Supreme Court Renders a Decision Recognizing an Intermediate Holding Company as Substantive Owner

I. Background

On July 10, 2014, in a case involving Carrefour (a France-based global discount store operator), the Supreme Court rendered a decision recognizing a foreign shareholder which directly held the shares in a Korean company as the substantive owner of capital gains income for the first time. An earlier decision by the Supreme Court on treaty benefits had held that the domestic substance over form principle can apply to deny the treaty benefits and found that the upper-level entities, rather than the foreign shareholder that directly owned the Korean shares, should be treated as the substantive owners of capital gains from the transfer of shares. The Supreme Court subsequently rendered a similar line of decisions, disregarding the substance of the immediate holding company in a treaty jurisdiction and denying the treaty benefits.

As seen in the structure chart above, in this case, a French company ("French SA") established a subsidiary in the Netherlands ("Dutch BV") in 1982 as an intermediate holding company for foreign investments. By 2005, Dutch BV held interests in 52 subsidiaries in 25 countries. Dutch BV established a subsidiary in Korea ("Korean Sub") in 1994 and made a substantial amount of investment in Korean Sub until selling the shares (79.44%) to Korean buyers in 2006. French SA held the remaining shares (20.56%) in Korean Sub and also sold the shares to Korean buyers at the same time.
Under the Korea-France Tax Treaty, French SA is not entitled to the capital gains tax exemption under the substantial shareholder exception (more than 25% ownership together with its related parties), so the Korean buyers (as withholding agent) withheld tax on the capital gains realized by French SA at the domestic Korean corporate tax rate.

On the other hand, under Article 14(4) of the Korea-Netherlands Tax Treaty, capital gains from the transfer of shares can be taxed only in the country where the alienator (the transferor) resides. The parties took the position that no withholding is due under the Korea-Netherlands Tax Treaty and withheld no tax on the capital gains realized by Dutch BV. The National Tax Service of Korea (“NTS”) challenged such position and assessed tax on capital gains realized by Dutch BV from the transfer of shares in Korean Sub, at the domestic Korean corporate tax rate, on the ground that Dutch BV was a mere conduit company and French SA was the substantive owner of the capital gains at issue.

II. Discussion of the Case

The Supreme Court in this case first noted the Korea-Netherlands Tax Treaty provides that capital gains from the transfer of shares can be taxed only in the country where the alienator (the transferor) resides, and then discussed the application of the domestic substance over form principle in the context of a tax treaty application. According to the Supreme Court, the substance over form principle requires that, where the nominal owner of the property has no capacity to control or manage the property, there is a separate person who substantively controls or manages such property through right of control of the nominal owner, and such disparity between nominal owner and substantive owner arose from a purpose to avoid tax, income from such property should be attributed to the person who substantively controls and manages such property as the taxpayer. However, where there is no such discrepancy between nominal owner and substantive owner, the income should be attributed to the nominal owner of the income.

In applying the substance over form principle to the case at hand, the Supreme Court first mentioned the key factual findings made by the lower court, such as that French SA established Dutch BV, and Dutch BV established Korean Sub on March 8, 1994, held the shares in Korean Sub, and then realized gains by selling the shares in 2006. The Court next noted that, in light of the purpose and background of establishing Dutch BV, details of its business activities, existence of employees and offices, decision making process in relation to the sale of the shares at issue, and flow of the sales proceeds, Dutch BV should be considered a holding company structurally independent from its parent French SA and thus can be deemed the substantive owner of the capital gains at issue. Accordingly, the Supreme Court found the lower court decision to be reasonable and upheld it, which found the NTS’s denial of benefits under the Korea-Netherlands Tax Treaty to be illegal.

III. Assessment

This case is significant in that it can serve as a welcome precedent for foreign investors who wish to invest in Korea through overseas holding companies and wish to ascertain the application of the tax treaty in reference to such holding companies. Various factors appear to have played determinate roles in the Supreme Court
ultimately rendering a decision in favor of the taxpayer, such as the operating history and scale of the holding company and how the operating profit was disposed of, and may potentially be referred to or relied on in other investment structures.

Yulchon’s international tax team has up-to-date knowledge and experience on a wide spectrum of treaty-based structuring and dispute matters. Please feel free to contact any of our experts below or your contacts at the firm if you wish to discuss any issues in this area.

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