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The International Tax Bible - Treaty Shopping Case

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Position Paper on Withholding Tax Assessment

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I. Introduction

In connection with the corporate tax audit on OOO Korea (hereinafter referred as “A”), the Korean tax authority has raised several issues concerning the interest payments made by A to OOO International Finance Ireland (hereinafter referred as “B”) following the loan transaction of 35,940,000,000 Korean Won on October 1, 19XX between A(borrower) and B(lender).

Since the interest payments on the loan transaction are paid to B through OOO Bank located in New York US, the Korean tax authority has cast doubt on the status of B as the beneficial owner of the interest payments. The Korean tax authority stated that the actual beneficial owner is a company which is located in the US or another country other than B.

Thus, the Korean tax authority asserts that A should fulfil its obligation of withholding taxes on interest payments pursuant to the domestic tax regulations and the tax treaty between Korea and the country in which the actual beneficial owner resides.

We understand that the Korean tax authority requested various financial data from B to determine whether B is indeed a beneficial owner of the interest payments\(^1\). In summary, the Korean tax authority’s position is as follows:

“B does not have economic or commercial purpose. In substance, B should be viewed as a mere conduit company established for the primary purpose of evading the Korean government’s taxing rights by taking advantage of the Korea-Ireland tax treaty. It would therefore be inappropriate to treat B as a beneficial owner of the interest payments made by A. Rather, A should fulfill its withholding tax obligation pursuant to the relevant domestic tax regulations and the tax treaty between Korea and the country in which the actual beneficial owner resides”.

\(^1\) The resident registration, financial statements, and corporate tax returns of B are separately attached.
Thus, taxpayer explains its position with respect to the issues raised by the Korean tax authority based on relevant facts, tax treaty and domestic tax laws.
II. Background

Loan Transaction

Before the merger in May 1999, A’s parent company, OOO Inc. (hereinafter referred as “C”), had been the manufacturer of producing many kinds of automobile components. However, due to the abrupt changes in the automobile component market (decrease in demand due to an increase in the number of competitor and the financial crisis in Asia including Korea), C encountered a significant managerial crisis at the end of the 1990’s. As a result, C suffered a 5% drop in sales volume and 99% drop in net profit in 1998.

Due to such managerial difficulty on the part of C, C decided to enter into a merger and acquisition deal with Y Group in May 1999. As a part of effort to improve and reform C’s unsuccessful business practices, the Y Group started to administer its worldwide policy toward all the related parties of C, emphasizing a cost-effective and flexible organizational management and to strengthen overall competitiveness.

Together with the above changes, all business related matters of A have undergone major changes in response to the Y Group’s worldwide policy. One of those changes was the restructuring of A’s loan transactions. This was carried out in accordance with Y Group’s funding plan which sought to ensure greater financial stability for A.

Specifically, A borrowed KRW 35,940,000,000 from B under the new loan agreement on October 1, 1999 to redeem all preexisting long-term debts obtained prior to merger process (i.e. loan from foreign banks – USD 12,000,000; loan from C – USD 10,000,000).

Under the new Loan Agreement, A made quarterly interest payments on the outstanding loan using the interest rate of 1.25% \(^2\) over the KRW (Korean Won) Commercial Paper

\(^2\) Similar to the grantees fee of the parent company
(CP) rate\(^3\) as quoted by Bloomberg Financial Services.

**B’s business activities**

As explained earlier, B was established in Dublin, Ireland to engage in financial business.

B maintained USD $294,161,819 during the period 1999 thru 2001 as capital in its financial statements. Through its financial activity, B realized interest revenue of USD $36,679,057 and USD $36,632,804 in FY 2000 and 2001, respectively. Also, B pays corporate income tax on the interest income annually to the Irish government.

\(^3\) It refers to commercial papers translated in Korean won which are traded in the international financial market. In general, these notes are issued at lower cost than ordinary bank loans even if dealers’ commission fees are included.
III. Related Regulations

Article 11 of the Korea-Ireland Tax Treaty: Interest arising in a Contracting State and paid to a resident of the other Contracting State shall be taxable only in that other State.

Article 98 of the Corporate Tax Law (Exception to Withholding or Collection for Foreign Corporations): With regard to a foreign corporation, where the person who pays the amount of income generated in Korea which has no substantial connection with the domestic place of business or does not accrue to the domestic place of business makes such payment, the amounts under each of the following subparagraphs shall be withheld as corporate tax on the income for the fiscal year of the concerned corporation and paid to the district tax office having jurisdiction over the place of tax payment as prescribed by the Presidential Decree by the 10th day of the month following the month including the date of the withholding.

