

February 1, 2023

## 2022 TAX LAW AMENDMENTS AFFECTING KOREAN AND FOREIGN INSTITUTIONAL INVESTORS INVESTING VIA FUND VEHICLES

On December 23, 2022, proposed amendments to Korean tax laws for 2022 were finally adopted and implemented by the National Assembly ("**Tax Reform**"). As a follow-up measure, on January 18, 2023, the Ministry of Economy and Finance of Korea announced proposed amendments to the enforcement decree of Korean tax laws for 2022 ("**Proposal**"). The Proposal is expected to be promulgated in February 2023.

Below is a summary of the Tax Reform and the Proposal focusing on international tax for Korean and foreign investors investing via fund vehicles:

### I. Special Tax Treatment for Foreign Flow-Through Entities: Reverse Hybrids

To prevent Korean investors from facing adverse tax implications arising from investments made through reverse hybrid entities, a special tax treatment was introduced for entities treated as flow-through entities for tax purposes in the jurisdiction of its establishment but treated as taxable entities for Korean tax purposes.

#### A. Key Summary of Tax Reform / Proposal

- **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 "**Investors**") subject to tax in the jurisdiction of their establishment.
- **Requirement:** Investors seeking to treat the foreign entity as a flow-through entity for Korean tax purposes are required to file an application with the Korean tax authorities in the first taxable year or accounting year for which the special tax treatment is to be applied. If multiple investors exist in the same flow-through entity, the election may be filed separately by each investor such that the tax treatment on a foreign entity may be different for each Korean investor depending on whether or not the election is made. Investments made by certain types of sovereign funds may require each fund (or the consignment entity) to make the election.
- **Tax Implications:** Income received by the flow-through entity will be simultaneously recognized at the Korean Investors' level. In addition, characterization of income recognized by the flow-through entity will remain unchanged at the Korean Investors' level. This will have the effect of eliminating the hybrid mismatch between the two jurisdictions.
- **Other Considerations:** In the event multiple layers of foreign flow-through entities are

sequentially in existence within a particular investment structure, the election for special tax treatment is deemed to be made and applicable to all the foreign-flow through entities if the election is made on the immediate entity into which the Investors directly invest. The application may exclude a particular entity that does not seek to have the special tax treatment apply to such entity.

## **B. BKL Comment**

- The new rules are intended to eliminate hybrid mismatches for tax purposes arising from reverse hybrid entities to prevent Korean investors from facing adverse tax implications in foreign jurisdictions.
- As the new rules apply to broad categories of investors such as sovereign funds established and enumerated under the National Finance Act and an investment trust established under the Financial Investment Services and Capital Markets Act ("**FISCMA**"), most Korean institutional investors are expected to generally be eligible for the benefits under the new rules.
- It would be recommended for Korean investors to make the election with respect to foreign flow-through entities to ensure that foreign flow-through entities eligible for the election are not deemed as reverse hybrid entities for tax purposes. However, additional measures and rules would need to be introduced in Korea through amendment of the tax laws or issuance of tax rulings to provide further guidance on certain issues, such as:
  - (i) whether foreign flow-through entities deemed as entities which do not have legal personality under the current Korean tax law (e.g., Cayman Islands exempted limited partnership) would also need to make the election; and
  - (ii) various practical issues that may arise in implementation, including the method of income recognition received by the foreign flow-through entities.

## **II. Additional Procedural Requirements for Application for Tax Exemption under the Tax Treaty Applicable to Foreign Corporations**

### **A. Key Summary of Tax Reform / Proposal**

If the taxable income of a foreign corporation which files an application for tax exemption under a tax treaty in effect with Korea is KRW 1 billion or more, the following additional information would need to be provided:

- (i) information of incorporation (e.g., composition of board of directors, status of shareholders etc.);
- (ii) business information (e.g., audited financial statements for recent 3 financial years etc.); and
- (iii) documents which support identification of actual owner(s) of intangible assets for royalty income.

The above information would also need to be submitted where tax exemption is being requested retroactively for taxable income exceeding KRW 1 billion.

**B. BKL Comment**

The above change imposes more onerous documentary requirements for foreign corporations seeking tax exemption under relevant tax treaty. Foreign entities seeking tax exemption on income should be prepared to provide additional supporting documents once the requirements come into effect.

**III. Changes to Method of Taxation on Foreign Investors Investing into Korean Private Equity Funds****A. Key Summary of Tax Reform / Proposal**

Distributions paid out to non-residents or foreign corporations by the Korean private equity funds ("PEFs") under the FISCMA are classified and taxed according to the source of income.

**B. BKL Comment**

- Prior to the Tax Reform/Proposal, distributions received by non-residents or foreign corporations (except for certain categories of foreign investors such as foreign sovereign wealth funds) from PEFs were classified as dividends and taxed accordingly for Korean tax purposes regardless of the underlying character of income earned by the PEFs.
- However, once the new rules are introduced, distributions to general foreign investors as well as foreign sovereign wealth funds would be taxed based on the character of income earned by the PEFs. In such case, as capital gains which would flow-through to such foreign investors could be exempt under the tax treaty, we expect the effective tax burden for foreign investors to generally decrease.

**IV. Amendment to Method of Computing Foreign Tax Credits for Korean Fund Vehicles****A. Key Summary of Tax Reform / Proposal**

- Effective from January 1, 2025, adjustments to double taxation on foreign tax amount by regulated investment vehicles, including investment trust under the FISCMA and real estate investment trusts ("REIT") under the Real Property Investment Company Act, will change from the current method of claiming foreign tax refunds by filing a separate foreign tax refund application with the Korean tax authorities at the vehicle level to a method whereby each investor or beneficiary of the fund vehicles applies foreign tax credits directly at the time each investor or beneficiary files its own corporate income tax returns in Korea. To implement the amendment, specific rules are introduced in terms of computing foreign tax amount per fund of investors, computing adjusted foreign tax amount (i.e., adjustment ratio) and computing foreign withholding tax rates per fund vehicle.
- Where a Korean fund vehicle or a REIT paid tax in a foreign jurisdiction indirectly through another Korean fund or a REIT (e.g., Korean investor invests in a foreign jurisdiction via a two-tiered fund or REIT structures and the lower-tiered fund or REIT has paid tax in the foreign jurisdiction), the new rules allow foreign tax credits to be applied directly at the Korean investor level.

**B. BKL Comment**

As the new rules are introduced effective from January 1, 2025, asset management companies which operate fund vehicles or REITs would need to pay special attention to the new rules and set up practical internal procedures in advance to comply with the rules.

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For questions or inquiries on the above, please feel free to contact us.

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