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Notable Cases on Tax Law

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I. Supreme Court Decision 2015Du1984 Decided December 13, 2017

1. Background Facts

Plaintiff corporation ("Parent Co"), incorporated according to German law, had held 100% of shares of the other corporation (SubCo), also incorporated according to German law, and merged with SubCo on November 2005. SubCo had stock issued by a Korean company and listed on Korea Stock Exchange.

2. Issues

[1] Whether an acquisition of the shares issued by a Korean company by a merging corporation constitutes 'transfer of shares' which the Corporate Income Tax Act ("CITA") regards as a taxable event to impose corporate income tax ("CIT") on capital gains accumulated on the said shares, or 'transfer of share certificates' which Securities Transaction Tax Act ("STTA") regards as a taxable event to impose securities transaction tax ("STT").

[2] Whether it violates Non-Discrimination Principle of the "Agreement

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between the Republic of Korea and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital" ("Korea-Germany Tax Treaty") to treat the merger of a 100%-owned German subsidiary by its German parent company, as a taxable event of CIT as described above, despite the fact that the merger between Korean parent company and its 100%-owned Korean subsidiary is not regarded as such a taxable event.

3. Summary of Supreme Court Decision

[1] Upon a merger between foreign corporations, the matter of whether the transfer of shares issued by a domestic corporation, which had been owned by the merged corporation, to the merging corporation constitutes a 'transfer of shares' under Article 93 Subparag. 10(ga) of the CITA (as amended by Act No. 7838 on Dec. 31, 2005; hereinafter the same) should be determined depending on whether the unrealized capital gain can be viewed to have been realized due to the above-mentioned transfer of shares and thus included as taxable income.

However, in the case of a domestic corporation, Article 80(1) and (4), and Article 16(1)5 and (2) of the CITA, and Article 122(1) and Article 14(1)1 items (ga) and (da) of the Enforcement Decree of the CITA (as amended by Presidential Decree No. 19328 on Feb. 9, 2006) view the transfer of assets resulting from a merger as an event of realization of capital gains. However, there used to be an exception to the rule in cases involving a merger that meet the requirements under Article 44(1)1 and 2 of the CITA, which effectively allowed deferral of CIT by using the par value (rather than fair market value) of the newly issued shares of the merging corporation in calculating the income of the merged corporation until the merging corporation disposes of the assets in question. On the other hand, in the case of a foreign corporation, Article 93 Subparag. 10(ga) of the CITA has a provision that levies CIT on capital gains realized by a foreign, non-resident corporation upon transfer of shares that are issued by a domestic corporation and does not have the aforesaid exception that results in tax deferral.

Furthermore, no reasonable ground exists to not regard the transfer of domestic assets resulting from a merger between foreign corporations as a

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taxable event, unlike the transfer of assets resulting from a merger between domestic corporations.

Therefore, insofar as the transfer of shares issued by a domestic corporation resulting from a merger between foreign corporations is regarded as a transfer of assets upon which capital gains are realized and is thus viewed as constituting a 'transfer of shares' under Article 93 Subparag. 10(ga) of the CITA, even in cases where a merging corporation holds the entire shares of the merged corporation prior to the merger, the resulting transfer of share is invariably taxable under the CITA. This principle holds even where no newly issued shares or cash (or "boot") are provided to the merged corporation's shareholders.

[2] In view of the language and purpose of Articles 1 and 2(3) of the STTA (as amended by Act No. 8838 on Jan. 9, 2008; hereinafter the same), and the text of Article 117(1)14 of the Restriction of Special Taxation Act (as amended by Act No. 6538 on Dec. 29, 2001) stipulating that, in case where shares are transferred as a result of a merger that meets the requirements of each subparagraph under Article 44(1) of the CITA, that transfer is exempted from STT, it should be assumed that a share transfer resulting from a merger generally qualifies as a 'transfer of share certificates' as prescribed by Articles 1 and 2(3) of the STTA.

[3] Article 24(1) of Korea-Germany Tax Treaty provides that "Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances, in particular with respect to residence."

As can be seen, the underlying context of this non-discrimination principle is that, in cases where a national of a Contracting State, who either is in a situation or conducts activities identical to those of a national in that other Contracting State, then that national should not suffer discriminatory taxation solely on the ground of its nationality.

