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# Reactions to Hybrid Mismatch Arrangements and Strategy Suggestions for Korea

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# REACTIONS TO HYBRID MISMATCH ARRANGEMENTS AND STRATEGY SUGGESTIONS FOR KOREA

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Abstract

In recent years, the Organisation for Economic Co-operation and Development (OECD)'s Base Erosion and Profit Shifting (BEPS) project has been one of the biggest issues in international taxation. The OECD refers to BEPS as "tax avoidance strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations." In 2014, the OECD released BEPS Action 2 as responds on Hybrid Mismatch Arrangements ("HMA"s), which are arrangements exploiting differences in the tax treatment of instruments, entities or transfers between two or more countries. Two of the major factors of HMAs are hybrid entities and hybrid instruments.

In Action 2, OECD recommends that counties introduce a "linking rule" that denies the deduction of costs which give rise to HMA outcomes in the payer jurisdiction, such as double deduction, deduction with no inclusion, indirect deduction with no inclusion, as the main measures for addressing HMAs. Among the 15 Actions of the BEPS Project, Action on HMAs is strongly recommended by OECD and G20 to the 100 countries that plan to implement BEPS. However, considering the historical and economic background of each country, it is difficult to solve HMAs solely with the uniform introduction of a linking rule. Some countries have developed their own countermeasures to HMAs. To successfully counter HMAs, one needs to study the HMA phenomenon and research the current rules. The purpose of this thesis is to examine the ways of responding to the hybrid entities and hybrid instruments of countries including the U.S. and to make policy proposals to solve HMA problems in Korea.

## I. Purpose of the research

South Korea, like the U.S. and other many countries, has different tax systems for individuals and corporations. For example, under the Korean Individual Income Tax Act, which was amended in 2016, an individual resident[1] of Korea pays taxes at a rate of 6% to 40% of his or her tax base, which includes worldwide income.[2] However, generally a corporation that is incorporated in a foreign country[3] only pays corporate tax based on Korean income, and the maximum rate of tax is only 22%.[4] Debt and equity are handled differently, and the payments on debt are deductible as interest,[5] while dividends are not deductible.[6] Generally, interest increases taxable income, but dividends that a

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[1] "[T]he term "resident" means any individual who has his/her domicile or has his/her place of residence in the Republic of Korea for more than 183days." Sodeuksebeob [Income Tax Act], Act No. 33, Jul. 15, 1949, *amended by* Act No. 14389, Dec. 20, 2016, art. 1-2(1)1. (S. Kor.), *translated in* Korea Legislation Research Institute ("KLRI") online database, http://elaw.klri.re.kr/kor_mobile/viewer.do?hseq=28557&type=sogan&key=5.

[2] *Id*. at art. 55.

[3] "[T]he term 'foreign corporation' means an organization that has its headquarters or main office in a foreign country in the form of a corporation that meets the standards prescribed by Presidential Decree (limited to such a corporation that does not have a place for actual management of its business in the Republic of Korea)" Beobinsebeob [Corporate Tax Act], Act No. 62, Jul. 15, 1949, *amended by* Act No. 14386, Dec. 20, 2016, art. 1 3. (S. Kor.), *translated in* KLRI online database, http://www.law.go.kr/DRF/lawService.do?OC=mofe&target=elaw&MST=141083&type=HTML&mobileYn=.

[4] *Id*. at art. 55.

[5] Beobinseneob sihaengryung [Enforcement Decree of the Corporate Tax Act], Act No. 238, Dec. 16, 1949, *amended by* Act No. 27828, Feb. 3, 2017, art. 19 (S. Kor.) *translated in* KLRI online database, http://elaw.klri.re.kr/kor_mobile/viewer.do?hseq=37193&type=sogan&key=5.

[6] "[D]eductible expenses shall be the amount of losses incurred by transactions which reduce the net assets of a corporation, excluding return of capital or financing, disposition of surplus funds, and what is provided for in this Act." Beobinsebeob [Corporate Tax Act], Act No. 62, Jul. 15, 1949, *amended by* Act No. 14386, Dec. 20, 2016, art. 19(1) (S. Kor.).

holding company has received are not included in calculating taxable income.[7]

Traditionally, these kinds of dichotomous classifications, such as individual and corporation, debt and equity, have been effective. However, as the economy has grown more complicated, new kinds of entities and instruments that have characteristics of both started to emerge.[8] In a single jurisdiction, these "hybrid" entities or instruments can be classified according to their own tax laws or tax administrations' rulings for tax purposes.[9] But at the international level, determining classifications for hybrid entities or instruments can be different country by country, because of economic and historic circumstances.[10] The attempt by multinational corporations to reduce their total tax burdens using these hybrid entities or instruments is not new, but the recent increase in electronic commerce and globalization has deepened this problem.[11] This kind of arrangement is called a Hybrid Mismatch Arrangement ("HMA").

The Organization for Economic Co-operation and Development ("OECD")[12] defined HMAs as "[a]rrangements exploiting differences in the tax treatment of instruments, entities or transfers between two or more countries."[13] A HMA arises when

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[7] *Id*. at art. 18(2) (S. Kor.).

[8] *See* Peter Harris, *Neutralizing Effects of Hybrid Mismatch Arrangements* 3 (Sept. 2014), http://www.un.org/esa/ffd/tax/2014TBP2/Paper_%20HybridMismatchArrangements.pdf.

[9] OECD, ACTION PLAN ON BASE EROSION AND PROFIT SHIFTING 9 (2013) [hereinafter OECD, BEPS REPORT].

[10] For example, partnership taxation has first introduced in Korea in 2009. Before that, partnerships generally were treated the same as corporations.

[11] *See* Harris, *supra* note 8, at 3.

[12] As of May 2017, 35 countries are members of the OECD, including the United States, Korea, Japan, and the Netherlands, Australia, Mexico, etc.

[13] OECD, HYBRID MISMATCH ARRANGEMENTS: TAX POLICY AND COMPLIANCE ISSUES 5 (Mar. 2012).

these conditions are combined: i) a hybrid instrument or entity, ii) international transactions, and iii) different countries' standards.

"Hybrid mismatch" can cause double taxation or double non-taxation[14] for taxpayers. Traditionally, the "Single Tax Principle," which means that "income from cross-border transactions should be subject to tax once"[15], has been one of the general purposes of tax treaties between countries,[16] and tax treaties were primarily focused on the adjustment of taxation between countries for the prevention of double taxation. Therefore, tax treaties haven't given sufficient guidance for double non-taxation situations. Under these circumstances, countries assumed that multi-national enterprises ("MNE"s) have used HMAs to lessen or avoid their world-wide tax amount,[17] and this is connected with considerable tax base erosion.[18]

The OECD recognized MNEs' aggressive attempts to lower their taxes.[19] To counter this phenomenon, the OECD's Base Erosion and Profit Shifting ("BEPS")

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[hereinafter OECD, HMAS REPORT].

14 "Taxation of circumstances or transactions at a level that is lower than they would have faced in a purely domestic setting" Yariv Brauner, *What the BEPS?*, 16 FLA. TAX REV. 55, 79 (2014).

15 Reuven S. Avi-Yonah , *Tax Competition, Tax Arbitrage and the International Tax Regime*, 61 BULL. FOR INT'L TAX'N 130 (2007);

16 *See Id.*; *Tax Competition, Tax Arbitrage and the International Tax Regime*, 61 BULL. FOR INT'L TAX'N 130 (2007); OECD, BEPS REPORT, *supra* note 9.

17 *See* Harris, *supra* note 8, at 3.

18 The OECD report provide anecdotal evidence as grounds of HMA phenomenon, as follows: "[N]ew Zealand settled in 2009 cases involving 4 banks for a combined sum exceeding NZD 2.2 billion (EUR 1.3 billion). Italy recently reported (…) a number of cases involving hybrids for an amount of approximately EUR 1.5 billion. In the United States, the amount of tax at stake in 11 foreign tax credit generator transactions has been estimated at USD 3.5 billion." OECD, HMAS REPORT, *supra* note 13, at. 5-6.

19 OECD, BEPS REPORT, *supra* note 9.

Project started in 2012, and final reports were released in 2015.[20] BEPS refers to "tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity."[21] The OECD has pointed to HMAs as one kind of tax-planning strategy. Measures against HMAs are included in BEPS Project as Action 2. In Action 2, the BEPS Project suggests reformation of domestic tax laws and treaties, in order to solve the HMAs problem.[22]

Successful implementation of this Action in the real world requires sufficient investigation of the actual situation of HMAs in each country, and studies about the expected effects of new rules to achieve the policy goals. Although the OECD has released a report about the phenomenon and examples of HMAs, identifying HMAs in the real world isn't simple because most of the examples can only be revealed by deep investigations into the individual MNEs, such as tax audits. The purpose of this thesis is to study the present relevant regulations and cases in Korea and other countries, including the U.S., and to offer guidance for implementation of the OECD's Action 2 in Korea, in order to make suggestions to deal with HMAs.

## II. OECD BEPS Project and Action 2

### A. BEPS overview

[20] "Until recently it was clear that the strong trend was of rule convergence and of increasing power accumulation by the OECD as the caretaker of the international tax regime." Brauner, *supra* note 14, at 62.

[21] OECD, ABOUT BEPS AND THE INCLUSIVE FRAMEWORK, http://www.oecd.org/tax/beps/beps-about.htm.

[22] OECD, NEUTRALISING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS FINAL REPORT (2015), http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/neutralising-the-effects-of-hybrid-mismatch-arrangements-action-2-2015-final-report_9789264241138-en#.WPua5NrhCMo#page1 [hereinafter, OECD, RECOMMENDATIONS ON HMAS].

With the development of information and communication technologies and the emergence of digital economy, the deployment of MNE's global value chain and integration of corporations' functions for efficiency have become easier.[23] In addition, factors or activities, such as data, network effects, and intangibles, which have not existed in the past or are regarded as less important are emerging as key factors or activities for increasing value.[24] The current principles of international taxation, which were designed a century ago, do not reflect this economic phenomenon; instead, MNEs use it as a means of tax avoidance.[25] International taxation standards, such as the OECD Model Tax Conventions and Commentaries on Model Tax Conventions, and the OECD Transfer Pricing guidelines, which have functioned as standard in the conclusion and interpretation of tax treaties by many jurisdictions, have been continually revised and supplemented to counter offshore tax evasion.[26] However, those have failed to provide sufficient and clear guidance to the tax authorities in the enforcement of treaties and domestic tax laws in international taxation, and have not been effectively coping with the latest tax avoidance strategies of MNE's.[27] The OECD's BEPS project was launched in 2013 with a particular focus on these situations.[28] In other words, the BEPS project intends

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[23] OECD, THE OECD WORK ON BASE EROSION AND PROFIT SHIFTING (2013), https://www.oecd.org/ctp/TheOECDworkonBEPS.pdf (last visited May 16, 2017) [hereinafter OECD, WORK ON BEPS].

