Executive summary

On 30 July 2018, Korea’s Ministry of Strategy and Finance announced the 2018 tax reform proposals (the 2018 Proposal), aimed at improving wealth distribution and sustaining growth. The 2018 Proposal also includes provisions in line with the Organisation for Economic Co-operation and Development’s (OECD) Base Erosion and Profit Shifting (BEPS) Action Plan 7, among others. Unless otherwise specified, the proposals in the 2018 Proposal will generally become effective for fiscal years beginning on or after 1 January 2019.

Detailed discussion

Repeal of certain foreign investment tax incentives

On 5 December 2017, the European Union (EU) included Korea in the list of non-cooperative tax jurisdictions, noting a harmful preferential tax regime related to Korea’s foreign investment tax incentives that are only granted to nonresidents. On 23 January 2018, the EU removed Korea from the list after Korea pledged to revise its foreign investment tax incentive rules in line with global standards.
The current law grants a corporate income tax exemption for up to 7 years and certain local tax exemptions for up to 15 years to foreign-investment companies engaging in the new growth sector businesses and in specially designated areas. The 2018 Proposal repeals the corporate income tax exemption and will be effective for tax incentive applications filed on or after 1 January 2019. The repeal has no effect on local tax; accordingly, the tax incentives on local taxes will continue to apply.

Rationalization of taxation on Korean source income of overseas investment vehicles (OIVs)

Definition of a foreign corporation under the Korean tax law

Currently a foreign entity that has its headquarters or main office in a foreign country (with no place of effective management in Korea) would be treated as a foreign corporation for Korean tax purposes if any of the following conditions are met: (i) a foreign entity which is incorporated under the law of the jurisdiction of establishment; (ii) a foreign entity whose members are all partners with limited liability; (iii) a foreign entity that can take actions based on its own rights or has duties and obligations of its own; or (iv) a foreign entity that is the same or similar to a Korean entity treated as a corporation under the Korean laws.

The 2018 Proposal removes the condition (iii), causing the members/interest holders of the entity vs the entity itself to be subject to Korean income tax, unless any of the other conditions in the preceding paragraph is also met. The proposed rule will be effective for fiscal years beginning on or after 1 January 2020.

New rule on beneficial ownership on Korean source income of offshore investment vehicles (OIVs)

The 2018 Proposal introduces a new rule that will treat an OIV as a beneficial owner of the Korean source income if any of the following conditions are met: (i) the OIV is subject to taxation in the jurisdiction where it resides and there is no intention to wrongfully evade Korean tax on the Korean source income by establishing the OIV in its jurisdiction; (ii) the OIV is unable to substantiate its investors; or (iii) the OIV is deemed as the beneficial owner under a tax treaty. The new rule clarifies the circumstances in which the OIV will be treated as the beneficial owner of the Korean source income and will be taxed in accordance with the domestic tax law or the tax treaty. The proposed rule will be effective for fiscal years beginning on or after 1 January 2020.

Expanded scope of foreign companies’ permanent establishment (PE) in Korea

As a commitment to implement the PE rules recommended by BEPS Action 7, the 2018 Proposal reflects contents of the updates to Article 5 (PE) of the OECD Model Tax Convention approved by the OECD Council on 21 November 2017.

More requirements to a non-PE definition

Under the current law, the term PE does not include a fixed place solely for: (i) the purposes of purchasing goods or merchandise for the foreign company; (ii) the purposes of storing goods or merchandise belonging to the foreign company; and (iii) the purposes of maintaining a stock of goods or merchandise belonging to the foreign company for processing by another company. The 2018 Proposal adds that the above exemption applies only if the activity of the fixed place is of a preparatory or auxiliary character.

Preventing misuse of specific exceptions to the PE rules

The 2018 Proposal introduces a new rule to prevent misuse of specific exceptions to the PE rules. Under the 2018 Proposal, even if the activity of a fixed place is of a preparatory or auxiliary character, such fixed place would constitute a PE if any of the following conditions are met: (i) if such fixed place or other place constitutes a PE of the foreign company or its related party, and the activity of such fixed place is complementary to the business activity carried on by the PE of the foreign company or its related party; or (ii) the overall activity resulting from the combination of the activity of the fixed place carried on by the foreign company or its related party constitutes a complementary function and is not of a preparatory or auxiliary character.

Expanded scope of agency PE

A foreign company may be deemed to have an agency PE in Korea if it has a person in Korea, who is authorized to conclude contracts on its behalf and repeatedly exercises such authority, or who is regarded to have such authority. Under the 2018 Proposal, a foreign company may be deemed to have a PE in Korea if a person continuously plays the principal role leading to the conclusion of contracts by the foreign company without material modification even if the person has no legal authority to conclude contracts on its behalf.
The 2018 Proposal clarifies that the types of contracts that may be deemed to create an agency PE in Korea are contracts executed in the name of the foreign company: (i) for the transfer of the ownership of, or for the granting of the right to use, property owned by the foreign company, or (ii) for the provision of services by the foreign company.

**Limitation on net operating losses (NOLs) utilization for Korean branches of foreign companies**

Effective for fiscal years beginning on or after 1 January 2017, Korean branches of foreign companies are subject to an 80% of taxable income limitation on utilization of NOLs. The 2018 Proposal further reduces the 80% to 60%.

**Reduced scope of the buyer subject to secondary tax liability in a business transfer**

The 2018 Proposal limits the applicability of the buyer’s secondary tax liability in a business transfer transaction only if either of the following two conditions exists: (i) the buyer is a related party of the seller; or (ii) the buyer acquired the business to aid the seller’s tax evasion.

**Expanded scope of electronic services subject to Value Added Tax (VAT) registration**

Nonresidents providing electronic services (e.g., games, sounds, video files, or software) to non-VAT registrants in Korea (i.e., business-to-consumer transactions) currently must register for VAT purposes using a simplified online VAT registration method and pay the 10% VAT on its supply of electronic services. Under the 2018 Proposal, the scope of electronic services includes cloud computing.

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**Endnote**

1. Changed to Ministry of Economy and Finance as of 1 August 2018.
2. Acquisition tax and property tax.
3. If the OIV is able to substantiate only a portion of its investors, then the OIV would be treated as the beneficial owner of the Korean source income to the extent of the Korean source income attributable to those investors that the OIV is unable to substantiate pursuant to the Korean domestic tax law.
5. Renting web storage space or stored software at a centralized computer that is connected to internet server.
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