[4] In this case, the Parent Co established under German law merged with another foreign corporation, i.e. SubCo, 100% of whose stake Parent Co A had owned before the merger took place; the merger resulted in the transfer of the Shares issued by a domestic corporation, which SubCo had owned as assets, to Parent Co; however, upon the transfer of the Shares,

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Parent Co neither issued new shares nor provided boot to either SubCo or its shareholders, and consequentially, the tax authorities assessed CIT and STT on the ground that the aforementioned share transfer qualify as a transfer of "share certificates."

It is held that: notwithstanding the fact that Parent Co had 100% stake in SubCo prior to the merger between them, the transfer of the "Shares", which SubCo had owned as assets, to Parent Co upon the merger constituted a 'transfer of shares' and 'transfer of share certificates' under Article 93 Subparag. 10(ga) of the CITA and Article 2(3) of the STTA, respectively; moreover, even if the transfer of the Shares resulting from the merger between foreign corporations as above is regarded, unlike a merger between domestic corporations, as a taxable transfer of assets or securities, as a matter of principle, foreign corporations cannot be said to be in the same situation as that of domestic corporations, nor can the imposition of tax be deemed a discrimination solely on the basis that the laws governing the establishment of a foreign corporation and a domestic corporation are different; and therefore, the tax assessments at issue did not violate the non-discrimination principle under Article 24(1) of Korea-Germany Tax Treaty.

4. Comment

When a foreign corporation transfers shares issued by a Korean company and derives capital gains, the CITA taxes it as Korea-sourced income. An issue arises when there is a merger between foreign corporations. A merger may be described as comprising a step in which all assets of the merged corporation are transferred to the merging corporation, and this is the reason for which a merger may be considered as a taxable "transfer" of assets under the CITA. Along the same line, it may also qualify as a "transfer" of marketable securities under the STTA. Such conclusion had already been confirmed by the Supreme Court in its 2013 decision (Supreme Court Decision 2010Du7208, rendered on November 28, 2013), and the decision in the present case reiterated the same holding.

On the other hand, if a merger between corporations meets certain requirements, CITA defers tax on income of the merged corporation or its shareholders. However, it is widely agreed that these provisions do not apply to a merger between foreign corporations, and the benefit of deferral

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does presumably not apply to this case, in which the both merging and merged corporation were German companies. Yet, because there is a provision in Korea-Germany Tax Treaty that prohibits any tax-relating discrimination based on nationality, there may be a question regarding whether denying the benefit of tax deferral to a German corporation violates the aforesaid non-discrimination clause.

Most tax treaties, including Korea-Germany Tax Treaty, contain provisions based on certain 'non-discrimination' principle, and, as mentioned in this decision, this includes prohibition of discrimination based on nationality. While the meaning of 'nationality' of a corporation is ambiguous, the decision relied on the premise that the laws according to which the company has been incorporated is determinative. However, it should foremost be noted that the obvious premise here for the non-discrimination clause to apply is that the German corporation concerned should be in the same or similar situation as the Korean corporation. It should also be added that, although discrimination based on nationality is prohibited, tax systems usually treat residents differently from non-residents, which is nevertheless usually not be viewed as a violation of the non-discrimination principle. In the present case, the plaintiff, Parent Co was established under German law and it is not a Korean resident for tax purposes. Accordingly, it is doubtful that the non-discrimination may play any role in this case.

As demonstrated by the decision's somewhat equivocal reasoning, it is difficult to discuss or predict the exact scope of the non-discrimination clause in any specific individual case. It is nonetheless difficult to object to the conclusion of this decision, for there is no practical reason from the policy perspective to extend the benefit of tax deferral to mergers between foreign corporations, in regard of which one may also say foreign and Korean corporations are not in a same or comparable status.

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II. Supreme Court Decision 2017Du59727(Decided on March 13, 2018)

1. Background Facts

The Protocol which followed the Korea-China Tax Treaty provides for a deemed-foreign tax credit (also called 'tax sparing credit') up to 10% of the amount of dividend received by a non-resident of either country. With regard to source taxation of dividend income, Korea-China Tax Treaty distinguishes dividends received by a non-resident company that directly own 25% or more shares from those received by other shareholders, and applies the reduced rate of 5% to the former category whereas a higher limit of 10% applies to the latter.

