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Deemed acquisition tax when acquiring a company's shares through a subsidiary

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In Korea, it has been common practice for foreign investors to acquire Korean real estate companies indirectly by establishing Korean subsidiaries, which acquire Korean companies that have real estate holdings, to avoid paying the deemed acquisition tax. The Korean Local Tax Act states that when a person or an entity becomes a controlling shareholder by acquiring shares of a company, a deemed acquisition tax is imposed on the shareholder because the shareholder will be deemed to have acquired certain assets (e.g., real property) of the acquired company. The parent company that acquires, through its subsidiary, a company with real estate holdings shall be referred to hereinafter as the 'Acquiring Company'.

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In a recent case, the Korean Supreme Court (the Supreme Court) ruled that in the case where (i) the Acquiring Company established subsidiaries for the purpose of avoiding paying the deemed acquisition tax applicable to a controlling shareholder and (ii) obtained control of target companies by having its subsidiaries purchase 50 percent or fewer shares of the target companies, then it would be lawful to treat the Acquiring Company as the controlling shareholder of the target companies and impose the deemed acquisition tax on the Acquiring Company (Case Number 2008Du8499, decided January 19th, 2012).

In deciding the case, the Supreme Court made it clear that the doctrine of substance over form applies in this case to regulate the unlawful tax evasion activities and to promote fairness in taxation. The Supreme Court found that the subsidiaries were sham paper companies formed by the Acquiring Company for the sole purpose of avoiding the paying of taxes and thus imposed the deemed acquisition tax on the Acquiring Company, expounding the following reasons for its decision:

1. The addresses, telephone numbers, and representative directors of the subsidiaries and the Acquiring Company were identical and the subsidiaries had no employees other than said representative directors;
2. The subsidiaries all used the same representative when the shares of the target companies were acquired and disposed of;
3. At the shareholders meeting of the target companies, the same person was the proxy for the subsidiaries; and
4. Although the shares of the target companies were purchased with funds held in the bank accounts of the subsidiaries, the Acquiring Company provided said funds to the subsidiaries.

The Supreme Court further expounded that the factors in determining whether the deemed acquisition tax should be imposed on the Acquiring Company include the following factors: (i) the reason and purpose of acquiring the shares; (ii) sources of the acquisition fund; (iii) the management and disposition of the shares; and (iv) the capability of the registered owners and their relationship with actual owners.

Conclusion

In light of this recent Supreme Court decision, it is advisable to closely monitor the Supreme Court's rulings on similarly situated cases in the future and assess whether it would be sound practice to establish subsidiaries to avoid paying deemed acquisition tax when acquiring companies.

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