Paragraph 1, Article 14 of the Basic Law for National Taxes (Assessment based on “substance over form”): If the attribution of income, profit, property, act or transaction which is subject to taxation is just nominal, and there is another person to whom such an income, etc., actually belongs, the latter person shall be liable for tax payment and tax laws shall apply accordingly.

Paragraph 1, Article 4 of the Corporate Tax Law (Assessment based on “substance over form”): Where a corporation to which all or part of revenue from assets or business legally accrues and a corporation to which it actually accrues are different from each other, this Law shall apply to the corporation to which the revenue actually accrues.

Paragraph 1, Article 16 of the Basic Law for National Taxes (Ground of Assessment): Where taxpayer keeps and records a book under related tax laws, the examination and determination of tax base of the national taxes concerned shall be based on the book and related documentary evidence.
Paragraph 3, Article 16 of the Basic Law for National Taxes: When the Government determines its tax assessment amount based on facts different from the contents of entry or omissions in the entry …, the facts examined and the determination ground shall be stated additionally in the determination documents.

Article 18 of the Basic Law for National Taxes (Standard of Tax Law Interpretation and Prohibition of Retroactive Taxation): In construing and applying tax laws, attention shall be paid so that the property rights of a taxpayer are not to be unreasonably damaged in the light of the equity in taxation and purpose of the pertinent provisions.
IV. B’s Substantiality

Summary of B’s activities based on its financial statements

B’s main activities as shown in the financial statements are as follows: (For the purpose of explanation, only FY 2000 and 2001 data were used).

<table>
<thead>
<tr>
<th></th>
<th>FY 2000</th>
<th>FY 1999</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan Interest Income</td>
<td>607,673</td>
<td>32,755,909</td>
</tr>
<tr>
<td>Deposit interest earned</td>
<td>261,721</td>
<td>596,371</td>
</tr>
<tr>
<td>Other interest income</td>
<td>1,228,974</td>
<td>1,188,137</td>
</tr>
<tr>
<td>Factoring income earned</td>
<td>41,987,591</td>
<td>15,751,480</td>
</tr>
<tr>
<td></td>
<td>44,085,959</td>
<td>60,291,897</td>
</tr>
<tr>
<td>Total Operating Income</td>
<td>(2,302,583)</td>
<td>(3,570,603)</td>
</tr>
</tbody>
</table>

As shown in the two-year income statements, B’s entire revenue derives from interest income source. This clearly shows that B’s principal activity consists of provision of loan for which B is compensated in the form of interest income.

Although the Korean tax authority expresses concerns on A’s payment of interest to B through US bank, it cannot be denied that B is the actual beneficial owner since B properly reports interest income in its financial statements in accordance with Irish tax regulations in relation to lending loan to A.
Status on capital held and corporate tax filing

(a) Status on capital held

As shown in the attached financial statements, B’s capital on balance sheets during fiscal years 1999, 2000 and 2001 was USD 294,161,819.

This amount is equivalent to KRW380,000,000,000 which is close to the level of capital held by large financial enterprises in Korea such as LG Card Co. and Korea Exchange Bank Credit Service Co. Ltd. Thus, the fact that B has considerable level of capital serving as a springboard for its business proves that B is not a conduit established merely to take advantage of tax treaty.

(b) Status on corporate tax payment

As shown in the attached corporate tax return files and financial statements, B has paid $3,356,035 and $4,379,403 as corporate tax in FY 2000 and FY 2001 to the Irish tax authority4.

In general, the fact that a profit-seeking corporation is paying taxes to the tax authority implies the following: (i) the corporation is recognized as an entity that is obligated by the relevant tax law to make tax payment, (ii) the corporation is recognized as a resident in the country pursuant to the related tax treaty, and (iii) taxing rights on the corporation is held by the government of the country in which the corporation is based.

For example, assume that a foreigner establishes a financial institution “A” in Korea through proper registration procedure and the institution “A” makes corporate tax payment to the Korean government each year.

4 The amounts include corporation tax (10%) and surtax.
① As A has properly been registered in the place where it is situated, A constitutes a legal entity under Article 33 of Civil Law and Article 172 of Commercial Law.

② As a corporation with domestic place of business, A falls under “domestic corporation” as stated under Article 1-1 of Corporate Tax Law.

③ Thus, A is liable to pay corporate income tax under Article 3-1 of Corporate Tax Law and **the Korean tax authority holds taxing rights on A**.  

Given the fact that A maintains considerable capital for its principal business and pays corporate income tax under Irish tax law for the income realized through its funding activity, it must be recognized that B is a resident as defined under the tax treaty.

**Comparison of A’s loan transaction with Aiken case**

There is a foreign case (Aiken case) similar to this pending issue. Although two cases are similar to each other, since their facts are different from each other, it is necessary to perform a comparative analysis against two cases in order to distinguish the difference.

