

NEWSLETTER

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Tax Group

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Strategic Considerations for Korean Investors

• • • Leveraging the Special Tax Provision for Foreign Pass-Through Entities

It has been a year since the introduction of the special tax provision that enables taxpayers to treat foreign pass-through entities, which may not be considered as such in Korea, as pass-through entities for Korean tax purposes (the **Provision**). This Provision was designed to address foreign tax risks associated with the application of anti-hybrid rules under which Korean taxpayers could be affected despite the absence of identified tax arbitrage. If elected, profits or losses of foreign pass-through entities are passed through for Korean tax purposes, causing electing taxpayers to report income whether or not distributions are made.

Previously, Korean investors faced uncertainties and unknown tax exposures due to the tax status of foreign investment vehicles, potentially leading to hybrid mismatch arrangements that often result in the denial of treaty benefits. The introduction of the Provision has significantly mitigated such risks and has been crucial for Korean investment management companies and institutional investors.

Lee & Ko having successfully navigated numerous cases even before the Provision came into effect, this article aims to highlight the increasing importance of the Provision as a strategic tool for Korean investors considering outbound investments.

1. Investments through 'Corporations' Established in Cayman Islands

The Provision applies not only to foreign entities treated as transparent for tax purposes, but also to corporations treated as opaque if the jurisdiction does not impose both corporate and individual taxes on income. This flexibility is particularly advantageous for opaque vehicles in Cayman Islands, allowing Korean investors to navigate tax-efficient investment structures effectively.

2. Multi-Tiered Fund Structure

Many foreign investment funds utilize a multi-tiered structure, involving master funds and feeder funds. If the Provision is elected, Korean investors are deemed

to have applied it to all foreign transparent entities in a continuous investment relationship. Importantly, investors have the discretion to choose not to apply the Provision to specific foreign transparent entities under a multi-tiered structure, offering greater flexibility in its applicability. Taxpayers are advised to assess their investment structures to make the most effective use of the Provision.

3. More Foreign Tax Credit Availability

With the Provision allowing direct attribution of income to investors, Korean taxpayers are now eligible to claim credits for corresponding foreign taxes incurred. The Provision clarifies the eligibility criteria for certain foreign taxes, particularly withholding taxes suffered at the fund level, providing clarity on the extent to which these taxes can be considered in determining foreign tax credit limitation.

In summary, the Provision effectively addresses and resolves unintended adverse tax consequences resulting from hybrid mismatch arrangements. It brings clarity to the intricacies of the Korean foreign tax credit regime, making certain withholding taxes at the fund level creditable as foreign income taxes. As a result, the Provision fosters a more favorable tax environment for Korean investors engaging in outbound investments.

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