[24] *See* OECD, WORK ON BEPS, *supra* note 23.

[25] OECD, OECD/G20 BASE EROSION AND PROFIT SHIFTING PROJECT EXPLANATORY STATEMENT 2015 FINAL REPORTS 4 (2015).

[26] OECD, WORK ON BEPS, *supra* note 23.

[27] *Id.*

[28] *Id.* ,

fundamental changes of past international taxation principles.[29]

### Pre-BEPS era

Since the 1990s, the OECD has encouraged tax haven countries[30] to exchange information with other countries by signing tax treaties, but the number of treaties had been decreasing until 2008.[31] However, the financial crisis in 2008, which aggravated governmental budget deficits world-wide, gave countries an incentive to actively enter into fights against offshore tax evasion.[32] In April 2009 alone, each tax haven country concluded at least 12 treaties under the threat of economic sanctions from G20 countries, and by the end of 2009, more than 300 treaties with tax haven countries had been signed.[33] Until 2012, information exchange and removal of bank secrecy had been the main strategies used to combat offshore tax evasion.[34] The U.S.'s Foreign Account Tax Compliance Act ("FATCA") which was adopted in 2010, accelerated information exchange between countries, and automatic information exchange became the new global standard.[35]

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[29] OECD, BEPS REPORT, *supra* note 9.

[30] The OECD pointed out four characteristics of tax havens, as follows: a) No or only nominal taxes, b) Lack of effective exchange of information, c) Lack of transparency, and d) No substantial activities. OECD, HARMFUL TAX COMPETITION 24 (1998).

[31] Niels Johannesen & Gabriel Zucma, *The End of Bank Secrecy? An Evaluation of the G20 Tax Haven Crackdown*, 6 AM. ECON. J. ECON. POL'Y 65–91 (2014).

[32] *Id*.

[33] *Id*.

[34] *Id*.

[35] "In 2010 the United States enacted FATCA, which effectively requires foreign financial institutions around the globe to report account details of their U.S. customers to the U.S. tax administration. The U.S. developed, together with five other OECD member countries (France, Germany, Italy, Spain and the United Kingdom), a model for the intergovernmental implementation of FATCA (Model FATCA IGA). The Model FATCA IGA provides for the implementation of FATCA through reporting by financial institutions to their local tax authorities, which then exchange the information on an automatic basis with the U.S. tax

BEPS project

The BEPS Project deals with tax-planning strategies that exploit gaps and mismatches in tax rules.[36] Tax evasion by entities isn't a new phenomenon.[37] Conceptually, any corporation or person has always had a motive to reduce tax.[38] However, as the media's interest in the tax evasion practices of multinational corporations such as Apple and Google has increased, those actions, along with deepening budget deficits, have sparked political interest around the world.[39]

Some scholars point to the "Google tax" (Diverted Profits Tax) of the U.K. as a beginning of the BEPS project.[40] However, to the U.K. tax authorities, a lack of information on the business or transactions of foreign subsidiaries was an obstacle to judging the appropriateness of taxation.[41] For example, it is difficult for the U.K.

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authorities. In September 2013, the G20 Leaders at their Summit fully endorsed the OECD proposal for a truly global model of automatic exchange." OECD, AUTOMATIC EXCHANGE OF FINANCIAL ACCOUNT INFORMATION BACKGROUND INFORMATION 5 (Jan. 2016), http://www.oecd.org/tax/exchange-of-tax-information/Automatic-Exchange-Financial-Account-Information-Brief.pdf.

36 *See* OECD ABOUT BEPS AND THE INCLUSIVE FRAMEWORK. http://www.oecd.org/tax/beps/beps-about.htm.

37 *See* Brauner, *supra* note 14, at 57.

38 The OECD quotes the following 1961 President Kennedy speech on the homepage. "Recently more and more enterprises organised abroad by American firms have arranged their corporate structures aided by artificial arrangements between parent and subsidiary regarding intercompany pricing, the transfer of patent licensing rights, the shifting of management fees, and similar practices [...] in order to reduce sharply or eliminate completely their tax liabilities both at home and abroad." Pascal Saint-Amans & Raffaele Russo, *What the BEPS are we talking about?* OECD (2013), http://www.oecd.org/forum/what-the-beps-are-we-talking-about.htm (last visited May 24, 2017).

39 *See* Brauner, *supra* note 14, at 57.

40 E.g., Juhyun Cho, *Gukga gan Sodeukijeonul Jejaehaneun BEPS Doipgwa Gieupui Daeeung Noryuek* [*The adoption of BEPS to prevent the transfer of income between countries and the response of companies*], POSRI ISSUE REPORT [POSCO RESEARCH INSTITUTE ISSUE REPORT] (Apr. 2016), https://www.posri.re.kr/ko/board/content/13930; *see also*, Rupert Neate, *What is the 'Google tax'?*, THE GUARDIAN, (Sep. 29 2014), https://www.theguardian.com/politics/2014/sep/29/what-is-google-tax-george-osborne.

41 *See* Cho, *supra* note 40, at 3.

government to argue that the amount of tax paid by Google is not adequate because it is hard to figure out what kind of work is being performed by Google subsidiaries in Ireland or the Netherlands.[42]

Inter-governmental cooperative strategies against MNE's tax avoidance became known to the public in 2013, when the OECD submitted a report titled "Addressing Base Erosion and Profit Shifting" to the G20 Financial Ministers and commenced the development of an Action Plan on the BEPS project.[43] The purpose of the OECD's BEPS project is to counter tax evasion behaviors of MNEs through inter-governmental cooperation. U.S. law professor Yariv Brauner summarizes the core principles of the BEPS project as follows: i) establishing the international tax regime on a collaborative-based paradigm; ii) taking a systematic or holistic approach to substantive international tax reform; and iii) accepting completely new solutions to problems that could not be resolved by the applicable norms.[44]

Under the BEPS project, fifteen Actions have been announced through 2015. The final package of the BEPS recommendations was announced on October 5, 2015. The OECD actions recommend that the measures suggested in each plan be implemented through revision of domestic tax laws or tax treaties.[45] The "Inclusive Framework" was

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[42] *Id*.

[43] *See* Mark P. Keightely &Jeffrey M. Stupak, *Corporate Tax Base Erosion and Profit Shifting (BEPS): An Examination of the Data*, C.R.S. (April 30, 2015).

[44] Brauner, *supra* note 14, at 58.

[45] ACTION 1 Address the tax challenges of the digital economy, ACTION 2 Neutralise the effects of hybrid mismatch arrangements, ACTION 3 Strengthen CFC rules, ACTION 4 Limit base erosion via interest deductions and other financial payments, ACTION 5 Counter harmful tax practices more effectively, taking into account transparency and substance, ACTION 6 Prevent treaty abuse, ACTION 7 Prevent the artificial avoidance of PE status, ACTIONS 8, 9, 10 Assure that transfer pricing outcomes are in line with value creation (Intangibles, Risks and capital, Other high-risk transactions), ACTION 12 Require taxpayers to

launched as a follow-up system for reviewing and monitoring BEPS Actions implementation, with more than 100 countries and jurisdictions are participating in it.[46]

### B. HMAs in the OECD: BEPS Action 2

The OECD deals with HMAs in the BEPS Project's Action 2.[47] According to the OECD reports, HMAs are composed of three elements: a hybrid element, inconsistency in tax results, and lessening of the tax burden of the parties.[48] A hybrid element includes entities and instruments that are treated differently in two or more jurisdictions. Hybrid entities means "entities that are treated as transparent for tax purposes in one country and as non-transparent in another country"[49], and hybrid instruments are those instruments that are generally treated differently from one country to another.[50]

Hybrid instruments can be specifically divided into hybrid transfers and hybrid financial instruments.[51] The term "hybrid transfer" refers to a transaction that involves an asset in two taxation jurisdictions where taxpayers take positions incompatible with the nature of the ownership of the particular asset.[52] Hybrid financial instruments are

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disclose their aggressive tax planning arrangements, ACTION 13 Re-examine transfer pricing documentation, ACTION 14 Make dispute resolution mechanisms more effective, ACTION 15 Develop a multilateral instrument, OECD, BEPS REPORT, *supra* note 9.

[46] Over 100 countries participate in the inclusive framework which is for the implementation of the BEPS Actions. ABOUT BEPS AND THE INCLUSIVE FRAMEWORK. http://www.oecd.org/tax/beps-about.htm.

[47] OECD, RECOMMENDATIONS ON HMAS, *supra* note 22.

[48] *See* Seounggwon Gu, *Gukjejosee Isseo Honseong Bulilchie Gwanhan Yeongu* [*A study in Hybrid Mismatch in International Taxation*], KOR. DAEHAGGYO [KOR. UNIV.] 17 (Jun. 2016).

[49] OECD, HMAS REPORT, *supra* note 13, at 7.

[50] *Id*.

[51] This thesis only deals with hybrid financial instruments.

[52] OECD, HMAS REPORT, *supra* note 13, at 7.

those financial instruments that are treated differently for tax purposes in the countries involved, most prominently as debt in one country and as equity in another country.[53]

The OECD characterizes the tax outcomes for payments related to hybrid entities and hybrid instruments as Double Deduction (D/D), Deduction/No Inclusion (D/NI) and Indirect Deduction/No Inclusion (Indirect D/NI).[54] The OECD concludes that it is impossible to identify countermeasures by causes since transactions and situations are vary by each country.[55] Instead, the OECD provided examples and recommends solutions based on three types of outcome (D/D, D/NI, Indirect D/NI) that result from the hybrid mismatch.

A D/D outcome is created under an arrangement that a cost related to "the same contractual obligation" is claimed for income tax purposes in two jurisdictions.[56] A D/NI outcome happens when an arrangements cause a deduction in one country, but avoid a corresponding inclusion in the taxable income in another country.[57] An Indirect D/NI outcome arises when the income from a deductible payment is set-off by the payee in a third country against a deduction using a HMA.[58]

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[53] *Id*. at 17.

[54] *Id*. at 16.

[55] *Id*. at 18.

[56] OECD, PUBLIC DISCUSSION DRAFT BEPS ACTION 2 BRANCH MISMATCH STRUCTURES 4 (Aug. 22, 2016), https://www.oecd.org/tax/beps/Discussion-draft-Action-2-Branch-mismatch-structures.pdf.