2. Issues

Whether Korea should grant 10% of tax sparing credit, even though China withheld income tax at the rate of only 5% pursuant to Korea-China Tax Treaty.

3. Summary of Supreme Court Decision

According to Article 10(2)(ga) of Korea-China Tax Treaty, 'when the beneficial owner is a corporation (excluding partnership) which directly owns at least 25% of the shares of the corporation paying the dividends', the lower tax rate of 5% applies to the gross dividends income rather than the general tax reduction rate of 10%. This is because of the understanding that the need to minimize the probability of double taxation and promote foreign investment is greater in these cases of direct investment made by companies (rather than individuals). In addition, the latter part of the article states that in this case, it should be assumed that foreign tax has been paid at the uniform rate of 10% for the purposes of calculating foreign tax credits, which intends to effectively attract foreign investment.

The range and time limit of giving such special tax benefits of deemed-foreign tax credit is clearly defined by Korea-China tax treaty. Considering

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the contents of, and the relationship between, the aforementioned provisions, even if the plaintiff corporation had paid with the reduced tax rate of 5% according to Article 10(2)(ga) of Korea-China Tax Treaty, it is still reasonable to accord a deemed foreign tax credit of an amount equivalent to 10% of the gross dividend income, according to the latter part of the same article.

4. Comment

When imposing tax on so-called "worldwide income", the question of how to eliminate or alleviate the burden of the tax levied on foreign-sourced income in the source country arises. The method of crediting dollar-for-dollar the amount of the tax paid to a foreign country from the amount of tax payable in Korea – "foreign tax credit" as set forth in Article 57 of the CITA and the Income Tax Act – is commonly used. However, when the source country exempts or reduces tax burden for various reasons, such (unpaid) foreign tax credit is usually not be available, because otherwise, the tax exemption or reduction provided by the source country would absurdly result in mere additional tax revenue of the residence country. For the source country to prevent this perverse consequence and make the tax benefits be fully conveyed to the taxpayer as the country's policy intends, it is necessary to make the amount of the reduced-tax still be credited in the residence country, as if the amount of the exempted tax had actually been paid. This is commonly called a "tax sparing credit", and it is allowed only in accordance with what is explicitly stated in the tax treaty between the two countries.

There is such a tax sparing credit provision in Korea-China Tax Treaty. However, as China abolished across-the-board tax incentives or benefits it established to attract foreign direct investments during the mid-2000s, the issue this case deals with arose. There had been no controversy over whether the amount of tax reduced according to the Chinese domestic law should be deemed to have been paid in China and thus be credited against Korean tax liabilities as discussed above. However, when tax is not reduced by domestic law but only as a result of application of Korea-China Tax Treaty, it has now become an issue whether such tax sparing credit is applicable.

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To provide a simple example, let's assume that a Korean subsidiary in China is paying dividends to the Korean parent company. It used to be that the subsidiary did not need to pay (or withhold) any Chinese income tax on that dividend thanks to the many tax incentives provided for foreign investors. Under these circumstances, there is no doubt that 10% tax sparing credit should be available in Korea. However, now that Chinese tax law requires a withholding of, for instance, 10% tax, the Korean subsidiary would withhold only at the rate of 5% thanks to Korea-China Tax Treaty. Should a 10% tax sparing credit still be granted to the Korean parent company in such a case?

In brief, the Supreme Court concluded that 10% tax should be credited against the Korean tax liability of the parent company, of which 5% tax is credited as ordinary "foreign tax" that was actually paid, and the other 5% credited as "foreign tax" deemed to have been paid, thus as "tax sparing credit." To support this conclusion, however, the Supreme Court simply referred to the particularity of the relevant article in the Korea-China Tax Treaty without further elaborating its reasoning.

Because Tax sparing credit is not a typical system in a tax treaty and each treaty with such a clause is different from the others, the holding of this case has little potential to be widely applied to future cases where other tax treaties are at issue. It should, however, be noted that the Supreme Court finally ruled on an issue that had been in practice heavily debated and litigated, which is all the more significant when one considers the large volume of trade and investment going back-and-forth between Korea and China.