In relation to Aiken Indus., Inc. v. Commissioner case, the US tax court reached the following conclusion.

*A company (“A”) established in Bahamas (Tax Haven territory) provided certain amount of loan to its subsidiary in US (“B”). Subsequently, company A transferred the*
loan receivable to its subsidiary located in Honduras ("C") under the same conditions applied in loan transaction between company A and company B.

As company C is obligated to pay the entire amount of interest income to company A immediately upon receiving from company B, company C gains practically no benefit from the loan transaction.

Thus, the US tax court concluded that the interest income earned by company A from company B should be imposed taxes according to US tax authorities’ treatment of transactions undertaken between affiliates located in US and Bahamas. This judgment was passed on the ground that company A attempted to use company C as a mere conduit to transfer income from company B. In other words, company C’s involvement in the concerned transaction shows no purpose from either economic or business perspective. Judging by the facts and circumstances, it can only be inferred (by court) that company A tried to exploit tax treaty to its advantage for purpose of avoiding the US tax authorities’ right to impose taxes.

Under the US Law, “received by”⁶ means possession beyond that which is temporary. Thus, in order for the US-Honduras tax treaty to be applicable, company C must have complete dominion and control over the interest payments from B.⁷

By contrast, B realized interest income of USD 36,000,000 for each fiscal year between 2000 and 2001 through the loan transaction, and paid USD 3,356,035 and USD 4,379,403 as corporate tax in each respective year. Thus, it is clear that the loan transaction undertaken by B is essentially different from that of the Aiken case by nature. Consequently, B cannot be regarded as a conduit as in the case of company C-Honduras company.

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⁶ We are free to, under Article II, to assign to those terms “not otherwise defined” by the convention the meanings which would normally attach to such terms under our laws unless the context otherwise requires.

⁷ The words “received by” refer not merely to the obtaining of physical possession on a temporary basis of funds representing interest payments from a corporation of a contracting State, but contemplate complete dominion and control over the funds.
Meaning of Beneficial Owner

No specific definition is provided in relation to the term “beneficial owner” by the Korea-Ireland Tax Treaty or the Korean tax law. The Commentary on the OECD Model Convention, however, occasionally refers to a *beneficial owner* as a *beneficiary*. Thus, the two terms can be used interchangeably.

A crucial element in defining “*beneficial owner*” is the meaning of the term “*beneficial*”. The term ‘benefit’ means anything that brings help, advantage, or profit. Thus, it can be said that the beneficial owner refers to the receiver of a benefit or advantage, esp. of money or property.

In the Aiken case, the IRS treated the Honduras company “C” as a mere conduit which did not realize any economic benefit from the loan transaction due to the fact that “C” simply transferred the entire amount of interest income directly to its Bahamas affiliate immediately upon receiving the payment from the US subsidiary. As a result, tax assessment was made on the suspicion of treaty shopping.

In the case of the pending issue, however, B had actually realized interest income of $36,000,000 for each fiscal year between 2000 and 2001 through loan transactions with affiliates.

Like other profit seeking enterprises, B seeks profit through loan transaction with A. And it is confirmed that B is the beneficial owner of the interest payment concerned since B actually realizes its taxable income through interest transaction with A.

Resident Certificate

Paragraph 1, Article 4 of the Korea-Ireland Tax Treaty provides that “Irish resident” means any person who, under the tax laws of Ireland, is liable to tax therein by reason of his domicile, residence, place of head or main office, place of management or any other criterion of a similar nature.
In this manner, B was established under the Business Law in Ireland and its main office was registered with Irish government. Accordingly, Irish tax authorities issued a certificate of resident to B pursuant to the relevant laws in Ireland.

Article 11 of the Korea-Ireland Tax Treaty provides “Interest arising from sources in a Contracting State which is derived and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State.”

According to the Tax Treaty, if an Irish resident receives the interest payment from A and the Irish resident is the beneficial owner, the **Irish tax authority shall be the only authority eligible to exercise taxing rights on the same interest.** As explained above, B as a resident of Ireland pays corporate taxes to the Irish tax authority. Thus, the **State of source (Korea) cannot withhold taxes with respect to the concerned transaction.**

Article 29 of the Law for Coordination of International Tax Affair (“LCITA”) (Special Application of Withholding Tax Rate on Interest, Dividend and Royalty) states “The Korean tax authorities, where the Contracting State requests residents or domestic corporations in Korea to furnish a resident certificate in relation to an application of the limited tax rate, may issue the certificate as prescribed by the Presidential Decree.”

Article 43 of the Enforcement Decree of the LCITA provides “The head of tax office having jurisdiction over the tax payment place shall, upon receipt of an application for issuance of the resident certificate under paragraph (l), issue the resident certificate as provided by the Ordinance of the Ministry of Finance and Economy, after confirming the facts thereof.”

