



Should companies withhold taxes when paying patent infringement settlement compensation to foreign companies?

As Taiwan, known as the "Silicon Island", is a hub for technology. Its tech industry often finds itself entangled in cross-border patent infringement disputes. Even slight missteps can result in having to pay damages or settlement fees to foreign companies. However, for the nature of these payments, whether they are intended to compensate for "damages incurred" or "lost interests" can affect whether they are considered to be "Taiwan-sourced income" for the recipient foreign companies, thereby raising issues regarding the requirement for making withholding taxes under the tax laws. Nevertheless, in practice, some domestic companies fail to distinguish the nature of such compensation or settlement payments during litigation or settlement processes. Consequently, the domestic companies may overlook the fact that the damages or settlement payments may constitute Taiwan-sourced income for the foreign companies, leading to the companies' responsible individuals facing penalties imposed by the tax authorities due to failing to withhold taxes as required by tax laws. In light of the foregoing, this article aims to further analyze the nature of damages for patent infringement and the points to be noted.

Taxation regulations related to patent infringement settlement compensation

Pursuant to Tax Ruling No. 35580 issued by the Ministry of Finance on August 20, 1977 (hereinafter referred to as the "Ruling 1977"), compensation paid by domestic enterprises for the illegal infringement of patents or trademarks owned by foreign enterprises

is considered to be income sourced in the Republic of China (hereinafter referred to as "Taiwan") for those foreign enterprises. Therefore, domestic firms are required to withhold income tax at a rate of 20% in accordance with the law when making such payments.

Furthermore, the Tax Ruling No. 831598107 issued by the Ministry of Finance on June 16, 1994 (hereinafter referred to as the "Ruling 1994") provides clearer guideline on whether the nature of damages is "compensation for damages incurred". According to the Ruling 1994, when parties involved in litigation reach a settlement agreement on the condition that the litigation is withdrawn, and one party receives compensation from the other party, the portion of the compensation intended to compensate for the damages suffered by the creditor is considered "compensation for damages incurred" and is exempt from income tax.

However, the portion not intended to compensate for the damages suffered by the creditor falls under the category of "other income" as stipulated in Article 14(1)(9) of the Income Tax Act and is subject to income tax as required by law.

Above two rulings are summarized in the following table:

Rulings	Nature of Infringement Settlement Compensation	
	For damages incurred	For lost interests
Ruling 1977	All are considered Taiwan-sourced income without distinguishing its nature is compensation for damages incurred or lost interests and are required to be withheld with 20% tax by domestic companies.	
Ruling 1994	Considered non-Taiwan-sourced income, and is exempt from withholding tax	Considered Taiwan-sourced income, and is subject to withholding tax.

From the Ruling 1994, it is understood that the portion of compensation intended to compensate for the damages suffered by the rights holder is considered non-taxable income; while the portion not intended to compensate for the damages suffered, such as compensation for "lost interests", is classified as taxable "other income" and subject to income tax as required by tax laws. Furthermore, in accordance with Article 97(1)(1) of the Patent Act, damages resulting from patent infringement may be calculated according to Article 216 of the Civil Code, which distinguishes between compensating for "damages incurred" and "lost interests". Therefore, patent infringement may lead to damages suffered by the rights holder, not limited to lost interests.

Moreover, concerning the distinction between "damages incurred" and "lost interests", the Supreme Administrative Court holds that "damages incurred" as positive damage, which pertains to the reduction of existing assets due to the occurrence of damage. In contrast, "lost interests" as passive damage that hinders the acquisition of new assets due to the occurrence of damage. Specifically, if the infringement of patent rights affects future product sales performance, it constitutes intangible passive damage rather than a reduction of existing tangible assets resulting from the infringement. Therefore, it should be classified as "lost interests" rather than compensating for damages incurred by the rights holder. Hence, settlement compensation received should be considered Taiwan sourced income

for foreign companies and subject to income tax (referenced from the Supreme Administrative Court's judgment No. 584 of 2009).

Conversely, if the patent holders can prove that their patent rights have been infringed and that this has resulted in damage to their existing tangible assets, then, in accordance with Ruling 1994, settlement payments intended to compensate for "damages incurred" are considered to be non-taxable income and exempt from income tax. Specifically, if the right holder is held liable to compensate a third party for damages caused by the infringing act of another party, and such compensation results in a reduction of the right holder's assets (e.g., cash assets), it can be categorized as "damages incurred" by the right holder.

However, in practice, it is often difficult to provide evidence to prove that patent infringement has resulted in damage to existing tangible assets. Therefore, in accordance with the latter part of Article 97(1)(1) of the Patent Act, as well as Articles 97(2) and 97(3), the calculation of damages is based on the concept of "lost interests", which includes:

1. A patentee may claim damages based on the difference between the profit earned through patent exploitation after infringement and the profit normally expected through exploitation of the same patent.
2. The profit gained by the infringer as a result of patent infringement.
3. The amount calculated on the basis of reasonable royalties that may be collected from exploiting the invention patent being licensed.

Thus, in practice, whether from the perspective of tax authorities or administrative courts, it is generally recognized that settlement compensation obtained due to damages suffered from patent, trademark, or copyright infringement is considered compensation for "lost interests" and is subject to income tax as required by tax laws. From the standpoint of domestic companies, those who make payments of patent infringement damages or settlement payments to foreign companies intending to compensate for the nature of "lost interests" are required to withhold taxes.

