IBA National Report

Tax

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I. Recent Tax Law Changes for 2019

The tax law proposals issued by the Ministry of Economy and Finance passed the Korean National Assembly on December 8, 2018. The main changes to the tax law involving foreign corporations, foreign invested corporations or cross-border transactions are addressed below. The changes take effect from January 1, 2019, unless otherwise stated.

A. Corporate Income Tax Act("CITA")

- Rationalization of Standards for Determining Foreign Corporation Status

  Under the former CITA, an entity qualified as a foreign corporation if it met the following requirements: (i) it had a juridical personality granted by the laws of the jurisdiction in which it is established; (ii) it consisted solely of members (partners) with limited liability; (iii) it had an independent existence that enabled it to act as a principal with rights and obligations separate from that of its partners; or (iv) it possessed legal characteristics similar to a Korean corporate entity under the Korean corporate laws.

  However, there have been instances where overseas investment vehicles were treated as corporations for Korean tax purposes as a result of meeting condition (iii) above, even though such entity was not treated as a corporation in its country of residency. In order to address this issue, condition (iii) has been deleted from the revisions to the CITA to allow for taxation of the individual members of a foreign entity lacking corporate personality. This revision applies from January 1, 2020.

- New tax provision on beneficial ownership of offshore investment vehicles

  A special regulation was newly enacted regarding offshore investment vehicles for purposes of determining the beneficial owner of Korean source income. An offshore investment vehicle is deemed as the beneficial owner of Korean source income where: (i) the offshore investment vehicle is regarded as the beneficial owner pursuant to tax treaty; or (ii) the offshore investment vehicle bears tax liability in the country of residence and is not established for purposes of unfairly reducing income tax or corporate income tax on Korean source income.

  On the other hand, if an offshore investment vehicle is unable to substantiate the investors investing in the offshore investment vehicle, such offshore investment vehicle is deemed as the beneficial owner to the Korean source income. However, under such circumstances, treaty benefits are unavailable and taxation is based on domestic tax laws. The above provisions apply from January 1, 2020.

- Expanded scope of dependent agency

Under the previous CITA, if an agent of a foreign corporation without any permanent establishment "has contract concluding authority on behalf of the foreign corporation and habitually carries out such authority" ("dependent agent"), the business place of the dependent agent is deemed as a permanent establishment.

This created instances whereby agents that were habitually carrying out contract concluding activities were able to avoid creating permanent establishment as dependent agents so long as they did not have contract concluding authority. However, according to the amendments to the CITA, dependent agent requirements are met even if an agent does not have the authority to conclude contracts if the agent repeatedly plays a principal role in the course of contract negotiations and the foreign company routinely concludes such contracts without making any material modifications.

Under the amended tax provisions, the types of contracts applicable to dependent agent PE are: (i) contracts concluded in the name of non-resident/foreign company; (ii) contracts relating to the transfer of ownership or grant of rights to use intangibles held by non-resident/foreign company; and (iii) contracts relating to provision of services by non-resident/foreign company.

- Anti-Avoidance Measure to Prevent Artificial Avoidance of Permanent Establishment status

Under the previous CITA, permanent establishment ("PE") was not deemed to exist with respect to: (i) the maintenance of a fixed place of business solely for the purpose of purchasing goods/merchandise for the foreign company; (ii) the maintenance of a fixed place of business solely for the purpose of storing goods/merchandise; or (iii) the maintenance of a fixed place of business solely for the purpose of processing of stock of goods/merchandise by another entity ("PE Exceptions").

Under the amended provisions of the CITA, the scope of application involving the PE Exceptions is limited to instances where the above activities performed at a fixed place of business are preparatory or auxiliary in nature. This amendment aligns with the 2017 revisions to Article 5(4) of the OECD Tax Convention, and was intended to prevent use of the specific activity exemption in cases where such activities constitute core business activities of the entity.

In addition, new laws introduced a regulation to prevent artificial avoidance of PE through fragmentation of activities. According to the new laws, even if an activity of a fixed place is of a preparatory or auxiliary character, such fixed place constitutes a PE if: (i) such fixed place or other place constitutes a PE of the foreign company or its related party and the activity of such fixed place is complementary to the business activity carried on by the PE of the foreign company or its related party; or (ii) the overall activity resulting from the combination of the activities carried on by the foreign company and closely related entity at the same place or two places constitute a complementary function and are not preparatory or auxiliary. This is intended to prevent a company or group of companies from fragmenting a cohesive business operation into several smaller operations to argue that each is merely engaged in a preparatory or auxiliary activity

B. Value-Added Tax Act("VATA")

- Expanded scope of electric services supplied by foreign companies

Under the previous VATA, VAT was levied on the supply of games, audios or video files, electronic documents, or software supplied in Korea by foreign companies.

