

January 22, 2020

**Legal Update**

# 2020 Korean Tax Update – Spotlight on International Tax

The recent approval of tax amendments for 2020 by the National Assembly of Korea included the following international tax-related changes:

## 1. Burden of proof shifted to a taxpayer involved in an indirect transaction through a third party<sup>1</sup>

- Where a taxpayer pursues an indirect transaction through a third party for the purpose of gaining tax benefits under the “Adjustment of International Taxes Act” and the relevant tax treaty, the Korean tax authority can apply the “substance-over-form” principle to the transaction.
- Previously, in order to apply such a principle, the Korean tax authority was required to

1. See Article 2-2 (4) and (5) of the Adjustment of International Taxes Act; Article 3-2 of the Proposed Amendment to the Enforcement Decree of the Adjustment of International Taxes Act

substantiate that the taxpayer's intent through the indirect transaction was to avoid taxation in Korea without a reasonable business purpose or commercial objective (reasoning). However, due to the Korean tax authority's limited access to the relevant information of the foreign taxpayer (who is based in another jurisdiction for tax purposes), it was not easy for the Korean tax authority to substantiate the foreign taxpayer's intent (i.e., whether he or she intended to avoid taxes in Korea through the indirect transaction).

- In this context, **this 2020 tax amendment** was intended to shift the burden of proof to the taxpayer, who has obtained a substantial tax benefit in Korea, surpassing the prescribed threshold (i.e., 50% or more of the tax burden). Hence, the **Korean tax authority can apply the substance-over-form principle to set aside the unjust tax benefits unless the taxpayer proves that he/she (or the entity) did not have any bad faith intent to avoid taxes in Korea** concerning the subject matter.
- The **exception** to this rule is a minor tax benefit, which is defined as a tax benefit of KRW 10 million or less, provided that the underlying transaction amount is not more than KRW 1 billion.

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## 2. Taxation of royalties concerning an unregistered patent improved<sup>2</sup>

- There has been an ongoing debate on whether the Korean tax authority has a valid right to tax for a payment made by a Korean company to a foreign (e.g., U.S.) corporation in connection with an unregistered patent owned by the U.S. corporation and/or infringement of the patent.
- Under the 2008 tax amendment, any payment for a patent used in manufacturing or distribution in Korea is deemed as Korean-sourced income. However, even after the tax amendment, the Supreme Court of Korea still held that a payment for using an unregistered patent of a U.S. corporation should not be deemed as Korean sourced income. The court's reasoning was that the issue of taxability of a royalty payment of a Korean corporation to a U.S. corporation should be determined in accordance with the Korea-US tax treaty.

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2. Article 119 and Article 156 (1) of the Income Tax Act; and Article 93 and Article 98 of the Corporate Tax Act

- In this regard, the 2020 new tax amendment is deemed to strengthen the legal right of the Korean tax authority in response to the Korean Supreme Court’s ruling.
  - i. As such, under the 2020 tax amendment, an unregistered patent of a U.S. corporation is deemed “other like property or rights” specified in the Korea-US tax treaty, while a payment for infringement of an unregistered patent is deemed as “other income” to the income recipient.
  - ii. In addition, where there is no definition of a term or word in the relevant double tax treaty, such a term or word should be construed as the meaning defined or used by the tax laws of Article 2, subparagraph 2 of the “Framework Act on National Taxes.”
- In this respect, the **most likely effect** is that the Korean tax authority will pursue taxation of the royalty income derived from an unregistered patent of a U.S. corporation based on the assumption that the Korean tax authority’s right to impose taxes on the income is affirmed by this 2020 tax amendment. **However, due to the recent court’s rulings in favor of U.S. corporations, who received payments in connection with their unregistered patents and infringement of such patents, this issue may not be so clear yet, unless both governments amend the Korea-US tax treaty to clarify the issue.**

### 3. Other tax amendments

#### A. Improvements / Clarifications:

- **Improved process for a foreign taxpayer to recover overpaid withholding taxes<sup>3</sup>**  
: The intent behind this amendment is to streamline the process and procedure for a foreign individual or corporation to recover overpaid withholding taxes. Also, under the tax amendment, a foreign taxpayer can seek recovery of the overpaid withholding taxes arising from the incorrect application of a reduced tax rate under the relevant tax treaty.

3. See Article 45-2 of the Framework Act on National Taxes; Article 156-2, Article 156-4 and Article 156-6 of the Income Tax Act; and Article 98-4, Article 98-5 and Article 98-6 of the Corporate Tax Act.

- **Overlapping filing requirements for international tax removed<sup>4</sup>** : The submission of “International Transaction Schedule” is no longer required by the corporation which is required to file the Consolidated Entity Report (also known as the “Master File”), and the Individual Entity Report (also known as the “Local File”).
- **Clarification on the scope of Korean sourced capital gain from real estate assets<sup>5</sup>** : Under the tax amendment, the definition of “Real Estate” in the Korea-US tax treaty is deemed to include shares in a corporation, whose real estate ownership accounts for at least 50% of its total assets.
- **Enhanced tax compliance for exchange of information about the financial institution and the party involved in the transaction<sup>6</sup>** : The head of a financial institution can refuse to open a bank account for a non-resident, who has not provided the prescribed information. Further, the Korean tax authority is given the power to make an inquiry and/or an investigation into the financial institution’s handlings.
- **Taxation of deemed dividend arising from a temporary difference of the specific foreign corporation improved<sup>7</sup>** : Under the 2020 tax amendment, the specific foreign corporation is given an extended period for filing an amended tax return to claim its foreign tax credits when paying dividends. Additionally, where the specific foreign corporation has at least 10% shares in a foreign corporation that carries on active wholesale or retail operations the dividend income derived from the foreign investee company is not to be characterized as passive income.

