

Taxation on the Deemed Dividend Income of Foreign Corporations

Sept 30, 2015

I. Overview

The foreign corporation has tax liability when it has domestic source income which is prescribed in Article 93 of Corporate Tax Act in Korea. It will be reviewed here whether the deemed dividend income of foreign corporation prior to the revision of the relative provision is taxable or not according to the tax law after the revision.

II. Fact Relevance

- (1) The plaintiff is a foreign corporation based in Singapore, and has established a Branch in Korea (Branch of Plaintiff) for financial business operation on Oct. 1, 1981.
- (2) The Branch of Plaintiff has paid the interest expenses of total KRW3,237,559,039 (KRW1,144,008,381 for business year 2003, KRW265,499,959 for 2004 and KRW1,828,050,699 for 2005) on borrowings which exceed 6 times as the amount invested by it's Head office which is regarded as 'foreign controlling shareholder' according to the Article 2 (1) 11 of Adjustment of International Taxes Act (former Act amended by Act no. 9914, Jan. 1, 2010) in Korea under the Article 14 (2) of the same Act and Article 26 of Enforcement Decree of the same Act (former Act, amended by Act no. 19650, Aug. 24, 2006) and this has been disposed as an 'outflow of income' and treated as not to be included in deductible expenses as prescribed in the Article 14 (1) of Adjustment of International Taxes Act.
- (3) As a result of the tax audit on the Branch of Plaintiff, the Defendant has made the 'income amount alteration notice' (hereafter, Disposition of this case) to the Branch of Plaintiff on Feb. 25, 2010, disposing the amount of total KRW2,093,550,658 (KRW265,499,959 for the business year of 2004 and KRW1,828,050,699 for 2005) as 'Dividend' income as prescribed in the Article 25 (5) of Enforcement Decree of the Adjustment of International Taxes Act
- (4) The Plaintiff has filed and paid the KRW23,136,360 (withholding corporate tax for the business year 2004) and KRW166,186,427 (withholding corporate tax for the business year 2005) as per the 'income amount alteration notice', and filed an appeal to a Tax Tribunal on May 12, 2010, but it was dismissed by Tax Tribunal on Dec. 31, 2010.

III. Review Points

Article 93 of Corporate Tax Act (Domestic Source Income)

IV. Case Review

- (1) Having the issue amount of this case included in the earning in reporting, determining or correcting the tax base of corporate tax on the revenues in each business year at the domestic business places of foreign corporations and reverted to the foreign corporation as prescribed in the Article 14 (1) of Adjustment of International Taxes Act, Article 106 (1) 3 j of Enforcement Decree of the Corporate Tax Act, it should have been disposed as an 'outflow of income', but it is premised that the disposition of this case is to take it as income disposition as 'Dividend'.

- (2) The domestic source income of a foreign corporation is taxable only when it is prescribed in Article 93 of Corporate Tax Act in Korea. The clause taking the 'amount disposed as dividend' to the domestic source income as prescribed in the Article 14 of Adjustment of International Taxes Act, had been newly added after the revision of the Article 93 (2) (hereafter, Revision Clause of this Case) of Corporate Tax Act (Act before it was amended by Act No.7838, Dec. 31, 2005 and amended by Act No. 8831, Dec. 31, 2007), the issue of this case having the dividend of business year of 2004, 2005 as income disposition is against the principle of the prohibition on retroactive legislation as prescribed in the Article 13 (2) of Constitution of the Republic of Korea, as it takes the Dividend income disposition retroactively applied upon the prior business years even after the revision made. Accordingly, the issue amount of this case is not regarded as domestic source income as prescribed in Corporate Tax Act, as the Article 93 (2) of former Corporate Tax Act (Act before it was amended by Act No.7838, Dec. 31, 2005) is applicable for this case.
- (3) Also, as it is prescribed that the provision of tax treaty should be preferentially applied regarding the domestic source income of a foreign corporation under the Article 28 in the Adjustment of International Taxes Act, it is not taxable when the tax treaty does not take domestic source income despite it is prescribed as domestic source income in Corporate Tax Act. But as the issue amount of this case of having a deemed dividend as prescribed in the Article 14 (1) of Adjustment of International Taxes Act and Article 25 (5) of Enforcement Decree of same Act is not applicable to both in the Article 10 (Dividends) and Article 11 (Interest) of Tax Treaty between Korea and Singapore, it could not be regarded as domestic source income under the Tax Treaty. ___

