2016 Asia Pacific tax update

Korea

1. Legislative Developments (2016 Legislative Amendments)

1.1 Additional Transfer Pricing Documentation Requirements for Multinational Enterprises

Articles 11(1) and 12(1) of the Law for the Coordination of International Tax Affairs ("LCITA") and Article 21-2 of the Enforcement Decree of the LCITA have been amended to impose an obligation on multinational enterprises (whether foreign or Korean) to submit more extensive information on their international transactions. This amendment was adopted to better align the Korean transfer pricing documentation requirements with those in Action 13 of the OECD's anti-Base Erosion and Profit Shifting (BEPS) project. This obligation would tighten the Korean tax authority's supervision of multinational enterprises' transfer pricing practices.

Multinational enterprises are required to submit a Combined Report of International Transaction ("CRIT"), which consists of a Local file and a Master file, to the Korean tax authority. The CRIT should include information about the management and the detailed status of intercompany transactions affecting transfer pricing. CRIT is due on the due date for filing a corporate tax return. A penalty up to KRW 100 million is imposed for non-compliance.

CRIT is applicable to Korean companies and foreign multinationals having a permanent establishment in Korea that meet both of the following criteria during the applicable fiscal year: (i) cross-border related-party transaction volume in excess of KRW 50 billion (approximately USD 45 million) and (ii) sales revenue in excess of KRW 100 billion (approximately USD 90 million). The obligation is effective from tax years beginning on or after January 1, 2016.

1.2 Narrowed Scope of VAT Reporting Requirements for Foreign Companies' Supply of Electronic Services (Article 53(2) of the VAT Act)

Under the new VAT rule that came into effect from July 1, 2015, non-residents/foreign companies providing electronic services (defined to include items such as games, sounds, video files, software, etc.) in Korea are required to register for VAT purposes using a simplified online VAT registration system even if they do not have a permanent establishment in Korea in the traditional sense. They must then report and pay VAT on their taxable supply of electronic services occurring on or after July 1, 2015.

In light of taxpayers' comments that certain exceptions should be made to B2B transactions (in which the Korean B2B customer would be required to collect VAT with respect to its own supply to end users), the VAT Act has been amended to exclude such transactions from the scope of taxable supply of electronic services. This amendment is effective from the tax years that includes the publication date of the proposed 2015 Tax Amendments. This

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means that the amendment is made retroactively effective from July 1, 2015 with regards to B2B transactions.

1.3 Revision of the Tax Incentive Regime for Foreign Investment (Article 121(2)-11, 13, and 14 of the Special Tax Treatment Control Law ("STTCL"))

The STTCL was amended to modify the eligibility and scope of tax reductions afforded to foreign investments.

1.3.1 Limiting Indirect Investments by Korean Persons

In order to further limit benefits given to indirect investment made by Korean persons through foreign invested companies, the new rules exclude the following from the scope of tax reductions: (i) where a Korean person owns directly or indirectly more than 5 percent (previously 10 percent) of the shares of a foreign corporation or exercises substantial influence over such foreign corporation, the investment amount corresponding to the shares owned by the Korean person; and (ii) where a Korean person owns directly or indirectly more than 5 percent (previously 10 percent) of the shares of a foreign invested company or exercises substantial influence over such foreign invested company (i.e., the Korean person appoints CEO or majority of the directors of the foreign invested company), the amount lent to a foreign investor by the Korean person.

1.3.2 Discouraging the Deferral of Foreign Investment after Procuring a Decision Allowing a Tax Reduction

Under the previous STTCL, if an initial investment is not made within three years from the date on which the Korean tax authorities issue a ruling granting a tax reduction, the granting of the tax reduction would be invalidated. The purpose of this provision is discourage excessive delays in making the actual foreign investment.

In addition to the above provision, Korean lawmakers added a new provision, which prescribes that where a business does not start to operate within five years from the date the decision to grant a tax reduction is issued, the business shall be deemed to have started on the 5th anniversary of the decision. This provision applies to applications for tax reduction made on or after January 1, 2016.

1.3.3 Increasing the tax benefits for foreign invested companies with regards to employment criteria

Under the previous STTCL, a foreign invested company is allowed to claim a tax reduction of income tax up to (i) the ceiling determined based on the criteria relating to the investment amount and (ii) the ceiling determined based on the criteria relating to employment.

The newly amended rules reduce the ceiling (i) relating to the investment amount and increase the ceiling (ii) relating to employment, both of which are used for calculating the maximum tax reduction amount for foreign invested companies. It is intended to boost employment by foreign invested companies.

This amendment is applicable to the first investment made on or after January 1, 2016.

1.4 Refinement of Definition of Real Property Holding Company

Under the previous law, whether a Korean company is a real property holding company ("RPHC") held by a foreign investor is determined based on whether the value of real property assets held by the Korean company exceeds 50% of its total assets.

