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A TAIWANESE APPROACH TO TAXING DIGITAL ECONOMY: THE CASE OF CHINESE GAMING BUSINESSES GOING GLOBAL

By Jie Wang, PhD researcher at Erasmus University Rotterdam and a lawyer in China.[1]

INTRODUCTION

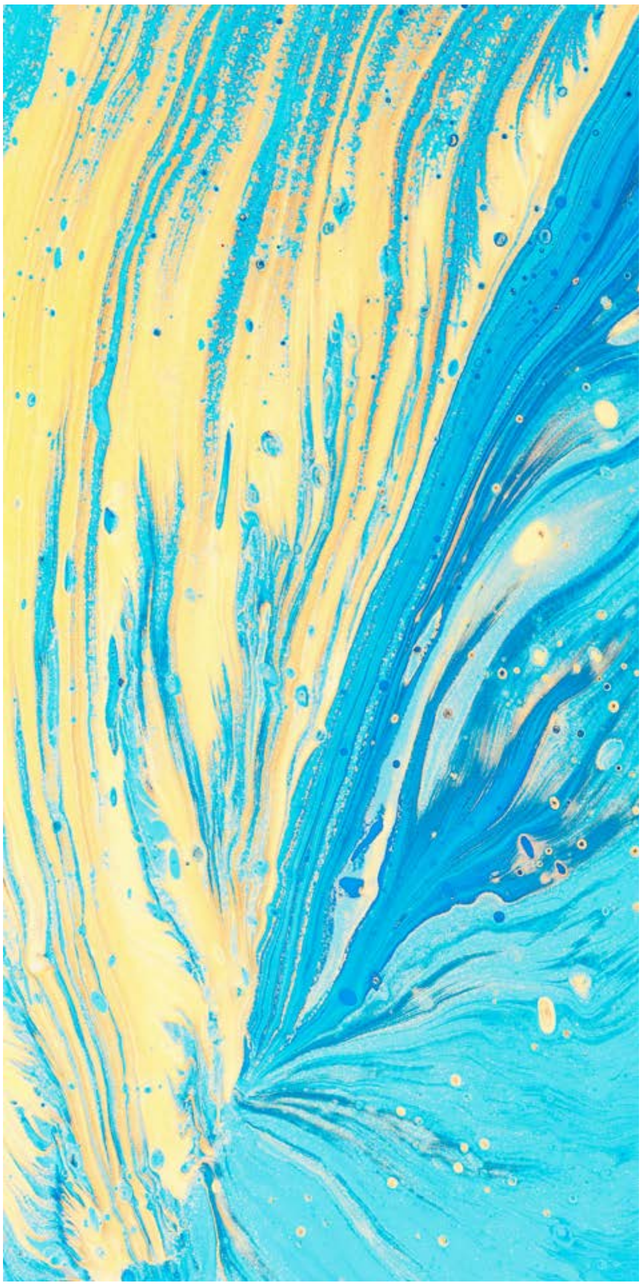
The taxation of the digital economy poses significant challenges to the modern international tax regime. While digitalization has transformed business operations, tax collection methods have not yet fully adapted, particularly when digital businesses operate across borders. Typically, source states can only tax non-residents if they have a local permanent establishment (PE).

In response, the international tax community has made substantial efforts to reform tax rules, notably through the BEPS Project and the Two-Pillar Solutions. However, with Pillar One Amount A missing its deadline for formal ratification, the future of a multilateral approach to taxing the digital economy remains uncertain.

Amid the evolving global tax landscape, China's outbound investments, driven by the "going global" strategy, are expanding, with Taiwan as a key destination due to strong cross-strait economic and cultural ties, despite the lack of a bilateral tax treaty.

This unique situation makes cross-strait tax dynamics particularly relevant for study.

This article explores Taiwan's unilateral approach to taxing the digital economy through a puzzle-solving process based on real-world cross-strait business practices in the online gaming industry. The insights gained are applicable to other online industries and may also be valuable for Caribbean nations, aiding them in navigating digital taxation complexities and developing sustainable tax frameworks.



1. THE PUZZLE CASE: THE EXPANSION OF CHINESE GAMING BUSINESS INTO TAIWAN'S MARKET

Let's start with the case below: A Chinese game company, G Co., and a Taiwanese company, T Co., signed a Joint Operation Agreement for a game on the mobile phone developed by G Co. T Co. handles local operations in Taiwan, including platform listing, marketing, after-sales services, and regulatory compliance, while G Co. manages technical operations and updates.[2] For the convenience of analysis, the illustrative case is referred to as "Puzzle Case".

