

EY Family Office Succession Forward-looking insights

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Breaking news:

Taiwan Ministry of Finance issued a tax decree concerning CFC tax implications for trusts – An offshore trust structure is no longer a safe harbor for CFC

Offshore trusts have consistently served as a key succession tool for high-net-worth (HNW) families in the planning of family businesses or wealth succession. With the implementation of Taiwan's Controlled Foreign Company (CFC) regulations set for 2023, the potential impact of the CFC regulations on offshore trusts has remained a focal point of public discussion. In fact, under the pre-amendment CFC regulations, if an individual transfers their shares or capital of an affiliated enterprise (hereinafter referred to as "Trust Shareholding") registered in a low-tax burden country or jurisdiction (hereinafter referred to as the "Low-tax Burden Region") to a trustee through an offshore trust structure, the Trust Shareholding may still be considered a CFC of the individual. However, there are still many uncertainties regarding how taxpayers will be taxed for offshore trust structures under the CFC regulations, and whether it will have any impact on the trustee and beneficiary of the trust.

In response to public inquiries and suggestions, the Ministry of Finance (MOF) announced amendments to the "Regulations Governing Application of Income Calculation from Controlled Foreign Company for Individual" (hereinafter referred to as "CFC Regulations for Individual") on 22 December 2023, and issued Tax Decree No.11204665340 on 4 January 2024 (hereinafter referred to as the "CFC Tax Decree on Trust"), further clarifying the tax implications of Trust Shareholding under the CFC regimes.

This article summarizes the key points of the latest amendment to CFC regulations and further analyzes the applicable rules, reporting obligations, and tax liabilities for individual CFC compliance within offshore trust structures, providing taxpayers with insights in preparing for upcoming tax event.

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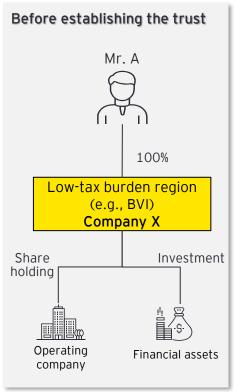


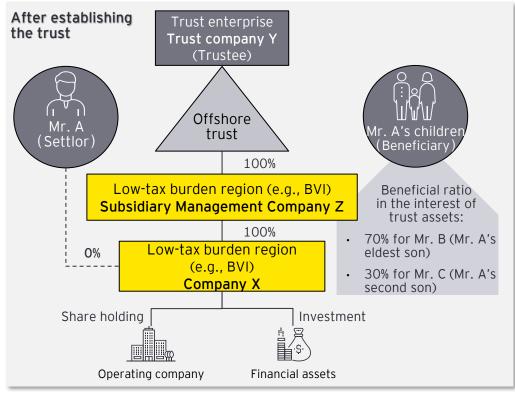
Common arrangements of offshore trust structures

With comprehensive advantages in asset protection, anti-forced heirship, and the ability to assist family businesses for perpetual control in shareholding, an "Offshore Trust" is inevitably an important consideration for HNW individuals with cross-border assets and family businesses in planning for their family businesses and wealth succession. The components that form an offshore trust structure, in principle, includes the settlor, trustee, beneficiary, and trust deed, etc. Commonly seen trust types are as follows:

- Depending on whether the trust deed can be amended or terminated, such as:
 - "Revocable Trust" or "Irrevocable Trust"
- Depending on whether the trustee has the rights to decide the distribution of trust interest such as:
 - "Fixed Interest Trust" or "Discretionary Trust"
- Depending on whether the beneficiary is the same person as the settlor, such as:
 - "Self-benefit Trust" and "Other Interest Oriented Trust"

In an offshore trust structure, the trust enterprise (i.e., trustee) typically does not directly hold the trust property. Instead, an underlying management company of the trustee is established to hold the trust property settled by the settlor. A typical offshore trust structure is illustrated below.







