

November 9, 2022

PROPOSED AMENDMENTS TO KOREAN TAX LAWS: INTRODUCTION OF SPECIAL TAX TREATMENT ON FOREIGN FLOW-THROUGH ENTITIES TO ELIMINATE HYBRID MISMATCH ARISING FROM REVERSE HYBRID ENTITIES

On October 14, 2022, a proposal ("**Proposal**") was announced for purposes of introducing a special tax regime applicable to foreign flow-through entities for Korean tax purposes. The primary legislative intent of the Proposal is to allow Korean investors to make investments into foreign jurisdictions primarily through foreign private equity (PE) funds without facing additional adverse tax implications in foreign jurisdictions resulting from making such investments via foreign corporations or investment vehicles that are deemed as reverse hybrid entities.

Provided below is a summary of the major tax reforms proposed which may, if adopted by the National Assembly, have positive impacts on Korean investors investing into foreign jurisdictions via foreign flow-through entities.

Dongwook Kang

Partner

T 82.2.3404.6538

E dongwook.kang@bkl.co.kr

Seung-Wan Chae

Senior CPA

T 82.2.3404.0577

E seungwan.chae@bkl.co.kr

Young Houn Kim

CPA

T 82.2.3404.0588

E younghoun.kim@bkl.co.kr

Maria Chang

Senior Foreign Attorney

T 82.2.3404.7589

E maria.chang@bkl.co.kr

Jong Woo Kim

Foreign Attorney

T 82.2.3404.6991

E jongwoo.kim@bkl.co.kr

I. Background of the Proposal: Reverse Hybrid Entity

Generally, a reverse hybrid entity is an entity treated as a flow-through entity for tax purposes in the jurisdiction of its establishment but is treated as a taxable entity for Korean tax purposes and thus a mismatch in terms of tax treatment on the same entity exists between two jurisdictions.

In response to the OECD's recommendations as part of the Base Erosion and Profit Shifting ("**BEPS**") Action Plan on neutralizing such mismatch in tax outcomes arising from the reverse hybrid entity with the aim of enhancing global tax transparency and preventing tax avoidance motives on the part of taxpayers, members of the European Union (EU) introduced rules to impose additional tax on income received by such reverse hybrid entities beginning 2022.

Recognizing the widespread concern by Korean investors on the potential adverse tax impact resulting from the new EU rules, the Ministry of Economy and Finance of Korea ("**MOEF**"), which is responsible for drafting bills on tax matters, issued a press release recognizing such hybrid mismatch issues and stating its intent to implement appropriate measures to the extent deemed necessary, including revising the Korean tax law, to prevent Korean investors from facing adverse tax implications arising from investments made through reverse hybrid entities.

The Proposal is the official legislative action taken to reflect the MOEF's statement contained in the press release.

Under the Proposal, if Korean investors investing into foreign jurisdictions via a foreign entity treated as a flow-through entity for local tax purposes file an application with the Korean tax authorities to make an election for the foreign entity to be treated as a flow-through entity for Korean tax purposes, such foreign entity will also be treated as a flow-through entity for Korean tax purposes so that the hybrid mismatch between the two jurisdictions is eliminated. Specifically, if the Proposal is adopted by the National Assembly, no mismatch would exist in terms of (i) timing of income recognition (i.e., income received by the foreign flow-through entity should be simultaneously recognized at the Korean investors' level); and (ii) income classification of foreign source income (i.e., the character of foreign source income should remain unchanged).

II. Summary of Special Tax Treatment on Foreign Flow-Through Entities

- A. **Eligibility:** The new rules will apply to flow-through entities established in foreign jurisdictions whereby income derived by such entities are directly attributable to their shareholders, investors or beneficiaries (collectively referred to as "**Shareholders**") subject to tax in the jurisdiction of their establishment.
- B. **Requirement for Special Tax Treatment:** Korean Shareholders are required to file an application with the Korean tax authorities to make an election for the foreign flow-through entity to be treated as a flow-through entity for Korean tax purposes.
- C. **Tax Implications:** Income received by the flow-through entity should be simultaneously recognized at the Korean Shareholders' level. In addition, the characterization of income recognized by the flow-through entity should remain unchanged at the Korean Shareholders' level.

III. BKL Comments

If the Proposal is adopted by the National Assembly and is implemented, the following would additionally need to be considered:

- A. Korean investors seeking to make investments in foreign jurisdictions should consider making an election for flow-through treatment with respect to certain foreign investments vehicles, such as Delaware limited partnerships, whose tax treatment in Korea remains unclear. The same applies to certain foreign entities which may be treated as foreign corporations for Korea tax purposes, such as Delaware limited liability companies that are treated as either partnerships or disregarded entities for U.S. tax purposes.
- B. An official notice or tax ruling on foreign investment vehicles which do not have legal personality in their jurisdiction of establishment (e.g., Cayman Islands exempted limited partnership or Luxembourg special limited partnership) would need to be issued by the Korean tax authorities to clarify whether such foreign entities would be treated as flow-through entities for Korean tax purposes under the current Korean tax law to avoid situations in which treaty benefits under the US–Korea tax treaty are denied based on U.S. IRC Section 894(c).
- C. If Korean investors make an election for a foreign entity to be treated as a flow-through entity for Korean tax purposes, income received by the foreign flow-through entity will be deemed directly

attributable to the Korean investors simultaneously and the character of income will remain unchanged. From the perspective of Korean investors, some practical difficulties may arise as Korean investors may need to have the income received by the foreign flow-through entity prepared in advance and would need to recognize such income as taxable income at the Korean investors' level as soon as the income is received by the foreign flow-through entity. Considering such practical burdens at the Korean investors' level, certain exceptional rules such as allowance of income deferral akin to the lag method concept in the U.S. may additionally need be introduced in Korea.

* * *

For any inquiry or questions regarding the content of this newsletter, please contact us.