[57] *Id*.

[58] *Id*.

## Double Deduction (D/D) Scheme[59]

The most common D/D method is to use a hybrid subsidiary, which is treated as transparent in the investor's taxation jurisdiction, but as opaque under the jurisdiction of

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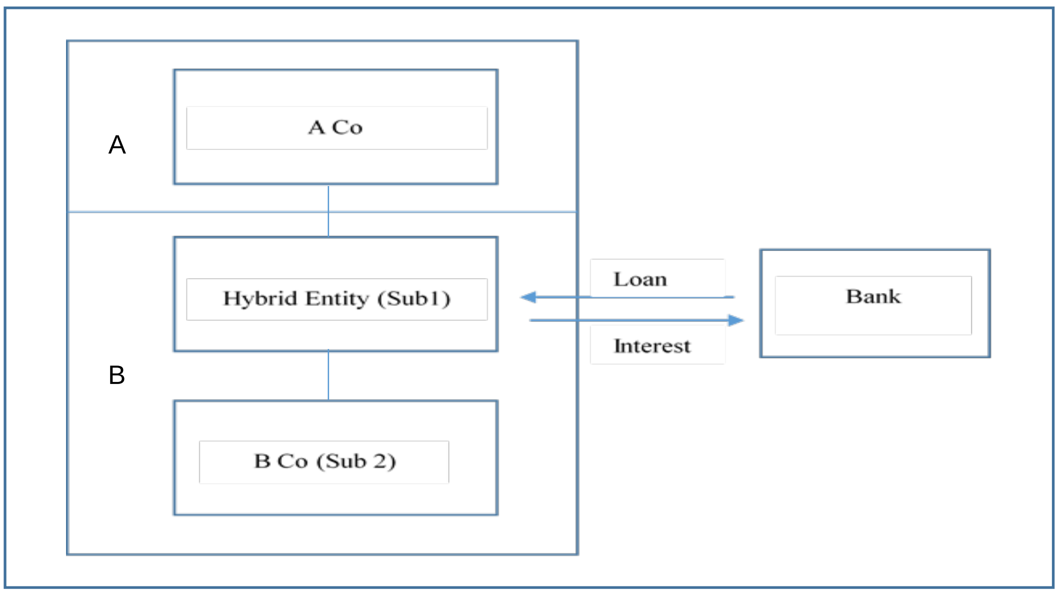
the establishment and operation.[60] An example of a simple transaction using this scheme is shown in Figure 1 below.

### a. Example[61]

**Figure 1. Example of D/D**




In this example, a parent company in country A ("A Co") holds the shares of an operating company in country B ("B Co") through a Hybrid Entity that is treated as transparent for country A's tax purposes and as non-transparent for country B's tax

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[59] Following part summarized two OECD reports, RECOMMENDATIONS ON HMAS, *supra* note 22 and HMAS REPORT, *supra* note 13.

[60] OECD, RECOMMENDATIONS ON HMAS, *supra* note 22, at 51.

[61] OECD, HMAS REPORT, *supra* note 13, at 8.

purposes. A Co owns all of the equity of the Hybrid Entity. The Hybrid Entity acquired the equity of B Co by borrowing from Bank. The Hybrid Entity does not report any significant income.

Payments on the Hybrid Entity's loan can be deducted as interest expense from B Co's income, under country B's group-relief regime. However, country A treats the Hybrid Entity as transparent, so the Hybrid Entity's interest expenses can be deducted from A Co's income, treating the Hybrid Entity's income as attributed to A Co. In conclusion, two deductions arise, in two different countries, for the same contractual obligation.

#### b. Recommendations for domestic laws

To solve this problem, the OECD provides the introduction of a linking rule that aligns tax effects in the jurisdictions of the payer and the parent company.[62] A primary rule is to deny deductions in the jurisdiction of the parent company, which is A in the example above.[63] If the jurisdiction of the parent company doesn't apply this rule, the jurisdiction of the payer would deny the deduction to the payer, as a defensive rule.[64] The defensive rule is only applied to structured arrangements or mismatches arising in controlled group.[65]

### 2. Deduction / No inclusion Scheme

[62] OECD, RECOMMENDATIONS ON HMAS, *supra* note 22, at 69.

[63] *Id*. at 15.

[64] *Id*.

[65] *Id*. at 75.

a. Example[66]

D/NI arrangements using hybrid financial instruments are as follows. A company resident in country A ("A Co") acquires a hybrid financial instrument that is issued by a company resident in country B ("B Co"). The financial instrument is a hybrid instrument that is treated as debt in country B and as equity in country A. In this case, payments made under the instrument from B Co are deductible as interest expenses for B Co under the tax laws of country B, but, they are treated as "exempt dividends" for country A tax purposes. (This example can involve other tax benefits such as a deduction or indirect foreign tax credit.)[67] As a result, a deduction arises in country B, but there's no "a corresponding income inclusion" in country A[68].

b. Recommendations on domestic laws

In accordance with the linking rule, as the primary rule, the country of payment (Country B) must deny the deduction for the relevant payment to the extent that the D/NI result occurs.[69] If the payer's jurisdiction does not deny the deduction, the payee's jurisdiction will include such payments into income, as a defensive rule.[70] Differences in timing of recognition of payments will not be included in a D/NI outcome, and the taxpayer will have the burden of proof.[71] This rule only applies to payments to related

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[66] OECD, HMAS REPORT, *supra* note 13, at 8.

[67] *Id*.

[68] *Id*.

[69] *Id*.

[70] *Id*.

[71] *Id*. at 34.

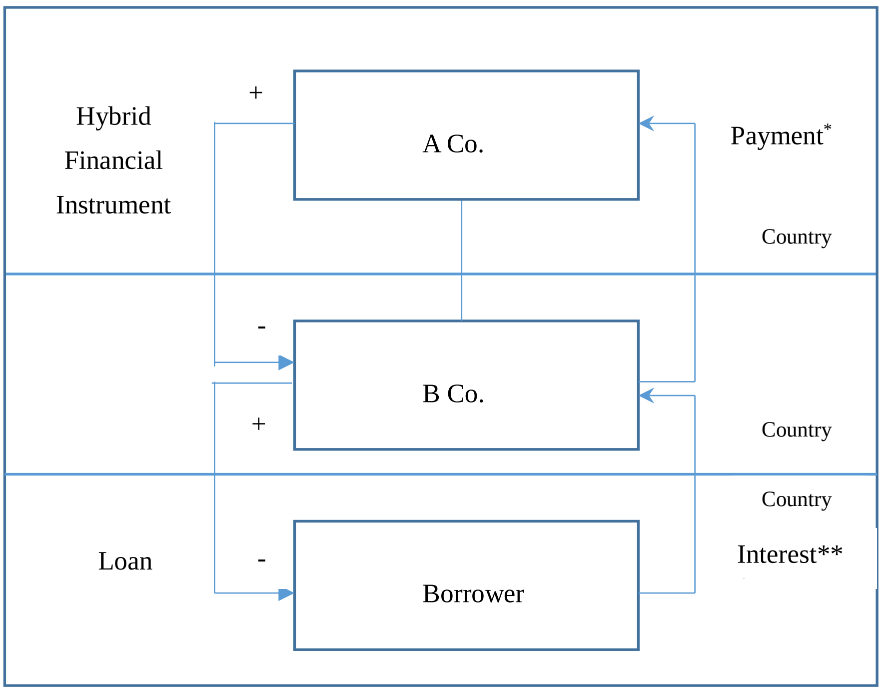
persons or payments made under a structured arrangement.[72]

### Indirect Deduction / No Inclusion scheme

The effects of a hybrid mismatch between two tax jurisdictions can be transferred to other jurisdictions through an ordinary loan. An example of a transaction structure in which mismatches move into different tax jurisdictions is shown in the figure 2.[73]

#### a. Example[74]

**Figure 2 Indirect D /NI (Importing Mismatch from Hybrid Instrument)**




The effects of a hybrid mismatch can be imported to other jurisdictions through basic financial instruments such as general loans. A company in country A (“A Co”) lends

72 *Id.* at 44.

73 *Id.* at 59.

74 *Id.*

money to a subsidiary company in country B ("B Co") through hybrid instruments. The hybrid instrument is treated as equity in country A, and treated as debt in country B. B Co lends money to the Borrower, which is a resident of country C, as an ordinary loan. The interest paid by the Borrower can be deducted from the Borrower's income as interest and the same amount is included in B's income. Since B Co's payment to A Co is treated as interest in country B, that amount is deducted from B Co's income. But B Co's payment isn't included in A Co's payment, since it is treated as a dividend in country A. Therefore, this scheme causes Indirect D/NI between country A and country C.

#### c. Recommendations for domestic laws[75]

The OECD recommends denying the deduction in the payer's (Borrower in Figure 2) jurisdiction to the extent the payee treats it as a set-off in the payee's jurisdiction. It will be the lesser amount as between the Payment* and Interest** in the above case. This rule only applies when the taxpayer is in the same control group as the parties to the arrangement or the payment is made under a structured arrangement[76]

### C. Reactions to the OECD Action 2

The OECD has established a country compliance monitoring framework for successful and effective implementation of the BEPS project, and given levels of enforcement to each Action. Though Action 2 is not mandatory, it is classified as a "Common Approach" which is a strongly recommended level to over 100 countries

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[75] OECD, RECOMMENDATIONS ON HMAS, *supra* note 22, at 83.

[76] *Id*. at 91.

participating the implementation of the BEPS project.[77] As a result, some countries are considering or are in the process of revising domestic laws based on the OECD's HMA recommendations.

As we can see from the introduction of the Google tax, the U.K. is one of the most active countries in the implementation of Action 2. Based on the OECD's recommendations, the U.K. enacted new legislation, Part 6A of Taxation (International and Other Provisions) Act 2010 (TIOPA 2010), on January 1, 2017.[78] The legislation is aimed at MNEs that avoid taxation through international business structures or financial transactions with hybrid elements.[79] The U.K. also released "Draft Guidance Hybrid and Other Mismatches" to assist understanding of the application of the legislation, in December 2016.[80]

The U.S. also plans to introduce a system to prevent MNEs' tax avoidance using HMAs. The Obama administration's Fiscal Year 2016 & 2017 budget proposals (the Green Book) contained suggestions to restrict the use of hybrid arrangements that create stateless income.[81] The Obama Administration proposed to deny deductions for interest

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[77] An Implementation system for BEPS is called an "Inclusive Framework."