In terms of revenue generation and distribution, the Game App generates income through in-app purchases. Assuming users spend a total of 100, T Co. will initially receive the revenue. After deducting all platform fees and applicable local taxes in Taiwan, T Co. will remit a net profit of 70 to G Co., as stipulated in the contract. The basic business structure of the Puzzle Case is illustrated in Figure 1.

Given the following tax and fee information, the Puzzle case must consider these necessary expenses:

- Taiwan's corporate income tax (CIT) rate is 20%;
- Mobile app distribution platforms, like Google Play, charge at least a 15% service fee;
- The VAT on most goods and services in Taiwan, including electronic software services, is 5%.

When a user spends 100 in the Game App, after deducting VAT, platform service fees, and CIT, how can T Co. guarantee G Co. a net profit of 70 (the "Puzzle") while still remaining profitable?

This article explores and solves this puzzle, highlighting Taiwan's unique digital economy taxation innovations.

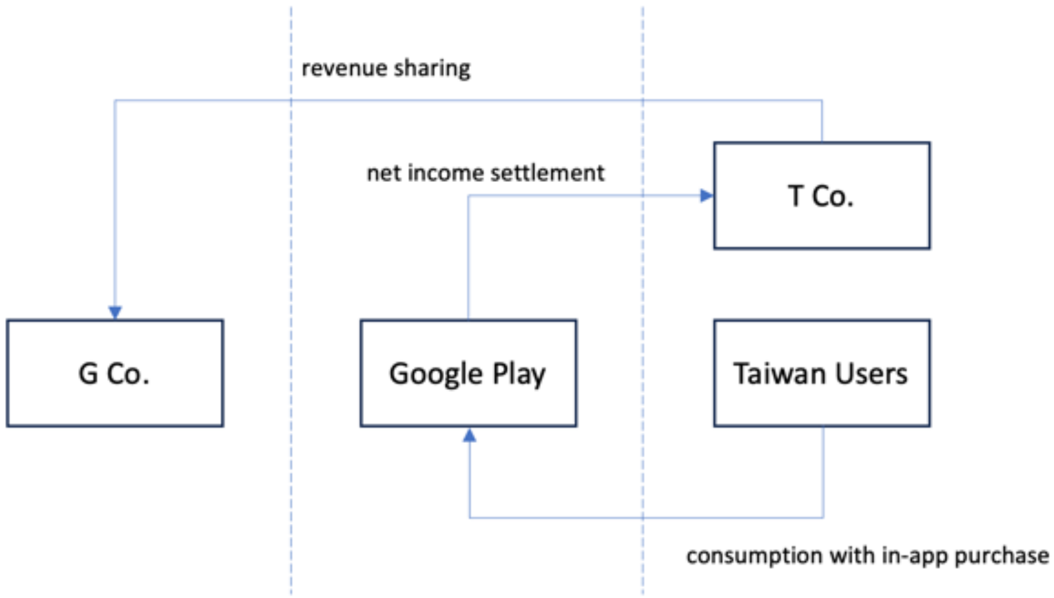


Figure 1: structure of Puzzle Case

2. TAX CALCULATIONS OF THE PUZZLE CASE: THE BUSINESS CHAIN

To unravel the tax Puzzle, it is essential to clarify the flow of funds within the business chain of the cross-border gaming industry. The chart below highlights three critical stages, illustrating how money spent by consumers through in-app purchases flows from the platform to the agent, T Co., and eventually to the Chinese developer, G Co. It also details the various expenses incurred throughout this chain.

