A Before and After Impact Comparison of Applying Statute for Industrial Innovation Article 23-1 Draft on Venture Capital Limited Partnerships

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I. Background

Because the business models adopted by Industries, such as venture capital, film, stage performance and others, are intended to be temporary entities, and the existing business laws are not applicable for such industries,[1] the Legislature Yuan passed the “Limited Partnership Act” in June 2015,[2] for the purpose of encouraging capital injection into these industries. However, since the Act was passed, there are currently only nine limited partnerships listed on the Ministry of Economic Affairs' limited partnership information website. Among them, “Da-Zuo Limited Partnership (Germany) Taiwan Branch” and “Stober Antriebstechnik Limited Partnership (Germany) Taiwan Branch”, are branch companies established by foreign businesses, the remaining seven companies are audio video production and information service businesses. It is a pity that no venture capital company is adopting this format.[3]

In fact, several foreign countries have set up supporting measures for their taxation systems targeting those business structures, such as limited partnerships. For example, the pass-through taxation method (or referred to as single entity taxation) is adopted by the United States, while Transparenzprinzip is used by Germany. These two taxation methods may have different names, but their core ideas are to pass the profits of a limited partnership to the earnings of partners.[4] However, following the adoption of the Limited Partnership Act in Taiwan, the Ministry of Finance issued an interpretation letter stating that because the current legal system confers an independent legal entity status to the business structure of a limited partnership, it should be treated as a profit-seeking business and taxed with Profit-Seeking Enterprise Income Tax.[5] Therefore, to actualize the legislative objective of encouraging innovative businesses organized under tenets of the Limited Partnership Act, the Executive Yuan presented a draft amendment for Article 23-1 of the Statute for Industrial Innovation (hereinafter referred to as the Draft), introducing the "Pass Through Taxation Principle" as adopted by several foreign countries. That is, a Limited Partnership will not be levied with the Profit-Seeking Enterprise Income Tax, but each partner will file income tax reports based on after-profit-gains from the partnership that are passed through to each partner. It is expected that the venture capital industry will now be encouraged to adopt the limited partnership structure, and thus increase investment capital in new ventures.

II. The Pass Through Taxation Method is Applicable to Newly Established Venture Capital Limited Partnerships

1. The Requirements and Effects

(1) The Requirements

According to the provisions of Article 23-1 Paragraph 3 of the Draft, to be eligible for Pass Through Taxation, newly established venture capital limited partnerships must meet the following requirements:

1. The venture capital limited partnerships are established between January 1, 2017 and December 31, 2019.
2. Investment threshold of the total agreed capital contribution, total received capital contribution, and accumulated total capital contribution, within five years of the establishment of venture capital limited partnerships:

	Total Agreed Capital Contribution in the Limited Partnership Agreement	Total Received Capital Contribution	Accumulated Investment Amount for Start-up Companies
The Year of Establishment		×	×
The Second Year		×	×
	3 hundred million		

The Third Year		1 hundred million	×
The Fourth Year		2 hundred million	Reaching 30 percent of the total received capital contribution of the year or 3 hundred million NT dollars.
The Fifth Year		3 hundred million	

3. The total amount, that an overseas company applies in capital and investments in actual business operations in Taiwan, reaches 50% of its total received capital contribution of that year.
4. In compliance with government policies.
5. Reviewed and approved by the central competent authority each year.

(2) The Effects

The effects of applying the provisions of Article 23-1 Paragraph 3 of the Draft are as follows:

1. Venture capital limited partnerships are exempt from the Profit-Seeking Enterprise Income Tax.
2. Taxation method for partners in a limited partnership after obtaining profit gains:

(1) Pursuant to the Income Tax Act, Individual partners and for-profit business partners are taxed on their proportionally-calculated, distributed earnings.

(2) Individual partners and foreign for-profit business partners are exempt from income tax on the stock earnings distributed by a limited partnership.

2. Benefit Analysis Before and After Applying Pass Through Taxation Method

A domestic individual A, a domestic profit-making business B, and a foreign profit-making business C jointly form a venture capital limited partnership, One. The earnings distribution of the company One is 10%, 80% and 10% for A, B, and C partners, respectively. The calculated earnings of company One are one million (where eight hundred thousand are stock earnings, and two hundred thousand are non-stock earnings). How much income tax should be paid by the company One, and partners A, B, and C?

