The Extent to Which Substance-Over-Form Principle Is Applicable

As taxation has a considerable influence on the rate of return of a cross-border investment, a tax treaty between countries is also important. In general, such a treaty is modeled upon the OECD Model Tax Convention or the UN Model Tax Convention, with revisions made as countries deem necessary.

The OECD Model Tax Convention provides that the income-source country shall impose taxes on the real-estate income of the "resident" of a contracting state but the resident country shall impose taxes on gains from share transfers. In contrast, the UN Model Tax Convention provides that the income-source country shall have the taxation right with respect to gain from a share transfer if the share acquisition exceeds a certain threshold and the resident country shall have such taxation right in other cases. The two tax conventions are similar in that both provide that the income-source country shall impose taxes on the real-estate income of the resident of a contracting state. Because tax treaties differ on the treatment of gains from share transfers, there are differences in many cases of actual taxation depending on which tax treaty is applied. The matter of which tax treaty is applicable is crucial to someone investing in shares in a foreign company.

In the event that a foreign corporation establishes a Special Purpose Company (SPC) in a tax haven and makes an investment in Korea, and then earns income from such an investment, such an SPC meets the requirements of a "resident" in the tax haven in most cases, as it is established under license or authorization pursuant to the provisions of local laws. Therefore, generally, an investor who has established an SPC in a contracting state to invest in shares in the other contracting state under tax planning argues that (i) such an SPC shall not be subject to taxation by the other contracting state as it constitutes a "resident" of a contracting state, and (ii) the status of the "resident" of the SPC recognized by a contracting state under the tax treaty shall not be denied and the benefits under such tax treaty shall not be deprived under the substance-over-form principle pursuant to the internal law of the other contracting state, and (iii) even if the substance-over-form principle is applicable, the tax treaty between a contracting state and the other contracting state shall apply to the SPC, as it is a company with legal substance, not a conduit.

Korean taxation authorities treat an SPC of an investor as a conduit of the investor and apply the substance-over-form principle to the SPC under domestic tax laws, and accordingly impose corporate income taxes on the investor, treating the investor as the owner of the capital gain from the share-transfer transaction if the SPC was created as a formality, according to the pre-designed investment/governance structures only for tax-avoidance purposes through "Treaty Shopping" regardless of whether the SPC is a resident of a contracting state.

Courts in Korea have accepted the position of Korean taxation authorities. In fact, regarding several recent cases in which an issue was whether the tax treaty is applicable, the court has consistently denied the application of benefits under a tax treaty between a contracting state and the other contracting country, applying the substance-over-form principle in line with the position of Korean taxation authorities, and ruled that the applicable tax treaty is the one signed by and between a country of which the actual investor is a resident and the other contracting state.

Such judgments are based on the view that the substance-over-form principle may be applied as a standard of the interpretation of the relevant tax treaty even if such a tax treaty does not contain separate provisions on the substance-over-form principle, as it is based on the Constitution of the Republic of Korea. The position of Korean courts is that the substance-over-form principle is a legal system designed to realize the principle of equality of tax burden, which has been derived from the principle of equality or that of prohibition of discrimination, as provided in Article 11.1 of the Constitution.

Then, arguments can be made about to what extent the substance-over-form principle is applicable. It is clarified by existing precedents that ① the substance-over-form principle shall apply in determining who is a "party to which the capital gain belongs" at least, and ② the application of the substance-over form principle shall neither deny the effect of an agreement under private laws validly constituted between the parties nor create a new agreement.

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