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Tax treaty rates to apply to offshore investors only upon application including disclosure of beneficial owners

New rules requiring prior information, subject to some exceptions, apply from July 1, 2012.

Under amendments to the Corporate Income Tax Act (CITA) promulgated on December 31, 2011, in order to have favorable tax treaty withholding rates applied to payment of Korean-source income (including dividends, interest and royalties) from July 1, 2012, the offshore beneficial owner of the income must first submit an application for such treatment to the tax withholding obligor (normally the income-paying Korean counterparty). In the case of an “offshore investment vehicle” or offshore fund serving as conduit for the income to beneficial owners,¹ the fund must submit an application by its beneficial owners, together with an offshore investment vehicle report. Thus, the income-paying entity in Korea will have to obtain, up front, details of the beneficial owners—information that till now was sought, if at all, only by tax examiners after the fact.

As an exception, the application filing requirement will not apply to income from investment in overseas depository receipts of Korean issuers. As discussed below, other important exceptions have been proposed as part of the implementing regulations, but are yet to be decided.

In short, with some exceptions, the amended CITA will require disclosure of beneficial owners, or ultimate investors, in order to secure for them the application of favorable tax treaty provisions to Korean-source income as of and from July 1, 2012. Otherwise, the beneficial owners will be subject to domestic withholding rates under the CITA. Beneficial owners may subsequently, within 3 years (from the end of the month in which withholdings are made), file a request for retroactive treatment according to a tax treaty. But meanwhile, absent a timely application, the income-paying entity is not at liberty to apply the favorable treaty rates. The form or specific content for the applications has yet to be promulgated. In any case the information submitted must suffice to verify the beneficial owners.

¹ An “offshore investment vehicle” is defined simply as an entity, set up overseas, that manages funds for investors and engages in investment by acquiring, disposing of and otherwise managing investment targets and distributing the proceeds to investors.

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The applications, and the offshore fund report when applicable, must be filed every three years. Changes in matters stated, such as changes in ownership, should be notified as they arise, prior to the next payment of income. Once filed, applications and reports are to be kept by the tax withholding entities for 5 years (from the due date for remittance of the relevant withholdings to the tax office), and must be furnished to the tax office upon request.

The filing requirements for offshore funds apply at each tier of holdings: Where an investor in a Korea-invested fund is itself an offshore fund, it must likewise submit an application, with a list of its beneficial owners, and an offshore fund report to the tax withholding entity.

Further possible exceptions: According to implementing regulations proposed by the Ministry of Strategy and Finance, i.e. the Ministry's draft of amendments to the Enforcement Decree of the CITA, there would be exemptions from the investor disclosure requirements for certain types of funds, including public funds or regulated, relatively widely held funds. The regulations would treat as beneficial owners, and thus exempt from further disclosure of their investors, pension funds set up under foreign laws analogous to Korean pension laws. Also exempted from disclosure of investors (though required to file an offshore fund report) would be an offshore fund meeting certain conditions, principally the following under the current draft rules: (i) the fund is regulated by the financial regulatory body of its tax treaty jurisdiction, (ii) it satisfies eligibility criteria under the tax treaty, and (iii) it has had at least 100 investors as a daily average during the preceding taxable year. There are additional exceptions for non-profit entities that do not make distributions to their members, and offshore investment vehicles of special types classed as residents of the foreign country under an applicable tax treaty.

These exemption rules could, possibly, be adopted within a few months substantially in their present shape, but at present this is uncertain.

Conclusion: While Korean tax office scrutiny of offshore investment vehicles has intensified in recent years, the new rules represent a fairly striking departure from the past framework of applying tax treaty benefits. Critical treaty benefits, including lower withholdings on dividends, interest and royalties, will now be predicated on disclosure of beneficial owners. This will no doubt pose a burden for many funds, as well as companies and other entities, that seek to invest in Korea. Definite as well as pending exceptions may offer a degree of leeway for some investors.