Other accounts as approved by the MOF.

The amount of the accounts specified in the preceding Items 2 to 7 shall be limited to those actually occurring prior to the end of the fiscal year following the year in which the respective incomes are taxable.

In the case where the financial statements in the current year of a profit-seeking enterprise were duly audited and certified by a certified public accountant, the amount of income after tax shall be based on the amount which was assessed by such certified public

accountant. However, if thereafter the collection authority-in-charge conducts an assessment of such financial statements and makes an adjustment to the amount of income after tax, the original amount shall be replaced by the amount after such adjustment of which the authority-in-charge has informed the enterprise.

If the reasons why distributable surplus earnings were restricted from distribution pursuant to the preceding Items 4 and 6 are no longer pertaining, the part of which the distributable surplus earnings therefrom have been undistributed prior to the end of the fiscal year following the year when the reasons no longer pertain shall be added to the surplus earnings of the year when the reasons no longer pertain and be subject to a levy of 10% surtax.

IV. Taxation of Non-Resident Shareholders

The introduction of the imputation system did not substantially affect the tax liability of non-resident shareholders. Dividends paid to non-resident shareholders are subject to a withholding tax at the same rates as before; the tax incentives which were enjoyed by foreign investors also remain the same as before. The imputation credit is not given to non-resident shareholders whose withholding taxes are final. However, the 10% surtax paid at the corporate level is allowed to offset the withholding tax on the dividends distributed to non-residents. If a foreigner stays in the ROC for no less than 183 days in a taxable year, and has become a resident for income tax purposes, he or she may also be entitled to the imputation credit.

A “non-resident” is defined as a non-resident individual or a profit-seeking enterprise having not its head office within the territory of the ROC.

The creditable amount on the 10% surtax paid shall be calculated as follows:

Balance amount of the 10% surcharge of profit-seeking income tax which was actually paid under the provisions of undistributed earnings each year on the dividends or surplus earnings distribution date \times [(Distributed amount of net dividends or net surplus earnings subject to a 10% surcharge of profit-seeking income tax) \div (Balance amount in the accumulative undistributed earnings of which 10% of profit-seeking enterprise income tax was already levied on the dividends or surplus earnings distribution date)] \times Shareholding ratio of non-resident shareholders on the dividends or surplus earnings distribution date

Ceiling on the creditable amount = Distributed amount of net dividends or net surplus earnings subject to a 10% surcharge of profit-seeking income tax received by non-resident shareholders \times 10%

V. Comparison of the Differences in Account-Keeping

After the implementation of the imputation system, the account-keeping and the tax-related documentation requirements are slightly different than before. Though additional work is required to calculate the creditable tax and the chargeable surtax, some procedures are simplified while others remain the same.

Simplified Item

| Item | Explanation |
|---|---|
| Withholding Obligations of Corporations | Upon distribution, only the dividend paid to non-residents shall be withheld. There is no withholding tax on dividends paid to resident shareholders. |

Identical Items

| Item | Explanation |
|--|--|
| Account-Keeping Procedures of Corporations | Remains unchanged. |
| Filing of Dividend Vouchers | Remains unchanged. |
| Filing of Individual Income Tax | Filing of the dividend amount according to the dividend voucher. |

Additional Work

| Item | Explanation |
|--|---|
| Setting Up of an Imputation Credit Account and Keeping of Correct Records | The imputation credit account shall be kept as a memorandum, which is unrelated to a company's financial accounting, so that the imputable tax credit can be correctly determined based on the account. |
| Calculation of the Credit Imputed on Dividends Distributed to Shareholders | A corporation should calculate the exact amount of the imputed credit for each of its shareholders. |
| Calculation and Filing of the 10% Surtax on Undistributed Earnings | For every year that earnings are not totally distributed before the due date, the company shall file a return stating the amount and the additional tax payable. |

VI. Summary

The main features of the imputation scheme may be summarized as follows:

- A. Taxable income derived by a profit-seeking enterprise is taxed at the profit-seeking enterprise income tax rate, and undistributed income, as calculated by a profit-seeking enterprise in accordance with the Commercial Accounting Act less the sums of the prescribed items, is subject to an additional 10% surtax.
- B. Credits will be given only for profit-seeking enterprise income tax paid in the ROC and to resident individual shareholders. However, the 10% surtax paid at the corporate level is allowed to offset the withholding tax on the dividends distributed to non-residents.
- C. Cash refunds for excess credits will be given to resident individual shareholders.
- D. An account-based approach will be adopted as a means of limiting credits to the amount of profit-seeking enterprise income tax paid in the ROC. It is designated that companies keep

an imputation credit account and calculate the imputation credits which are allocated to shareholders.

- E. Credits will be pro-rated uniformly across dividends paid on all classes of shares in any year.
- F. Dividends and imputed tax credits, received from a resident company, are exempt from profit-seeking enterprise tax. However, credits imputed thereon are not refundable and are to be passed on to the shareholders in the company.
- G. Only resident companies will be able to pay dividends with credits.

VII. Recent Development

In order to achieve the goals of fiscal sustainability and fairness in taxation, the MOF following the trend in international tax reform, further adjusted the taxation on dividends received by resident individual shareholders from full imputation to partial imputation, so that, in the case that when the profit-seeking enterprise makes a distribution, the dividend tax credit of the individual resident shareholders shall be half of the amount of the profit-seeking enterprise income tax (including the 10% surtax) paid by the profit-seeking enterprise.

As a part of the aforesaid tax reform, a profit-seeking enterprise (excluding small-scale) organized as a sole proprietorship or a partnership shall calculate and pay half of the amount of income tax payable. The after-tax profit shall be included in the partners' or the sole proprietors' individual consolidate income.

The aforesaid amendments to the Income Tax Act were promulgated on 4th June, 2014. The above measures will take effect from 2015.