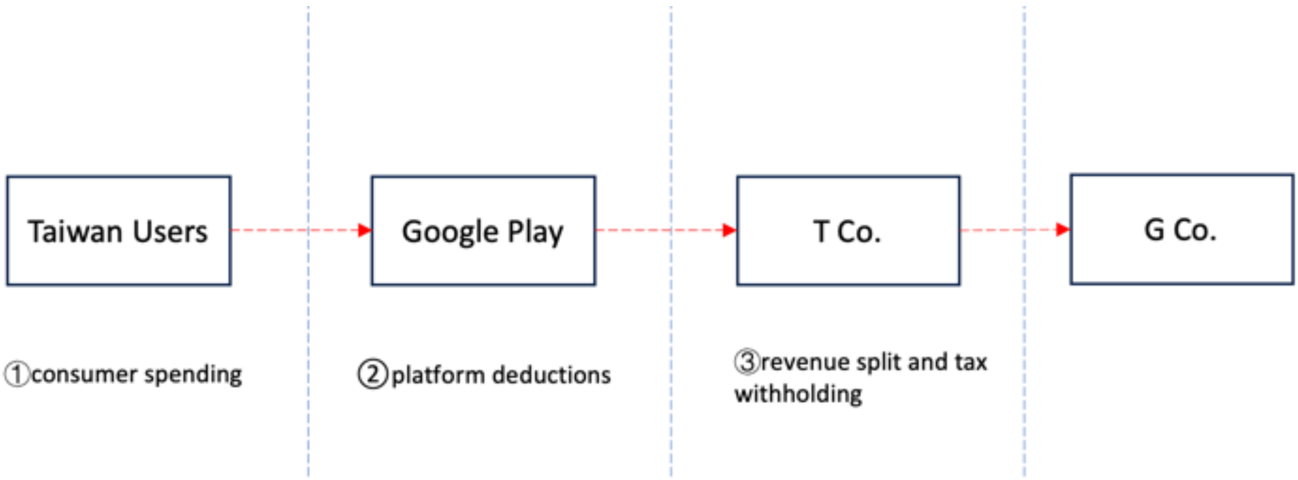


Figure 2: stages in the flow of money

	Money Collector	Items
1. consumer spending	Taiwan tax authority	VAT
2. platform deductions	Google Play	Service fee
3. revenue split and tax withholding	T Co.	Revenue split
	Taiwan tax authority	Potential Income tax

Table 1: tax and fees in the stages

When a Chinese gaming company engages local agents in Taiwan, the primary tax consideration is the potential CIT on profits remitted from Taiwan. Additionally, considering the app distribution platforms' role in VAT, the potential tax obligations and financial consequences for each party are outlined in the following table:

Parties	Parties Taxation Event	CIT/VAT/Fees Consequences
Google (Play)	Receiving consumer spending	Collecting VAT and service fees
G Co.	Receiving revenue split from T Co.	Potential Taiwan CIT obligations as non-resident

Table 2: taxes and taxpayers

Below is the calculation based on the table 2.

In Stage 1, the amount spent by consumers on in-app purchases is tax inclusive. Taiwan's regular VAT rate is 5%, meaning that when a Taiwan consumer spends 100, 100/(1+5%) = 95.24 is the pre-tax price, with the remaining 4.76 as the VAT amount.

In Stage 2, the platform of Google Play, deducts a service fee ranging from 15% to 30% in each specific case. For our purposes, we can calculate using a 15% fee (since a 30% fee would clearly contradict the puzzle fact that G Co. receives 70). This results in a fee of 14.29 (95.24*15%), leaving 80.95 (95.24*(1-15%)) to be remitted from the platform to T Co.

By Stage 3, it seems very close to solving the puzzle itself: how does Taiwan levy taxes on such payments and what is the amount of imposed tax? In other words, the question is how (much) Taiwan taxes income earned by non-residents from the sale of electronic products to Taiwan resident users.

3. CLARIFICATION: THE REGULAR WITHHOLDING TAX RATE IS NOT YET THE CORRECT ANSWER

In the discussion above, we mention that Taiwan would necessarily tax the income G Co. earned through its joint operation agreement with T Co. via levying a withholding tax, and this approach requires further examination.

(1) DETERMINATION OF SOURCE OF INCOME FROM ELECTRONIC SERVICES: WITHIN TAIWAN

Under international taxation principles, a country's right to tax depends on two factors: first, whether G Co. is deemed to have earned income from Taiwan, granting Taiwan the source taxing right; and second, how Taiwan classifies this income to determine the applicable tax rate.

Taiwan's income tax system taxes non-residents only on Taiwan-sourced income (TSI). According to Article 8, Paragraph 3 of Taiwan's Income Tax Act (ITA), remuneration for services provided "within" Taiwan is considered TSI. However, applying this general provision to digital economy scenarios, like the Puzzle case, is challenging.

In response to the challenges, of taxing the digital economy Taiwan's Ministry of Finance issued a specific regulation in 2009 that significantly refined the source rules under Article 8 of the ITA (the "Source Regulation"). This regulation has undergone four amendments since its release, with the latest revision in 2023[3]. Article 4 of this regulation provides further interpretation of Article 8, Paragraph 3 of the ITA.

Accordingly, remuneration for services provided "within" Taiwan requires that all or part of the services be carried out or provided within Taiwan; if the service is carried out outside Taiwan, such service must be jointly participated in or assisted by Taiwanese individuals or Taiwanese enterprises to qualify the service income as TSI.

