Introduction to Tax Incentive Regime for SMEs

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I. Introduction

The developments of SMEs (small-and-medium enterprises) plays an important pillar of development of industries and creation of jobs in Taiwan. In 2017, the total number of SMEs in Taiwan was 1,437,616. They offer 8,904,000 jobs, accounting for 78.44% of the workforce[1]. However, SMEs have difficulties in entering international supply chains because of their weakness in finance. Therefore, how to enhance the global competitiveness of SMEs is an important issue for the concerned authority. Chapter 4 of the Act for Development of Small and Medium Enterprises prescribes the tax incentive regime based on the financial capability of SMEs and characteristics of industries in order to facilitate the development of SMEs, especially the globalization of SMEs. This paper will review the importance of tax incentives to SMEs and introduces the tax incentive regime under the Act for Development of Small and Medium Enterprises In order to help SMES have an understanding of such regime.

II. SME Tax Incentives Scheme

As the gatekeeper of the market, the government may intervene the market with various policies or tools to reallocate and improve the soundness of the market environment when the market competitions is impaired due to information asymmetry or externalities. At this juncture, preferential tax rates or tax deductions can be offered to specific taxpayers through legal institution. This allows these taxpayers to retain higher post-tax earnings so that they are incentified to invest more resources in the legally defined economic activities. Tax incentives targeting at risky or spillover investments to create benefits to specific economic activities will help the development of industries and markets.

Whilst Article 10 of the Statute for Industrial Innovation has provided tax cuts for R&D expenditures, these incentives are not focus on SMEs and hence not supportive to their research and innovations. This was the reason for the 2016 amendment of the Act for Development of Small and Medium Enterprises added Article 35 to offer tax incentives in order to encourage R&D and innovative efforts and Article 35-1 to activate intellectual properties via licensing. These articles aim to accelerate the momentum of innovations and transformations which promoting investments for SMEs. OthersTo assist SMEs to cope with change of the business environment, the Article 36-2 added the tax incentives for salary or headcount increases, to contribute to the sustainability of SMEs and stabilize the labour market and industrial structures. Following is an explanation of the applicability of these schemes and the requirements to qualify such incentives.

III. Tax Incentives to Promote Investments

(I) Tax deductions for R&D expenditures

Governments around the world seek to encourage corporate R&D activities, that Tax incentives are put in place to reduce R&D costs and foster a healthy environment of investment for more R&D initiatives. Neighboring countries such as Japan, Korea and Singapore are frequently practicing belowing tax burdens to encourage R&D efforts. Article 35 of the Act for Development of Small and Medium Enterprises in Taiwan allows accelerated depreciation and offers tax cuts[2] to stimulate R&D and innovations and create an investment friendly environment for SMEs.

1. Taxpaying Entities and Requirements

(1) Qualifications for SMEs

Article 35 of the Act is applicable to qualified SMEs and individual taxpayers, which are (1) from manufacturing, construction & engineering, mining and quarrying industries, with paid-in capital below or equal to NT$80 million or with the number of full-time employees less than 200 people; (2) from other industries with the sales of the previous year below or equal to NT$100 million or with the number of full-time employees less than 100 people. Thus, the qualifications of Small and Medium Enterprises are based

on either paid-in capital/sales or number of employees under the Act[3].Meanwhile, SMEs may not have an independent R&D department due to the limit of size or operating cost.Therefore, if the taxpayers hiring full-time R&D personnel that can provide records of job descriptions and work logs to R&D activities, the SMEs can access the tax incentives provided that the R&D functions. The recognized by government agencies is increasingly flexibility for SMEs seeking policy support.

2. Taxpayers and requirements

(1) A certain degree of innovativeness

As the tax incentive regime strives to promote innovations, the R&D expenses should be used to fund innovative developments. According to the official letters from the Small and Medium Enterprise Administration, Ministry of Economic Affairs, there is no high bar as forward-looking, risky and innovative as usually" required for other incentives previously, which is considering the size of SMEs and their industry characteristics. The "certain degree" of innovativeness shall be based on industry environments and SME businesses as determined by competent authorities in a flexible manner.