III. Supreme Court Decision 2015Du2710 Decided February 28, 2018

1. Background Facts

According to the Act for the Coordination of International Tax Affairs ("ACITA"), if a domestic corporation borrows from certain "foreign controlling shareholders" in an amount which exceeds six times the paid-in capital, a portion of the interest on the excess loans is not recognized as

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deductible business expenses of a Korean corporation but is taxed as dividend income. The same is the case when a branch located in Korea is deemed to have borrowed funds from an overseas main office. However, in defining the "dividend," the Convention between the Republic of Korea and the Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income ("Korea-Singapore Tax Treaty") makes no special mention of the kind which is paid out to the main office by a branch.

2. Issues

Whether Singaporean foreign controlling shareholders' income in the form of interest paid to the main office, which is treated as dividend income by the ACITA, would also be treated as dividend income under the Korea-Singapore Tax Treaty and be subject to the relevant provisions.

3. Summary of Supreme Court Decision

The Korea-Singapore Tax Treaty allows taxation on dividend and interest income by both the residence country and the source country and defines dividend income under Article 10, Paragraph 4, and interest income under Article 11, Paragraph 5. Also, Article 28 of the former ACITA (as amended by Act No. 11606 on Jan 1, 2013) states that, the provisions of tax treaties shall be determinative in deciding the types of income initially decided by Article 93 of the CITA on Korea-sourced income of foreign corporations.

Considering the contents of and the relationship between the aforementioned provisions, when a domestic corporation, including branches of foreign corporations, borrows funds from certain foreign controlling shareholders, interest on the part of the loan which exceeds a certain threshold should be considered to be dividend income in principle because the above Articles characterize them as dividends and Korea-sourced income of foreign controlling shareholders. However, whether such interest may be taxed by the source country as dividend income under a tax treaty should be judged in light of the particular tax treaty to which the residence country of the foreign controlling shareholder is a contracting

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party. If, under the tax treaty, the interest falls under categories other than dividend income, such as interest income, tax should be levied accordingly.

In particular, Article 10, Paragraph 4 of the Korea-Singapore Tax Treaty defines dividends as "income from shares as well as income assimilated to income from shares according to the taxation laws of the Contracting State of which the company making the distribution is a resident" and fails to refer to dividend income under the tax law of the country in which a branch that is not a corporation is located. Also, it has not been demonstrated that Singaporean tax law treats interest which is paid by a branch to the main office and income from stocks equally. Therefore, the amount disputed in this case does not fall under 'dividend income' as defined in the Korea-Singapore Tax Treaty.

4. Comment

The aforementioned system is commonly called "thin capitalization regime" and is now widely used in many countries, including Korea. This is related to how debt and capital, or borrowed funds and capital stock, are treated differently under corporate income taxation. It is possible to reduce CIT at the branch's location by being paid interest for loans rather than investing capital and taking the proceeds in the form of dividends. In consideration of the fact that subsidiary corporations may therefore reduce the capital stock to the minimum and procure funds in the form of loans from their parents or controlling shareholders, the ACITA treats loans over a certain threshold to be the same as capital stock. Therefore, interest for such loans then takes the character of dividends and cannot be deducted when calculating the taxable income of the corporation.

Furthermore, the ACITA applies this system to not just domestic subsidiaries with an independent corporate entity but also to domestic branches of foreign corporations. It is clear that the main office cannot lend to a branch because they are not legally separate entities. A similar problem may arise when, in the process of calculating the domestic CIT of the branch, one has to decide whether to count the operating funds as capital or debts. In other words, if the funds are counted as debt to the main office, the same problem arises of whether to treat the interest as deductible expenses of the branch. In line with the above reasoning on the parent-

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subsidiary relation, the ACITA only deducts a limited amount as expenses of the branch in this case.

This is a logical outcome of the ACITA and, at the level of domestic tax law, cannot change unless the ACITA changes. The problem is whether this kind of dividend income is treated as dividend income also at the level of treaty law. This is because tax treaties have their own definition of dividend income, and not many of them include this kind of interest which is characterized as dividend income in their definitions. Deemed payments from a branch to the main office have even less possibility of being included in such definitions. This is also the case in the Korea-Singapore Tax Treaty, and the Supreme Court, focusing on this point, decided that the interest payments to the Singaporean main office, while treated as dividends under the ACITA, must be treated as interest under the Korea-Singapore Tax Treaty. Therefore, Korea's right to tax this amount falls under the realm of interest income, rather than dividend income. If this result is not in line with the intention of the Korean tax authorities, the relevant tax treaty will have to be amended to widen the definition of dividend income.

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