Mitigation measure of withholding taxes related to patent infringement settlement compensation

As mentioned above, patent settlement compensation which intending to compensate for "lost interests" obtained by foreign companies is considered to be Taiwan source income and is subject to withholding tax at the time of payment made by domestic companies. However, if the foreign company does not have a fixed place of business or a business agent in Taiwan, it may claim a deduction for relevant expenses incurred in acquiring such income (e.g., litigation, forensic and expert opinion costs, etc., incurred by the foreign company as a result of patent infringement events) in accordance with Article 15 of the Guidelines for the Determination of Income from Sources in the Republic of China. This can help to mitigate the burden of withholding tax.

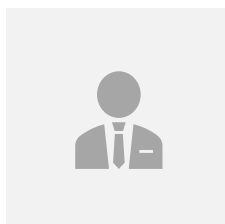
Article 15 of Guidelines for the Determination of Income from Sources in the Republic of China. This approach helps to mitigate the tax risk of retroactive payment and penalties. It is worth noting that if both parties agree that the withholding tax on the settlement compensation is to be borne by the Taiwanese company, in order to facilitate the Taiwanese company's subsequent application for exemption from tax withholding and refund of overpaid taxes, it is advisable to clearly stipulate in the settlement agreement that the foreign company shall, if necessary, cooperate with the domestic company in providing relevant information on the costs incurred in obtaining the settlement compensation.



KPMG Observation

To sum up, the domestic payer is required to withhold tax when making settlement payments for patent infringement to foreign companies. Therefore, when entering into a settlement agreement, the domestic company should pay special attention to the following issues in order to protect its own interests:

1. If the settlement compensation is intended to compensate for "damages incurred", the nature of the damages and the method of calculating them should be explicitly stated in the settlement agreement. In addition, the foreign company should be requested to provide supporting documents for the calculation of the settlement compensation as a basis for exemption from withholding tax under the Income Tax Act.
2. If the settlement payment is intended to compensate for "lost interests" or if it is difficult to distinguish the amount of damages incurred from the settlement compensation, it is advisable for the company to initially withhold taxes at the statutory rate of 20% on the total settlement payment. Subsequently, the company can claim a refund of the overpaid taxes by applying for a deduction of related expenses according to the



Authors

Ethan Hsieh Partner

Lina Chen Manager

Henry Su Assistant Manager



Our team members

Hazel Chen
Head of Tax

02 8101 6666 ext.08995
hazelchen@kpmg.com.tw

Sherry Chang
Partner

02 8101 6666 ext.04590
schang1@kpmg.com.tw

Stephen Hsu
Partner

02 8101 6666 ext.01815
stephenhsu@kpmg.com.tw

Anita Lin
Partner

02 8101 6666 ext.03418
anitalin@kpmg.com.tw

Ellen Ting
Partner

02 8101 6666 ext.07705
eting@kpmg.com.tw

Rita Yu
Partner

02 8101 6666 ext.14139
ryu17@kpmg.com.tw

Kevin Chen
Partner

02 8101 6666 ext.03174
kchen4@kpmg.com.tw

Debra Liu
Partner

02 8101 6666 ext.08514
dliu@kpmg.com.tw

Vivia Huang
Partner

02 8101 6666 ext.03567
viviahuang@kpmg.com.tw

Aaron Yeh
Partner

02 8101 6666 ext.06767
aaronyeh@kpmg.com.tw

Rick Hung
Partner

02 8101 6666 ext.11161
rhung@kpmg.com.tw

Robin Huang
Partner

02 8101 6666 ext.07271
rhuang3@kpmg.com.tw

Aikey Wu
Partner

07 213 0888 ext.07178
aikeywu@kpmg.com.tw

Sam Hu
Partner

02 8101 6666 ext.03172
samhu@kpmg.com.tw

Yang Chang
Partner

02 8101 6666 ext.12349
yangchang@kpmg.com.tw

Eason Lin
Partner

02 8101 6666 ext.10941
easonlin@kpmg.com.tw

Ethan Hsieh
Partner

02 8101 6666 ext.11307
ethanhsieh@kpmg.com.tw

Ying-Tai Ting
Partner

02 8101 6666 ext.16154
yingtaiting@kpmg.com.tw

Kevin Tsai
Partner

04 2415 9168 ext.04581
ktsai@kpmg.com.tw

Chris Lin
Partner

02 8101 6666 ext.07886
chrislin@kpmg.com.tw

Lynn Chen
Partner

02 8101 6666 ext.05676
lhchen@kpmg.com.tw

Joanne Liao
Partner

02 8101 6666 ext.13375
joanneliao@kpmg.com.tw



Contact us

Ethan Hsieh

Partner

02 8101 6666 ext.11307

ethanhsieh@kpmg.com.tw

Joe Kok

Senior Specialist

02 8101 6666 ext.21477

joekok@kpmg.com.tw

Lina Chen

Manager

02 8101 6666 ext.17670

leilachen@kpmg.com.tw

Hank Ku

Senior Specialist

02 8101 6666 ext.22066

hku1@kpmg.com.tw

Henry Su

Assistant Manager

02 8101 6666 ext.22209

hsu1@kpmg.com.tw



@KPMGTaiwan

kpmg.com/tw

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