(2) Flexibility in the utilization of business income tax reductions

To encourage regular R&D activities, The case that SMEs may not have R&D undertakings each year due to funding constraints, or start-up company may have incurred R&D expenditures but are not yet profitable and hence have no tax liabilities during the year, Corporate taxpayers were able to choose beside deduct the payable taxes during a single year, and reduce the payable taxes during the current year over three years starting from the year when tax incentives are applicable.

3. Tax incentive effects

As previously mentioned, Article 35 of the Act for Development of Small and Medium Enterprises accommodates the characteristics of SMEs by allowing reductions of corporate business taxes for up to 15% R&D expenditures during the current year, or spreading the tax reductions by spreading up to 10% of the R&D expenditures over three years from the first year when the incentives are applicable. It is worth noting that the tax deductions shall not exceed 30% of the payable business income taxes during a single year.

If the instruments and equipment for R&D, experiments or quality inspections have a lifetime over two years or longer, it is possible to accelerate the depreciation within half of the years of service prescribed by the income tax codes for fixed assets. However, the final year less than 12 months over the shortened service years shall not be counted. Accelerated depreciation brings in tax benefits for fixed asset investments during the initial stage, that meets the requirements for new technologies and risk management by frontloading the equipment depreciation and creates a buffer for capital utilization.

(II) Deferred taxations on licensing/capitalization of intellectual properties

The deferral of tax payments under the Act for Development of Small and Medium Enterprises is meant to avoid any adverse effect on the application of technological R&Ds by SMEs. As the equity stakes via capitalization of intellectual properties by inventors or creators are not cashed out yet and the subsequent gains may not be at the same valuation as determined at the time of capitalization, the immediate taxation may hinder the willingness to transfer intellectual properties. Therefore, assisting SMEs to release intellectual properties with potential economic value, the licensing and capitalization of intellectual properties is strongly encouraged. The tax expenses shall be deferred within SME or an individual acquires stakes on a non-publicly-listed company by transferring their intellectual properties.

This is to stimulate the applications and sharing of relevant manufacturing technologies. When an SME or an individual acquires stakes on a non-publicly-listed company by transferring their intellectual properties, their tax expenses shall be deferred.

1. Taxpayers and requirements

(1) Qualifications for individuals or SMEs

Article 35-1 of the Act for Development of Small and Medium Enterprises is applicable to SMEs and individual taxpayers. This is to foster the growth of SMEs and enhancement of industry competitiveness by encouraging R&D and innovations from individuals and start-ups. To promote the commercialize of intellectual properties in different ways, the Act for Development of Small and Medium Enterprises provides income tax incentives to individuals and SMEs transferring intellectual properties. The purpose is to encourage different paths to industry upgrades.

(2) Ownership of intellectual properties

To ensure that the proceeds of intellectual property is linked to the activity of intellectual properties which perform by individuals or SMEs. Only the owners of the intellectual properties capitalized and transferred can enjoy the tax benefits.

Intellectual properties referred to in the Act for Development of Small and Medium Enterprises are the properties with value created with human activities and hence conferred with legal rights. These include but are not limited to copyrights, patent rights, trademarks, trade secrets, integrated circuit layouts, plant variety rights and any other intellectual properties protected by laws[4].

(3) Acquisition of stock options

The abovementioned tax incentives are offered to the individuals or SMEs who transfer intellectual properties to non-listed companies in exchange of their new shares. The income taxes on the owners of intellectual properties are deferred until acquisition of shares. These shares are not registered with the book-entry system yet. Before the transferrers of intellectual properties dispose or offload these shares, immediate taxations will impose economic burdens and funding challenges given the unknown prices of the eventual cash-out. Therefore, this legislation is only applicable to taxpayers who obtain options for new shares.