[78] THE U.K. PARLIAMENT WEBSITE, https://www.publications.parliament.uk/pa/cm201617/cmpublic/Finance/memo/FB07.htm (last visited May17, 2017).

[79] *Id*.

[80] HM REVENUE AND CUSTOMS, INTERNATIONAL MANUAL GUIDANCE HYBRID AND OTHER MISMATCHES (Mar. 2017) (Eng.), https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/605052/Hybrid_and_Other_Mismatches_-_updated_draft_guidance__March_2017_.pdf.

[81] *See* EY, *US Administration's fiscal year 2017 budget includes international tax provisions substantially similar to 2016 proposals*, INTERNATIONAL TAX ALERT (12 Feb. 2016), http://www.ey.com/Publication/vwLUAssets/US_Administrations_fiscal_year_2017_budget_includes_international
tax_provisions_substantially_similar_to_2016_proposals/$FILE/2016US_CM6238_US%20fy%202017%2

and royalties paid to related persons involving an "HMAs."[82] However, the Trump Administration's position on the BEPS Project may be different.[83] The Trump Administration's tax plan, which was released in April 2017, doesn't mention the OECD's BEPS Actions.[84] Though it contains parts relevant to HMAs, "Reducing or eliminating corporate loopholes that cater to special interests (…)"[85], it is unclear whether the OECD Action2's HMA recommendations, such as a linking rule, will be introduced.

In May 2016, the Treasurer of Australia released "A tax plan for Australia's future" that includes introduction of "anti-hybrid rules."[86] The Australia legislature is currently developing measures to implement of the OECD HMAs recommendations.[87] The "anti-hybrid rules" will apply to "related parties, members of a control group and

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0budget%20includes%20intl%20tax%20provisions%20substantially%20similar%20to%202016%20props.pdf; U.S. DEP'T OF THE TREAS., GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2016 REVENUE PROPOSALS 35 (2015), https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2016.pdf [hereinafter TREAS., GREEN BOOK 2016]; U.S. DEP'T OF THE TREAS., *General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals* 32 (2016). http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2017.pdf [hereinafter TREAS., GREEN BOOK 2017].

82 *See* TREAS., GREEN BOOK 2016, *supra* note 81; TREAS., GREEN BOOK 2017, *supra* note 81.

83 *See* Interview by John Gimigliano with Manal Corwin, *Preparing for BEPS under the New Administration* (videotaped, Jan. 5, 2017), http://www.kpmg-institutes.com/institutes/taxwatch/articles/2017/01/preparing-for-beps-under-the-new-administration.html.

84 TRUMP TAX REFORM THAT WILL MAKE AMERICA GREAT AGAIN, https://assets.donaldjtrump.com/trump-tax-reform.pdf.; *see* also THE WHITE HOUSE, https://www.whitehouse.gov/blog/2017/04/26/president-trump-proposed-massive-tax-cut-heres-what-you-need-know (last visited May. 17, 2017).

85 *Id*.

86 A TAX PLAN FOR AUSTRALIA'S FUTURE, http://sjm.ministers.treasury.gov.au/media-release/055-2016 (last visited May. 17, 2017).

87 IMPLEMENTATION OF THE OECD HYBRID MISMATCH RULES, https://www.ato.gov.au/General/New-legislation/In-detail/Other-topics/International/Implementation-of-the-OECD-hybrid-mismatch-rules/ (last visited May. 17, 2017).

structured arrangements that involve cross-border hybrid financial instruments and/or hybrid entity structures", and "will apply to payments made on or after the later of January 1, 2018 or six months following the date of enactment."[88]

## III. Hybrid Entities

### A. Introduction

"Hybrid entities" are organizations where the classification and treatment of an organization is different in the treaty country of source and the treaty countries of residence.[89] Hybrid entities can be divided into "regular hybrid entities" and "reverse hybrid entities." A "regular hybrid entity" is an entity that is treated as transparent in the country of source but as non-transparent in the country of residence. Conversely, a "reverse hybrid entity" is an entity that is treated as non-transparent in the country of source but as transparent in the country of residence.[90] Collective Investment vehicles ("CIV"s) and partnerships are representative hybrid entity examples.[91]

Hybrid entities result from differences between domestic tax systems that cause a single entity to be classified differently by countries. Tax conventions between countries are also relevant to hybrid entities, considering that treaties generally determine which country retains the right to tax and have overriding authority on domestic tax laws. The

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[88] *Id*.

[89] 2 PHILIP F. POSTLEWAITE, INTERNATIONAL TAXATION CORPORATE AND INDIVIDUAL 547 (6th ed., 2011).

[90] *Id*. at 547-48; The OECD report states "Hybrid entities" as "entities that are treated as transparent for tax purposes in one country and as non-transparent in another country"; OECD, HMAS REPORT, *supra* note 13, at 8; Similar to OECD, U.S. tax law defines a hybrid entity as an entity that is "fiscally transparent" for U.S. tax purposes but not fiscally transparent for foreign tax purposes, 26 C. F. R. § 1.894-1 (d)(3)(ii),(iii).

[91] OECD, RECOMMENDATIONS ON HMAS, *supra* note 22, at 24.

issue in tax treaties about hybrid entities is whether the tax treaty benefits can be granted to organizations that are transparent in the country and treated as opaque in the other country.

Possible outcomes concerning hybrid entities are double taxation and double non-taxation. First is the case of double taxation. Imagine an entity that is treated as pass-through in the resident country and as non-transparent in the source country. In that case, the resident country's tax administration imposes tax on the members of the entity, and the source country's tax administration may also impose tax on the entity. And the members of the entity can't claim foreign tax credits since the taxes in the foreign country were paid by the entity. Consequently, the entity and shareholders of the entity can be taxed twice on the same amount of income.

For example, if a Limited Partnership ("LP") that was established in Delaware acquired income in Korea, the U.S. tax administration would treat the LP as transparent and impose income taxes on its partners. However, the Korean National Tax Service ("NTS") may treat that LP as a "foreign corporation" ("oegukbeobin" in Korean) under the Korea Corporate Income Tax Act[92] and can impose a corporate tax on the LP from the Korean source. The application of the US–Korea Tax Treaty[93] under these circumstances has been controversial until recently, as discussed below. On the other

[92] "[B]oth of the following corporations are liable to pay corporate tax on any income pursuant to this Act: 1. A domestic corporation; 2. foreign corporation which has income from a domestic source.", Beobinsebeob [Corporate Tax Act], Act No. 62, Jul. 15, 1949, *amended by* Act No. 10423, Dec. 30, 2010, art. 2(1) (S. Kor.).

[93] Convention for the Avoidance of Double Taxation of Income and the Prevention of Fiscal Evasion and the Encouragement of International Trade and Investment, Kor.-U.S., Oct. 20, 1979, S. TREATY DOC. No. 94-27(1976).

hand, the OECD's HMA report points out the hybrid entity is an example of D/D scheme as mentioned above in Chapter II.

Even before the BEPS Project, each country had taken its own approach to solving the international taxation problem related to hybrid entities such as partnerships. In this part, I will first identify the approaches to classifying foreign entities and preventing the use of hybrid entities for double non-taxation. I will then discuss current Korean Tax Law provisions and the Supreme Court cases regarding hybrid entities. After evaluation of the current rules, I will provide some suggestions for Korean Tax laws to counter HMAs, reflecting the OECD's recommendations.

## B. Approaches to Classifying Foreign Entities for Tax Purposes

Tax planning by exploiting hybrid entities of MNEs is no longer a new phenomenon.[94] To respond to this, countries have suggested new rules to classify foreign entities or interpreted their rules in a new way. At the same time, countries around the world have prepared their own rules that specifically focus on preventing tax avoidance using hybrid entities.

### 1. Approaches to Classifying Foreign Entities for Tax Purposes

Although a great variety of criteria is used by countries to classify foreign

[94] "[B]efore World War II, there were tax decisions in the United States that treated partnerships or trusts that have more than two of four corporate characteristics (that is, limited liability, continuity of life, transferability of interests, and central management) as corporations. These developments suggested to tax planners that when a country has ongoing crossborder business or investment relations with the United States and is seen as not departing from traditional form-driven characterizations, there could be tax arbitrage opportunities from the differing characterization of a legal entity or relationship." Nathan Boidman & Michael Kandev, *BEPS on Hybrids: A Canadian Perspective*, TAX NOTES INTL. 1233 (Jun. 30, 2014).

entities for tax purposes, generally there are in four approaches: i) the similarity approach; ii) the elective approach; iii) the fixed approach,[95] and iv) the OECD's approach.[96]

### a. Similarity approach

This approach classifies foreign entities by the legal nature of corporations under domestic law. For example, in Korea, this requires deciding whether the entity is classified as a corporation or not, according to the Korean laws. This approach can be divided into two methods. One is comparing the legal characteristics of the foreign entity with domestic business vehicles, and the other is imposing tax according to the same rules that are applicable to the domestic entity that most resembles the foreign entity (the resemblance test).[97]

For example, under the resemblance test, the U.S.'s limited partnership can correspond to the Korean "Johab,"[98] and the German law's "Offene

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[95] JESPER BARENFELD, TAXATION OF CROSS-BORDER PARTNERSHIPS 111 (2005).

[96] *See*, Seokhwan Kim, *Haeoe Honseongsaeobcheui Gwasebangsige Gwanhan Sogo* [*The study on Taxation of foreign hybrid entities*], 29 JOSEHAKSULNONJIP [J. OF IFA KOR.] 65, 72 (2013).

[97] BARENFELD, *supra* note 95, at 112.

[98] "[A] Habjajohab [limited partnership] shall be duly formed when general partners who, as managers of the partnership, bear unlimited liability for the partnership's obligations and limited partners who bear limited liability within the amount of their investment agree to make a mutual investment in, and jointly manage, a joint business." Sangbeob [Commercial Act], Act No. 1000, Jan. 20, 1962, *amended by* Act No. 12591, May 20, 2014 art. 86-2 (S. Kor.) http://elaw.klri.re.kr/kor_service/lawView.do?hseq=32692&lang=ENG; Korea Legislation Research Institute ("KLRI") translated Habjajohab as Limited Partnership. Generally Habajajohab is treated as (an) individual resident(s) for Korean tax purposes. Korea introduced "Habjajohab" in 2011.

