삼정 KPMG

May 2018, Issue 105

Korean Tax Brief

Update on Current Issues and Trends

1. Recent Regulations and Precedents

The income tax ("withholding tax") incurred for US tax purposes on the consideration received for paid capital reduction of its US subsidiary is not deductible from the taxable income of Korean parent company (Advance Interpretation Request -2017-Legal Interpretation-0752, 2018.04.10)

The US Corporation has reduced its capital in accordance with the relevant US Law and paid the corresponding consideration to the shareholder in Korea (refund of the original investment). Specifically, the US Corporation reduces its retained earnings for the decrease in shareholder's capital , in which the decrease in retained earnings under such paid capital reduction shall be regarded as deemed dividend income subject to withholding tax requirement for US tax perspectives.

In this respect, National Tax Service in Korea construes that the withholding tax paid in the US on the deemed dividend income above shall not be deductible from Korean tax perspectives.

Even though the response to this inquiry is not specified, in case the consideration in connection with the capital reduction is not regarded as taxable income for Korean tax purposes, and as a result, the Korean parent company is unlikely to be eligible for foreign tax credit. Furthermore, since the withholding tax incurred for US tax purposes cannot be treated as deductible expenses in Korea by this interpretation, the two general alternatives – foreign tax credit or deduction – applicable to corporate income tax incurred in overseas cannot be utilized if the relevant foreign sourced income is not taxable in Korea.

Income classification for interest expense in excess of the thin-capitalization threshold between head office and Korea branch shall be determined based on the tax treaty (Supreme Court 2018. 2. 28 Pronouncement 2015Du2710 Adjudication)

According to the Article 14 of Act for the Coordination of International Tax Affairs ("ACITA"), if a domestic corporation (including a domestic place of business of a foreign corporation) borrows funds from a foreign controlling stockholder (including the head office) and such borrowings exceed twice (sextuple for financial business) the amount of capital invested by the foreign controlling stockholder, the interest expense incurred on the excess portion of such debts is not deductible for tax purpose. Instead, the amount shall be deemed to be dividend, domestic source income of the foreign controlling stockholder. However, the provisions of the tax treaty shall override the ACITA in classification of a domestic source income of a foreign corporation, under the Article 28 of ACITA.

Accordingly, whether the Korea tax authority would have the right of taxation on such excess interest as dividend income shall be determined in accordance with the tax treaty concluded with the resident country of the foreign controlling shareholder. In other words, if the excess interest is to be classified as other income types than the dividend income under tax treaty, such as interest income, the existence of the right of taxation of the Korean tax authority and/or tax treatment (i.e., the income classification and the applicable reduced tax rate) will be determined based on the relevant tax treaty.

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Even if Korean company pays tax on the dividend income at the reduced tax rate of 5% in China according to Korea-China tax treaty, the amount of tax deemed to be paid in the China pursuant to the Article 5 (1) of Korea-China tax treaty Protocol No.2 shall be 10% of the total dividend income for foreign tax credit purpose. Hence, the 10% tax including the 5% deemed payment shall still be eligible for foreign tax credit (Supreme Court 2018. 3. 13. Pronouncement 2017Du59727 Adjudication)

According to Article 10 (2) (a) of Korea-China tax treaty, 'if the beneficial owner is a company (other than a partnership) which holds directly at least 25% of the capital of the company paying the dividends', the lower reduced tax rate of 5% is applied on the gross amount of the dividends rather than the general reduced tax rate of 10%, since the necessity of minimizing double taxation and promoting the foreign investment is greater for such cases than other cases. In addition, Article 5 (1) of Korea-China tax treaty Protocol No. 2 stipulates that for such beneficial owners, it shall be assumed that the general reduced tax rate 10% is uniformly applied in computing the amount of foreign tax payment for the purpose of applying for foreign tax credit in order to promote the foreign investment.

According to the Supreme Court adjudication, as the method and eligibility for such special tax benefits by allowing deemed paid-tax rates is clearly defined with limited scope and time of such application under Korea-China tax treaty, it is reasonable to assume that (deemed) foreign tax credit shall be available even for the deemed paid-tax of 5%.

The proxy VAT payment regime does not apply when receiving services from a foreign corporation without a domestic place of business for overseas resource development projects which generate sales outside of the country (Ministry of Strategy and Finance Value-Added Taxation Bureau-108, 2018. 2. 9)

According to Article 52 of Value-Added Tax Act ("VATA"), for the supply of services or the rights (hereafter referred to as "services, etc.") from (i) a non-resident or a foreign corporation without a domestic place of business or (ii) a non-resident or a foreign corporation with a domestic place of business (limited to the domestic supply of services, etc., with no relations to its domestic place of business, as stipulated under Article 95 (4) of Enforcement Decree of VATA) shall collect VAT from the provider of such services, etc., at the time of service fee payment for proxy VAT payment.

