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Tax News Flash

Korea Signed Treaty with Hong Kong

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In brief

Korea signed a comprehensive double tax agreement (CDTA) with Hong Kong on 8 July 2014. Professor K.C. Chan, Hong Kong's Secretary for Financial Services and the Treasury, and Cho Yong-Chun, the South Korean Consul-General in Hong Kong together signed the CDTA on behalf of their respective jurisdictions. The CDTA between Korea and HK represents the 30th CDTA signed by Hong Kong.

Potential benefits for Hong Kong investors under the Korea/HK CDTA include the reduced withholding tax (WHT) rates on dividends, interest and royalties. Also, permanent establishment (PE) including agent PE is defined in the CDTA. However, the Korea/HK CDTA does not offer any tax relief on capital gains derived by a non-resident from disposal of shares in the other party regardless of whether the company is a property holding company or not.

With the signing of the Korea/HK CDTA, Korea and Hong Kong companies currently investing through an intermediary should revisit their existing holding structures and assess if any such intermediary is still advantageous to the group from a tax perspective.

Effective date

If the CDTA is ratified and enters into force within 2014, it will become effective from:

- 1 April 2015 in Hong Kong; and
- 1 April 2015 (for taxes withheld at source) and 1 January 2015 (for other taxes) in Korea.

Taxes covered

- Korea- income tax, corporation tax, special tax for rural development and local income tax.
- Hong Kong- profits tax, salaries tax and property tax

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Definition of resident

In Korea, a resident is defined as any person (including individual and company) who, under the laws of Korea, is liable to tax therein by reason of his domicile, residence, place of head or main office, place of management or any other criterion of a similar nature. A company incorporated in Hong Kong is a Hong Kong resident under the Korea/HK CDTA. For a company incorporated outside Hong Kong, the company will be treated as a Hong Kong resident if it is 'centrally managed and controlled' in Hong Kong.

In case of dual residency (i.e. where a person other than an individual is a resident of both Korea and Hong Kong according to the provisions of the CDTA), the person shall be deemed to be a resident of the contracting party in which its place of effective management is situated. In case of doubt, the place of effective management will be determined by mutual agreement between the competent authorities of Korea and Hong Kong and, taking into account all relevant factors.

WHT rates on passive income

Please refer to the table in the Appendix for a comparison of the non-treaty and treaty WHT rates on dividends, interest, royalties and equipment rental derived by a Hong Kong resident company from Korea.

Under the Korea/HK CDTA, the withholding tax rates for interest and royalties will be capped at 10% while that of the dividend will be reduced to 10% (if the beneficial owner is a company which holds directly at least 25% of the capital of the company paying the dividends) or 15% (in all other cases).

In particular, the definition of "royalties" under the CDTA does not include consideration received from equipment rental, and thus, the income attributable to rental services should be determined to see whether it classifies as "business income" or "other income". In principle, business income is defined as profit derived from carrying on its business. We have to classify income properly as described in the CDTA first, and then if the income is not dealt with any of specific income therein, that income will be considered as other income. Such other income shall be taxed only in the resident county based on the CDTA.

WHT on service fee income

Under the Korean Corporate Income Tax Law, income from dependent personal services performed in Korea by a non-resident company involving the use of professional knowledge in the field of science/technology and business management, etc. without creating a PE in Korea will be subject to a WHT at 22% (including resident surtax). Under the Korea/HK CDTA, such withholding tax will be eliminated unless the service provider provides services in Korea for a period which exceeds an aggregate of 183 days in any twelve month period concerned under the assumption there is no PE of the non-resident in Korea.

Permanent establishment

In addition to the general provision covering fixed place PE and agency PE, the Korea/HK CDTA also includes provisions on construction site PE. That is, a Korea resident will have a PE in Hong Kong if its building site, construction, assembly or installation project or related supervisory activities in Hong Kong last more than 12 months. The 12-month threshold is more favourable than that found in treaties with other countries such as China, Japan and Singapore, where a lower threshold of 6-month is adopted.

The PE article in the Korea/HK CDTA does not contain a service PE clause that is found, for example, in Korea's treaty with China. Other than the case where conditions of certain PEs are explicitly stipulated in the relevant treaty, it is practice that the provisions in domestic tax law would be used to determine the constitution of the

PE even though there is the relevant treaty. Thus, if a tax treaty is silent regarding constitution of service PE, it would be appropriate that the Korean tax authorities apply definition of PE in accordance with the Korean CITL.