Handelsgesellschaft"[99] and "Kommanditgesellschafand"[100] are considered to fall under the Korean laws named "Habmyunghoesa"[101] and "Habjahoesa," which are classified as corporations in Korea.[102] The details of the resemblance approach generally follows the way in which each country classifies its domestic entities.[103]

According to the similarity approach, whether or not the foreign entity is regarded as transparent in its home country isn't significant for determining the characteristics of the entity in the classifying country.[104] Most countries, including Korea,[105] Japan, and Germany are adopting this method.[106] One of merits of this approach is neutrality, since a foreign entity will be taxed according to the same principles as domestic entities.[107] Another merit is that this approach isn't affected by foreign legislative changes because this approach simply focuses on the most similar

[99] Handelsgesetzbuch [HGB] [Commercial Code], § 105, http://www.gesetze-im-internet.de/hgb/__105.html (Ger.).

[100] Handelsgesetzbuch [HGB] [Commercial Code], § 161, http://www.gesetze-im-internet.de/hgb/__161.html (Ger.).

[101] Sangbeob [Commercial Act], Act No. 1000, Jan. 20, 1962, *amended by* Act No. 12591, May 20, 2014 art. 178-267 (S. Kor.) *translated in* KLRI online database, http://elaw.klri.re.kr/kor_service/lawView.do?hseq=32692&lang=ENG. KLRI translated "Habmyunghoesa" as partnership companies.

[102] Sangbeob [Commercial Act], Act No. 1000, Jan. 20, 1962, *amended by* Act No. 12591, May 20, 2014 art. 178-268-277 (S. Kor.), *translated in* KLRI online database, http://elaw.klri.re.kr/kor_service/lawView.do?hseq=32692&lang=ENG; KLRI translated Habjahoesa as limited partnership companies; Generally Both Habmyunghoesa and Habjahoesa are treated as corporations for Korean tax purposes. Chang Hee Lee, *Partnershipgwa Kukjejose* [Partnership and International Taxation], 10JOSEBEOBYEONGU [SEOUL TAX L. REV.] 806, 812 (2004).

[103] BARENFELD, *supra* note 95, at 112.

[104] *Id.* at 113.

[105] *See* Kim, s*upra* note 96, at 70.

[106] BARENFELD, *supra* note 95, at 112.

[107] *Id*. at 116.

domestic entities.[108] However, when there is no domestic entity similar to the foreign one, the classification process can be difficult and may increase compliance and administrative costs.[109] This problem is more likely to happen regarding entities whose characteristics considerably differ across countries.[110] As the OECD's Partnership report points out, the partnership is one of the most representative examples of differing treatment by countries.[111] Furthermore, this approach can cause asymmetrical taxation by treating the entity differently in the home country and its partner or source country. In other words, this approach can't resolve hybrid entities' double taxation or double non-taxation.[112]

b. Elective Approach

Under this approach, the power to classify foreign entities is handed over by the government to taxpayers.[113] The most well-known example of this approach is the U.S.'s "check-the-box" regime, which was enacted in 1997.[114] According to the check-the-box rules, a foreign entity may choose by filing an election to be classified either as a

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108 *Id*. at 116-7.

109 *Id*. at 117-8.

110 *Id*. at 117.

111 "Problems will also arise, however, where two countries classify a given entity in the same way but treat that entity in different ways. These problems are particularly important for partnerships and most of the examples in this report are based on these problems." OECD, THE APPLICATION OF THE OECD MODEL TAX CONVENTION TO PARTNERSHIPS 10 (1999) [hereinafter OECD**,** PARTNERSHIP REPORT]; OECD's BEPS Action on HMA points out that "The Partnership Report (OECD, 1999) did not expressly address the applications of tax treaties to entities other than partnerships." OECD, HMAS REPORT, *supra* note 13, at 139.

112 *See* Kim, s*upra* note 96, at 70.

113 BARENFELD, *supra* note 95, at 119.

114 26 C.F.R. § 301.7701-3 (2016).

corporation or, depending on the number of members, either (i) a partnership or (ii) what is known as disregarded entity.[115] However, there are some limitations like "*per se* corporations," which are regarded as non-transparent for U.S. tax purposes.[116] The "*per se* corporations" list includes roughly 80 foreign entities that are treated as non-transparent in their home countries.[117]

This approach can minimize the impact of tax laws regarding the classification of entities on the selection of a business structure.[118] Also, this can decrease uncertainty and costs to taxpayers and tax administrations.[119] However, this approach can allow aggressive tax planning opportunities by using hybrid entities, and it invites the introduction of anti-avoidance provisions, which makes the structure extremely complex.[120] This disadvantage can offset the core advantages of the elective approach.

#### c. Fixed approach

According to the fixed approach, *all* foreign entities are classified in the same way, as either transparent or opaque.[121] Italy is the only country adopting this approach. For the tax purposes of Italy, all foreign businesses are classified as opaque. This applies to foreign entities having income from Italian sources, and Italian residents who earn

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[115] 26 C.F.R. § 301.7701-3(c)(1) (2016).

[116] 26 C.F.R. § 301.7701-2 (2016).

[117] 26 C.F.R. § 301.7701-2(b)(8)(i) (2017).

[118] BARENFELD, *supra* note 95, at 120.

[119] *Id*. at 121.

[120] *Id*. at 122.

[121] *Id*. at 123.

income from foreign businesses.[122] The only exception is for the Controlled Foreign Corporation.[123] In that case, profits will be taxed as the business income of Italian owners rather than the dividends.[124] "Such income is consequently taxed as if the entity is transparent for tax purposes."[125]

The most important merit of this method is the taxpayer's high predictability and the certainty to the tax administration.[126] However, this approach can conflict with the non-discrimination provision (Art.24) in OECD's Model Tax Convention by differently treating foreign entities from domestic ones.[127]

#### d. OECD's Approach (OECD Partnership Report)[128]

Although the OECD's report, although "The Application of the OECD Model Tax Convention to Partnerships Organization" ("the OECD Partnership Report") is written only for "partnerships," it can be interpreted as generally being applied to foreign entities that don't pay taxes in their home countries.[129] According to this report, "if the

[122] *Id*. at 123.

[123] *See* Kim, s*upra* note 96, at 73.

[124] BARENFELD, *supra* note 95, at 123.

[125] *See* Kim, s*upra* note 96, at 75.

[126] BARENFELD, *supra* note 95, at 124.

[127] *Id*. at 124.; "1. Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances, in particular with respect to residence, are or may be subjected.(…)" OECD, MODEL CONVENTION WITH RESPECT TO TAXES ON INCOME AND ON CAPITAL art. 24 (2014), https://www.oecd.org/ctp/treaties/2014-model-tax-convention-articles.pdf [hereinafter, OECD, MODEL TAX CONVENTION].

[128] OECD**,** PARTNERSHIP REPORT, *supra* note 111.

[129] *See* Lee, *supra* note 102, at 812; Ji-Hyun Yoon, *'Danche BunRyu(Entity Classification)'e Gwanhan Daebeobwon Panryewa Kyeungjehyeubreukgaebalgigu(OECD)ui 'Partnership Bogoseo'ui Johwae Gwanhan Geomto [A Mission Impossible - Is There a Way to Reconcile the New Case Law on Entity*

State in which a partnership has been organized treats that partnership as fiscally transparent, then the partnership is not 'liable to tax' in that State within the meaning of Article 4, and so cannot be a resident for purposes of the Convention."[130] However, it also states that "the source State, in applying the Convention where partnerships are involved, should take into account, as part of the factual context in which the Convention is to be applied, the way in which an item of income arising in its jurisdiction is *treated in the jurisdiction of the taxpayer claiming the benefits of the treaty as a resident*."[131] Therefore, when applying tax conventions, OECD takes the position that the source country should consider how the partnership's home state treats the entity. According to the OECD Partnership report, whether a partnership is a stand-alone entity is decided based on whether the partnership pays income or corporate tax on its own income in the home country.[132] Therefore, when applying tax conventions, the OECD takes a position that the source country should consider how the partnership home state's treats the entity.

Sweden generally is categorized as a country that follows the OECD's approach. In 2004, Sweden revised its Income Tax Act and included provisions about treatment of foreign entities.[133] According to this rule, "a foreign association is characterized as a

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*Classification in Korea and the OECD Partnership Report?]*, 30 JOSEHAKSULNONJIP [J. OF IFA KOREA] 243, 245 (2014);.Action 2 points out the OECD Partnership Report's problems that did not explicitly address the application of tax treaties to entities other than partnerships, and recommends to insert provisions in the Model Tax Convention that ensure that the income of a transparent entity is treated the same as the principles of the OECD's Partnership Report. OECD, RECOMMENDATIONS ON HMAS, *supra* note 22, at 139.

130 OECD, PARTNERSHIP REPORT, *supra* note 111, at 14.

131 OECD, PARTNERSHIP REPORT, *supra* note 111, at art 53.

132 *Id.*

133 Before this revision, in the *Alect* case, the Swedish Supreme Administrative Court held that a Swedish parent company can't be allowed to get foreign tax credits for taxes paid by a LP established in the U.S., since under the double tax convention between Sweden and the U.S., a foreign tax credit claim requires that it is the same person that derives the same taxable income in both countries (RA 2001 ref. 46.). Therefore,

*foreign legal entity* (“FLE”) if, according to the law of the state in which the association is situated in, 1) it can acquire rights and incur obligations; 2) it can plead in court and to other authorities, and; 3) individual members do not have the assets of the association at their free disposal.”[134]

According to the OECD standards, when applying for a tax treaty to U.S. partnerships, the state of the partnership does not need to be considered, and only the country of each partner is important.[135] One of the fundamental reasons for that is to solve the problem of double taxation (or double non-taxation) by securing symmetry for the purpose of tax treaty application, which is essential to prevent problems related to hybrid or reverse hybrid entities.[136] In other words, if the same entity is treated as opaque in country A, but treated as transparent in country B and tax is imposed on its members, that can make it difficult to apply the tax treaties uniformly.[137]

Because the OECD’s Partnership Report is for the application of tax conventions, the OECD’s approach may look irrelevant to the way domestic tax administrations treat foreign entities, but considering that tax treaties generally have the same effect as domestic laws,[138] it is hard to say that the OECD’s Partnership Report is unconnected to the domestic tax laws. However, a source country need not comply with the tax

in that case, the court determined that U.S. LP is treated as non-transparent for Swedish domestic and convention purposes.

[134] Barenfeld, *supra* note 95, at 273 (2005).

[135] *See* Lee, *supra* note 102, at 817.

[136] *See* Kim, s*upra* note 96, at 75.

[137] *Id*.

[138] *See, e.g*. DAEHANMINKUK HUNBEOB [HUNBEOB] [CONSTOTUTION] art.6 (S. Kor.).

procedure of the partnership's residence country, in the real world. All sovereign countries can unilaterally create business forms, such as partnerships, under their domestic law and can tax these organizations in accordance with the principles they consider appropriate; there is no way for the OECD to prevent that. Therefore, the OECD Partnership report can be used as a recommendation to interpret tax treaties in each country, but it is not binding.

