TaxTalk Alert

MLI entering into force in Korea

1 September 2020

In brief

On 13 May 2020, Korea deposited with the OECD its instrument of ratification for the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting ("MLI"). As such, the MLI will enter into force in Korea on 1 September 2020 and it will supplement or modify the bilateral tax treaty which has been notified by both Korea and the other contracting state as a Covered Tax Agreement ("CTA") based on the reservations and notifications for MLI provisions (called MLI position) made by both states. For an entry into effect period, based on Korea's MLI position, relating to withholding taxes, the MLI will be effective for the payment made to non-residents or foreign companies on or after 1 January 2021 whereas effective for the taxable periods beginning on or after March 1, 2021 relating to all other taxes.

In detail

Korea notified the existing bilateral tax treaties with 73 contracting states including China, France, Hong Kong, Japan, UK, US, etc. as CTAs for the MLI. Out of the 73 contracting states, 32 contracting states (e.g., France, India, Japan, Ireland, UK) notified the tax treaties with Korea as CTAs before 13 May 2020. As a result, the MLI which will enter into force in Korea on 1 September will effectively amend Korea's 32 CTAs depending on the MLI position of both contracting states.

Solely based on Korea's MLI position, Korea reserved the application of most MLI articles to the CTAs while opting for the application of Article 6, Article 7, Article 16 and Article 17. Article 6 (purpose of a CTA) will modify the preamble of all of Korea's CTAs by including the text of "intending to eliminate double taxation with respect to the taxes covered by this agreement without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance". For Article 17 (corresponding adjustments), Korea reserved the right for Article 17 not to apply to the 45 CTAs (e.g., CTAs with Canada, India, UK which already contain the provision of Article 17(2)) and for the remaining 28 CTAs, Article 17 may apply only to the extent of incompatibility between the provisions of the CTAs and those of Article 17. As such, the application of Article 6 and Article 17 to Korea's CTAs may not have substantial impact on taxpayers and their transactions as compared with Article 7 and Article 16.

For Article 7 (prevention of treaty abuse), Korea opted for principal purpose test or PPT (paragraph 1 of Article 7) which would deny a benefit under a CTA if it is reasonable to conclude under all relevant facts and circumstances that obtaining such benefit was ***one*** of the principal purposes of any arrangement or transaction unless granting that benefit would be in accordance with the object and purpose of a CTA.

According to Korea's MLI position, the PPT of Article 7 will apply to Korea's 22 CTAs (e.g., India, UK) by replacing the provisions of the CTAs and it will apply to the remaining CTAs to the extent of incompatibility. Of a particular note, the PPT will apply if obtaining a benefit under a CTA is *one* of the principal purposes of an arrangement or transaction, rather than the main or decisive purpose.

Article 16 (mutual agreement procedure or MAP) allows that where a person considers that the actions of one or both of the contracting states result or will result for that person in taxation not in accordance with the CTA provisions, that person may present the case to the competent authority of ***either*** contracting state within 3 years from the first notification of the action resulting in taxation not in line with the CTA provisions. Based on Korea's MLI position, the provisions of Article 16 will replace or supplement the provisions of the CTAs. As compared with the existing tax treaties which require a taxpayer to present the case to the competent authority of the state where the taxpayer is a resident within a shorter time period under certain CTAs, Article 16 may enhance a taxpayer's right and interest by allowing a taxpayer to choose the competent authority of either contracting state for the MAP and present the case within 3 years.

Takeaway

Before the application of the PPT, the Korean tax authorities have applied the substance over form principle of the domestic tax laws for a transaction lacking business purpose or via an entity lacking substance to deny treaty benefits despite the absence of specific anti-abuse provisions under the tax treaty. However, as it will be sufficient under the PPT that obtaining a CTA benefit is *one* of the principal purposes of a transaction, the tax authorities may be in a position to more vigorously challenge the benefits obtained under a CTA by applying the PPT unless a taxpayer can establish that business or other non-tax driven purposes are the principal reasons for undertaking a transaction and outweigh the benefits of a CTA. As such, it will be prudent for taxpayers to clearly and thoughtfully document the principal reasons for entering into a transaction in advance to help ensure that the PPT should not apply.

For Article 16, taxpayers may need to carefully assess whether presenting the case for taxation by the Korean tax authorities that is not in line with a CTA to the competent authority of the other contracting state of the CTA would be more beneficial. Considering that recent Korean tax audits on foreign invested companies focus on issues concerning permanent establishment, intra-group service fees and beneficial ownership, taxpayers may also need to actively consider proceeding with the MAP for such non-TP taxation issues not in line with a CTA. By leveraging our extensive resources around the PwC Global Network, we can assist taxpayers in strategically assessing MAP as an option for dispute resolution.

Let's talk

For a further discussion of how the MLI might affect you and your business transactions, please contact our international tax experts:

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