Uncertainty over CFC taxation on offshore trust

As illustrated, Company X should be considered a CFC of Mr. A, given his 100% ownership in Company X before establishing the trust. However, through the establishment of a trust relationship and the subsequent transfer of all shareholding in Company X to the Underlying Management Company Z, held by Trust Company Y, Company X should no longer be treated as a CFC of Mr. A since he has no direct holding in Company X. Nevertheless, the pre-amendment of CFC Regulations for Individual explicitly states that the trustee and the beneficiary shall be considered as related parties to Mr. A. Consequently, when calculating Mr. A's CFC direct holding within a trust relationship, the shares held by Trust Company Y should also be taken into account. Despite the abovementioned, uncertainty still remains for the CFC tax implications, such as:



- Is Underlying Management Company Z held by Trust Company Y to be considered a CFC of Mr. A?
- If Company A is considered a CFC of Mr. A, how is the business income of an individual from the CFC calculated, especially when Mr. A does not have any direct holding in the CFC?
- Is there any tax exposure for the beneficiaries within the trust relationship?

Definition of the related parties under a trust relationship

According to the amended CFC Regulations for Individual, the term "related parties" under a trust relationship includes affiliated enterprises and related parties other than the affiliated enterprises, as described below.

- A profit-seeking enterprise that belongs to the same trust relationship with the individual acting as the settlor, trustee, or beneficiary, where the trust property is the shares or capital of an affiliated enterprise registered in a Low-tax Burden Region. However, if the trustee is an approved trust enterprise recognized by the competent authority within its tax jurisdiction, the trustee shall be regarded as a non-related party.
- The settlor, trustee or beneficiary who belongs to the same trust relationship with the individual, where the trust property is the shares or capital of an affiliated enterprise registered in a Low-tax Burden Region. Such settlor, trustee or beneficiary, their spouse and relatives within the second degree of kinship.

Analysis of the amended regulations

After the revision of the CFC Regulations for Individual, the trustee (trust enterprise) could possibly be excluded from the definition of related parties if the aforementioned requirement is met. Therefore, if Trust Company Y in the previous illustration is an approved trust enterprise recognized by the competent authority within its tax jurisdiction, it shall be excluded from being considered a related party of Mr. A. Consequently, the shares of Underlying Management Company Z held by Trust Company Y would not be considered as the shareholding of Mr. A or his children (Mr. B or Mr. C) under the trust structure. The Underlying Management Company Z should not be considered a CFC of Mr. A or his children.

It is important to note that in addition to the settlor, trustee, and beneficiary, the amended CFC Regulations for Individual also expand the scope of related parties to include their spouses and relatives within the second degree of kinship.





Analysis of CFC taxation of offshore trust

The purpose of the statute, as outlined in the recently issued CFC Tax Decree on Trust by the Taiwan MOF, essentially adopts the pass-through principle of trust taxation. This approach imposes tax liability on the substantial beneficiary who receives the economic interests of the trust property. In other words, attempting to avoid CFC regimes by transferring the shareholding of an affiliated enterprise registered in a Low-tax Burden Region to an offshore trust is not effective. Taxpayers should be mindful of the potential tax exposure.



Key summary of the CFC Tax Decree on Trust

- ► The settlor's Trust Shareholding is not included in the calculation of the trustee's direct holding ratio.
- ▶ The applicable taxpayer of CFC in a trust is determined based on the income beneficiary:
 - □ For trusts where the beneficiary of accrued income in the trust property (hereinafter referred to as "income beneficiary") is certain and specified:
 - If the "income beneficiary and its related parties" directly or indirectly hold 50% or more of the shares of an affiliated enterprise in a Low-tax Burden Region or have control over it, such an affiliated enterprise shall be considered a CFC of the income beneficiary.
 - □ For trust where the income beneficiary is undetermined (Note 1):
 - The settlor is regarded as the income beneficiary instead. Therefore, if the "settlor and its related parties" directly or indirectly hold 50% or more of the shares of an affiliated enterprise in a Low-tax Burden Region or have control over it, such an affiliated enterprise shall be considered a CFC of the settlor.
- ► The calculation method for the direct holding ratio in an affiliated enterprise registered in a Low-tax Burden Region is illustrated as follows:

The ratio of *Trust*Shareholding settled by settlor

The ratio of beneficial proportion of the income beneficiary (Note 2)

Ratio of shareholding directly held by income beneficiary

Direct holding ratio of Trust Shareholding

- ► The calculation method for individual CFC business income derived from Trust Shareholding is as follows:
 - The business income of an individual from a CFC shall be calculated based on the current-year earnings of the CFC, the previously mentioned direct holding ratio of Trust Shareholding, and the trust period of the current year.
- Note1: If the trust deed does not have a specified beneficiary, nor the scope and conditions of the beneficiary. Or, the settlor reserves the right to change (designate) the trust beneficiary or the right to make distributions or disposals to trust interest.
- **Note2**: The calculation shall be based on the explicitly provided ratio or the deductive proportion specified in the trust deed. If the ratio is unknown or cannot be deduced, it shall be calculated on an average basis among the income beneficiaries.
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Following the illustration of the previous offshore trust structure, when Mr. A established the offshore trust, he transferred 100% shareholding of Company A, an affiliated enterprise registered in a Low-tax Burden Region, to the trustee. According to the CFC Tax Decree on Trust issued by the MOF, the Trust Shareholding (shares of Company A) should not be considered in determining the direct holding ratio of the trustee.

