

Korea's controlled foreign corporation rules

By **Robert Kim**



In 1995, Korea enacted the Law for Coordination of International Tax Affairs (LCITA), which includes anti-avoidance rules widely accepted by the OECD countries and procedural rules intended to enhance the cooperation with foreign tax authorities. One of the anti-avoidance measures introduced in 1996 was the controlled foreign corporation (CFC) rule.

According to Korea's CFC rules, if a Korean resident shareholder owns a direct or indirect interest of 10 percent or more in a foreign corporation located in a low tax jurisdiction, distributable retained earnings derived by the foreign corporation are treated as dividends paid out to a Korean resident shareholder (deemed dividend), despite the fact that the reserved profits are not actually distributed. Low tax jurisdictions refer to jurisdictions in which the foreign corporation has an effective tax rate of 15 percent or less as well as the designated tax havens.

If a foreign corporation is classified as a CFC, the Korean resident shareholder will be deemed to have received dividends from the CFC equal to the amount of deemed distributable earnings multiplied by the shareholding ratio. The deemed dividend amount is basically the total distributable retained earnings, adjusted by previous deemed dividend amounts taxed to the Korean resident shareholder, mandatory reserves, share valuation gain/loss, etc.

Exceptions

There are two exceptions to Korea's CFC rules: (1) the active business operation exception; and (2) the same region holding company exception. Under the active business operation exception, the CFC rules do not apply when the CFC has an office, store, factory, or other fixed facility in the foreign country through which it actually conducts its business operations. This is so that legitimate foreign industrial or commercial activities are not penalised. Under the same region holding company exception, the CFC rules do not apply if the subsidiaries of the foreign hold-

ing company are located in the same region or country as the foreign holding company.

Changes

Recently, there were two changes to Korea's CFC rules. First, even if a foreign holding company has a subsidiary located in a different country or region, the foreign holding company can still qualify for the same region holding company exception if the passive income (i.e., dividends and interest income) derived by the foreign holding company from subsidiaries located in the same country or region as the foreign holding company is 90 percent or more of the foreign company's total income (excluding income derived from an active business). This revised provision is applicable from the fiscal year commencing on or after January 1st, 2012.

Second, the level of direct or indirect shareholding by a Korean resident shareholder in its foreign subsidiary which would cause the foreign subsidiary to be subject to the CFC rule is lowered from 20 percent or more to 10 percent or more in order to align with international standards. This revised provision is also applicable from the fiscal year commencing on or after January 1st, 2012.

Conclusion

The CFC rules are anti-tax haven regulations intended to regulate a company that has made overseas investments of an irregular nature. Korea's CFC rules try to prevent the accumulation of profits and income abroad. If corporations operating abroad are allowed to retain earnings indefinitely or at least for extended periods of time, the corporation's home country may never see the funds flow from the

corporation to the shareholders and taxation on the distributable retained earnings could be permanently or indefinitely deferred.

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