



## KOREA

### LATEST DEVELOPMENTS IN KOREAN TAXATION OF CROSS-BORDER TRANSACTIONS

This is a brief summary of Korean tax law changes concerning cross-border transactions. Some of the changes have come into force since January or February 2006, while other proposed amendments are awaiting the approval of the National Assembly at the time this article was written.

#### Anti-Treaty Shopping Rules

##### Codification of substance over form rule

Under the proposed amendment to the Law for Coordination of International Tax Affairs (LCITA), the domestic "substance over form" rules will be codified into the LCITA to clarify that these rules apply to international transactions and in interpretation of tax treaties. The proposed provision is being enacted to deter treaty shopping by foreign investors investing into Korea.

The new rule will be enforced from fiscal years beginning on or after the date the amended rule is proclaimed.

#### New withholding tax rule for foreign companies domiciled in designated foreign jurisdictions

Under the new withholding tax rules which will apply from 1 July 2006, if a foreign company is located in a foreign jurisdiction designated by the Minister of Finance, any Korean source income (such as dividend, interest, royalties) of such foreign company will be subject to the domestic withholding rate of 27.5% (which is the case for the dividend, interest, and royalties), regardless of whether or not the foreign company is resident of a treaty country.

The foreign company may claim a refund of any excess withholding tax paid within 3 years if it is able to prove to the Korean Tax Office that it should be entitled to the reduced treaty rates as substantive and beneficial owner of the income. Alternatively, a foreign company may attempt to seek a pre-approval in order to have the treaty benefits applied upfront by making an application to the Commissioner of Taxation. The Minister of Finance has not yet announced which foreign jurisdiction(s) will be subject to the new withholding tax rules.

#### Transfer Pricing Rules

##### Treatment of adjusted income

Under the current tax law, when a domestic company is considered to have transferred income to a foreign shareholder and the transferred income is not returned to the domestic company, such income is deemed to have been distributed as a dividend and subject to withholding tax.

Under the proposed amendment, deemed distribution made to foreign related parties other than a shareholder will also be treated as a dividend and subject to withholding tax.

This proposed change will be applicable to income adjusted on or after the date the amended rule becomes effective.

##### Consideration for intra-group services

A new provision providing guidance on the determination of arm's-length price with respect to intra-group services is proposed. Intra-group services are those service activities undertaken between overseas related parties and their Korean member company. Such services include management service, financial advisory service, payment guarantee, computer service, technical support service, training of personnel, legal and accounting services and other activities considered to be necessary in carrying on a business.

Intra-group services will be considered to have been conducted at arm's length if all of the following requirements are met:

- Services are rendered in accordance with contract;
- Benefits are expected from services provided;
- Methods used to determine fees charged for intra-group services are in accordance with the arm's length principle; and
- Documents exist to substantiate the above.

Certain services are excluded from intra-group services, such as services rendered by shareholders in their capacity as shareholders, services rendered by an independent 3rd party and services rendered relating to the company's ancillary activities (e.g. factory shutdown).

If cost plus method or transactional net margin method is used to determine the intra-group services fee, the arm's length price shall be determined by applying the following guidelines:

- Direct and indirect expenses should be included in the cost;
- Where a group member outsources the services and pays the fee on behalf of the other members with a view to being subsequently reimbursed, margin must be added to the reimbursement.

This change will be applicable to transactions taking place on or after the date the amended rules become effective.

### Exemption from submission of selection of arm's length pricing method schedule

The LCITA requires a resident taxpayer to use the most appropriate method in computing the arm's length price of related party transactions and submit a schedule disclosing the arm's length method selected and the reason for the selection along with its tax return. Under the proposed change, this schedule is not required to be lodged for de minimis transactions, being KRW 5 billion or less for goods and KRW 500 million or less for services.

This proposed change will be applicable to transactions taking place on or after the date the amended rules become effective.

## Anti-Tax Haven Rule

### Relaxation of anti-tax haven rule for wholesale industry

According to the current criteria, a company engaged in wholesale business is subject to the anti-tax haven rule if the following conditions exist: 1) purchases and sales relating to wholesale business are more than 50% of gross income for the year; and 2) 50% or more of such purchase and sales is derived from related party transactions. Under the proposed amendment, the one-year test period will be changed to average of the recent three fiscal years.