In the scenario where the trust beneficiaries are Mr. A's sons, Mr. B and Mr. C, with beneficial proportions of 70% and 30%, respectively, it is essential to assess whether the income beneficiary of the trust is certain and specified to determine if the Trust Shareholding falls under the definition of a CFC. Depending on the terms and relevant directives of the trust deed, the types of the trust may vary (e.g., revocable trust, irrevocable trust, fixed-interest trust, discretionary trust, self-benefit trust, other interest oriented trust, etc.). Therefore, careful assessment and analysis are essential to determine and verify whether Trust Shareholding should be considered a CFC of the settlor or beneficiary.

Assuming that the beneficiaries (Mr. B and Mr. C) under Mr. A's trust are certain and specified, income beneficiaries (Mr. B and Mr. C) shall calculate their direct holding ratio of the Trust Shareholding based on the ratio of Trust Shareholding when Mr. A established the trust and the beneficial ratio of income beneficiaries (Mr. B and Mr. C) to the interest. Therefore, Mr. B and Mr. C's direct holding ratio of Trust Shareholding would be calculated at 70% and 30%, respectively. Further referring to the amended CFC Regulations for Individual, beneficiaries Mr. B and Mr. C are related within second degree of kinship and should be considered as related parties for each other. Therefore, even though the direct holding ratio of Mr. C with respect to the Trust Shareholding in Company A is below 50% (i.e., Mr. B held 30%), he is still required to combine the direct holding ratio of 70% from his related parties, Mr. B to his Trust Shareholding in Company A. As a result, Company A should be considered a CFC of Mr. C. as Mr. C and his related party, Mr. B, hold 100% Trust Shareholding in total in Company A.





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Regarding the latest amendments to the CFC Regulations for Individual and the CFC Tax Decree on Trust issued by the MOF, Michael Lin, Tax Partner, Ernst & Young, reminds that the types of the trust may vary based on the terms and relevant directives in the trust deed. This variability can lead to different reporting obligations and tax liabilities. Therefore, in addition to being mindful of CFC tax exposure, it is recommended that individuals reassess whether their existing offshore trust structure have other potential tax exposures (e.g., inheritance tax, gift tax, income tax).

After the implementation of the CFC regimes, individuals arranging their foreign company ownership through offshore trust structures can no longer enjoy the advantage of tax deferral in offshore income tax. It is recommended that individuals promptly seek the service of a professional tax consultant to review their existing offshore trust structures. A comprehensive tax health check on the current offshore trust structure, along with an examination of the terms and relevant directives in the trust deed, is required. Early assessment of possible tax exposure is crucial, and individuals should prepare to address these challenges.

Ernst & Young, Family Office

If you have any questions or need for further advice after reading the article, we sincerely welcome you to email us to describe your needs. Upon receiving your email, we will contact you as earliest as possible and schedule an appointment.

Ernst & Young Family Office looks forward to receiving your email!! familyoffice@tw.ey.com



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Appendix: Decree No. 11204665340 issued by the Ministry of Finance on January 4, 2024

For the interpretive rule that regulations governing application of accrued income from controlled foreign company are applicable to parties holding shares or capital of a foreign affiliated enterprise registered in a low-tax burden country or jurisdiction as the trust property.