Furthermore, the National Tax Service has given a guideline (order in nature) to every local tax office in relation to the issuance of a resident certificate (Googil46501-643, 12/27/1993). The guideline reads “Where an enterprise applies for the issuance of the resident certificate, the head of district tax office should immediately issue a resident certificate to the applicant.”
The confirmation of facts by a district tax office in connection with issuance of a resident certificate can be performed by ascertaining the objective fact that the applicant performs the business registered with its district tax office and pays taxes to that district tax office. In other words, such confirmation does not generally need thorough examination on the detailed business activities of the applicant.

According to Paragraph 1, Article 4 of the Korea-Ireland Tax Treaty, whether a resident is liable to pay taxes in the Country shall be determined by reason of his domicile, residence, place of head or main office, place of management or any other criterion of a similar nature. Therefore, the Korean government should immediately issue a relevant certificate to an applicant upon confirmation of the fact that the applicant has his domicile, residence, place of head or main office, place of management in his district tax office and accordingly pays taxes to that tax office.

Similarly, the Irish government issued a certificate of resident to B in a manner mentioned above. This certificate serves as a proof that B as an Irish resident pays the relevant corporate income taxes for the interest under concern, and moreover, it was determined that B is qualified to receive benefits under Article 11 of the Korea-Ireland Tax Treaty. The resident certificate evidences that B performs business activities, pays taxes to its registered district tax office and is entitled to receive the benefits of tax treaties.
V. Tax Treaty

Applicability of Article 11 [Interest] under Korea-Ireland tax treaty

Paragraph 1, Article 11 of Korea-Ireland tax treaty states, “Interest arising from sources in a Contracting State which is derived and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State.”

Thus, in considering the applicability of the above provision to the interest payment by A to B, it must be determined whether (1) B is a resident under Korea-Ireland Tax Treaty, (2) the interest payment is actually received by B, and (3) B is the beneficial owner of the interest income.

(1) Is B a resident and a beneficial owner?

As previously explained, whether B satisfies the resident requirements is clearly demonstrated by the resident certificate and supplemental explanation to be submitted. Thus, it is considered that there would not need to be additional explanation to establish whether B is a resident of Ireland. Moreover, whether B is a beneficial owner is explained in detail in the section “beneficial owner.”

Specifically, it is explained that B had actually realized interest income of $36,000,000 in each fiscal year between 2000 and 2001 and therefore, B is the beneficial owner of the interest payment made by A.

(2) Explanation on the term “derived by” under tax treaty

Since Paragraph 1, Article 11 of the Korea-Ireland Tax Treaty reflects only Paragraph 1, Article 11 of the OECD Model Tax Convention (taxation in the State of residence), the Korean tax authority should consult OECD Model Tax Convention and Commentary 5
on Article 11 of the OECD Model Tax Convention ("the Convention") in interpreting Paragraph 1, Article 11 of the Korea-Ireland Tax Treaty.\(^8\)

Commentary 5 on Article 11 of the Convention states "Paragraph 1 lays down the principle that interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in the latter. In doing so, it does not stipulate an exclusive right to tax in favor of the State of residence. The term "paid"[emphasis added] has a very wide meaning, since the concept of payment means the fulfillment of the obligation to put funds at the disposal of the creditor in the manner required by contract or by custom."

As quoted above in the above Commentary, the concept of payment means the fulfillment of the obligation to put funds at the disposal of the creditor in the manner required by contract or by custom.

As the term "payment" or "is derived by" under the Korea-Ireland tax treaty has a very wide meaning, "payment" and "derived by" can be regarded as "fulfillment of the obligation to put funds at the disposal of the creditor in the manner required by contract or by custom."

Thus, A’s interest payment to B in a manner required by the contract or by custom under the Korea-Ireland tax treaty represents fulfillment of obligation to put funds at the disposal of the creditor, B. This shows that A has lawfully fulfilled its obligation within the meaning defined under the tax treaty and Commentary of the Convention.

In Aiken case, US tax court ruled that the possession on a temporary basis of funds representing interest payment as shown by Honduras Company “C” does not fall within the meaning of “received by” in US-Honduras tax treaty.

\(^8\) As a member country of OECD, Korea is obliged to comply with Commentary on OECD Model Tax Convention since no observation is given by the country with respect to Article 11 of the Convention
By contrast, B recognizes interest payment from A as income in its financial statements and pays relevant taxes to the Irish government. Thus, the loan transaction between A and B is fundamentally different from that of Aiken case.