Service fee paid by a business - which has officially reported its business plan for overseas resources development to the Minister of Trade, Industry, and Energy according to Article 5 (1) of Overseas Resources Development Business Act – for the services provided by a non-resident or a foreign corporation without domestic place of business for provision of information and relevant consulting related to exploration, development, and production of foreign petroleum and natural gas equipment, and evaluation, acquisition, and sales of overseas mines, is not subject to proxy VAT payment stipulated under Article 52 of VATA.

Undeclared corporate local income tax per the undistributed earnings tax regime is subject to penalty for under-reporting of taxes pursuant to Basic Act on Local Taxes (Tax Tribunal 2017Ji1044, 2018. 2. 14.)

In accordance with the Article 103-31 (5) of Local Income Tax Act, local income tax for corporate undistributed earnings shall be paid in addition to the amount of corporate local income tax. Furthermore, according to the Article 53-3 (1) of Basic Act on Local Taxes, any under-reported tax will trigger relevant penalty taxes.

Based on a previous tax ruling issued by Ministry of Strategy and Finance, the claimant corporation insists that the undeclared corporate income tax per the undistributed

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earnings tax regime is not subject to penalty for corporate income tax purpose and, in the same manner, it should not trigger the penalty on any under-reported tax for local income tax purposes. However, the Supreme Court adjudicates the following statement.

When a domestic corporation with reported undistributed earnings tax for CIT purpose fails to report the corresponding local income tax, the penalty on corporate local income tax shall be determined based on the Basic Act on Local Taxes rather than the Basic Act on National Taxes.

As Article 53-3 of Basic Act on Local Taxes regulates that "penalty for under-reporting of taxes shall be levied when a taxpayer has reported less amount of taxes than the amount of taxes to be paid", the corporation that fails to include the local income tax on undistributed earnings on its annual local income tax return shall be subject to penalty for under-reporting of taxes.

The method of utilizing reserve for future earnings distribution is still available for FY2017 to be reflected on the undistributed earnings tax calculation of the following business year (FY2018) (Ministry of Strategy and Finance, Corporate Income Tax Bureau-121, 2018. 2. 13)

In accordance with the Article 56 (5) and (6) of CITA, a domestic corporation may fully or partially set aside undistributed income for the relevant business year as reserve amount to be utilized in the following year and exclude the reserve amount from the current year's undistributed earnings tax calculation; accordingly, the undistributed earnings tax shall be levied in the following year for the reserved amount from prior year less any excess distribution of earnings amount in the following year.

Even though the sunset of the existing undistributed earnings tax regime expires after FY2017 and the "Special taxation for investment and collaborative cooperation promotion" regime from Article 100-32 of Restriction of Special Taxation Act is applicable from business years beginning on or after January 1, 2018, the calculation of excess distribution of earnings amount shall abide by Article 56 (2) (1) of CITA (Article 93 (23) of Enforcement Decree of CITA).

If a corporation has elected to apply the undistributed earnings calculation method including its spending for investment in FY2017 (one of the two selectable methods), a consistent approach should be taken even after the expiration of sunset of the existing law after FY2017; the calculation method including amounts spent for investment pursuant to the new regime under the Restriction of Special Taxation Act shall be applied until FY2019 (SaJeon-2018-Legal Interpretation-0133, 2018.03.28)

According to the Article 56 (3) of the CITA and the Article 93 (15) of Enforcement Decree of CITA, a domestic corporation that has elected to apply the undistributed earnings calculation method including its spending for investment shall continuously apply its selected method for 3 fiscal years, while the other calculation method excluding investment amounts only has to be applied for at least 1 fiscal year. On the other hand, the sunset of existing undistributed earnings tax regime under CITA ends at December 31, 2017, and is replaced by a new regime "Special taxation for investment and collaborative cooperation promotion" under Article 100-32 of Restriction of Special Taxation Act from fiscal years beginning on or after January 1, 2018. The required application period for the elected method of undistributed earnings calculation is equivalent to the previous regime prescribed in CITA.

If a domestic corporation has elected to apply the undistributed earnings calculation method including its spending for investment for the first time in FY2017, the domestic corporation shall continuously apply the identical method stipulated under the new regime to meet the 3-year time requirement. Thus, the calculation method including amounts spent for investment pursuant to the new regime shall be applied for FY2018 and FY2019 for the corporation.

In other words, the content of existing regime, which expires after FY2017, is substantially identical to the content of the new regime, which introduces in FY2018 and after; so that the domestic corporation shall continuously maintain the method elected in FY2017 for 3 fiscal years complied with the relevant regulation, rather than selecting a new method in FY2018.

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