



# Financial Services Tax Hot Topics

January 2017

## Transfer Pricing Developments

**Highlights:** Korea's Ministry of Strategy and Finance ("MOSF") introduced the Combined Report of International Transactions ("CRIT") last year to better align the transfer pricing documentation requirements contained in the Law for the Coordination of International Tax Affairs ("LCITA") with Action 13 of the OECD's Base Erosion and Profit Shifting ("BEPS") project. Through these latest amendments, MOSF is taking measures to implement the submission of the Country-by-Country Report ("CbCR") as part of a three-tiered structure along with the master file and local file for fiscal years beginning January 1, 2016. In addition, the due date for filing the CRIT was extended to allow a taxpayer to submit the CRIT within 12 months after fiscal year end.

### Introduction of CbCR

CbCR contains aggregated tax jurisdiction-wide information relating to the global allocation of the income, taxes paid, business activities, number of employees, etc.

According to the amendments of LCITA and the proposed amendments to the underlying Presidential Enforcement Decree ("LCITA-PED"), the filing of CbCR will be required if the consolidated revenues of the ultimate parent company of a Multinational enterprise ("MNE") group exceeds KRW 1 trillion (approximately USD 830 million) in the immediately preceding fiscal year.

In cases where the jurisdiction in which an ultimate parent company of a foreign MNE group is located does not require submission of CbCR or has not signed the Multilateral Competent Authority Agreement on the Exchange of CbCR ("MCAA"), the domestic subsidiary or branch of the MNE group located in Korea will be responsible for the submission of the CbCR.

CbCR is required to be filed within 12 months after fiscal year end, while a template including information on the company to prepare and submit the CbCR shall be filed with the tax authority within six months from the end of the tax year. This template shall be filed by the domestic company which is an ultimate parent company or the Korean subsidiary or branch of a foreign ultimate parent company.

Under the MCAA, CbCRs submitted to each tax authority by the end of 2017 are to be exchanged from 2018.

### Extension of due date for filing the CRIT

In order to mitigate excessive compliance burdens placed on taxpayers, MOSF extended the due date for filing the CRIT from the corporate tax return filing deadline (i.e. three months after fiscal year end) to within 12 months after fiscal year end. Taxpayers having fiscal years ending December 31st should submit the CRIT for FY2016 by December 31, 2017.

### Local File Exemption for Taxpayers with APAs

Given the similarity of the contents between local file documentation and an APA submission, taxpayers having an approved APA are exempted from the filing requirement of a local file with respect to covered transactions.

## ***Draft Guidelines for Preparation of the CRIT***

At a conference hosted by the Korea Institute of Public Finance on November 25, 2016, MOSF and the NTS released draft guidelines on the preparation of the CRIT. MOSF and the NTS indicated that they would gather taxpayer's comments on the draft guidelines and may release final guidelines in June 2017.

The draft guidelines requires inclusion of the MNE group's organizational structure, major related party transactions, a description of the MNE's businesses, and the MNE's value chain and risk factors in detail. The draft guidelines also contain specific instructions regarding the description on intangibles, service transactions such as intra-group services, management services, and intercompany financial activities.

With respect to CbCR, it is anticipated that a CbCR template will be released. The CbCR template is expected to be consistent with the OECD guidance.

## **Potential Tax Risks Associated with Management Services Fees Charged for Services Challenged as being Non-Beneficial**

### ***Background***

During a recent tax audit conducted on a Korean entity, tax auditors denied the deductibility of management service fees paid by the Korean entity to a UK affiliate. The management service fees were treated as expense for non-business purposes and classified as 'other income', which is not subject to withholding tax under the Korea-UK tax treaty.

The Board of Audit and Inspection subsequently investigated this tax audit case and concluded that the 'other income' should be subject to withholding tax under the Article 22 (3) of the Korea-UK tax treaty<sup>(1)</sup>. Following the imposition of withholding

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<sup>1</sup> **Summary of the Article 22 (3) of the Korea-UK tax treaty:** Where the amount of the 'other income' exceeds the amount which would have been agreed upon between them in the absence of a special relationship, the excess part of the income shall remain taxable according to the laws of each Contracting State, due regard being had to the other applicable provisions of this Convention.

tax including penalties for the failure to file a payment statement, the taxpayer filed an appeal to the Tax Tribunal.

### ***Summary of Tax Tribunal Ruling***

The Tax Tribunal concluded that with respect to the case at hand, other income should not be subject to withholding tax based on the following:

- It is unclear whether the foreign related company did not provide any management services to the taxpayer or the remuneration for the management services rendered exceeded arm's length.
- While the corresponding income was classified as other income for corporate income tax purposes according to the Korean tax law, this classification does not necessarily apply from a tax treaty perspective.
- The intent of Article 22 (3) of the Korea-UK tax treaty is to allow the tax authority of the income sourced jurisdiction to impose taxes on new types of income such as income derived from transactions involving new type of financial instruments arrangement.

### ***Key Takeaway***

While the Tax Tribunal concluded that other income should not be subject to withholding tax under the Korea-UK tax treaty, that the ruling also seems to imply that in situations where management services rendered by a foreign affiliate do not pass the benefit test, there is a high likelihood that the deductibility of corresponding management service fees would be denied as expense for non-business purposes under the corporate income tax law rather than the transfer pricing rule under the LCITA. This also raises the prospects of the imposition of withholding tax.

In case of the UK, Germany, and Japan, a withholding tax on other income (or dividends if income recipient is a shareholder) may be imposed based on the aforementioned provision in the tax treaty. In addition, in cases where other income provision is not contained in the tax treaty such as the US, Singapore, the Netherlands, Denmark, and Thailand, withholding tax on other income (or dividend) may be imposed according to a domestic corporate income tax law.