Additionally, the specific business model by which a foreign enterprise provides electronic services in Taiwan also influences the source determination. Electronic services that must be downloaded via the internet to computers or mobile devices to be provided directly constitute services provided "within" Taiwan.

The aforementioned provisions regarding the source country of income from cross-border service provision are rather general, and extensive, in terms of authorizing the taxation of cross-border service provision.

The "Regulations on the Income Tax Imposed on the Cross-Border Sale of Electronic Services by Foreign Profit-Seeking Enterprises" (Decree No. 10604704390) since 2018[4], however, further narrows such taxing rights provided in the Source Regulation and provides a nuanced distinction: Income earned by foreign enterprises from providing electronic services does not automatically qualify as TSI.

Electronic services without a physical place of use (e.g. hotel accommodation (such as Airbnb) and car rental are services involving physical place of use, such as Uber) and involving the cross-border transmission of overseas-produced software via the internet to personal devices can only generate TSI if the provision of such services requires the participation and assistance of Taiwanese individuals or enterprises. However, if the electronic services are real-time, interactive, and continuous (such as online games, music, or films), the relevant income is considered TSI directly.

In the Puzzle case, based on the two provisions above, income from selling through the Game App to Taiwan users in the Puzzle Case also constitutes TSI. First, the Game App is downloaded from the internet to the user's mobile devices; second, the Game App is an online game, providing real-time, interactive electronic services from the foreign enterprise G Co.; third, although the game software is produced outside Taiwan, its provision to Taiwanese game-buyers (players) has received customer assistance from Taiwanese resident enterprise T Co.

(2) The Business Profit Approach Is Not Applicable: No PE In Taiwan

In the Income Tax Act (ITA), "income from business profits" and "service income" are categorized as two different types of income. However, under Article 10 of the Source Regulation, electronic services are still treated as business conduct, meaning the sourcing rules for both income types are the same when the foreign service provider has a permanent establishment (PE) in Taiwan. This is known as the business profit approach.

When a foreign service provider has a PE in Taiwan and the income is effectively connected to it, the business profit approach applies specifically to service income. This approach, which includes comprehensive sourcing rules, income calculation, and tax payment methods, aligns with traditional international tax principles.

The key question in the puzzle case is thus, whether T Co. constitutes a business agent for G Co (supposing that G Co. does not have a physical PE in Taiwan). The answer is negative, based on Article 10 of the ITA on the limited definitions of a business agent and that T Co. in the Joint Cooperation Agreement does not fulfill the definition of a business agent:

Article 10 of the ITA stipulates three scenarios of being a business agent:

(1) in addition to handling procurement matters, the agent also has the authority to regularly represent the business they represent in negotiating business and signing contracts;
(2) the agent regularly stocks products belonging to the business they represent and delivers these products to others on behalf of the business;
(3) the agent regularly accepts orders on behalf of the business they represent.

The cooperation between T Co. and G Co. does not fall under any of these three scenarios because these three types of business agent are concepts in the traditional economy.

Since T Co. does not a business agent under ITA, G Co. does not have a PE in Taiwan either. When G Co. does not have a PE in Taiwan, its tax obligations will not follow the business profit approach. Instead, the service income earned by G Co. will follow “the electronic service approach” which applies to the provision of “electronic services” by foreign entities to Taiwan.

In short, although income earned from the electronic service is a special type of service income, such income is subject to the special electronic service approach in the Puzzle Case. I will explain further in Section 4 below.

(3) 20% CIT RATE IS NOT YET THE CORRECT ANSWER TO THE PUZZLE

From the calculation in Section 2 above, after deducting certain taxes and fees through subsequent stages, the profit to be allocated to G Co. that accumulates to T Co. is 80.95 from a user expenditure of 100. In the Puzzle Case, T Co. promises to pay at least 70 in taxable profit to G Co and still make profits.

When T Co. is not deemed to be a PE of G Co. in Taiwan, G Co. is still responsible for corporate income tax on the Taiwan-sourced income received from T Co. According to the ITA, the regular withholding tax rate in Taiwan is the same as CIT tax rate 20%. If this regular CIT rate were applied, G Co. would only receive 80.95 * (1 - 20%) = 64.76. This amount does not meet the 70 agreed by the parties' Joint Operation Agreement in the Puzzle Case, so the regular CIT rate is not applicable to the Puzzle case.

If the regular CIT rate is not applicable, what the rate is applicable in the Puzzle case? The answer is explained in Section 4 below.