V. Judgment 사례판단

- (1) Whether the Issue amount of this case is of domestic source income under the Corporate Tax Act
- 1) The domestic source income of a foreign corporation is taxable only when it is prescribed in Article 93 of Corporate Tax Act in Korea. The amount disposed as dividend as prescribed in the Article 17 (1) of Income Tax Act and Article 9 in Adjustment of International Taxes Act is prescribed as the domestic source income by 'the former clause of this case' and is not prescribed in Article 14 of Adjustment of International Taxes Act. And the, clause taking the 'amount disposed as dividend' to the domestic source income had been newly added after the revision as prescribed in the Article 14 of Adjustment of International Taxes Act. The Revision Clause of this Case is new clause of taking the deemed dividend income as taxable source income, and newly effective, the deemed dividend as prescribed in the Article 14 in Adjustment of International Taxes Act could not be taxable as dividend income (reference for the similar case: Supreme Court Decision 2008Du13415)
 - 2) It is prescribed in Article 1 of the Addenda of Corporate Tax Act that the effective date as Jan. 1, 2006 and also prescribed as 'this Act shall apply from the first business year that begins after this Act enters into force' in the Article 2 of the Addenda of same Act. Meanwhile, it is prescribed in the Article 18 (1) of same Act (hereinafter, Addenda Clause of this case) as 'the amended provisions of subparagraph 2 of Article 93 shall apply from the first portion disposes of as dividends after this Act enters into force'. The relevant business year for Issue amount of this case is the business year 2004 and 2005, and those are prior to the enforcement date of the amended Corporate Tax Act. So, what matters is whether the provision in addenda are

applicable to 'true retroactive legislation' which make it taxable only when the income disposition for the period of completion of tax requisition with tax right and liability relation which was already fixed before the enforcement date of revision. Normally, the withholding liability is fixed at the time of the receipt the 'income amount alternation notice', but the liability for withholding tax payment of the taxpayer is occurred when the taxation period closes for the income of the business year reverted (reference Supreme Court sentence 92Nu12483, Jun 8, 1993 etc.). So, the liability of the Corporate (withholding) tax payment for the Issue Amount of this case which is a deemed dividend is supposed to be occurred only until the closing date of the business year of 2004 and 2005. But the Addenda clause of this case is applicable to 'true retroactive legislation' as the liability of Corporate tax payment is newly occurred which has not been existed originally by having the Revision Clause of this Case effective on the business years after the taxation period is closed.

- 3) But it is against the Article 13 (2) of Constitution of the Republic of Korea to accept the 'true retroactive legislation'. It could be exceptionally accepted when it is considered as special circumstances, such as foreseeability by the public of retroactive legislation, the weakness or absence of the need to protect reliance due to legal uncertainty and disorder, justification of retroactive legislation by means of the existence of public concerns grave enough to supersede the protection of reliance (reference Constitutional Court sentence 97Heonba76, etc.). It is contradictory to the principle of the prohibition on retroactive legislation to interpret and apply the Addenda clause of this case as it is stated, as no justification grounds are found in special circumstances specified above for this case.

(2) Conclusion

The domestic source income of a foreign corporation is taxable only when it is prescribed in Article 93 of Corporate Tax Act in Korea. As the income disposition of the dividend prescribed in the Article 14 of Adjustment of International Taxes Act was not prescribed before the revision on Dec. 31, 2005 and the clause taking the 'amount disposed as dividend' as the domestic source income had been newly added according to the Article 14 of Adjustment of International Taxes Act, the deemed dividend according to the Article 14 of Adjustment of International Taxes Act before the implementation of the revision clause should not be regarded as taxable income.

[Decision Type] Decision against the Defendant

Trial history

Josik2010Seo1863 ▶ SeoulAdministrativeCourt2011Guhap10676 ▶ SeoulHighCourt2011Nu40327 ▶ SupremeCourt2012Du11737

(Reference: 외국법인의 간주배당소득 과세여부 \ 외국인투자기업의업무사례 \ 신고&세무실무)

Reference Provisions

CONSTITUTION OF THE REPUBLIC OF KOREA

[Enforcement Date 25. Feb, 1988.] [No.10, 29. Oct, 1987.]