The shares or capital of a foreign affiliated enterprise registered in a low-tax burden country or jurisdiction (hereinafter referred to as "affiliated enterprise in Low-tax Burden Region") that are settled as the trust properties (hereinafter referred to as "Trust Shareholding") by the settlor shall not be included in the direct holding ratio of the trustee. The taxation provisions applicable to the Trust Shareholding under Article 43-3 of the Income Tax Act and Article 12-1 of the Income Basic Tax Act (hereinafter referred to as "CFC Tax Provisions") for the settlor or the beneficiary of accrued income are as follows:

- 1. For trusts that the beneficiary of accrued income to trust property are certain and specified:
 - 1) Beneficiary of accrued income and their related parties directly or indirectly holding 50% or more of the shares or capital of an affiliated enterprise in a Low-tax Burden Region or having control to the affiliated enterprise, the affiliated enterprise in the Low-tax Burden Region is his/her controlled foreign company (hereinafter referred as to "CFC"). The direct holding ratio of the affiliated enterprise in a Low-tax Burden Region by the beneficiary of accrued income is calculated at the ratio of Trust Shareholding settled by settlor multiplied by the ratio of beneficial proportion of the income beneficiary. If the beneficiary of accrued income is also a beneficiary of accrued income from other trusts with the same affiliated enterprise in a low-tax region as trust asset, the direct holding ratios shall be combined. In addition, the shareholding that is directly held by the beneficiary of accrued income shall also be included.
 - 2) The term ratio of beneficial proportion described in the preceding subparagraph, according to Paragraph 2, Article 3-4 of the Income Tax Act, shall be determined by the ratio that is explicitly provided or the deductive proportions of the trust deed. If the ratio is unknown or cannot be deduced, it shall be calculated on an average basis among the beneficiaries of accrued income.
 - 3) In accordance with the CFC Tax Provisions, income tax is levied on the beneficiary of accrued income as an investment income or business income based on the current-year earnings of the CFC, the direct holding ratio of Trust Shareholding aforementioned subparagraph and the trust period of the current year if the affiliated enterprise in a Low-tax Burden Region is deemed as CFC of the beneficiary of accrued income.



Appendix: Decree No. 11204665340 issued by the Ministry of Finance on January 4, 2024

- 2. For trusts that the beneficiary of accrued income to trust property are undetermined¹, the settlor shall be deemed as the beneficiary of accrued income for the undetermined proportion of accrued income that is derived from Trust Shareholding, then determines its direct holding ratio of the affiliated enterprise in Low-tax Burden Region from trust and other direct shareholding in accordance with subparagraph 1 of the preceding paragraph, then recognizes the investment income or calculates the business income in accordance with the CFC Tax Provisions following the guidance of subparagraph 3 of the preceding paragraph.
- 3. The trustee of the trust relationship shall follow the guidance listed below in accordance with Article 92-1 of the Income Tax Act for the trust income reporting obligation of fiscal year 2024 and the upcoming years:
 - 1) Calculate the direct holding ratio of the affiliated enterprise in Low-tax Burden Region for the beneficiary of accrued income or the settlor from trust and other direct shareholding in accordance with subparagraph 1, paragraph 1 and the preceding paragraph, then combines it with the indirect holding ratio held and the direct and indirect holding ratio held by the related party or nominee party. If the total holding ratio is 50% or more, the trustee, in accordance with the CFC Tax Provisions, shall calculate the deemed investment income or business income of beneficiary of accrued income or the settlor based on the current-year earnings of the CFC, the direct holding ratio of Trust Shareholding aforementioned and the trust period of the current year.
 - 2) When the CFC distributes dividends or profits, the trustee may identify the fiscal year in which the distributed dividends or profits have been recognized as investment income or calculated as business income in accordance with the minutes of the CFC shareholders' meeting, surplus earnings distribution statement with remarks stating approval by the CFC shareholders' meeting, or other reliable documentation. For the dividends or profits distributed belong to fiscal year 2023 and upcoming years, the trustee shall calculate income taxes that have been paid for dividends or profits by beneficiary of accrued income or the settlor in accordance with the tax act of the source country based on Paragraph 4, Article 43-3 of the Income Tax Act and Paragraph 5, Article 12-1 of the Income Basic Tax Act.
 - 3) When the trustee disposes of CFC equity, the trustee shall record the sales price and the original cost, for beneficiary of accrued income or the settlor to calculate capital gains or losses in accordance with Paragraph 4, Article 9 of Regulations Governing Application of Accrued Income from Controlled Foreign Company for Profit-Seeking Enterprise and Paragraph 4, Article 9 of Regulations Governing Application of Income Calculation from Controlled Foreign Company for Individual.

^{1.} For instance, the trust deed does not have a specified beneficiary, nor the scope and conditions of the beneficiary. Or, the settlor reserves the right to change (designate) the trust beneficiary or the right to make distributions or disposals to trust interest.

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