

# Taipei: Ministry of Finance Issued Letter Ruling on the Application of CFC Taxation to Trusts

12 January 2024

## In brief

The Ministry of Finance ("MOF") issued a Letter Ruling (No. 11204665340) on 4 January 2024 ("Ruling"), clarifying the current "Regulations Governing Application of Income Calculation from Controlled Foreign Company for Individual" regarding the calculation of shareholding percentages in offshore trust structures. Henceforth, subject to further clarification from the MOF, the shares or capital held through an offshore trust by the settlor may no longer be excluded from the calculation of direct shareholding percentages.

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## Background

On 22 December 2023, the MOF released a new amendment to the Regulations Governing Application of Income Calculation from Controlled Foreign Company for Individual ("**Regulations**"), followed in a few days by the issuance of the Ruling. The Ruling clarifies the application of the Controlled Foreign Company ("**CFC**") system for trust properties consisting of shares or capital in low-tax burden countries or regions, addressing taxation issues of offshore trust structures under the current regulations.

## Key Changes

### 1. Prior to the Ruling:

Before the issuance of the Ruling, the calculation of CFC income would only apply to 10% or more shares of CFC held directly or constructively by a taxpayer, and the constructive ownership would only apply to shares that are held by the spouse or relatives within the second degree of kinship of the taxpayer (Article 2, Paragraph 2 of the Regulations). On the other hand, the shares or capital held through an offshore trust appear to be excluded from the calculation of "directly own 10% or more of the shares or capital" ("direct shareholding percentage").

### 2. After the Ruling:

The Ruling significantly expands the definition of "10% direct ownership" to include instances where the CFC is held through a trust. The actual calculation would look to the settlor or the beneficiaries depend on whether the trust is for the benefit of the settlor or others, as follows:

#### a. Tayi Trusts (non-self-benefit trust):

- i. [beneficiary's direct shareholding percentage of the company] = [Shareholding percentage of the company within the trust] x [beneficiary's proportion of the benefits of the trust]
- ii. If the proportion of benefits is unclear or indeterminable, it should be calculated evenly among the beneficiaries.
- iii. If the beneficiary and their related parties directly or indirectly hold a total of 50% or more of the shares or have control over the company, the company put into the trust by the trustee is considered the beneficiary's CFC, and income should be calculated based on this direct shareholding percentage.

b. Ziyi Trust (self-benefit trust)

If it is a Ziyi trust, the settlor is the beneficiary, and the above provisions apply similarly.

3. The trust shareholding of the settlor is not counted in the direct shareholding percentage of the trustee.

4. Examples:

- a. If Mr. A (a Taiwan tax resident) holds 100% of Company Y (a CFC) and establishes an offshore trust, placing all shares of Company Y into Trust X as the trust property, Trust X holds Company Z, which in turn holds all shares of Company Y. Would Mr. A become a direct shareholder of more than 10% in Company Y and therefore be required to report Company Y as a CFC and pay taxes.

Ans:

Yes. Before the issuance of the Letter, the direct shareholder of Company Y's shares was Trust X and its subsidiary, Company Z, not the settlor Mr. A, so he was not required to report Company Y as a CFC provided that the trustee is a licensed and professional trustee.

However, according to the Letter, if Trust X is for the benefit of the settlor (which is a Ziyi trust) and Mr. A is the beneficiary, the calculation of Mr. A's direct shareholding percentage of Company Y is [Shareholding percentage of Company Y within the trust (100%)] x [his proportion of the trust benefit (100% if Mr. A is the only beneficiary)] = 100%. Therefore, Mr. A is the sole shareholder of Company Y. Company Y is regarded as his CFC. Mr. A needs to report 100% of Company Y income and pay income taxes.

- b. Assumed that Trust X has beneficiaries Mr. B and Mr. C, if benefit proportions of Mr. B and Mr. C are undetermined, according to the Letter, is Mr. A's direct shareholding percentage in Company Y the same as in the previous question, 100%?

Ans: No.

If the trust has beneficiaries other than the settlor, and the benefit proportion is undetermined, the proportions should be calculated evenly. Therefore, the direct shareholding percentages of Mr. B and Mr. C are [Shareholding percentage of Company Y within the trust (100%)] x [Beneficiary's proportion of the trust benefit (100%/2=50%)] = 50%, exceeding 10%. Hence, Company Y is the CFC of Mr. B and Mr. C. They need to report Company Y as their CFC and pay income taxes on 50% of the CFC income respectively.

5. Relation to the amendment of the Regulations:

- a. An amendment to Article 3, Paragraph 2, Item 5 of the Regulations: "The term 'affiliated enterprises' shall refer to where there are any of the following situations between an individual and a domestic or foreign profit-seeking enterprise: The person and the profit-seeking enterprise are part of the same trust relationship as the settlor, trustee, or beneficiary, and the trust property of that relationship consists of shares or capital in a low-tax burden country or jurisdiction. However, trustees authorized by their tax jurisdiction are considered non-affiliated enterprises." This excludes trustees authorized by their tax jurisdictions from being considered affiliated enterprises, meaning shares or capital held by regular trust businesses are not included in the calculation of the 50% threshold for a CFC as per Article 2, Paragraph 1.
- b. However, the operational result of the Ruling makes no distinction in the application of the aforementioned amendment to Article 3, Paragraph 2, Item 5 of the Regulations. Regardless of whether the trustee of an offshore trust is an authorized business, the direct shareholding of the settlor or beneficiary must be calculated according to the Ruling, which would include the trustee's shareholding in the calculation.
- c. In summary, due to the proximity of the release dates of Article 3, Paragraph 2, Item 5 of the Regulations and the Ruling, it is unclear why the contents of the Ruling were not clarified within the Regulations and instead addressed separately in an administrative interpretation letter. The impact of the Ruling on the legal system is significant, and whether the Ruling will face challenges based on the principle of legal reservation or further clarifications may be made remains to be observed.

6. Our Observations:

- a. The Ruling explicitly mentions "the settlor makes the trust property consist of shares or capital of affiliated enterprises in a low-tax burden country or jurisdiction." If the trust property is "not" shares or capital in an affiliated enterprise in a low-tax burden country or jurisdiction, it appears to be outside the scope of the Ruling.

- b. The Ruling states that "For indeterminate beneficiaries [e.g., the trust deed does not specify particular beneficiaries, nor does it define the scope and conditions of beneficiaries; or the settlor retains the right to change (appoint) beneficiaries or distribute/dispose of trust benefits], the indeterminate part should consider the settlor as the beneficiary." However, the Ruling does not explain how to report the settlor as the beneficiary if the settlor has subsequently passed away, or whether it implies that if subsequent beneficiaries of the trust do not meet the conditions of the first point of the Ruling (i.e., "beneficiaries are determined and specific"), even if the settlor's heirs are Taiwan tax residents or the trust is controlled by Taiwan tax residents, they are not required to report and pay (income) tax.
- c. There seems to be much room for further analysis on how the Ruling and the Regulations can be consistently interpreted. We recommend that each inheritance structure should be thoroughly discussed with professional consultants.

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## Suggestion

- 1. For those who have already established trust structures, please re-evaluate the related tax compliance risks.
- 2. For ongoing trust structures, analyze the impact of changes in relevant regulations.
- 3. As we have consistently emphasized, any inheritance structure should prioritize legal considerations and should not be primarily driven by tax planning.
- 4. If there are any doubts, please discuss with a lawyer first to avoid misunderstandings of the regulations.

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