Article 13

- (1) No citizen shall be prosecuted for an act which does not constitute a crime under the Act in force at the time it was committed, nor shall he be placed in double jeopardy.
- (2) No restriction shall be imposed upon the political rights of any citizen, nor shall any person be deprived of property rights by means of retroactive legislation.
- (3) No citizen shall suffer unfavorable treatment on account of an act not of his own doing but committed by a relative.

INCOME TAX ACT

[Enforcement Date 26. Oct, 2011.] [Act No.10898, 25. Jul, 2011., Other Laws and Regulations Amended]

Article 17 (Dividend Income) (1) Dividend income shall be income under each of the following income generated during the relevant taxable period:

1. Dividends or shares of profits or a surplus received from a domestic corporation, and dividends of the interest during construction pursuant to Article 463 of the Commercial Act;

CORPORATE TAX ACT

[Enforcement Date 01. Jul, 2013.] [Act No.11873, 07. Jun, 2013., Other Laws and Regulations Amended]

Article 93 (Domestic Source Income)

Domestic source income of a foreign corporation shall be classified as follows:

...

2. Dividend income provided in Article 17 (1) of the Income Tax Act (excluding any income provided in subparagraph 6 of the same paragraph) that is paid in Korea by any domestic corporation, any organization deemed a corporation, or any other domestic source and the amount disposed of as dividends under Articles 9 and 14 of the Adjustment of International Taxes Act;

...

Formal CORPORATE TAX ACT

[Enforcement Date 01. Jan, 2005.] [Act No.7317, 31. Dec, 2004., Partial Amendment]

Article 93 (Income Generated from Sources in Korea)

The income generated from sources in Korea by a foreign corporation shall be classified as follows:

...

2. The dividend income provided for in Article 17 (1) of the Income Tax Act (excluding any income provided for in subparagraph 6 of the same paragraph) that is paid in Korea by any domestic corporation or any organization treated as a corporation and the amount disposed of as a dividend under Article 9 of the Adjustment of International Taxes Act;

ENFORCEMENT DECREE OF THE CORPORATE TAX ACT

[Enforcement Date 03. Jun, 2011.] [Presidential Decree No.22951, 03. Jun, 2011., Partial Amendment]

Article 106 (Disposition of Income)

- (1) The amount included in the calculation of earnings as prescribed in Article 67 of the Act shall be disposed of in accordance with the provisions in the following subparagraphs. This shall also apply to non-profit domestic corporations and non-profit foreign corporations:

...

3. The amounts referred to in the following items shall be the other outflows from the company, notwithstanding subparagraph 1:

...

- (j) In reporting, determining or correcting the tax base of corporate tax on the revenues in each business year at the

domestic business places of foreign corporations under Article 94 of the Act, the income reverted to the foreign corporation, which is an amount included in the earnings and the income that has not been returned from the specially related person abroad, which is an amount included in the earnings in accordance with the tax adjustment under Article 4 or 6-2 of the Adjustment of International Taxes Act.

ADJUSTMENT OF INTERNATIONAL TAXES ACT

[Enforcement Date 01. Jan, 2014.] [Act No.12164, 01. Jan, 2014., Partial Amendment]s

Article 2 (Definitions)

(1) The terms used in this Act shall be defined as follows

...

11. The term "foreign controlling shareholder" means a person who substantially controls a domestic corporation or a domestic business place of a foreign corporation and falls under any of the following items, and the detailed standards therefor shall be prescribed by Presidential Decree:
 - (a) In cases of a domestic corporation, a foreign shareholder or investor (hereinafter referred to as "foreign shareholder") or a foreign corporation financed by such foreign shareholder;
 - (b) In cases of a domestic business place of a foreign corporation, the head office or branch office of the foreign corporation, a foreign shareholder of the foreign corporation, or a foreign corporation financed by the foreign corporation or the foreign shareholder;

ADJUSTMENT OF INTERNATIONAL TAXES ACT

[Enforcement Date 01. Jan, 2014.] [Act No.12164, 01. Jan, 2014., Partial Amendment]s

Article 9 (Income Disposition and Tax Adjustment following Income Adjustment)

- (1) In the application of Article 4 or 6-2, where it is not verified by the evidence that the amount to be included in gains has been returned by a foreign related party to a domestic corporation as prescribed by Presidential Decree, the said amount shall be disposed of as a dividend to the foreign related party or adjusted as an investment, as prescribed by Presidential Decree, notwithstanding Article 67 of the Corporate Tax Act.
- (2) In relation to the application of paragraph (1), the method of disposition of incomes and other necessary matters shall be prescribed by Presidential Decree.

