Korea to implement guidelines on offshore partnership taxation

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In brief

The Korea National Assembly, on January 1, 2013, passed the government's proposal to amend its tax laws. This newsalert summarizes the key international tax laws changes that could affect US multinational corporations (MNCs). Noteworthy are the new rules regarding tax treatment on foreign partnerships.

Under Korean tax law, a foreign corporation is subject to corporate income tax and a foreign organization other than a foreign corporation is subject to individual income tax. However, since there are no clear guidelines on foreign partnerships for Korean tax purposes, the legal disputes over their classification (i.e., a corporation vs. an organization other than a corporation) have been frequent, and the most representative one is the case of Lone Star Fund III LP. The government has tried since 2010 to prevent the recurrence of similar issues, and eventually implemented the tax laws on offshore partnership taxation followed by the relevant Enforcement Decree and Regulations.

In detail

New guidance on offshore partnership taxation

An offshore partnership is currently defined as an entity incorporated by two or more nonresidents in a foreign country to jointly carry on a business. An offshore partnership is generally taxed in Korea as follows:

- If an offshore partnership is classified as a foreign corporation, the Corporate Income Tax Law (CITL) would apply.
- If an offshore partnership is classified as a foreign organization other than a corporation, the Individual Income Tax Law (ITL) would apply. If the offshore partnership does not distribute profits, it is viewed as a single nonresident. If the offshore partnership does distribute profits, it is viewed as a partnership and the partners are subject to Korean tax under ITL.

Under CITL, a foreign corporation is defined as a corporation which has a head office or principal office in a foreign country and does not have a place of effective management in Korea. However, there are no practical guidelines to determine the classification of a corporation. For example, with respect to a US limited liability company (LLC) treated as a corporate entity under Korean domestic law, a question arises as to whether an offshore partnership treated as a conduit for tax purposes by its country of residence may be treated as a foreign corporation under CITL. Given these concerns, the government will amend the Enforcement Decree to clarify whether an offshore partnership under this situation should be regarded as a foreign corporation subject to CITL.

Under the proposed amendment, based on the nature of its business, an offshore partnership is considered a foreign corporation if it meets one of the following conditions:

- it has a legal personality like corporate entities, as prescribed in the Korean Commercial Act
- it is comprised of partners with limited liability only
- it has assets under its name independent from its members, or can be a legal party to a lawsuit
- it has the characteristics that are the same or mostly similar to limited liability businesses that are corporate entities under Korean law.

In this regard, the government will establish a legal framework for the National Tax Service (NTS) to classify and release a list of major types of offshore businesses. The change will apply effective January 1, 2013.

Tax treatment of payment for equipment use

Under Korean tax law, certain payments received for the use of equipment may be classified as rental income, but also treated as royalty income under a tax treaty. The US/Korea tax treaty also views payment for the use of ships or aircraft as royalties (but only if the lessor is not operating an international transportation business).

Prior to the recent amendment, the NTS ruled that such payments are subject to the lower of 1) the withholding tax rate on rental income (2%) under Korean tax law or 2) the reduced withholding rate on royalties under tax treaties (0~15%). As such, payments for the use of equipment have generally been subject to the 2% withholding tax under most circumstances.

Effective January 1, 2013, however, payments for the use of industrial, commercial or scientific equipment will be subject to the lower of 1) the withholding tax rate on royalties under Korean tax law (22%), or 2) the reduced withholding tax rate on royalties under tax treaties (0~15%). Accordingly, unlike the past, payments for the use of equipment made on or after January 1, 2013 likely will be subject to the reduced withholding tax rate under the tax treaties (0~15%) in most circumstances.

Therefore, a US company that has been receiving royalties from a Korean lessee under a long-term ships/aircrafts lease agreement, should note that this law change increases withholding tax rates from 2% to 16.5%.

Taxation of passive foreign partners according to income sources

Prior to amendment, income allocated to passive foreign partners investing in domestic private equity funds (PEF) was classified as dividend income.

Effective January 1, 2013, if a passive foreign partner investing in a PEF is a qualified pension or a national fund incorporated in a country that has a tax treaty with Korea and exempts income from taxation, the income allocated by the PEF will be classified based on its original character of income for Korean tax purposes.

Therefore, certain allocated income may be classified as capital gain from the transfer or sale of shares (which may be subject to tax in the country of residence) and may be exempt from Korean taxes.

The takeaway

As the aforementioned tax law changes may impact the tax treatment for Korean source income received by a US MNC, companies receiving such income should consider this tax law change as well as subsequent Enforcement Decrees and Regulations. MNCs might also consider reviewing withholding tax implications due to this tax law change.

Let's talk

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