(1) Pursuant to the Income Tax Act, before the amended draft:

1. One Venture Capital Limited Partnership

Should pay Profit-Seeking Enterprise Income Tax = (NT$1,000,000 (earning) - NT$500,000[6])x12% (tax rate[7])=NT$60,000

2. Domestic Individual A

Should file a comprehensive income report with business profit income =(NT$1,000,000-NT$60,000) x 10% (company One draft a voucher for net amount for A) + NT$60,000÷2×10% (deductible tax rate)= NT$97,000

Tax payable on profit earnings＝NT$91,500×5%(tax rate)＝NT$4,850

Actual income tax paid＝NT$4,850 - NT$60,000÷2×10% (deductible tax rate) ＝NT$1,485

3. Domestic For-Profit Business B

Pursuant to the provisions of Article 42 of the Income Tax Act, the net dividend or net income received by a profit-seeking company is not included in the income tax calculation.

4. Foreign For-Profit Business C

Tax paid at its earning source＝(NT$1,000,000 - NT$60,000) ×10% (earning distribution rate) ×20% (tax rate at earning source)＝NT$18,800

(2) Applying Pass Through Taxation Method After Enacting the Amendment

1. One Venture Capital Limited Partnership

No income tax.

2. Domestic Individual A

Should pay tax＝NT$800,000 (non-stock distributed earnings)×10% (earning distribution rate)×5% (comprehensive income tax rate)＝NT$1,000

3. Domestic For-Profit Business B

Pursuant to the provisions of Article 42 of the Income Tax Act, the net dividend or net income received by a profit-seeking company is not included in the income tax calculation.

4. Foreign For-Profit Business C

Tax paid at its earning source＝NT$800,000 (non-stock distributed earnings)×10%(earning distribution rate)×20% (tax rate at earning source)＝NT$4,000

The aforementioned example shows that under the situation, where the earning distribution is the same and tax rate for the same taxation subject is the same, the newly-established venture capital limited partnerships and their shareholders enjoy a more favorable tax benefit with the adoption of pass through taxation method:

		Before the Amendment	After the Amendment
Venture Capital Limited Partnership		NT$60,000	Excluded in calculation
Shareholders	Domestic Individual	NT$1,850	NT$1,000
	Domestic For-Profit Business	Excluded in calculation	Excluded in calculation
	Foreign For-Profit Business	NT$18,800	NT$4,000
Sub-total		NT$80,650	NT$5,000

III. Conclusion

Compared to the corporate taxation, the application of the pass through taxation method allows for a significant reduction in tax burden. While developing Taiwan's pass through tax scheme, the government referenced corporate taxation under the U.S. Internal Revenue Code

(IRC), where companies that meet the conditions of Chapter S can adopt the “pass through” method, that is, pass the earnings to the owner, with the income of shareholders being the objects of taxation;[8] and studied the "Transparenzprinzip" adopted by the German taxation board for partnership style for-profit businesses. Following these legislative examples, where profits are identified as belonging to organization members,[9] the government legislation includes the adoption of the pass through taxation scheme for venture capital limited partnerships in the amended draft of Article 23-1 of the Statute for Industrial Innovation, so that the legislation is up to international standards and norms, while making an important breakthrough in the current income tax system. This is truly worthy of praise.

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[1] The Legislative Yuan Gazette, Vol. 104, No. 51, page 325. URL:http://misq.ly.gov.tw/MISQ//IQuery/misq5000Action.action
[2] A View on the Limited Partnership in Taiwan, Cross-Strait Law Review, No. 54, Liao, Da-Ying, Page 42.
[3] Ministry of Economic Affairs - Limited Partnership Registration Information URL: http://gcis.nat.gov.tw/lmpub/lms/dir.jsp?showgcislocation=true&agencycode=allbf
[4] Same as annotate 2, pages 51-52.
[5] Reference Letter of Interpretation dated December 18, 2015, Tai-Cai-Shui Zi No. 10400636640, the Ministry of Finance
[6] First half of Paragraph 1 of Article 8 of the Income Basic Tax Act
[7] Second half of Paragraph 1 of Article 8 of the Income Basic Tax Act
[8] A Study on the Limited Partnership Act, Master’s degree thesis, College of Law, Soochow University, Wu, Tsung-Yeh, pages 95-96.
[9] Reference annotate 2, pages 52.

Links

- The Legislative Yuan Gazette, Vol. 104, No. 51, page 325.
- Ministry of Economic Affairs - Limited Partnership Registration Information

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