2. Rules to Prevent Tax Avoidance Through Hybrid Entities

a. The U.S.

The U.S. has rules to deny the double deduction of expenses in certain cases.[139] For example, the "dual consolidated loss" of a corporation shall not be allowed to reduce the taxable income of any other member of the corporation's affiliated group.[140] Under Internal Revenue Code (Code) section 1503(d)(2)(A), "Dual consolidated loss means any net operating loss of a domestic corporation which is subject to an income tax of a foreign country on its income without regard to whether such income is from sources in or outside of such foreign country, or is subject to such a tax on a residence basis."[141] This rule can be effective to prevent D/D schemes.

The U.S. has rules on the application of tax treaties to hybrid entities. Under Code section 894(c)(1), for a foreign investor to claim the reduced tax rate in the tax treaty between the resident country and the U.S. on the income derived through a

139 OECD, HMAS REPORT, *supra* note 13, at 15.

140 26 U.S.C. § 1503(d)(1) (2017).

141 26 U.S.C. § 1503(d)(2)(A) (2017).

partnership,

> If—(A) such item is not treated for purposes of the taxation laws of such foreign country as an item of income of such person, (B) the treaty does not contain a provision addressing the applicability of the treaty in the case of an item of income derived through a partnership, and (C) the foreign country does not impose tax on a distribution of such item of income from such entity to such person.[142]

The Secretary of the Treasury can prescribe regulations (and has in fact done so) to determine the scope of the tax treaty application appropriately, regarding taxpayers who received payment from a U.S. hybrid entity that is treated as transparent in the U.S., but non transparent in foreign country.[143]

b. The U.K.

The U.K. has a special law that applies to payments that are deductible for U.K. tax purposes but excluded from the taxable income of the other country. An officer of Revenue and Customs can give "deduction notices", and "receipt notices" to companies, and the company must recalculate its income, gain and tax liability less advantageously when it receives a notice.[144]

The deduction notice is a rule for the D/D situation. "A tax officer may give a company a notice(…) if—(a) the company is within the charge to corporation tax, and

[142] 26 U.S.C. § 894(c)(1) (2017).

[143] 26 U.S.C. § 894(c)(2) (2017); 26 C.F.R. § 1.894-1 (2017).

[144] Taxation (International and Other Provisions) Act 2010, c. 3 § 231 (Eng.).

(b) the officer considers on reasonable grounds that each of the deduction scheme conditions is or may be met in relation to a transaction to which the company is party."[145] The deduction scheme conditions are as follows: "[C]ondition A is that the party is regarded as being a person under the tax law of any territory, (3) Condition B is that the party's profits or gains are treated, for the purposes of a relevant tax imposed under the law of any territory, as the profits or gains of a person or persons other than the person mentioned in condition A."[146] "Scheme" means "any scheme, arrangement, or understanding of any kind whatever, whether or not legally enforceable, involving one or more transactions."[147]

There is also a notice for a "receipt scheme which cause the "Deduction and No Inclusion" outcome.[148] The receipt scheme conditions under the provision are as follows:

> 1) the scheme makes or imposes provisions as between the company and another person by means of a transaction or series of transactions; 2) the paying party makes, by means of a transaction or series of transactions, a payment (a) which is a qualifying payment in relation to the company, and (b) at least part of which is not an amount to which corporation tax applies' 3) a payment constitutes a contribution to the capital of the company; 4) the company and the paying party expected that a benefit would arise; 5) there is an amount in relation to the qualifying payment

[145] Taxation (International and Other Provisions) Act 2010, c. 3 § 233 (Eng.).

[146] Taxation (International and Other Provisions) Act 2010, c. 3 § 236 (Eng.).

[147] Taxation (International and Other Provisions) Act 2010, c. 3 §258 (Eng.).

[148] Taxation (International and Other Provisions) Act 2010, c. 3 §249 (Eng.).

that (a) is a deductible amount, and (b) is not set against any scheme income arising to the paying party for income tax purposes or corporation tax purposes.[149]

c. Denmark

The OECD presents Danish rules for resolving issues of hybrid entities in its HMA report in 2012.[150] According to this report:

> A foreign company with a permanent establishment (PE) in Denmark is treated as transparent for all Danish tax law purposes if (i) the company is transparent for tax purposes in a foreign country, (ii) the income of the company is included in the foreign taxable income of one or more affiliated companies in the foreign country in which the company is transparent; (iii) the foreign affiliated companies control the company, and (iv) the foreign jurisdiction is an European Union (EU) or European Economic Area (EEA) state, or has concluded a tax treaty with Denmark.[151]

Under this rule, the company will not deduct payments made to the foreign parent company since the payments are considered to be within the same legal entity.[152] This is a rule to prevent D/NI using hybrid entities, and this is similar to the OECD's approach to

[149] Taxation (International and Other Provisions) Act 2010, c. 3 §250 (Eng.).

[150] OECD, HMAS REPORT, *supra* note 13, at 17.

[151] *Id.*

[152] *Id*.

classifying entities.

Denmark also has a rule to prevent D/D outcomes using hybrid entities. A Danish resident taxpayer cannot claim a deduction for an expense if "(i) that expense is claimable under foreign tax rules against income that is not included in the computation of Danish tax, or (ii) if under the foreign tax rules, the expense is deductible against income derived by affiliated companies which is not included in the computation of Danish tax."[153]

### C. Recommendations in OECD BEPS Action 2

As explained above, the OECD's BEPS project focuses on adjustments of double non-taxation outcomes D/D, D/NI and Indirect D/NI.[154] To neutralize the effects of hybrid entities, the OECD's BEPS Action 2 report recommends adoption of a "linking rule" that aligns the tax outcomes of the payer and payee.[155] In accordance with the linking rule, the country of payment shall deny the deduction for the relevant payment to the extent that the D/NI result occurs.[156] And if the payer's country does not take such action, the recipient's country shall ensure that the relevant payment is included in the taxable income to the extent that the D/NI result occurs (Defensive Rule).[157] Accordingly, these provisions apply only to disregarded payments that are deductible in the country of the payer but not in the recipient's country.[158] This rule does not apply

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153 *Id*.

154 OECD, HMAS REPORT, *supra* note 13, at 7.

155 OECD, RECOMMENDATIONS ON HMAS, *supra* note 22, at 69.

156 *Id*. at 52.

157 *Id*.

158 *Id*.

when special provisions that deny deductions for payments are applied in the recipient's country.

OECD Action 2 suggests amending Model Tax Conventions.[159] The OECD's Partnership Report analyzed the inconsistencies in tax treatment of partnerships. However, the application of tax treaties to entities other than partnerships was not explicitly addressed.[160] Regarding this, OECD Action 2 proposed to insert into the Model Convention clauses to ensure that income from other transparent entities is treated "in accordance with the principles of the (OECD) Partnership report[]" for the purpose of the tax treaty.[161] This ensures granting tax treaty benefits only in appropriate situations.[162]

## D. Approaches to Hybrid Entities in Korea

### 1. Classification of Foreign Entities in Korea

#### a. Statutes[163]

In Korea, many of the issues that have been discussed in cases are related to reverse hybrid entities, which are not transparent in the source country but transparent in the home country. The Korean (Individual) Income Tax Act, Corporate Tax Act, and the Restriction on Special Tax Act are relevant for classifying the characteristics of hybrid

159 *Id*. at 139.

160 *Id*.

161 *Id*.

162 *Id*.

163 Kuksegibonbeob [Framework Act on National Taxes], Sodeuksebeob [Income Tax Act], and Joseteukrejehanbeob [Restriction of Special Taxation Act] have relevant provisions to Hybrid entity. However, this thesis only deals with Beobinsebeob [Corporate Tax Act] which is the most directly relevant.

entities in Korea. In this section, I will focus mainly on the Corporate Tax Act, which is most relevant to hybrid entities classification.

The Korean Corporate Tax Act is applied to calculate corporations' taxable income. In the past, the Korean Corporate Tax Act just described "foreign corporation" as "an organization that has its headquarters or main office in a foreign country"[164] and didn't define the specific meaning of corporation. For that reason, in 2012, the Korean Supreme Court interpreted this provision in the *Lone Star* case, which is discussed below.[165]

In 2013, the Korean Corporate Tax Act and Enforcement decree of Corporate Tax Act were revised to enumerate four criteria for an organization classified as a "foreign corporation."[166] The four criteria are

> i) an organization endowed with legal personality pursuant to the law of the state in which it was incorporated; ii) an organization formed only with limited partners; iii) an organization that owns an asset, becomes a party to a lawsuit, or directly holds a right or owes an obligation, independent of its members; iv) other foreign organization, if a domestic

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[164] Beobinsebeob [Corporate Tax Act], Act No. 62, Jul. 15, 1949, *amended by* Act No. 11128, Dec. 31, 2011, art. 1 3. (S. Kor.), *translated in* KLRI online database, http://www.law.go.kr/DRF/lawService.do?OC=mofe&target= elaw&MST=141083&type=HTML&mobileYn=.

[165] Supreme Court [S. Ct], 2010Du5950, Jan. 27, 2012 (S. Kor.).

[166] Beobinsebeob sihaenryeng [Enforcement decree of Corporate Tax Act], Presidential Decree No. 238, Dec. 16, 1949, *amended by* Presidential Decree No. 24357, Feb. 15, 2013, art.1(2) (S. Kor.), *translated in* KLRI online database, http://www.law.go.kr/DRF/lawService.do?OC=mofe&target=elaw&MST=175719&type=HTML&mobileYn=.

> organization, whose type of business is the same as, or similar to, the type of business of such foreign organization, is a corporation under the Commercial Act or any other Act of the Republic of Korea.[167]

Criterion 1 states that if the entity is endowed with legal personality in its home country, that entity is also a corporation in the Korean Corporate Tax Act.[168] This standard is simple and objective.[169] However, it is premised on the assumption that other countries have the same "legal personality" concept as Korea, even though the problem of the classification of foreign entities started from differences between domestic tax systems.[170] Accordingly, this standard has been criticized as not a real solution by Korean scholars.[171]

Criterion 2 was likely introduced to prevent the use of foreign entities as a tax avoidance tool.[172] If an organization formed only with limited partners can be treated as transparent, by distributing a fake loss of the organization to its partners, the partners' taxable income can be reduced.[173] This criterion reflects the civil law nature of a corporation in Korea.[174]

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167 *Id*.