2. Taxpayers and requirements

(1) Transfer of intellectual properties

According to Article 36 of the Copyright Act as interpreted by official letters issued by the Ministry of Finance, the transfer of

intellectual properties is the conferring of intellectual properties to others, and the transferees access these intellectual properties within the scope of the transfer. In terms “transfer” of the first and second paragraphs of Article 36 does not include licensing[5], but such as granting, licensing and inheritance.

(2) Timing of income tax payments

In general, the particular time that calculation of taxes payable is based on when the taxpayers acquire the incomes, less relevant expenses or costs. The taxes payable timing should be depending on when the taxpayers obtain the newly issued shares by transferring intellectual properties. However, the levy of income taxes at the time of intellectual property transfers and new share acquisitions may cause a sudden jump in taxes payable in the progressive system and thus a burden on the economics of SMEs and individuals concerned. Thus, to avoid disruptions to company operations or personal finance planning, Article 36 makes the exception for the incomes earned by subscribing to new shares as a result of transferring intellectual properties. Such incomes are not subject to taxes during the year when the shares are acquired, in order to mitigate the tax barriers concerned.

In sum, the taxes shall be paid when such shares are transferred, gifted or distributed.

3. Tax incentive effects

Article 35-1 of the Act for Development of Small and Medium Enterprises provides tax incentives to stimulate the mobilization of intellectual properties by smoothing out the impact of income taxes payable. This is applicable to (1) SMEs who can postpone the business income taxes payable from the year when they acquire new shares of non-listed companies by transferring the intellectual properties they own; (2) individuals who can postpone the individual income taxes payable from the year when they acquire new shares of non-listed companies by transferring the intellectual properties they own.

IV. Tax incentives aiming to improve the business environment

(I) Tax reductions for wages to additional headcounts

SMEs are vital to the Taiwan, making uo 90% of the companies accounting in Taiwan, who employ more than 6.5 million people or 72.8% of the total workforce. Any economic recession may make it difficult for SMEs to maintain their labor costs given their smaller funding size and external challenges. This will cause higher unemployment rates and hurt the economy, which may cause impairment of the capacity or create a labor gap for SMEs, eventually shrink the industry scale. To lower the burden of operational and investment costs and learn from the legislatives in Japan and the U.S.[6], tax incentives are put in place as a buffer for adverse effects of external environments. The first paragraph of Article 36-2 of the Act for Development of Small and Medium Enterprises provide tax incentives for employee salaries of new headcounts based on the assessment on the economy over a time period. This is intended to encourage domestic investments and avoid the pitfall of direct government subsidies distorting salary structures. It is hoped that investments from SMEs can stimulate the momentum of economic growth.

1. Taxpayers

The tax incentives under Article 36-2 of the Act for Development of Small and Medium Enterprises aim to assist SMEs through difficult times in an economic downturn. The threshold of the period time is based on the unemployment rate has been below the economic indicator predetermined for six consecutive months, which calculated by the Directorate General of Budget, Accounting and Statistics, Executive Yuan. In number of the unemployment rate has been below the economic indicator predetermined for six consecutive months, it is deemed that the business environment is not friendly to SMEs. In this instance, the Regulations for the Tax Preferences Provided to Small and Medium-sized Enterprises on Additional Wage Payment will trigger the tax incentives. The abovementioned economic indicator shall be published by the competent authorities once every two years.

Moreover, to qualify for the tax incentives for new employees, SMEs should investing new ventures or instill new capital by at least $500,000[7] or hiring workforce at least two full-time headcounts compared with the previous fiscal year, that constitute at the Article 36-2 of the Act for Development of Small and Medium Enterprises, which aims to encourage SMEs investments.

