

Supreme Court endorses application of domestic “substance over form” principle to deny tax treaty benefits

Many foreign investors, when investing in real property in Korea, have acquired property through intermediary holding companies. At the time of exit, they realize a capital gain by selling the shares in the holding companies, rather than the real property itself. According to the Korean domestic tax law, such gain would constitute a gain from real property holding company shares and would be subject to corporate income tax, similar to that from the sale of real property. Based on the structure, however, a treaty exemption is usually claimed with respect to the capital gain based on a treaty between Korea and the immediate holding company's jurisdiction, which does not contain a specific provision allowing taxation of the capital gains from shares in the real property holding company by the jurisdiction in which the real property is located in accordance with its domestic tax law. In such a structure, a crucial question becomes the applicability of the tax treaty between Korea and the jurisdiction of the company selling the shares.

In April 26, 2012, the Supreme Court rendered a decision involving two U.K. investment funds (collectively to be referred to as “LaSalle”) that is expected to serve as meaningful precedent not only for treaty-based structuring for real property investments in Korea, but for all others types of investments in Korea as well. Please refer to the chart describing the investment structure of this case, involving LaSalle, U.K. limited partnerships, and intermediate holding companies in Luxembourg, Belgium and Korea. In this case, the exit from the investment took place in the form of the sale of shares in the Korean intermediate holding company (Northgate ABS SPC) and a capital gains tax exemption was claimed with respect to gain from such share sale, based on the Korea-Belgium tax treaty. The Korean holding company, by reason of its asset composition, may have constituted a real property holding company under Korean domestic tax law; however, the Korea-Belgium tax treaty does not contain any specific provision allowing Korea to tax shares in real property holding companies, as Korean treaties with the U.K. or the OECD Model Tax Convention does.

This case presents three key issues:

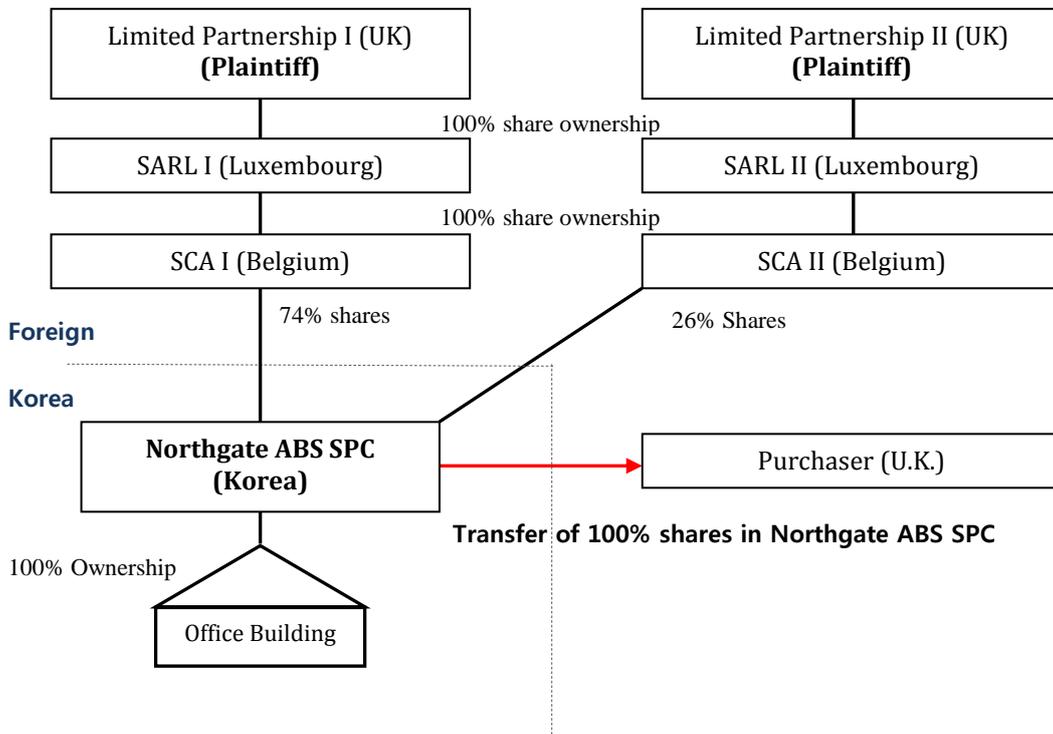
1. Whether the Belgian companies, the actual sellers of the shares in the Korean company (Northgate ABS SPC), could be disregarded to their ultimate U.K. parent entities, LaSalle, and a tax treaty could be applied based on the U.K. entities instead.
2. Whether the Korean Corporate Income Tax Act, Enforcement Decree's definition of what constitutes a real estate holding company, which is claimed by the taxpayer to be broader than the scope authorized by the Korean Corporate Income Tax Act, is invalid.

■ Tax Team

- **Sai Ree Yun**
sryun@yulchon.com
- **Dong Soo Kim**
dskim@yulchon.com
- **Seok Hoon Kang**
shkang@yulchon.com
- **Kyung Geun Lee**
kygelee@yulchon.com
- **Soo-Jeong Ahn**
sjahn@yulchon.com
- **Kyu Dong Kim**
kdkim@yulchon.com
- **Min Young Sung**
mysung@yulchon.com

3. Whether the purchaser, as withholding agent for the capital gains tax, of the Korean company shares has a justifiable ground to be waived the penalty for failure to withhold.