ADJUSTMENT OF INTERNATIONAL TAXES ACT

[Enforcement Date 01. Jan, 2014.] [Act No.12164, 01. Jan, 2014., Partial Amendment]

Article 14 (Non-inclusion of Interest Deemed Dividend in Deductible Expenses)

- (1) Where a domestic corporation (including the domestic business place of a foreign corporation; hereafter the same shall apply in this Chapter) borrow funds from a foreign controlling shareholder, or from a third party under a payment guarantee (including the offer of a security, etc. for guarantee of payment) by the foreign controlling shareholder, and such borrowings exceed three times as much as the amount invested by the relevant foreign controlling shareholder, the interest paid and discount fee as to the relevant amount in excess shall not be included in deductible expenses of the relevant domestic corporation but shall be deemed to have been disposed of as a dividend or an outflow of income pursuant to Article 67 of the Corporate Tax Act, as prescribed by Presidential Decree. In such cases, the scope of borrowings and the computing method of the amount treated as not to be included in deductible expenses and the amount of investment shall be prescribed by Presidential Decree.
- (2) The multiplier of the borrowings against the amount of investment of the foreign controlling shareholder under paragraph (1) may be separately prescribed by Presidential Decree by business type.

Article 28 (Preferential Application of Income Classification under Tax Treaty)

In the classification of a domestic source income of a nonresident or a foreign corporation, the provisions of tax treaty shall be preferentially applied, notwithstanding Article 119 of the Income Tax Act and Article 93 of the Corporate Tax Act.

ENFORCEMENT DECREE OF THE ADJUSTMENT OF INTERNATIONAL TAXES ACT

[Enforcement Date 15. Feb, 2013.] [Presidential Decree No.24365, 15. Feb, 2013., Partial Amendment]

Article 25 (Calculation Method of Non-deductible Expenses)

...

- (5) In applying paragraph (3), where the foreign controlling shareholder indirectly owns the shares of a domestic corporation, the ratio occupied by the foreign controlling shareholder's paid-in capital in the total paid-in capital shall be calculated by the methods in the following subparagraphs:
1. Where one or more corporations interpose between a foreign controlling shareholder and a domestic corporation by means of a stock ownership, and all of them correspond to the relationship connected in tandem (hereinafter referred to as the "tandem investment relationship"), the ratio of foreign controlling shareholder's paid-in capital in the domestic corporation shall be computed by multiplying all equity ratios in every phase: Provided, That where a foreign shareholder and a foreign corporation whose debts are added up as prescribed in Article 24 (3) are all included in the tandem investment relationship, it shall be computed by applying Article 2 (2) mutatis mutandis. In such cases, the "indirectly-owned ratio" shall be construed as the "ratio of paid-in capital";
 2. Where there exist two or more tandem investment relationships between a foreign controlling shareholder and a domestic corporation, the ratio of foreign controlling shareholder's paid-in capital in the domestic corporation shall be computed by adding up all paid-in capital ratios computed in a respective tandem investment relationship.
- (6) In applying Article 14 (1) of the Act, the interest on the debt borrowed from a foreign controlling shareholder which is not included in deductible expenses shall be deemed disposed of as dividend under Article 67 of the Corporate Tax Act, and the interest on the debt borrowed from a third party under a payment guarantee of a foreign controlling shareholder which is not included in deductible expenses shall be deemed disposed of as outflow of income under Article 67 of the Corporate Tax Act.

ENFORCEMENT DECREE OF THE ADJUSTMENT OF INTERNATIONAL TAXES ACT

[Enforcement Date 15. Feb, 2013.] [Presidential Decree No.24365, 15. Feb, 2013., Partial Amendment]

Article 26 (Multiples by Industry)

The multiple of a loan to apply with respect to equity in investment held by a foreign controlling shareholder shall be six times in accordance with Article 14 (2) of the Act in cases of the financial industry.