In addition, the above 50% related party test shall not be applicable for transactions undertaken within the same region/territories.

### Exemption of certain overseas holding company from anti-tax haven rule

Under the proposed amendment, although domiciled in a tax haven, an overseas holding company of a domestic corporation will not be subject to the anti-tax haven rule if the following conditions are met:

- The overseas holding company has owned shares in a foreign subsidiary for at least three months as of the ex-dividend date;
- Dividend income received by the holding company from the subsidiary makes up at least 90% of the sum of interest, dividend, royalty and capital gain of the holding company;
- The overseas holding company owns at least 50% of the total number of outstanding shares of the foreign subsidiary;
- The overseas holding company and the foreign subsidiary must be situated in the same country or region; and
- The foreign subsidiary is not subject to the anti-tax haven rule.

This proposed change will be applicable from the fiscal year in which the effective date of the rule falls.

## Amendment to tax haven criteria

The LCITA presently defines a tax haven as a low tax country where effective tax rate on taxable income for the past three years average 15% or less. While the 15% test rate remains intact, a new provision will be established to allow an exemption from the anti-tax haven rule in case where taxable income of a corporation in a tax haven amounts to KRW 100 million or less for the year.

Another amendment to the anti-tax haven rule will require the National Tax Service to designate and announce tax havens after the prior approval of the MOFE. Tax havens designated by the OECD member countries will be taken into account in determining whether a country will be designated as a tax haven.

## Foreign tax credit for deemed dividend under LCITA

Distributable retained earnings of a foreign company located in a low tax country is taxed as deemed dividends to the Korean residents that have direct or indirect interest of 20% or more in the foreign company.

Under the proposed amendment to the law, when the foreign company actually pays a dividend to the domestic company against which foreign taxes are deducted, such foreign taxes may be claimed as a credit in the year in which the deemed dividend arose. This is done by filing an amended income tax return for the taxable year in which the deemed dividend arose.

Also, indirect foreign tax credit will be available when the deemed dividend is included in the domestic corporation's gross income.

These proposed changes will be applicable from the fiscal year in which the effective date of the amended rules falls.

## Request for Mutual Agreement Procedures (MAP)

Under the proposed amendment, a non-resident or a foreign company having a business place in Korea will be allowed to file a request for MAP. Presently, request for MAP process may only be filed by Korean nationals, residents and domestic companies.

This proposed change will be applicable to requests filed on or after the effective date of the amended rule.

## Corporate Residence

For Korean corporate income tax purposes a domestic company is defined as a company having a head office or principal office in Korea. Under the amendment, a company will be defined as a domestic company for Korean income tax purposes if it has the place of effective management in Korea irrespective of whether the company's headquarters is located in a foreign country.

This change will be applicable from fiscal years beginning on or after 1 January 2006.

## Rollback of Unilateral Advance Pricing Agreement (APA)

Under the proposed amendment to LCITA, an arm's length pricing method approved by a unilateral APA may be rolled back for the preceding 3 years of the approval year in order to reduce unnecessary tax audits. Under the current law, a rollback application of the approved method is limited to a bilateral APA.

The proposed change is applicable to APA applications made on or after the proposed amendment is proclaimed.

## Foreign Tax Credit of Funds

According to a newly established provision of the amended Corporate Income Tax Act (CITA), indirect investment vehicles (e.g. mutual funds, investment trusts) are allowed to claim a refund for any foreign taxes paid up to 14% of foreign income.

This amendment applies to foreign income arising on or after 1 January 2006.

## Amendment to Personal Service Income Taxation

Currently under Korean tax law, personal service income derived by a non-resident or a foreign corporation not having a permanent establishment in Korea is subject to 22% withholding tax. Under the amended CITA, withholding tax will apply on the net income excluding reimbursements of certain necessary expenses such as air fare, accommodations and meals.

This change is applicable to income derived on or after 1 January 2006.