Capital gains

Under the domestic tax law of Korea, gains derived by a non-resident from disposal of shares in a Korean company or a company of which the assets are mainly comprised of Korean immovable property (i.e. a Korean property holding company) are subject to a WHT (including resident surtax) at the lesser of (1) 11% of the gross proceeds and (2) 22% of the gains from disposal.

The Korea/HK CDTA does not provide any tax relief on capital gains derived by a non-resident from disposal of shares in the other party regardless of whether the company is a property holding company or not.

In this regard, the Korea/HK CDTA is different from the tax treaties such as those entered into with Canada, China, Ireland and Japan. Under those treaties, gains from disposal of shares in non-property holding company are exempt from tax in sourced country.

Limitation on benefits

The Korea/HK CDTA contains the following anti-treaty abuse provisions:

- The 'beneficial owner' requirement is present in the Dividends, Interest and Royalties articles.

- There is a stand-alone Limitation on Benefits article that applies to the Dividends, Interest, Royalties and Other Income articles. Under this article, treaty benefits may be denied if 'the main purpose or one of the main purposes of any person concerned … is to take advantage of these Articles …'.

- The Limitation on Benefits article also specifically confirms that both contracting parties can apply their domestic laws to prevent the avoidance or evasion of taxes.

Exchange of information (EoI)

The Korea/HK CDTA adopted the EoI article in the 2004 OECD Model with additional safeguards against possible abuse of the article, such as providing that the information exchanged shall not be disclosed to any third jurisdiction for any purpose.

However, the protocol to the CDTA set out the following in relation to the EoI article:

- Information that precedes the effective date of the CDTA may be disclosed if the information is foreseeably relevant for a taxable period or taxable event after the effective date of the treaty.

- The EoI article also covers information relating to any other taxes as may be specified and agreed upon in letters exchanged between Hong Kong and Korea.

The key takeaway

Potential benefit under the Korea/HK CDTA for Hong Kong investors include (1) reduced WHT rates on dividends, interest and royalties, (2) possible elimination of the WHT on equipment rental in case there is no PE and (3) PE protection for active business income. However, the Korea/HK CDTA does not offer any tax relief on capital gains derived by a non-resident from disposal of shares in the other party regardless of whether the company is a property holding company or not.

In the absence of a CDTA between Hong Kong and Korea in the past, Hong Kong companies investing into Korea may do so through an intermediate holding company established in a jurisdiction having a tax treaty with Korea in an attempt to enjoy treaty benefits. However, in assessing whether treaty benefits should be granted, such investment structures are often vigorously challenged by the Korean tax authorities in terms of the beneficial owner status and substance of the intermediate holding company as well as whether treaty shopping is involved.

With the signing of the Korea/HK CDTA, Korean and Hong Kong companies investing through intermediary companies should revisit their current holding structures and assess if any such intermediary is still advantageous to the group from a tax perspective.

Appendix: Withholding tax rates on dividends, interest, royalties and equipment rental under the Korea-HK CDTA

The following table provides a comparison of the non-treaty and treaty withholding tax rates on dividends, interest, royalties and equipment rental derived by a Hong Kong resident company from Korea.

	Dividends	Interest	Royalties	Equipment rental
Korea non-treaty rate [1]	20%	14/20% [2]	20%	2%
Korea/HK treaty rate [3]	10/15% [4]	0/10%	10%	Nil [5]

Notes

1. In addition to the indicated tax rates, there is a resident surtax charged at a rate of 10% of the respective tax rates.
2. The 14% rate applies to interest arising from bonds issued by a Korean company or government bodies.
3. The beneficial ownership requirement is present in each of the Dividends, Interest and Royalties articles. In addition, Article 26 covering the Limitation on Benefits applies to all of these articles in such a way where treaty benefits available under these articles may be denied if *'the main purpose or one of the main purposes of any person concerned … is to take advantage of these Articles …'*.
4. The 10% rate applies 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 15% rate applies to all others cases.
5. The definition of 'royalties' in the Korea/HK CDTA does not include consideration received from lease of industrial, commercial and scientific equipment. Based on the current practice of the Korean tax authorities, such rental income derived by a Hong Kong resident company from Korea may be classified as business income (and not subject to Korean withholding tax if no PE exists in Korea) or other income (in which case the taxing right is allocated exclusively to the state of residence, i.e. Hong Kong).

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