Convention between the Republic of Korea and the Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income

Signed at Singapore 6 November, 1979, Entered into force 11 February, 1981

Article 10. [Dividends]

1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.
2. However, such dividends may be taxed in the Contracting State of which the company paying the dividends is a resident, and according to the law of that State, but if the recipient is the beneficial owner of dividends the tax so charged shall not exceed:
 - (a) 10 per cent of the gross amount of the dividends if the recipient is a company which owns directly at least 25 per cent of the capital of the company paying the dividends;
 - (b) 15 per cent of the gross amount of the dividends in all other cases.The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of these limitations. The provisions of this paragraph shall not affect the taxation of the company on the profits out of which the dividends are paid.
3. Notwithstanding the provisions of paragraph 2 of this Article as long as Singapore does not impose a tax on dividends in addition to the tax chargeable on the profits or income of a company, dividends paid by a company which is a resident of Singapore to a resident of Korea shall be exempt from any tax in Singapore which may be chargeable on dividends in addition to the tax chargeable on the profits or income of the company. However, when Singapore imposes a tax on dividends in addition to the tax chargeable on the profits or income of a company, the rates as prescribed under the provisions of paragraph 2 of this Article shall apply.

4. The term "dividends" as used in the Article means income from shares as well as income assimilated to income from shares according to the taxation laws of the Contracting State of which the company making the distribution is a resident.
5. The provisions of paragraph 2 shall not apply if the recipient of the dividends, being a resident of a Contracting State, has in the other Contracting State, of which the company paying the dividends is a resident, a permanent establishment with which the holding by virtue of which the dividends are paid is effectively connected. In such a case, the provisions of Article 7 shall apply.
6. Where a company which is resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company to persons who are not residents of that other State, or subject the company's undistributed profits to a tax on undistributed profits, even if the dividends paid or undistributed profits consist wholly or partly of profits or income arising in such other State.
7. Dividends shall be deemed to arise:
 - (a) in Singapore, if it is paid by a company resident in Singapore; or
 - (b) in Korea, if it is paid by a company resident in Korea.

Convention between the Republic of Korea and the Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income

Signed at Singapore 6 November, 1979, Entered into force 11 February, 1981

Article 11. [Interest]

1. Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.
2. However, such interest may be taxed in the Contracting State in which it arises and according to the law of that State, but if the recipient is the beneficial owner of the interest the tax so charged shall not exceed 10 per cent of the gross amount of the interest. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.
3. Notwithstanding the provisions of paragraph 2 of this Article, interest arising in a Contracting State and paid to the Government of the other Contracting State shall be exempt from tax of the first-mentioned Contracting State.
4. For the purposes of paragraph 3 of this Article, the term "Government"
 - (a) in the case of Korea means the Government of Korea and shall include
 - (i) the local authorities;
 - (ii) the Bank of Korea;
 - (iii) the Export-Import Bank of Korea; and
 - (iv) such institutions, the capital of which is wholly owned by the Government of Korea or the local authorities, as may be agreed from time to time between the Governments of the two Contracting States;
 - (b) in the case of Singapore means the Government of Singapore and shall
 - (i) the Board of Commissioners of Currency ;
 - (ii) the Monetary Authority of Singapore;
 - (iii) any institution which performs the functions similar to that of the Export-Import Bank of Korea ;
 - (iv) such institutions, the capital of which is wholly owned by the Government of Singapore, as may be agreed from time to time between the Governments of the two Contracting States.
5. The term "interest" as used in this Article means income from Government securities, bonds or debentures, whether or not secured by mortgage and whether or not carrying a right to participate in profits, and debt-claims of every kind as well as all other income assimilated to income from money lent according to the taxation laws of the State in which the income arises.
6. The provisions of paragraphs 1 and 2 shall not apply if the recipient of the interest, being a resident of a Contracting State, has in the other Contracting State in which the interest arises, a permanent establishment with which the debt-claim from which the interest arises is effectively connected. In such a case, the provisions of Article 7 shall apply.
7. Interest shall be deemed to arise in a Contracting State when the payer is that State itself, a political subdivision, a local authority or a resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment, then such interest shall be deemed to arise in the Contracting State in which the permanent establishment is situated.

8. Where, owing to a special relationship between the payer and the recipient or between both of them and some other person, the amount of the interest paid, having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the recipient in the absence of such relationship, the provisions of this Article shall apply to the last-mentioned amount. In that case, the excess part of the payments shall remain taxable according to the law of each Contracting State due regard being had to the other provisions of this Convention.