Since A’s interest payment to B was made in a manner required by the contract or by custom and A fulfilled its obligation to put funds at the disposal of B, A’s interest payment satisfies the word “derived by” under Korea-Ireland tax treaty.

**Principle of taxation in State of residence or taxation in State of source**

Since Paragraph 1, Article 11 of the Korea-Ireland Tax Treaty reflects **only** Paragraph 1, Article 11 of the OECD Model Tax Convention (taxation in the State of residence), the Korean tax authority should consult Commentary on the Convention in interpreting Paragraph 1, Article 11 of the Korea-Ireland Tax Treaty.

Article 11, Paragraph 2 of the OECD Model Convention states “*However, such interest may also be taxed in the Contracting State in which it arises and according to the law of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, 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.*”

Commentary 8 on Article 11 of the Convention stipulates “*Under paragraph 2, the limitation of tax in the State of source is not available when an intermediary, such as an agent or nominee, is interposed between the beneficiary and the payer, unless the beneficial owner is a resident of the other Contracting State*."

That is to say, as a supplemental explanation for Paragraph 2, Article 11 of the OECD Model Convention (taxation in the State of source), Commentary 8 on Article 11 of the Convention clarifies the point that the limitation of tax under Paragraph 2 would not apply unless the beneficial owner is a resident of the other Contracting State.
However, since the Korea-Ireland Tax Treaty adopted only the principle of taxation in the State of residence, that State of source withholds taxes on income from its source is not fundamentally possible under the Korea-Ireland Tax Treaty, with the exception of Paragraph 3, Article 11 of the Tax Treaty which allows imposition of tax in the case the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises, through a permanent establishment situated therein. In such cases, Articles 7 and 14 of the Tax Treaty shall apply and corporate taxes instead of withholding taxes shall be imposed pursuant to the domestic tax laws of each State.

Thus, in order for Commentary 8 on Article 11 of the Convention to apply, the Korea-Ireland Tax Treaty should have adopted Paragraph 2, Article 11 of the OECD Model Convention. Also, B must be either agent or nominee and not a beneficial owner. If that is the case, State of source (Korea) can withhold taxes under the tax rate of its local tax law instead of the limited tax rate under the Tax Treaty.

In other words, since the Korean and Irish government had agreed not to adopt provisions relevant to tax withholding in the State of source when the tax treaty was concluded, both governments cannot exercise withholding taxing rights upon source income. Therefore, where B is a resident of Ireland and a beneficial owner, State of source’s taxing rights issue would not take place.

**Difficulties in Applying the Korean Tax Law**

Paragraph 3, Article 3 of the Korea-Ireland Tax Treaty provides “As regards the application of the Convention by a Contracting State any term not defined therein shall, unless the context otherwise requires, have the meaning which it has under the law of that Contracting State concerning the taxes to which the Convention applies”.

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9 Refer to Honduras company as mentioned in Aiken case
In addition, Paragraph 1, Article 11 of the Tax Treaty provides “Interest arising from sources in a Contracting State which is derived and beneficilly owned by a resident of the other Contracting State shall be taxable only in that other State.”

The concept of “payment” and “received by” has been already explained by citing Article 4 of Korea-Ireland Tax Treaty and Commentary 8 of the OECD Model Convention. As a member country of OECD, Korea is obliged to comply with Commentary on OECD Model Tax Convention since no observation has been given by Korea with respect to Article 4 and Article 11 of the Convention.

Upon review of the Korea-Ireland Tax Treaty and Commentary 5 on Article 11 of OECD Model Convention which is the standard of construction of Article 11 of the Korea-Ireland Tax Treaty, it is very clear that the loan transaction between A and B was undertaken legitimately in accordance with Paragraph 1, Article 11 of the Korea-Ireland Tax Treaty.

If the Korean tax authority, in interpreting Article 11 of the Korea-Ireland Tax Treaty, insists upon interpreting related terms pursuant to the Korean tax law based on Paragraph 3, Article 3 of the Korea-Ireland Tax Treaty, it would be desirable for the Korean tax authority to provide taxpayer with the detailed explanation regarding the provisions of the relevant Korean tax laws and how to apply them in interpreting the Korea-Ireland Tax Treaty.

The book published by the National Tax Service (“NTS”) which deals with tax withholding on income from domestic source explains the well-known general principle of construction of tax treaty; since tax treaty has the status of special law with respect to domestic tax law, the tax matters of residents of Contracting States should be resolved based on the tax treaty before applying domestic tax laws. Therefore, it is very natural

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10 Commentary 5 on Article 11 of OECD Model Tax Convention: “…the term “paid” has a very wide meaning, since the concept of payment means the fulfillment of the obligation to put funds at the disposal of the creditor in the manner required by the contract or by custom.”