2. Taxpayers

(1) Qualifications of additional headcounts

As the dispatched human resource services typically meet temporary or short-term requirements and contractors do not enjoy employment security, this is not consistent with the spirit of the legislation to create jobs and reduce unemployment. Therefore, to avoid the one-time increase of headcounts from accessing the tax reductions during the year and the deterioration of labor relations in Taiwan. Tax incentive is not offered to the additional recruitment of part-time or contracted workers.

Meanwhile, the tax incentives are only applicable to the additional employment of Taiwanese nationals, above or below 24 years old. A tax deduction of 50% based on annual wages is provided for the hiring of people below 24 years old. The extra tax deduction will stimulate young employment.

(2) Definition of additional employment

The number of additional headcounts is based on permanent hires and calculated as the difference between the average number of Taiwanese employees covered by labor insurance per month throughout a single fiscal year or before and after the incremental increase of workforce. The conversion of regular contracts to indefinite employment in writing or signing up for indefinite R&D headcounts under the military service scheme can also be deemed as additional employment. It is worth noting, however, the new headcounts resulted from M&A activities or transfer between affiliated companies are excluded in this legislation.

(3) Calculation of wages

Companies are also required to increase employment as well as the Comparable Wages. The comparable wages are estimated with the summation of 30% of the wages for the year before and after additional employment that based on the aggregate of the new hires comparable wages compared to the prior year. In other words, if the aggregate wages paid out are

higher than comparable wages during the year, the companies concerned have indeed incurred higher personnel expenses. Tax incentives are thus granted because it improves the business environment and it is the purpose of this legislation.

3. Tax incentive effects

The first paragraph of Article 36-2 of the Act for Development of Small and Medium Enterprises provides deductions of business income taxes during the year to qualified SMEs at an amount equivalent to 130% of the incremental wages paid to new headcounts who are Taiwanese nationals. The deductible amount is equivalent to 150% of the incremental wages if new headcounts are Taiwanese nationals below 24 years old.

(II) Tax incentives for companies that increase salaries

Companies are subject to the effect of changes in the external factors such as global supply and demand on the international market, as well as the domestic business environment as a result of risk aversion from investors and expectation from customers. These uncertainties associated with investments and the rising prices for consumers will suppress the wage levels in Taiwan. This the reason why the second paragraph of Article 36-2 of the Act for Development of Small and Medium Enterprises grants tax deductions for the companies who increase salaries, to encourage companies share earnings with employees and enhance private-sector consumption. SMEs may deduct their business income taxes payable during the year up to 30% of salary increase for existing entry-level employees who are Taiwanese nationals, not as a result of statutory requirement for basic wage adjustments.

1. Taxpayers

The tax incentives are applicable to SMEs as defined by the Regulations for the Tax Preferences Provided to Small and Medium-sized Enterprises on Additional Wage Payment and based on the same economic indicators previously mentioned.

2. Qualification for tax incentives

(1) Definition of entry-level employees

The object of taxation under this act is the enterprise's average wage payment to the entry-level employees. The entry-level employees referred to in this act are authorized by the "Small and medium-sized enterprise employee salary increase, salary deduction act " that refers to employees of local nationality with an average monthly recurring salary below nt $50,000[8] whose were entered into indefinite employment contracts with SMEs. Through such conditions, the effect of tax concessions will be concentrated on promoting the salary level of grassroots staff and helping enterprises to cope with changes in the industrial environment.

(2) Average salaries

The salaries to entry-level employees refer to the basic salaries, fixed allowances and bonuses paid on a monthly basis. Payment-in-kind shall be discounted based on the actual prices and included into the regular salaries. Meanwhile, regular salaries should be calculated with annualized averages, as this legislation seeks to boost salary levels. The regular salaries to entry-level employees during the year are estimated with the monthly number of entry-level employees during the same year. Only when the average basis salaries during the year are higher than those in the prior year can the tax incentives be applicable.

3. Tax incentive effects

Applying this article, SMEs can deduct their business income taxes each year up to 130% of salary increase for existing entry-level employees who are Taiwanese nationals, which are not as a result of statutory requirement for basic wage adjustments. However, it is not allowed to double count the increased personnel expenses for new headcounts applicable to the first and second paragraphs of the same article.