4. THE ANSWER: THE UNIQUE MECHANISM FOR CROSS-BORDER ELECTRONIC SERVICES

The solution to the Puzzle problem ultimately lies in Taiwan's unique taxation mechanism for Cross-border Electronic Services (hereinafter 'CEST'). This mechanism combines withholding tax system and formula-based tax assessment. The mechanism is consistent with the principles of economic allegiance and benefit principle and balances the potential conflict between tax collection efficiency and tax fairness.

The CEST regime comprises two components: source rules, as discussed in Section 3(1) above, and an estimation-based tax collection system, which includes two cumulative elements: (1) the estimated net profit ratio and (2) the Taiwan Contribution Rate.
It might be surprising for the readers when revealing the answer to the Puzzle case: in short, when applying the CEST mechanism to the Puzzle case, foreign companies without a PE in Taiwan, like G Co., can enjoy an effective tax rate as surprisingly low as 1.6% for the income

of providing electronic gaming services to Taiwanese consumers, as explained in three steps analysis below.
Since Taiwan has the right to tax foreign electronic service providers based on its source rules, the Taiwan tax authorities, under the CEST mechanism, are allowed to use the estimated net profit ratio ("ENPR") to (partly) determine the net taxable income of foreign enterprises (step 1); in addition to the estimated net profit ratio, the Taiwan profit contribution ratio ('TPCR', either 50% or 100% or as a ratio actually assessed and approved by tax authority based on the taxpayers' provided documents) is introduced (step 2); the two ratios are then multiplied by the regular corporate income tax rate (step 3) to decide the tax rate. The formula is therefore illustrated as follows:
Tax rate on "Taiwan-sourced revenue"=estimated net profit ratio*Taiwan profit contribution ratio*CIT rate 20%

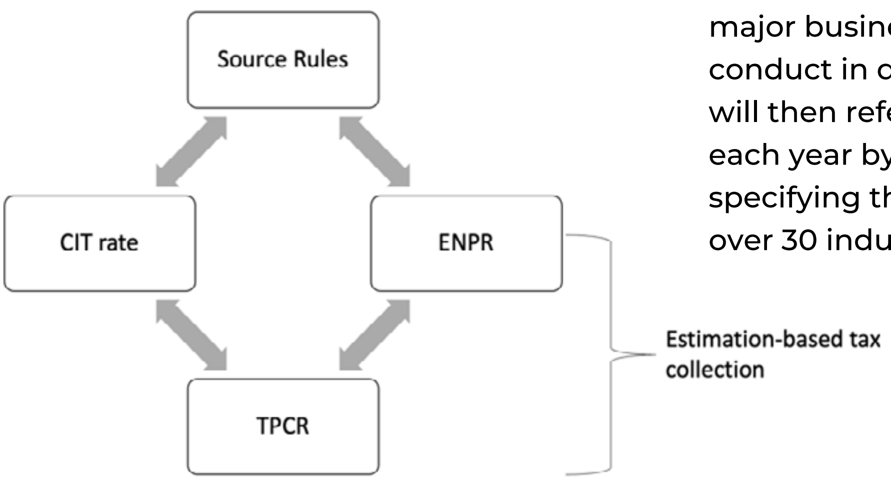


Figure 3: The CEST regime

(1) THE FIRST COMPONENT: THE ESTIMATED NET PROFIT RATIO FOR NON-RESIDENT ENTERPRISES

Income, as a proxy for individual well-being, is a net concept, making the tax base revenue minus costs. However, in cross-border transactions, non-resident enterprises often cannot fulfill registration and bookkeeping obligations in all market jurisdictions. As a result, gross income is taxed at a lower rate to approximate net income taxation. This simplified mechanism can make withholding tax seem separate from income tax, but it is not. Withholding tax essentially serves as an estimated alternative to income tax, particularly for non-resident enterprises in cross-border contexts where full information is unavailable.

In this vein, the ENPR component depends on whether the foreign enterprise can provide evidence (books and documents of the revenue and the deductible costs) for Taiwan tax authority's approval. If the tax authority approves, the actual net income calculated by the provided evidence will be used. If there is no approval from tax authorities but the documentation simply establishes what type of the major business models that the business conduct in question falls into, the ENPR will then refer to the index published each year by Taiwanese tax authorities, specifying the Industry Profit Standard of over 30 industrial sectors.[5]

In the latest index published in 2023 by Taiwanese tax authorities, the Industry Profit Standard for the Distribution of Gaming Software is 16%.