A. Investment Structure



B. Relevant Facts

As seen in the structure chart in A. above, each of the two U.K. limited partnerships, LaSalle, invested in the Korean commercial office building in 2002 through intermediate holding companies in Luxembourg, Belgium and finally Korea. The Belgium companies in the structure (established in the form of SCAs) sold the shares (74% and 26%, respectively) in the Korean holding company, Northgate ABS SPC, in 2004 to a U.K. purchaser (hereafter “Purchaser”) and derived capital gains. The Belgian companies claimed the exemption for capital gains for disposition of shares, which is provided in the Korea-Belgium tax treaty, and the Purchaser, in line with such position, did not withhold any tax in respect of the share transfer.

Upon review of the structure, the National Tax Service (“NTS”) found LaSalle, U.K. limited partnerships, to be the beneficial owners and denied the exemption provided by the Korea-Belgium tax treaty for capital gains from disposition of shares in a real estate holding company. NTS also imposed a penalty on the Purchaser for failure to withhold taxes.

The taxpayer appealed the assessment to the Tax Tribunal, the Administrative Court and the High Court in turn, but the case at each level was found in favor of the NTS. The taxpayer, then, appealed to the Supreme Court.

C. The Supreme Court Decision

Key Issues	Holding by the Supreme Court
<p>1. The domestic law principle of substance-over-form will be applicable in determining whether tax treaty benefits apply</p>	<p>The Supreme Court expressly held that the domestic law principle of substance over form is also applicable in the interpretation of the tax treaty (which has the same force of law as the domestic law) unless there is a provision specifically precluding the application. The Korea-Belgium tax treaty does not have a specific provision allowing Korea to tax capital gains arising from the sale of real property holding company shares, while the Korea-U.K. tax treaty does. The Supreme Court found that the Belgian companies in the structure were only conduits established for avoiding tax and cannot be treated as the beneficial owners of the capital gains at issue.</p>
<p>2. The Enforcement Decree under the Corporate Income Tax Act, providing for a seemingly broader definition than the Act as to what constitutes a real property holding company, is valid</p>	<p>The Decree's definition of a real property holding company only specified the asset composition test, which renders a broader definition than that specified in the Decree under the Personal Income Tax Act (also specifying the minimum share ownership and share disposition tests in addition to the asset composition test). The taxpayer had argued that such broader definition goes beyond the scope of authority granted to the Decree by the Corporate Income Tax Act. However, the Supreme Court has held the Decree's definition to be valid.</p>
<p>3. Ground to waive the penalty for failure to withhold</p>	<p>The Supreme Court found that there was no ground to waive the penalty for failure to withhold taxes imposed on the Purchaser (the withholding agent in this case). The Purchaser had presented the receipt issued by the tax office of the application for treaty-based exemption as evidence establishing a justifiable ground for waiving the penalty. However, the Supreme Court affirmed that the Purchaser appear to have known in fact that the substantive counterparty to the transaction was LaSalle, U.K. limited partnerships, rather than the Belgium companies and the receipt was not sufficient to waive the penalty.</p>

D. Significance

This case is significant in that the earlier decision by the Supreme Court on Lone Star (January 27th, 2012) confirmed the lower court's decision in general, but did not specifically address or confirm the application of the domestic substance over form principle in the interpretation of a tax treaty. In the LaSalle case, the Supreme Court specifically addressed this issue.

In relation to the beneficial ownership issue in a fund structure generally, we note that a new withholding procedure for claiming reduced withholding taxes under treaties will take effect on July 1st, 2012 (please see our [earlier newsletter](#) on this subject). Under such procedure, if Korean-source income is paid through an overseas (non-Korean) investment vehicle, such vehicle would not be able to claim a treaty benefit itself as beneficial owner; instead, it would be required to obtain the beneficial owner certificate from its underlying investors and prepare and submit the Overseas Investment Vehicle Report (OIV Report) to the withholding agent, disclosing all of its investors' identities and resident jurisdictions.

In light of the LaSalle decision and recent developments in the Korean tax arena, it is advised that extreme care be exercised in any treaty-based structuring to ensure sufficient substance. It is also expected that the Korean tax authorities' scrutiny over treaty-based structuring continue to increase, as they accumulate more experience and source of information for enforcement.

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■ Yulchon, LLC (Seoul)

Textile Center 12F, 518 Teheran-ro, Daechi-dong,
Gangnam-gu, Seoul 135-713, Korea
Tel : +82-2-528-5200 Fax : +82-2-528-5300
E-mail : mail@yulchon.com

■ Yulchon LLC (Beijing)

9F,SK Tower,6A Jianguomenwai Avenue,
Chaoyang District,Beijing 100022,P.R.China
TEL: +86-10-8567-0828 FAX: +86-10-8567-0738

■ Yulchon LLC (Ho Chi Minh)

Unit 03, 4th Floor, Kumho Asiana Plaza,
39 Le Duan St., Ben Nghe Ward, Dist.1,
Ho Chi Minh City, Vietnam
Tel : +84-8-3911-0225 Fax : +84-8-3911-0230

■ Yulchon LLC (Hanoi)

Suite 2502, Keangnam Hanoi Landmark Tower,
Pham Hung Street, Tu Liem District, Hanoi, Vietnam
Tel: +84-4-3837-8200 Fax : +84-4-3837-8230