11 Page 20, Guideline of tax withholding on income from domestic source of non-resident/foreign enterprise, National Tax Service (2001)
that the tax treaty should have priority over domestic tax law in relation to international transaction with the other Contracting State.

In accordance with Paragraph 3, Article 3 of the Korea-Ireland Tax Treaty, the meaning of a term defined under the Korean tax law should be applied only in the case where the provision in the Korea-Ireland Tax Treaty containing such term is inapplicable due to its ambiguity. However, since the terms “resident” is well defined in Article 4 of Korea-Ireland Tax Treaty, it is thought that there is no reason to resort to the Korean tax law for their definition.

If the Korean tax authority decides to interpret the terms (in the treaty) based on its own opinion without observing the above general principle of construction of tax treaty, it would be necessary that the Korean tax authority provides taxpayer with the reason for taking such approach and the Korean tax law provisions to be used in interpreting the terms “resident” and “beneficial owner.”
VI. Matters related to Tax Treaty

As set forth above, B is strongly capitalized and a resident of Ireland having an office and personnel capable of managing its day-to-day business operations. Accordingly, the appropriateness of transactions between A and B should be reviewed by the Korea-Ireland tax treaty.

Tax treaty normally consists of some 30 articles. Thus, circumstances often arise where tax treaty with some 30 articles may not prove to be sufficient to resolve all types of tax issues taking place in connection with international transactions.

In order to resolve such difficulties, States concluding tax treaty adopt provisions such as Paragraph 3 Article 3, of the Korea-Ireland Tax Treaty: “As regards the application of the Convention by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning which it has under the law of that Contracting State concerning the taxes to which the Convention applies”.

Tax authorities have shown major concerns on improper use by taxpayers of tax treaty, and the OECD Model Tax Convention recommends that contracting states agree to control treaty shopping activities by including necessary provisions in the tax treaty in order to prevent such misuse.

As such, Commentary on the OECD Model Tax Convention proposes that the tax authorities in Contracting States single out treaty shopping activities by including specific provision(s) in their tax treaties. Related Commentary is as follows;

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**Commentary 19 on Article 1 of the OECD Model Tax Convention**

It has been suggested that the conduit problem be dealt with in a more straightforward way by inserting a provision that would single out cases of improper use with reference to the conduit arrangements themselves (the channel approach). Such a provision might have the following wording:

“Where income arising in a Contracting State is received by a company that is a resident of the other Contracting State and one or more persons who are not residents of that other Contracting State
a) have directly or indirectly or through one or more companies, wherever resident, a substantial interest in such company, in the form of a participation or otherwise, or
b) exercise directly or indirectly, alone or together, the management or control of such company

any provision of this Convention conferring an exemption from, or a reduction of, tax shall not apply if more than 50 percent of such income is used to satisfy claims by such persons (including interest, royalties, development, advertising, initial and travel expenses, and depreciation of any kind of business assets including those on immaterial goods and processes).”

Commentary 20 on Article 1 of the OECD MODEL TAX CONVENTION

A provision of this kind appears to be the only effective way of combating “stepping-stones” devices. It is found in bilateral treaties entered into by Switzerland and the United States and its principle also seems to underly the Swiss provisions against the improper use of tax treaties by certain types of Swiss companies.

States that consider including a clause of this kind in their convention should bear in mind that it may cover normal business transactions and would therefore have to be supplemented by a bona fide clause.

Commentary 21 on Article 1 of the OECD MODEL TAX CONVENTION

The solutions described above are of a general nature and they need to be accompanied by specific provisions to ensure that treaty benefits will be granted in bona fide cases. Such provisions could have the following wording:

a) General bona fide provision

“The foregoing provisions shall not apply where the company establishes that the principal purpose of the company, the conduct of its business and the acquisition or maintenance by it of the shareholding or other property from which the income in question is derived, are motivated by sound business reasons and do not have as primary purpose the obtaining of any benefits under this Convention.”

b) Activity provision

“The foregoing provisions shall not apply where the company is engaged in substantive business operations in the Contracting State of which it is a resident
Commentary on the OECD Model Convention suggests that States which are concerned about conduit problem should, at the time of concluding tax treaty, insert necessary clauses to prevent tax avoidance by the use of conduit.

Accordingly, unless Contracting States agree to include the clauses in the tax treaty in an effort to eliminate such tax avoidance, it is practically difficult for the Contracting States to effectively prevent them.

For instance, the United States in general strongly demands other Contracting State to include ‘limitation on benefits’ clause at the time of concluding a tax treaty with the United States. Otherwise, it would be difficult to discourage taxpayers from engaging in treaty shopping.