V. Conclusions

The funding scales and relatively weak financial structures are the factors that led SMEs be susceptible influenced by supply change dynamics and business cycles. To the extent that is suppressing the flexible in capital utilization for SMEs, also influencing on the sustainability of SMEs. Differ from government subsidies require budgeting, reviewing and implementations, there are complications regarding the allocation of administrative resources. Therefore, it is important to plan for tax incentives in order to stimulate R&D, innovation and job creation by SMEs and ultimately make SMEs more competitive.

The tax incentives to SMEs amended in 2016 by the Small and Medium Enterprise Administration are known for the following:

(I) The lowering of thresholds for tax reductions of R&D expenses in order to encourage SMEs to invest in R&D activities with a “certain degree” of innovativeness and enhance the momentum for SMEs to upgrade and transform themselves;

(II) Deferral the income taxations on the transfer of intellectual properties for equity, in order to encourage application and utilization of such intellectual properties, provide incentives for R&D programs or innovations by individuals and SMEs. This also creates a catalyst for industry upgrade;

(III) Tax deductions for the employment of new headcounts or the increase of employee wages during the time the economic indicators have reached a certain threshold and based on the health of the investment environment. This is to encourage company investments and capital increases in Taiwan and mitigate the volatility of economic cycles, in order to get ready for business improvement.

The above tax incentive programs, i.e. tax deductions for R&D and innovations; deferral of taxations on the transfer of intellectual properties for equity; tax deductions for the hiring of new headcounts and the increase of employee salaries, are meant to boost the investment from SMEs and the competitiveness of SMEs. The Act for Development of Small and Medium Enterprises seeks to reduce tax burdens of SMEs actively investing for their future and competitive advantages. Tax incentives help to mitigate the adverse effect of the economy on the business environment. It is also the fostering of the sources of business income tax revenues for the government. This is the very purpose of the Act for Development of Small and Medium Enterprises.

[1]White Paper on Small and Medium Enterprises in Taiwan, 2018, p21 (November 9, 2018) published by the Ministry of Economic Affairs

[2]Pursuant to the authorization conferred by Article 35 of the Act for Development of Small and Medium Enterprises, the Ministry of Economic Affairs has announced the Regulations Governing the Reduction of Expenditures for Small and Medium Enterprises Research and Development as Investment.

[3]Article 2 on the definition of SMEs. The abovementioned criterion is universally applicable to the Act for Development of Small and Medium Enterprises. It also applies to the eligibility of tax incentives to be introduced in this paper unless otherwise specified.

[4]Official Letter Economic-Business No. 10304605790, Ministry of Economic Affairs

[5]Official Letter Taiwan-Finance No. 10300207480, Ministry of Finance

[6]“Assessment of the Taxations under Article 35, Article 35-1, the first paragraph and the second paragraph of Article 36-2, the Act for Development of Small and Medium Enterprises” published by the Small and Medium Enterprise Administration, Ministry of Economic Affairs, pages 15-17, https://www.moeasmea.gov.tw/files/2670/93B9AF54-84E2-4293-A5CA-EA7DD9FAA05A(most recently browsed date September 9, 2019).

[7]Order of Interpretation Economics-Business No. 104004602510 from the Ministry of Economic Affairs: “Second, on the day when the economic indicator has reached the threshold, the paid-in capital of the new business should be at least NT$500,000 and there is no need to instill additional capital during the period when tax incentives are applicable. For existing businesses, there is no limitation on the number of capital increases during the applicable period. So long as the cumulative increase in capital reaches NT$500,000 and new employees are hired during the same fiscal year or during the prior fiscal year.”

[8]Paragraph 1, Article 2 of the Regulations for the Tax Preferences Provided to Small and Medium-sized Enterprises on Additional Wage Payment

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Chen, Ming
Legal Researcher

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