168 *Id*.

169 *See* Jaeho Lee, *Oegukdanche beobinbullyugijunui jeongbibangan* [*Suggestions for Classification Criteria for Foreign Entities*], 30 JOSEHAKSULLONJIP [J. of IFA Kor.] 139, 142 (2014).

170 *Id*.

171 *Id*.

172 *See* Lee, *supra* note 98, at 808.

173 *Id*.

174 Junbong Lee, et al., *Ijunggwasewa josehoepireul bangjihagi wihan Hybrid Entitye daehan gwasejedo gaeseone gwanhan yeongu* [*A Study for the Improvement of Taxation System for Hybrid Entity to Prevent Double Taxation*] 180, (Dec. 2013) (on file with the OECD Korea Policy Centre),

Criterion 3 seems to codify the Korean Supreme Court's ruling in *Lone Star*,[175] mentioned below. Under criterion 3, interpreting the foreign country's law and finding out its substance is needed for the Korean legal view. In other words, this criterion means a similarity approach. In reality, this isn't a simple task. Also this provision doesn't suggest the specific degree of similarity that is needed to be determined as a corporation.

Criterion 4 is also the same as the similarity approach, especially the resemblance approach. However, if there are two different domestic entities that are similar to a foreign entity and if one of the similar Korean entities is treated as having legal personality but the other is not, criterion 4 is hard to apply. For example, the present Korean Commercial Act lists two entities which are similar to LP, "Hapjahoesa[176]" and "Hapjajohap[177]." However, "Hapjahoesa" is considered as a corporation, but "Hapjajohap" isn't. So it looks like there is still room for interpretation.

Another relevant provision is Article 98-6(2) of the Korean Corporate Tax Act. This article states

> (1) Where a foreign corporation (…) intends to apply for the restrictive tax rates stipulated under the tax treaties (…), it shall submit a request for application of restrictive tax rates to a person liable for withholding

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http://www.oecdkorea.org/user/nd3855.do?View&uQ=&page=1&pageSC=START_YMD&pageSO=DESC&dmlType=&pageST=SUBJECT&pageSV=&boardNo=00001872&itemShCd1=35&itemShCd2=2&itemShCd3=&dmlType=.

[175] Supreme Court [S. Ct], 2010Du5950, Jan. 27, 2012 (S. Kor.).

[176] Sangbeob [Commercial Act], Act No.1000, Jan. 20, 1962, *amended by* Act No. 13523, Dec. 1, 2016, art. 169 (S. Kor.) *translated in* KLRI online database, http://elaw.klri.re.kr/kor_service/lawView.do?hseq=32692&lang=ENG.

[177] *Id.* at art. 86-2; *See* Lee, *supra* note 169, at 139.

> referred to in Article 98 (1) (…). (2) In applying paragraph (1), where the relevant domestic source income is paid through a foreign investment scheme prescribed by Presidential Decree (…), the foreign investment scheme shall receive a request for application of restrictive tax rates from the relevant real beneficiary and submit a report on the foreign investment scheme to the person liable for withholding, along with the relevant statement.[178]

At first glance, this provision appears to prescribe only the administrative procedure for applying the limited tax rate in the tax treaty. However, if investors in a hybrid entity that is treated as a foreign corporation in Korea, submits applications pursuant to Article 98-6(2), the question of whether or not the tax treaty between their countries of residence and Korea must be applied can be problematic. Article 98-6(2) is textually interpreted such that the treaty between Korea and the investor's country of residence can be applicable, if an application of restrictive tax rates is submitted. However, if this is allowed, there is a concern that the investment vehicle would encourage treaty shopping.

In response to an inquiry about this controversy, the Korean Ministry of Strategy and Finance released an interpretation of the Article as response to a question from the relevant corporation, stating that even though the fund, established in a country where a tax treaty has not been concluded, was treated as a foreign corporation, when the investors were beneficial owners of the income, the investor can apply the tax treaty

[178] Beobinsebeob [Corporate Tax Act], Act No. 62, Jul. 15, 1949, *amended by* Act No. 14386, Dec. 20, 2016, art. 98-6(2) (S. Kor.).

between Korea and its residence country.[179] In general, given the complex structure of the investment mechanism, the interpretation of Article 98-6(2) in this reply may cause taxpayers to choose an intermediate investor that is favorable to the tax rate, claiming that the investor is the beneficial owner. Additionally, this administrative interpretation of Article 98-6(2) contradicts Supreme Court precedent.[180] This is because the Supreme Court sees private equity funds in the form of limited partnerships as the beneficial owners. In general, private equity funds are included in the foreign investment scheme.[181] However, the Supreme Court considers private equity funds to be beneficial owners, based on their own investment objectives or unique business activities.[182]

Of course, the Korean Supreme Court's precedents cannot be generalized because they were decided on the facts of individual cases. However, it is unlikely the Korean Supreme Court would change its position on substantial ownership of private equity funds under Article 98-6 of the Corporate Tax Act.

#### b. Cases

The following cases include the Korean Supreme Court's decisions on foreign hybrid entities. These cases show that aggressive tax avoidance strategies are actually used in the foreign entities' investment processes in Korea, and that Korea is not free

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179 BEOBINSEGWA [MINISTRY OF STRATEGY AND FIN. INT'L. TAX DIV.]-12, (Jan. 11, 2016). (S. Kor.).

180 *See* Gu, *supra* note 48, at 86; Supreme Court [S. Ct.], 2010Du25466, Oct. 25, 2012 (S. Kor.); Supreme Court [S. Ct.], 2011Du3159, Apr. 11, 2013 (S. Kor.), Supreme Court [S. Ct.] 2011Du4411, Jul. 11, 2013 (S. Kor.).

181 *See* Mihyun Lee, *Gukuetujagiguui sodeuke daehan josejoyakui jeokyong* [*Application of Tax Treaties on Cross-border Collective Investment Vehicles: Specifically on Private Equity Funds in the form of Limited Partnership*] 31 JOSEHAKSULLONJIP [J. OF IFA KOR.] 141, 147 (2015).

182 Supreme Court [S. Ct.] 2010Du11948, Apr. 26, 2012 (S. Kor.).

from challenges of new investment methods of MNEs or investment vehicles. Also, these cases show the position of the Korean judiciary on the criteria for classification of foreign entities, and the application of tax treaties in the absence of legislation.

### 1) *Lone star* case (2012)[183]

One of the leading cases in Korea relevant to classifying a hybrid entity is the *Lone Star* case (2012). One of the issues in this case was whether the Delaware LP was a "foreign corporation" under the Korean Corporate Income Tax Act, or an association of joint businessmen under the Individual Income Tax Act. In this case, the plaintiff, an LP established in Delaware, was an investor in Lone Star III Fund, which is a private equity fund. Lone Star III Fund acquired a Korean real estate company's equity through a Belgian corporation and obtained capital gains by selling the equity (Delaware LP-Lone Star III Fund-Belgian corporation-Korean real estate company). At first, the Belgian company didn't file taxes under the Korea-Belgium Tax Treaty Article 13.[184] However, Korean NTS regarded the Belgian company as a conduit, and imposed individual income tax[185] on the plaintiff, classifying the Delaware LP as an association of joint businessmen

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[183] Supreme Court [S. Ct], 2010Du5950, Jan. 27, 2012 (S. Kor.).

[184] "[1]. Gains from the alienation of immovable property, as defined in paragraph 2 of Article 6, may be taxed in the Contracting State in which such property is situated.

2. Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State including such gains from the alienation of such a permanent establishment (alone or together with the whole enterprise) may be taxed in the other State. (…)

3. Gains from the alienation of any property other than those mentioned in paragraphs 1 and 2, *shall be taxable only in the Contracting State of which the alienator is a resident*." Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income, Kor.-Bel. art. 13, Dec. 31, 1996 [hereinafter Korea-Belgium Treaty].

[185] The details of the taxes imposed by NTS, including on other members of Lone Star Fund III are as follows:

under the Income Tax Act[186] and Korea-U.S. Tax treaty.

Regarding this, the Korean Supreme Court held that Delaware LP is a foreign corporation for Korean tax purposes, so corporate tax should be levied to the LP, not as individual income tax. As the basis of the holding, the Korean Supreme Court stated as follows:

> [S]ince the Corporate Income Tax Act has no special provision regarding whether or not the organization can be classified as a foreign corporation, except based on the location of the head office or main office, it must be decided on the ground of our (Korean) civil law whether it can be seen that the body attributed separate rights and obligations, which are independent from the members in light of the substance of the organization, according to the content of the laws and regulations of the country in which it was established.[187]

This case is considered one the Korean Supreme Court's important resolutions in

| Taxpayer | Shares | Tax | Capital Gains (KRW) | Notified Tax Amount (KRW) |
|---|---|---|---|---|
| Lone Star Fund Ⅲ, LP(U.S Delaware) (Plaintiff) | 60% | Income Tax (Capital gain) | 147,059,412,746 | 61,365,637,480 |
| Lone Star Fund Ⅲ LP(Bermuda) | 38% | Income Tax (Capital gain) | 93,405,448,785 | 38,846,116,190 |
| Hudco Partners Korea. Ltd. (Bermuda) | 2% | Corporate Tax | 4,901,323,726 | 1,675,521,340 |

Seoul High Court [Seoul High Ct.], 2009Nu8016, Feb. 12 (S. Kor.).

186 Under Old Sodeuksebeob sihaenggyuchik [Enforcement Rules on the Income Tax Act], Act No. 1000, Jan. 20, 1962, before *amended by* Ministry of Strategy and Finance No. 424, Mar. 19, 2005 art. 2(1) (S. Kor.), "organizations, other than organizations regarding as the corporation, of which representatives or administrators are appointed but the distribution method of distribution of profits and the distribution ratio are not specified, are applied the law as one resident."

187 Supreme Court [S. Ct], 2010Du5950, Jan. 27, 2012 (S. Kor.).

the international taxation field.[188] In judging this, the Supreme Court used Korean civil law as the criterion of the judgment while considering the various attributes of the foreign organization in the establishment country. However, some scholars point out that this case focuses only on the domestic legal classification of the hybrid entities and does not consider the relationship with the tax treaty.[189]

2) *E. Land World*[190] case[191]

In this case, investors[192] created an LP under U.S. law, and the LP established a corporation in Labuan, Malaysia. This Labuan Corporation acquired convertible bonds equivalent to Korean Won (KRW) 42.4 billion (USD 37.5 million), issued by a Korean corporation, and the convertible bonds were converted into preferred shares. When the dividends were paid on the preferred shares, E. Land World withheld income tax at only the 10% rate applied under the Korea-Malaysia Tax Treaty.[193] However, the Korean NTS regarded the Malaysian company as a conduit company, and imposed corporate income tax at a rate of 15% on the plaintiffs. It applied the Korea-U.S. Tax Treaty Article

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188 Jihyun Yoon, *Lone Star Pangyeului UiUiya Hangye* [*Significance and Limitations of Lone Star decision*], 30 JOSEHAKSULNONJIB [J. OF TAX IN KOREA], 123, 135 (2014).