The United States retains her own model tax convention for the purpose of concluding tax treaty. Although there are differences found among the tax treaties concluded by the United States with other Contracting States, for the purpose of preventing treaty shopping, the United States adopts the provision that, if more than 50 percent of shares of a corporation residing in other Contracting State is owned by a taxpayer who is not a resident of that other Contracting States, that corporation cannot benefit from the tax treaty concerned.

For example, assume that a Saudi Arabian investor establishes a 60 percent owned company in France and this French company invests in US securities. Under the US-France tax treaty, the French company is not eligible to benefit from limited tax rate applicable to interest and dividends paid from US to France.
On the contrary, assume that the Saudi Arabian investor appoints a Frenchman to own entire shares in a French company whose stock value is only nominal and that Saudi Arabian investor has substantial control over a French company by lending enormous amounts of fund to the French company. In this case, since the Frenchman own the entire shares in a French company, the aforementioned requirements for possession of shares under “limitation on benefits” clause would be met and accordingly, the French company would be eligible to benefit from the limited tax rate prescribed in the US-France tax treaty.

In order to prevent this type of problem, when concluding a tax treaty with other Contracting State, the United States adopts the provision that, if the income of a corporation (e.g. ‘the French company’) is mostly used for the purpose of redeeming debts from a non-resident (e.g. ‘the Saudi Arabian investor’), that corporation is not eligible for benefits provided by the tax treaty (e.g. ‘base erosion test’). However, the United States understands that the strict implementation of provisions to prevent treaty shopping would impede active international trades. Thus, as a way to circumvent such problem, the United States inserts in its tax treaty the provision that, even if a company does not meet the ‘requirements for possession of shares under the limitation on benefits’ and ‘base erosion test’, the company might be eligible to receive benefits provided by tax treaty provided that the company performs actively (bona fide) its business with no intention of tax evasion.

Other States with similar interest in prevention of treaty shopping have sought various modes (e.g. insertion of clause in tax treaty) to effectively discourage tax avoidance.

However, in case of Korea, there are no provisions to prevent treaty shopping activities in either the tax treaty concluded with Ireland or in the domestic tax law.

12 Richard L. Doernberg, International Taxation, pp.127-128
Thus, with respect to treaty shopping, it would be virtually impossible for the Korean tax authority to exert its taxing rights without legal provisions by which the tax assessment can be justified.
VII. Tax Assessment based on Substance over Form

As interest payments made by A on the loan transaction are paid to an account of B through OOO Bank located in New York, the Korean tax authority thinks that it can exert its taxing rights based on the “substance over form principle” of the Basic Law for National Taxes and the Korean Corporate Tax Law.

B realized interest income of US$36,000,000 in each fiscal year between 2000 and 2001 through loan transactions and paid taxes to the Irish government in the amount of US$3,356,035 and $4,379,403 in the respective years. Thus, it is clear that B is the real beneficial owner of the interest payment.

As explained earlier, since the transactions between A and B had been undertaken in accordance with Article 11 of the Korea-Ireland Tax Treaty, the Korean Tax Law would no longer apply due to priority of tax treaty over domestic tax laws. For clarity, however, the substance over form principle of the Basic Law for National Taxes and the Korean Corporate Tax Law is set forth.

Paragraph 1, Article 14 of the Basic Law for National Taxes (Assessment based on “substance over form”) provides “If the attribution of income, profit, property, act or transaction which is subject to taxation is just nominal and there is another person to whom such an income, etc., actually belongs, the latter person shall be liable for tax payment and tax laws shall apply accordingly”.

Paragraph 1, Article 4 of the Corporate Tax Law (Assessment based on “substance over form”) provides “Where a corporation to which all or part of revenue from assets or business legally accrues and a corporation to which it actually accrues are different from each other, this Law shall apply to the corporation to which the revenue actually accrues”.

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As discussed in the Factual Background, B recognizes interest payment by A as income and pays corporate taxes to the Irish government. In other words, interest payment was effectively accrued to B and the payment was included as taxable income in B’s tax return. Under such circumstance, since the interest payment was actually accrued to B, substance over form principle cannot be applied.

For the Korean tax authority to make tax assessment based on the treaty shopping, there should be relevant provisions in the Korea-Ireland Tax Treaty or an amendment to the current Korean tax law to prevent occurrence of such activity.

In conclusion, although the Korean tax government is not satisfied with the transactions between A and B, the Korean government cannot regulate treaty shopping activities due to lack of related provisions/regulations in the Korea-Ireland Tax Treaty or domestic tax law.
VIII. Position of the Other Contracting State

B realized the interest income of US$36,000,000 through loan transactions and pays reasonable amount of taxes to the Irish government in accordance with Irish tax law.