## **B. New Requirements / Expanded Scope:**

- **Electronic submission of the “Consolidated Entity Report” and the “Individual Entity Report”<sup>8</sup>** : Under the tax amendment, the relevant taxpayer is required to submit the Master File and the Local File via the Korean tax authority’s portal.
- **Korean tax authority empowered to impose taxes using its own arm’s length price for a taxpayer, who fails to submit the prescribed documents or reports**

4. See Article 11 (1) of the Adjustment of International Taxes Act; Article 7(1) of the Proposed Amendment to the Enforcement Decree of the Adjustment of International Taxes Act.

5. See Article 119 of the Income Tax Act; Article 93 of the Corporate Tax Act.

6. See Article 31 (11) and Article 31-2 of the Adjustment of International Taxes Act.

7. See Article 33 (4) and Article 36 (1) of the Proposed Amendment to the Enforcement Decree of the Adjustment of International Taxes Act.

8. See Article 21-3 (5) of the Proposed Amendment to the Enforcement Decree of the Adjustment of International Taxes Act.

**concerning international transactions**<sup>9</sup> : Where a corporation failed to submit the prescribed documents or reports concerning international transactions, the Korean tax authority is now empowered to impose taxes on the corporate taxpayer using the arm's length price computed by the authority.

- **Enhanced degree of obligation to comply with the “Mutual Agreement” and new submission procedure introduced**<sup>10</sup> : Currently, article 27(4) of the Adjustment of International Taxes Act stipulates that a judicial decision in Korea is intended to prevail over the Mutual Agreement between competent tax authorities. Under the 2020 amendment, this article is to be repealed. Also, the 2020 tax amendment has introduced a new procedure for submission of the relevant taxpayer's opinion before the completion of the Mutual Agreement Procedure.
- **Basis for collection and exchange of information concerning the beneficial owner expanded**<sup>11</sup> : Under the tax amendment, the scope of tax information to be provided to non-Korean tax authority includes the beneficial owner's information. Also, the Korean tax authority can request a taxpayer to provide the beneficial owner's information.
- **Simple computation method for arm's length price introduced**<sup>12</sup> : The simple computation of the service cost plus 5 % mark-up is deemed to be the arm's length price for low-valued service offerings from a Korean resident or corporation to his/her (or its) foreign-related entity, or vice versa.
- **New obligation imposed for document retention relating to arm's length price of an intangible asset**<sup>13</sup> : Where a foreign taxpayer uses the discounted cash flow method for computing arm's length price, the taxpayer is required to maintain the documents that validate the underlying assumptions.

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9. See Article 11 (7) of the Adjustment of International Taxes Act; Article 19 of the Proposed Amendment to the Enforcement Decree of the Adjustment of International Taxes Act.

10. See Repeal of Article 27(4) of the Adjustment of International Taxes Act; Article 41-3 of the Proposed Amendment to the Enforcement Decree of the Adjustment of International Taxes Act.

11. See Article 31 of the Adjustment of International Taxes Act; Article 47(11) of the Proposed Amendment to the Enforcement Decree of the Adjustment of International Taxes Act.

12. See Article 6-2 of the Proposed Amendment to the Enforcement Decree of the Adjustment of International Taxes Act.

13. See Article 6-3 (5) of the Proposed Amendment to the Enforcement Decree of the Adjustment of International Taxes Act.

### C. Penalties:

- **Penalty for the taxpayer, who fails to submit the prescribed documents concerning international transactions increased<sup>14</sup>** : The maximum penalty amount for a failure to submit the prescribed documents relating to international transactions has been increased from KRW 100 million to KRW 300 million. Further, the same amount of the penalty repeatedly incurs for each 30-day period after the due date for the submission passes.

### About Shin & Kim's Tax Practice:

Shin & Kim's Tax Practice Group provides our domestic and foreign-based entities doing business in Korea with comprehensive services concerning all aspects of tax-related issues and tax-related disputes, including general tax consulting advice, tax audits, and tax appeals.

Our Tax practice is comprised of attorneys, CPAs, tax attorneys, and former high-ranking officials from the National Tax Service ("NTS"), National Tax Tribunal, Supreme Court of Korea, the Ministry of Economy & Finance ("MOEF"), Korea Customs Service, among others.

### Questions/Comments:

Should you have any questions or comments about the contents of this newsletter, or if we can be otherwise helpful, please do not hesitate to contact us.

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14. See Article 12 of the Adjustment of International Taxes Act; Article 51 (2) of the Proposed Amendment to the Enforcement Decree of the Adjustment of International Taxes Act.

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