Pursuant to the revised VATA, VAT may also be levied on foreign companies engaged in the supply of

the following: (i) advertising publication services, (ii) cloud computing services and (iii) intermediary services for renting, using or consuming goods in Korea; renting or using places in Korea; or supplying or receiving goods or services in Korea.

This revision to the VATA is aimed at achieving equity among Korean and foreign companies. The revisions apply only with respect to business-to-consumer transactions and is not relevant to business-to-business transactions. The new law applies with respect to the supply of services from July 1, 2019.

C. Adjustment of International Taxes Act("AITA")

- Clear understanding of actual transaction and rejection for lack of commercial rationality

In the case of transactions with foreign affiliated persons, 'the price which is generally applied in an independent transaction with unrelated parties' is considered the arm's length price ("Arm's length principle").

Under the revised AITA, the actual substance of the transaction with related parties must be considered in light of: (i) the contractual terms of the transaction, (ii) functions performed by each of the parties to the transactions taking into account assets used and risks assumed, (iii) characteristics of property transferred/services provided; and (iv) economic circumstances and business strategies. A transaction may, if considered commercially irrational, be disregarded and replaced by an alternative transaction.

It is understood that this amendment clarifies the grounds for the tax authorities to identify the substantive content of international transactions and thereby deny or reconstitute such transactions

- Deleted deferential application of tax treaty provisions in characterization of Income

The previous Article 28 of the AITA stated that "the provisions of the tax treaty shall preferentially apply to the classification of a domestic source income of a nonresident or foreign corporation".

The Supreme Court ruled that "the income classification under tax treaty applies preferentially with respect to taxation in the source country and in the application of the reduced treaty rates and is not intended to determine the income classification under the domestic tax law" (Supreme Court Decision, Feb. 28, 2018, 2010-Du-2710). It is understood that the above amendment is intended to prevent potential interpretation that the income classification of tax treaty should always take priority over the domestic income classification requirements.

D. Restriction of Special Taxation Act ("RSTA")

- Sunset clause for the corporate income tax incentives to foreign-invested company

The RSTA provided exemptions for corporate taxes, income taxes, customs duties and local taxes with respect to foreign investments that met the following requirements: (i) businesses belonging to the new growth engine industry; or (ii) foreigners who meet certain requirements, such as business type or investment amount, among businesses operated by companies residing in foreign investment zones or free economic zones.

The amended RSTA stipulates that the corporate tax and income tax exemption for foreign-invested enterprises shall be applied only with respect to tax exemption applications filed by December 31, 2018. The previous exemption system for customs duties and local taxes remains unchanged. It is understood that such amendment of the law is intended to pursue equity in taxation.

II. Other Developments of Interest

- <u>Removal from EU Black List</u>

  The EU has declared 17 countries, including Korea, on the black list of tax-non-cooperating countries due to unfair and discriminatory tax-exemption schemes aimed at tax avoidance. Korea was the first OECD country to be included on this list. Most of the countries on the list are small economies or islands commonly deemed as tax havens. Many were surprised to find Korea, which is one of the top 10 economies in the world, included on this list.

  The EU blacklisted countries and regions which were considered tax havens providing favorable schemes for tax avoidance and took measures to exclude them from the blacklist if such countries promise to reform the tax system. It seems that the EU blacklisted Korea on grounds that the Korean government's provision of tax benefits to foreign companies investing in foreign investment zones and free economic zones corresponds to discrimination between domestic and foreign companies or between residents and non-residents.

  The Korean government deemed foreign investment incentives to be irrelevant to tax havens. However, after reviewing the EU blacklist, it decided to revise the system in accordance with the requests of the international community. Since then, the Korean government has amended the RSTA to revise the system by abolishing the foreign investment tax exemption system from January 1, 2019. Aside from the corporate income tax and individual income tax, tax incentives for customs duties and local taxes continue to remain in place.

  Following such measures, the EU included Korea on the "gray list", which is one step lower than the black list, on January 2018. Since then, it has completely excluded Korea from the list of non-EU countries as of March 2019.