If the Korean tax authority exercises its taxing right along with the Irish government on the same transactions between A and B, B would confront the problem of double taxation. Thus, it would be necessary to explain the following problems based on the relevant facts and provisions under the Korea-Irish Tax Treaty.

Article 23 of Korea-Ireland Tax Treaty (Elimination of Double Taxation) states as follows;

1. Subject to the provisions of Korea tax law regarding the allowance as a credit against Korean tax of tax payable in any country other than Korea (which shall not affect the general principle hereof), Irish tax payable (excluding, in the case of a dividend, tax payable in respect of the profits out of which the dividend is paid) under the laws of Ireland and in accordance with this Convention, whether directly or by deduction, in respect of income from sources within Ireland shall be allowed as a credit against Korean tax payable in respect of that income. The credit shall not, however, exceed that proportion of Korean tax which the income from sources within Ireland bears to the entire income subject to Korean tax.

2. (a) Subject to the provisions of the laws of Ireland regarding the allowance as a credit against Irish tax of tax payable in a territory outside Ireland (which shall not affect the general principle hereof), Korean tax payable under the laws of Korea and in accordance with this Convention, whether directly or by deduction, on profits, income or chargeable gains from sources within Korea (excluding in
the case of a dividend tax payable in respect of the profits out of which the dividend is paid) **shall be allowed as a credit against any Irish tax computed by reference to the same profits, income or chargeable gains by reference to which Korean tax is computed.**

That is, for purpose of eliminating double taxation, both the Korean and Irish governments allow taxpayers a tax credit. If the Korean tax authority imposes tax on the interest payment made by A to B, the Irish tax authority must allow B a tax credit for the tax amount paid to the Korean government according to Korea-Ireland tax treaty.

However, if the Korean government exercises taxing right on the loan transaction between A and B without regarding the purpose of the tax treaty and the Irish government also exercises its taxing right on it, the resulting effect would be that the taxpayers (A and B) pay taxes on the same income to both the Korean and Irish governments. This is undoubtedly a double taxation.

Residents of Korea must pay taxes to the Korean government in return for the Korean government’s protection. By the same token, B must pay taxes to its government in consideration of receiving protection in the territory in which B operates.

B does not receive protection from the Korean government. According to the Article 11 of the Korea-Ireland Tax Treaty, interest shall be taxable only in the State of residence unless the interest arises through a permanent establishment situated in Korea.

If the Korean government exercises its taxing rights on an unreasonable basis even though A makes interest payment to B in a justifiable manner, the Irish government will strongly oppose the actions of the Korean government based on Korea-Ireland Tax Treaty.
IX. Conclusion

Paragraph 1, Article 16 of the Basic Law for National Taxes (Ground of Assessment) provides “Where taxpayer keeps and records a book under related tax laws, the examination and determination of tax base of the national taxes concerned shall be based on the book and related documentary evidence”.

Also, Paragraph 3, Article 16 of the Basic Law for National Taxes provides “When the Government determines its tax assessment amount based on facts different from the contents of entry or omissions in the entry, the facts examined and the determination ground shall be stated additionally in the determination documents”.

Furthermore, the Article 81-5 of the Basic Law for National Taxes (Assumption of Sincerity of Taxpayers) states “The tax officials should assume the taxpayers are sincere and the tax returns filed by them are reliable ones except for cases where the taxpayers did not fulfill their tax payment obligation such as non-filing of tax returns in compliance with the tax law, or where there is obvious evidence in support of the suspicion of tax evasion and other cases as prescribed by the Presidential Decree”.

According to the Basic Law for National Taxes, for tax assessment on the loan transaction, the Korean tax authority is under lawful obligation to provide A with the detailed explanation of the problems/issues identified in the filed returns.

In other words, as long as A files its tax returns on a reasonable basis, the contents therein should be regarded as factual and accurate. If the tax authority intends to raise a tax issue concerning the reasonableness of the reported tax return, the tax authority should bear the burden of proof in proving that the reported tax return is unjust.

Also, where the Korean tax authority decides to make tax assessment on the loan transaction between A and B, the Korean tax authority should explain why Article 4 of Korean Corporate Tax Law is applicable and why Article 11 of Korea-Ireland Tax Treaty is not applicable to the loan transaction concerned.
This position paper was prepared to resolve the withholding tax issues raised by the Korean tax authority and the taxpayer’s position has been thoroughly stated on an issue-by-issue basis based on relevant facts, tax treaty, and domestic tax laws.

If the Korean tax authority has a different opinion with regard to the matters discussed in this position paper and related evidences regarding the interest payment transactions between A and B, it would be desirable that the Korean tax authority provides taxpayer with its position on an issue-by-issue basis based on the relevant facts and regulations pursuant to Article 16, Article 16-3, and Article 18-5 of the Basic Law for National Taxes.