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Korean Tax Reform: Opportunities and Challenges for Foreign Companies and Investors



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The Korean Ministry of Strategy and Finance (“MOSF”) has finalized the changes to the Presidential Decree of Korean tax laws (“2018 PD Amendments”) which will be of particular interest to foreign companies with business and foreign nationals residing in Korea.

Key 2018 PD Amendments announced in February 2018 are described below.

Limitations on Hybrid Instruments (BEPS Action Plan 2)

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The tax law amendments enacted in December 2017 (“2018 Tax Law Amendments”) also introduced a new rule denying deductions for hybrid mismatch arrangements. This is in line with BEPS Action Plan 2. Briefly, this law denies deductions for the payor in

Korea if the interest is treated as dividends and not taxed in the income recipient’s jurisdiction (“hybrid instruments”).

In that regard, the 2018 PD Amendments (generally, Presidential Decrees can be regarded as explanations that are meant to expand upon or clarify the enacted tax law) further clarifies the scope of hybrid instruments subject to this limitation. The 2018 PD Amendments define hybrid instruments as financial instruments which have both debt and equity charac-

teristics, and where the tax treatment is different in Korea and the counterparty jurisdiction. And, under the 2018 PD Amendment, interest deduction in Korea should be denied if the interest is not included in the taxable income of the recipient, or if less than 10 percent of the interest is includable in the taxable income of the recipient (e.g. on the basis that the income is treated as dividends in the jurisdiction of the income recipient).

This is effective from January 1, 2018.

Limitations on Interest Deductions (BEPS Action Plan 4)

The 2018 Tax Law Amendments also introduced additional limitations on interest deductions. This is in line with BEPS Action Plan 4. The 2018 Tax Law Amendments provide additional limitations on the deductibility of interest paid to foreign related parties. Briefly, “net interest expense” in excess of 30 percent of “adjusted taxable income” will not be deductible.

In that regard, the 2018 PD Amendments clarifies that net interest expense is calculated by (i) deducting interest income received from foreign related parties from (ii) interest expense paid to foreign related parties. Furthermore, adjusted taxable income is defined as earnings before interest, taxes, depreciation and amortization (i.e. EBITDA). In addition, the 2018 PD Amendment clarifies that certain prescribed Korean financial institutions and insurance companies will be exempt from this new limitation rule.

This will be effective from January 1, 2019.

Expansion of the Scope of Use of Documents Submitted for APA

Up to 2017, the Korean National Tax Service (“NTS”) was not permitted to use documentation submitted as part of application for advance pricing agreement (“APA”) for any purpose other than for examining the APA application.

The 2018 PD Amendments loosens this restriction. Under the 2018 PD, the NTS is now permitted to use such documentation for purposes of exchanging information with the competent authority of another Contracting State. Readers will note that this is in line with BEPS Action Plan 5. As a result, taxpayers should be aware that any documentation submitted to the NTS as part of an APA application can be shared with the tax authority of the foreign jurisdiction where the counterparty is resident.

This is effective for exchange of information procedures from February 13, 2018.

Revision to the Standard for Korean Tax Residency for Individuals

Up to 2017, one of the ways that a foreign individual was regarded as a Korean tax resident was if he/she has resided in Korea for 183 days. In calculating 183 days, if the foreign individual resided in Korea for 183 days in one year, the individual would clearly be regarded as a Korean tax resident. However, under the Presidential Decree prior to 2018, the period to calculate 183 days was also prescribed as over two years. In other words, if a foreign individual resided in Korea for three months in year 1, and then another three

months in year 2, then it was likely that the foreign individual could be regarded as a resident for Korean tax.

The 2018 Presidential Decree revised this standard to 183 days or more over one year, which is more reasonable. This new rule addresses complaints from foreign taxpayers that the current standard for Korean tax residency is unduly broad and may also conflict with the threshold for taxation of personal services in many Korean tax treaties (which is typically triggered when a foreign individual is in Korea for 183 days in a year). We expect that this new rule will remove some uncertainty regarding whether foreign individuals would be considered to be a Korean tax resident.

This is effective from January 1, 2018.

Decrease in Threshold for Foreign Financial Account Reporting for Korean Residents

Korean residents have an annual reporting requirement (by the end of June) to the NTS for financial accounts held overseas. Up to 2017, the threshold for this reporting requirement was if the sum of the balances in the foreign financial accounts exceeds 1 billion won at the end of any month during a calendar year.

The 2018 PD Amendments reduces this threshold from 1 billion won to 500 million won. Hence, the lower threshold applies for reporting of financial account beginning in 2019.

This is effective for foreign financial accounts held from January 1, 2018.

Expand the Scope of Withholding Tax for Service Fees Paid to Foreign Company for Dispatched Employees

Up to 2017, a Korean company was required to withhold tax on service fees paid to a foreign company with respect to services provided by the foreign company’s employees in Korea (Korean-source income only). It should be noted that this withholding tax is related to the Korean-source income attributable to the seconded employees of the foreign company (i.e. withholding on individual income), rather than on the total fees earned by the foreign company. Under the 2018 Tax Law Amendments, the withholding tax rate is 20.9 percent. Two of the key requirements for this withholding tax to apply were as follows:

- (i) total service fees paid to a foreign company exceed 3 billion won in a year; and
- (ii) Korea service recipient is in the air transportation, construction, professional, scientific or technical service business.

The 2018 PD Amendments broadens the scope of this withholding tax requirement as follows:

- (i) The service fee threshold is reduced from 3 billion won to 2 billion won a year; and
- (ii) The list of Korean service recipients subject to this withholding obligation is expanded to include shipbuilding and financial institutions.

Practically, it may be difficult for the Korean company to withhold if it does not have sufficient information about the portion of the service fee that should be attributed to the services provided by the seconded employees in Korea.

This will be effective for payments of service fees on or after July 1, 2018.

Planning Points

The 2018 PD Amendments, in conjunction with the 2018 tax law changes enacted earlier in December 2017, represent significant changes to the tax environment in Korea. Foreign companies and investors should review their investments and business activities in Korea to determine if these changes will have an impact on them.

Key considerations may include the following:

- If the foreign company is using a hybrid instrument to hold investments in Korea (e.g., profit participating loan), then the company may need to consider restructuring their investment.
- In addition to the thin capitalization limitation (150 percent debt-equity ratio), the new limitation on interest deductions rule (this 30 percent limitation is

based on adjusted taxable income and is effective from January 1, 2019) represents additional restrictions on the use of debt to reduce the taxable income of Korean investments. This PD Amendment, along with the increase in tax rates under the 2018 tax law changes, could increase tax costs in Korea in the future.

- Since the scope of services subject to the 20.9 percent withholding tax on service fees has been broadened, if the foreign company will dispatch its employees to Korea to provide personal or technical services, the company should consider more carefully whether it could be subject to this tax.
- Since the threshold for tax residency have changed, foreign individuals should review their tax compliance requirements in Korea.

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