(2) THE SECOND COMPONENT: TAIWAN PROFIT CONTRIBUTION RATIO

The second component is "Taiwan Profit Contribution Ratio", which is the second method used by the Taiwanese tax authorities to estimate how much contribution of a non-resident taxpayer's cross-border electronic service can be attributed to Taiwan when there is no PE in Taiwan.

The TPCR mechanism examines three factors of the transaction: the transaction flows, the location of service provision, and the location of service use. Based on the distribution of these factors inside and outside Taiwan, it determines the contribution ratio of the transaction income to Taiwan as 50%, 100%, or the actual TPCR supported by documents provided by the taxpayers. To be specific, the TPCR rule can be structured into 3 tiers as follows.

Obviously, in the Puzzle Case, the transaction flows are carried out both in and outside Taiwan. The place of provision of the gaming service is difficult to pin down, yet the bottom line is clear: both G Co. and T Co. play a role in the operation of the game, which is enough to rule out the application of the Tier 2 of the TPCR rule. Disregarding the applciability of Tier 1 considering its high requirement, the 50% in Tier 3 thus applies.

(3) UNVEILING THE ANSWER BY OPERATING THE CEST

Based on the above analysis, the Taiwan tax rate on the revenue earned by G Co. from its joint operation with T Co. can be reached with multiplying the ENPR for game softare distribution, that is, 16% (the index specifically for distributing the gaming software as indicated above), by the TPCR of 50% and the regular corporate income tax rate of 20%:

$$1.6\%=16\%*50\%*20\%$$

Therefore, the tax payable by G Co. is 1.3=80.95*1.6%. The after-tax profit that T Co. will remit to G Co. will be 79.65=80.95-1.3. Since T Co. agreed to remit 70 with all else tax and fees included in the Joint Operation Agreement, T Co. can still realize a 9.65 profit (79.65-70) profit margin from every 100 spent by Taiwanese users on the Game App.

	Conditions	TPCR
Tier 1	Taxpayers can provide supporting documents regarding transactions flows for their contribution to profit making	As assessed factually
Tier 2	All transaction flows are in Taiwan,or service provision and using are in Taiwan	100%
Tier 3	Other circumstances	50%

Table 3: Tiers in the TPCR

CONCLUSION

Within the ambit of taxing digital economy, Taiwan's tax regime for cross-border electronic services was initiated almost concurrently with the OECD-led Pillar One reform. The two reform efforts share both commonality and differences. The commonality lies in their disruption of the traditional approach of taxing business profits built on the concept of permanent establishment. This, of course, corresponds to core of the challenges brought by digital economy to the international tax system. In addition, both the Taiwanese CEST regime and the Pillar One Amount A employ pre-determined ratio for the calculation of tax liability. As for differences, Pillar One Amount A is a multilateral instrument that, in substance, creates a new taxing right on the residual profits of large MNEs. The CEST regime of Taiwan, contrastingly, is unilateral and applies restrictively to electronic services. Beyond the commonalities and differences with the OECD's approach, Taiwan's CEST regime, with its cumulative ENPR and TPCR components as clear, quantitative, formula-based standards, offers a practical method for reforming the taxation of the digital economy without introducing overly complex rules that would burden both taxpayers and tax authorities. This is the key takeaway from unraveling the Puzzle and the main contribution of this article, particularly in light of the delayed progress of Pillar One.[6]

Jie Wang

[1] The author can be contacted at wang@law.eur.nl. This article is funded by China Scholarship Council.
[2] Taiwan has adopted a prohibitive policy against Chinese game operators, requiring those governed by Chinese law to operate in Taiwan through local Taiwanese agents. This policy is stipulated under Article 40, Paragraph 1, Subparagraph 1 of the Act Governing Relations Between the People of the Taiwan Area and the Mainland Area, and further detailed in Point 2 of the Operational Procedures for the Registration and Agency of Mainland China Games issued by the Digital Development Agency of Taiwan's Ministry of Digital.
[3] Available at https://law-out.mof.gov.tw/LawContent.aspx?id=FL050237, as accessed on 25 August 2024.
[4] Available at https://www.dot.gov.tw/singlehtml/ch_478?cntId=dot_201801290001_478, as accessed on 25 August 2024.
[5] 2023 Standard Industrial Classification of the Republic of China & Industry Profit Standard), available at https://www.ntbt.gov.tw/singlehtml/ba1c058d32ea40828a9d8889200efcd3?cntId=6f5461989c1f48f4821ca6acefa23ef8, as accessed on 25 August 2024.