The new rules refine such definition by including the value of shares the Korean company holds in other RPHCs in the value of "real property assets" held by the Korean company and counting it toward the 50% test. The amendment makes the definition applicable to foreign investors consistent with that applicable to Korean investors, which had already been refined by a prior amendment. The new rules are applicable to share transfers made on or after January 1, 2016.

1.5 Imposition of a Duty to Withhold Tax on Korean Corporations to which High-Income Foreign Workers Provide Services (Article 156(7) of the Personal Income Tax Law ("PITL"))

Effective January 1, 2016, a withholding tax obligation is imposed on Korean companies that utilize high-income foreign workers dispatched from a foreign company (i.e., Korean companies are required to withhold tax on payments made to the foreign company in consideration for services received from a high-income foreign worker).

The amount subject to withholding tax is the consideration for services or work provided to high-income foreign workers. The withholding tax rate is 18.7 percent (17% (national) personal income tax plus a 10% local income tax).

The foreign company that dispatches the high-income workers to the Korean company may be able to seek a refund of a portion of the withholding tax amount through filing a refund request with the head of the relevant tax office.

2. 2017 Proposed Amendment ("Proposal")

2.1 Extension of Special Income Tax Regime for Expatriate Workers (Article 18(2) of the STTCL)

Under the current STTCL, an expatriate worker can choose to have his or her income taxed at a special flat tax rate of 17 percent for a period of five years from the date on which he or she first began work in Korea. This benefit was scheduled to sunset on December 31, 2016.

The Proposal extends the expiration of this benefit to December 31, 2019 for those who began to provide services in Korea on or after January 1, 2014. Those who began providing services prior to January 1, 2014 are eligible for this benefit only until December 31, 2018. The Proposal also increases the flat rate from the current 17 percent to 19 percent (20.9%, including the local income tax). The amended rate will be applicable to income earned on or after January 1, 2017.

The government expects that, by extending the expiration of this benefit, Korea will continue to be able to attract talented foreign workers and extend the stay of such workers in Korea.

2.2 Limit on Use of Losses Carried Forward for Foreign Companies (Article 91(1) of the Corporate Income Tax Law ("CITL"))

The Proposal will limit the amount of loss carried forward that a foreign company can deduct to 80 percent of the income earned in the relevant business year. The purpose of the Proposal is to provide equal footing between foreign and domestic companies as domestic companies began to be subject to this rule from January 1, 2015. This rule will apply to tax years beginning on or after January 1, 2017.

2.3 Expanded Transfer Pricing Documentation Requirements for Multinational Enterprises

2.3.1 Imposition of duty to submit a Country-by-Country ("CbC") Report on multinational enterprises (Article 11 of the LCITA and Article 21(2) of the Enforcement Degree of the LCITA)

The Proposal will require a Korean company, which is the ultimate parent of a multinational business group with a consolidated turnover of at least KRW 1 trillion (approximately USD 900 million) in the preceding year, to submit a CbC Report that includes information on the business activities (revenue, profits, number of employees, assets, etc.) and the taxes paid, of the Korean company (i.e., entire business group).

As the amount of taxes paid by multinational enterprises and other tax information will be disclosed through CbC Reports, tax compliance costs of multinational enterprises which carry out a significant level of international transactions will increase.

Under this amendment, a Korean ultimate parent company is required to submit a CbC Report for the taxable year of 2016 by the end of 2017.

2.3.2 Extension of the deadline for submission of CRIT (Article 11 of the LCITA)

The Proposal extends the period for submitting the CRIT (i.e., the local file and master file) from the corporate tax return filing due date to within 12 months from the end of the relevant tax year. This amendment is expected to reduce the burden on companies subject to CRIT by lessening documentation-related compliance costs.

The amendment will apply to the submissions made on or after January 1, 2017.

2.3.3 Exemption from duty to submit local file for Advance Pricing Agreement ("APA")-approved transactions (Article 21(2) of the Enforcement Decree of the LCITA)

In light of the similarity between APA documents and the local file, Article 21(2) of the Enforcement Decree of the LCITA will be amended so that the duty to submit the local file will be exempted for APA-approved transactions.

This amendment will be applicable to submissions made on or after January 1, 2017.

2.4 Strengthening taxation of multinational IT companies

Following the United Kingdom's unilateral implementation of a diverted profits tax aimed at aggressive tax planning that erodes the UK tax base through the diversion of profits, some Korean lawmakers proposed a bill on September 20, 2016 to strengthen taxation on multinational IT companies. This bill proposes to expand the scope of Korean source royalties by including royalties arising from "overseas computer program copyrights" in Korean source income. According to the bill, where overseas computer program copyrights are used in Korea via an information and communication network or royalties are paid in Korea in consideration for the use of such overseas computer program copyrights, royalties paid for such overseas computer program copyrights will be regarded as Korean source income and accordingly be subject to Korean withholding tax.