## Potential Tax Refund Opportunity for Luxembourg SICAVs

### *Background*

There has been a significant amount of controversy regarding whether SICAVs are eligible for benefits under the Korea-Luxembourg tax treaty and whether reduced rates can be applicable for the withholding tax purposes.

SICAVs established under the Luxembourg law may generate interest income or dividend income from investments in Korean listed stocks or bonds. Such income shall be subject to Korean domestic withholding tax rates, subject to treaty relief.

The Korean domestic withholding tax rates for dividend, interest from bond, other interest are 22%, 15.4%, and 22% (including local income tax), respectively, whereas the reduced rates under the Korea-Luxembourg Tax Treaty are 15%, 10%, and 10%.

### *History of Rulings and Court Cases*

In the past, some of the custodian banks of SICAVs withheld taxes at reduced rates under the Korea-Luxembourg Tax Treaty. The National Tax Service (“NTS”) imposed tax assessments on four local custodians for the tax years from 2006 to 2011 based on domestic withholding tax rates by arguing that the reduced rates under the tax treaty are not applicable to SICAVs.

In January 2014, the Tax Tribunal held that SICAVs shall be treated as holding companies under Article 28 of Korea-Luxembourg Tax Treaty, and are thus excluded from treaty benefits. However, in January 2015 and in February 2016, the Seoul District Court and the Seoul High Court, respectively, concluded that SICAVs are eligible for treaty benefits and reduced tax rates are applicable.

The final verdict from the Supreme Court is expected to be made within a year and there is a strong likelihood that the taxes imposed will be refunded to the custodian banks considering the favourable decisions from the lower tax courts.

### *Timing Considerations*

Previously, the period for filing a tax reclaim was 3 years. As of 1 January 2015, the period for filing a reclaim was extended from 3 years to 5 years. Please note, however, that the extension is only applicable prospectively, i.e. for requests for which the deadline has not passed under the previous 3 year rule.

Considering the time limit for filing a refund request and the possibility that it could take a year for the Supreme Court to render a decision, it is advisable for SICAVs to take early action by filing a tax reclaim ahead of the outcome of the Supreme Court in order to prevent any potential loss of reclaimable withholding taxes. Assuming a favourable outcome, this will enable SICAVs to maximize the amount of refundable withholding taxes.

### *Other Considerations*

The revised Korea-Luxembourg Tax Treaty entered into force on September 4, 2013. The primary amendment was the removal of Article 28, which provided for the exclusion from treaty benefits of specific holding companies. As a consequence of this amendment, SICAVs should be entitled to benefit from reduced treaty rates as of 4 September 2013, provided that they are the beneficial owner of the income.

In addition, there was an amendment to the Korean tax law in 2012 which requires a beneficial owner of a Korean source income to submit application forms for reduced tax rates (including an OIV form) in order for the beneficial owner to get a tax relief. The amended rule was applicable to a Korean source income where taxes are withheld on or after July 1, 2012.

Accordingly, some of the custodian banks in Korea have withheld taxes at reduced rates under the revised Korea-Luxembourg Tax Treaty if applications for reduced tax rates were submitted by SICAVs. However, some custodian banks have not applied treaty benefits and further review of the appropriate amount of taxes withheld may be merited.

## **Updates of Tax Ruling and Court Ruling Relating to Financial Services**

### ***Tax Book Value of Equities acquired via Debt-to-Equity Swap (Josim2016Seo3619, 2016.11.25)***

The Tax Tribunal ruled that the tax book value of equities acquired via debt-to-equity swap made in compliance with the approval of a rehabilitation plan should be the tax book value of bonds converted into equities as of the previous fiscal year end.

This decision was based on the following:

1. Bad debt expense subject to Financial Supervisory Service (“FSS”) approval can be deductible after the end of the fiscal year when the bad debt expense has been recorded on the books.
2. MOSF’s tax ruling (Jaebubin-88, 2014.2.19) interpreted the tax book value of bonds converted into equities which is treated as the acquisition price of the equities to mean the book value for tax purposes as of the end date of the “previous” fiscal year of the conversion.
3. The amendment of tax laws in 2006 clarified that recognition of income or loss associated with debt-to-equity swap should be deferred to the year when disposing the converted equities.

A key takeaway of this ruling is that even if FSS approval on recognizing bad debt expense of bonds has been obtained, the deduction of losses associated equities converted from bonds via debt-to-equity swap is not allowable for corporate income tax purposes until the converted equities are disposed of.

### ***Beneficial Owner of Royalty Income (Josim2016Seo2081, 2016.11.24)***

The Tax Tribunal concluded that an Irish intermediary company should be looked through and a US company be a beneficial owner of Korean sourced royalty income, which should be subject to withholding tax in Korea under the Korea-US tax treaty.

The Tax Tribunal expressed that the authority to dispose of benefits of the income, discretion associated with incurring the income, etc. should be taken into account when determining whether the income recipient is a beneficial owner of the Korean sourced income.

Given the fact that the Irish intermediary company immediately passed on almost all royalty income received to the US parent company and the employees of the Irish intermediary company were not involved in any activities related to the earning of the royalty income, the Irish intermediary company should be treated as a conduit entity and the US parent company be viewed as the beneficial owner of Korean sourced royalty income for tax purposes.

### ***Classification of Income derived from Gold Banking (Daebub2015Du1212, 2016.10.27)***

The Supreme Court held that the classification of income derived from Gold Banking should not be considered as dividend income therefore should not be subject to withholding tax.

This decision was based on the following:

1. The generation of income was not up to trusted banks or asset management companies but rests entirely with the client.
2. There is no causal relationship between the performance of trusted banks or asset management companies and the income clients earned from Gold Banking

Accordingly, it should not be viewed as having the nature of income distribution and similarity to income arising from collective investment.

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