3. Judicial Developments

On July 14, 2016, the Supreme Court rendered a noteworthy decision in respect of the substance-over-form principle (Korea's version of anti-abuse rule) in the context of tax treaty application. The case arises from payment of dividends by a Korean company (which was a joint venture between another Korean company and a French company) to a U.K. company. The French company ("SA") held its interest in the Korean company ("Joint Venture") through an intermediate holding company located in the U.K. ("UK Holdco"). The Joint Venture applied the reduced 5% dividend withholding tax under the Korea-U.K. Tax Treaty.

The lower courts (Daejeon District Court and High Court) had disregarded UK Holdco as a conduit company and considered SA as the substantive owner, thereby rejecting the application of the Korea-U.K. Tax Treaty (and agreeing with the tax authorities' assessment based on the 15% dividend withholding tax under the Korea-France Tax Treaty). The courts reached this conclusion based on the following grounds: (i) UK Holdco is an investment holding company that has no business activities of its own, no workforce, or physical facilities, (ii) the Joint Venture had been formed based on the negotiations between the Korean company and SA, which primarily took place in France, and (iii) there was no purpose other than tax avoidance (i.e., obtaining the benefits of the Korea-U.K. Tax Treaty) for acquiring/holding the shares in the name of UK Holdco.

However, the Supreme Court, in July 2016, reversed such decisions. The Supreme Court concluded that an intermediate holding company such as UK Holdco can be considered, and has determined in this case to be, a substantive owner with independent substance and business purpose.

As basis for the above conclusion, the Supreme Court found that (i) UK Holdco was established in 1983 under U.K. law and is an intermediate holding company holding more than 30 subsidiaries; (ii) UK Holdco performed its role as a holding company (such as making important decisions through the board of directors, receiving dividends from subsidiaries, and making payment guarantee for subsidiaries), paid corporate income tax in the U.K., was audited by outside accounting firm, and published annual reports, environmental and social accounting reports, etc.; (iii) UK Holdco was stated as the party to the joint venture agreement, the associated legal and accounting costs were ultimately borne by UK Holdco, and its board of directors made decisions for the conclusion of the joint venture agreement and the subsequent investment; (iv) the funds for the acquisition of the shares were UK Holdco's remitted under its instructions; (v) UK Holdco exercised its rights as a shareholder (holding board meetings to delegate the authority to attend the Plaintiff's shareholders meeting and to discuss the Plaintiff's dividends policy, exercising the right to appoint a director of the Plaintiff under the joint venture agreement); and (vi) the dividends were ultimately remitted to UK Holdco, and UK Holdco managed and used the dividends.

Thus, the Supreme Court concluded that dividend income UK Holdco derives from Korea would be entitled to the 5% reduced dividend withholding tax under the Korea-U.K. Tax Treaty.

This decision is significant in that it serves as a continuation of the Supreme Court's similar line of decisions such as the July 2014 Carrefour decision. It is another welcome precedent for foreign investors who wish to invest in Korea through overseas holding companies and wish to ascertain the application of treaty benefits in reference to such holding companies. The decision reiterates the rule that an intermediate holding company could be found to have substance for treaty application purposes based on the factual circumstances.

4. Tax Authority Trends

4.1 FATCA - Intergovernmental Agreement

On June 10, 2015, the governments of Korea and the U.S. officially signed the Korea-US Intergovernmental Agreement related on the intergovernmental agreement (IGA) related to Foreign Account Tax Compliance Act (FATCA). The two governments had reached an agreement in substance in March 2014.

The National Assembly in Korea ratified the IGA on September 8, 2016. As a result, the IGA between Korea and US entered into force on that date. Under the Model 1 IGA, financial institutions in both countries must report the account information to the NTS or the Internal Revenue Service (as the case may be) for periodic exchange of information between the two.

The automatic exchange of information (which includes account information for years 2014 and 2015) is expected to commence sometime in December 2016.

4.2 Korea-Hong Kong Tax Treaty

The Korea-Hong Kong Tax Treaty, which was officially signed by Korea and Hong Kong in July 2014, has been ratified by the National Assembly in Korea on September 7, 2016. Thus, the treaty entered into force on September 27, 2016.

The treaty will be effective for Korean tax for taxable years beginning on or after January 1, 2017 (for Korean withholding tax, the treaty will be effective for any amounts payable on or after April 1, 2017). For Hong Kong tax, the treaty will be effective for any year of assessment beginning on or after April 1, 2017.

Under the Korea-Hong Kong Tax Treaty, the Korean tax authority will be able to obtain information on suspected Korean tax evaders from Hong Kong in accordance with the international standards (and vice versa). In particular, each tax authority will be able to receive information held by financial institutions of the other, including information on past transactions.

Other notable terms of the tax treaty are as follows:

Tax Item	**Terms (limit on withholding tax)**
Dividends	10% (for shareholders holding at least 25%) / 15%
Interest	10%
Royalties	10%