189 *Id*. at 136.

190 "E. Land World Company, Ltd. manufactures and distributes women clothing, children's wear, sportswear, casual wear, underwear, and accessories in South Korea and internationally." https://www.bloomberg.com/research/stocks/private/snapshot.asp?privcapid=108958363.

191 Supreme Court [S. Ct], 2011Du22747, Oct. 24, 2013 (S. Kor.).

192 The relevant fund's management company is 'Warbug Pincus.' In its Web site (http://www.warburgpincus.com/), Worberg Pincus states that its current assets are worth more than $ 44 billion. (last visited Apr. 6. 2017)

193 Agreement for the avoidance of double taxation and the prevention of fiscal evasion, Kor.-Mal. art. 10, Apr.20. 1982.

12(2)(a),[194] regarding the dividend income was attributable to the U.S. LP.

One of the issues in this case was whether the Korea-U.S. treaty's 10% limited tax rate can be applied when imposing tax on a U.S. LP. The Administrative Court classified the U.S. LP as a "corporation" because the U.S. LP's characteristics were similar to the Korean "Hapjahoesa ('Partnership company')." As a result, the 10% tax rate in Article 12(2)(b) of the Korea- U.S. Tax Treaty applied to the dividend income.[195]

However, on appeal, the High Court ruled that the partnership did not fall under the category of "corporation" in Article 12 (2)(b) of the Korea- U.S. Tax Treaty for three reasons: i) in the U.S., corporations and partnerships differ in their governing law, and ii) although partnerships are treated as foreign corporations under Korean domestic law and the corporate tax is applied, the Korea-U.S. Tax Treaty has no provision stating that the partnership be regarded as a corporation in such cases and such interpretation is against the "principle of no taxation without law" as it corresponds to excessive interpretation of expansion or analogy interpretation without rational reason,[196] and iii) it cannot be concluded that the concept of corporation in Korean corporation tax law exactly coincides with the corporation in the U.S.-Korea tax treaty.[197]

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194 "(2) The rate of tax imposed by one of the Contracting States on dividends derived from sources within that Contracting State by a resident of the other Contracting State shall not exceed: (a) 15 percent of the gross amount of the dividend; or (b) When the recipient is a corporation, 10 percent of the gross amount of the dividend if: (…)", Convention for the Avoidance of Double Taxation of Income and the Prevention of Fiscal Evasion and the Encouragement of International Trade and Investment, Kor.-U.S., art. 12(2) Oct. 20, 1979, S. TREATY DOC. No. 94-27(1976).

195 *Id*.

196 Seoul High Court [Seoul High Ct.], 2011Nu4758, Aug. 23, 2011 (S. Kor.).

197 *Id*.

The Supreme Court affirmed the High Court's decision, on the premise that the Korea-U.S. Tax Treaty is applicable to this dividend income, stating that the U.S. LP can't be a "corporation" in the U.S.-Korea Tax treaty although it is classified as a "foreign corporation" in the Korean Corporate Tax Law on two grounds: i) Article 2 of the Korea-U.S. Tax Treaty clearly distinguishes between corporations and partnerships,[198] and ii) in U.S., corporations and partnerships differ from their establishment or registration governing laws.[199]

Some scholars regard this case as being subjected to the Korea-U.S. Tax Treaty without further discussion.[200] If the Korea-U.S. tax treaty does not apply, a 20% withholding tax rate, applicable to residents of countries that do not have a tax treaty with Korea, may be applied, pursuant to Article 98 of the Korean Corporate Income Tax Act.[201] However, in this case, the tax authorities did not make any argument relying on the application of the Korea-U.S. tax treaty as a premise.

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[198] Convention for the Avoidance of Double Taxation of Income and the Prevention of Fiscal Evasion and the Encouragement of International Trade and Investment, Kor.-U.S., art. 2. Oct. 20, 1979, S. TREATY DOC. No. 94-27 (1976).

[199] Supreme Court [S. Ct], 2011Du22747, Oct. 24, 2013 (S. Kor.).

[200] Jihyun Yoon, *'Pateuneoswip'gwa Gosejoyageseoui 'Geojuja* [*Partnership and a resident concept in tax treaties*] 55 SEOULDAEHAKGYO BEOPAK [SEOUL L. J.] 695 (2014).

[201] "(1) Where any person pays a foreign corporation the amount of domestic source income provided in subparagraphs 1, 2, and 4 through 10 of Article 93 (…) which is not substantially related to the domestic place of business of the foreign corporation or does not revert to the domestic place of business of the foreign corporation (…), he/she shall withhold, as the corporate tax, the following amounts from the income of the relevant foreign corporation for each business year, and pay it at the tax office having jurisdiction over the place of tax payment, etc., (…) That the same shall not apply to income provided for in subparagraph 5 of Article 93 which is taxable as domestic source business income under the applicable tax treaty: (…) 3. Income provided in subparagraphs 1, 2, 8, and 10 of Article 93: 20/100 of the amount paid" Beobinsebeob [Corporate Tax Act], Act No. 62, Jul. 15, 1949, *amended by* Act No. 10423, Dec. 30, 2010 art. 98 (S. Kor,).

In order to apply the Korea-U.S. Tax Treaty, it is necessary first to determine whether the U.S. LP is a U.S. resident. According to the OECD Model Tax Convention on Income and Capital 2014 ("OECD Model Tax Convention") Article 4(1), "the term 'resident of a Contracting State' means any person who, under the laws of that State, is liable to tax therein by reason."[202] Regarding meaning of "liable to tax" to a partnership, Commentaries on the Articles of the Model Tax Convention Article 1 paragraph 5 states as follows:

> [w]here a partnership is treated as a company or taxed in the same way, it is a resident of the Contracting State that taxes the partnership on the grounds mentioned in paragraph 1 of Article 4 and, therefore, it is entitled to the benefits of the Convention. Where, however, a partnership is treated as fiscally transparent in a State, the partnership is not "liable to tax" in that State within the meaning of paragraph 1 of Article 4, and so cannot be a resident thereof for purposes of the Convention.[203]

And Article 1 paragraph 6.3 also states that

> [t]he results described in the preceding paragraph should obtain even if, as a matter of the domestic law of the State of source, the partnership would not be regarded as transparent for tax purposes but as a separate taxable entity to which the income would be attributed, provided that the partnership is not actually considered as a resident of the State of

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[202] OECD, MODEL TAX CONVENTION, *supra* note 127, at art. 4(1).

[203] OECD, COMMENTARIES ON THE ARTICLES OF THE MODEL TAX CONVENTION (2010), http://www.oecd.org/berlin/publikationen/43324465.pdf.

source.[204]

In other words, if an organization is treated as "transparent", the members of the entity should be subject to the tax treaty, and these results should be attained despite the domestic law provisions of the source country. Therefore, this case's conclusion, which assumes the application of the Korea-U.S. Tax Treaty to the U.S. LP, does not fit the view of the OECD.

However, since the Korea-U.S. tax treaty was ratified in 1979, which is prior to the creation of the OECD Model Tax Convention (2014), different terms are used from the Model Tax Convention. Article 3(1)(a) of the Korea-U.S. Tax Treaty defines the residents covered by the treaty as follows:

> The term 'resident of the United States' means: (i) A United States corporation; and (ii) Any other person (except a corporation or any entity treated under United States law as a corporation) resident in the United States for purposes of its tax, but in the case of a person acting as a partner or fiduciary only to the extent that the income derived by such person is subject to United States tax as the income of a resident….[205]

There can be two views of the interpretation of Article 3(1)(a) (ii). One treats the partnership as a U.S. resident, to the extent that partners pay U.S. taxes as residents of the

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204 *Id*.

205 Convention for the Avoidance of Double Taxation of Income and the Prevention of Fiscal Evasion and the Encouragement of International Trade and Investment, Kor.-U.S., art. 3. Oct. 20, 1979, S. TREATY DOC. No. 94-27(1976).

United States.[206] The other applies the Korea- U.S. Tax Treaty by considering the partner as a resident rather than a partnership. This is a rational interpretation possible in the context of Article 3. However, applying this view in this case, there is an asymmetry in that the Korean tax authority treats the entity as the U.S. corporation, but that entity can't apply the Korea-U.S. Tax Treaty. The Supreme Court has addressed this contradiction in the following cases.

3) *Dongwon Enterprise* case[207]

This case deals with issues of the taxation of capital gains from transfer of stock to the plaintiff through a Belgian corporation which was invested by the Luxembourg Limited Liability Company (LLC), which was owned by a Cayman LP and a U.S. LLC. The U.S. LLC is made up of shareholders of the U.S. and Hong Kong. The plaintiff didn't withhold the capital gains tax from the Belgian corporation under the Korea-Belgium treaty Article 13(3). However, the Korean NTS imposed withholding capital gains tax on the plaintiff for the Cayman Islands LP's stake and the U.S. LLC's Hong Kong stakeholder stake.[208] This is because the NTS found that the shares held by the Hong Kong corporations in the U.S. LLC were not subject to the Korea-U.S. Tax Treaty.

The issue, which was not discussed in the previous *E. Land* case, is whether a tax treaty can be applied to an entity as a resident of the contracting country, in which the

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206 Yoon, *supra* note 200, at 716.

207 Supreme Court [S. Ct.], 2012Du11836, Jun. 26, 2014 (S. Kor.).

208 Under the Korea-U.S. Tax Treaty, the share transfer income of the U.S. residents is generally not taxable in Korea. "(1) A resident of one of the Contracting States shall be exempt from tax by the other Contracting State on gains from the sale, exchange, or other disposition of capital assets unless ; (…)" Korea-U.S. Tax Treaty, art. 16.

entity is considered fiscally transparent, when the income earned by the entity is attributed to the entity as foreign corporation in our law. In this regard, the Administrative Court found the U.S. LLC as a beneficial owner of the capital gains since taxes are not imposed on an LLC itself. An LLC is treated the same as partnerships under the U.S. tax laws, and income taxes are imposed on their members according to their own interests.[209] However, the High Court held that the capital gains corresponding to the U.S. LLC's share were virtually attributed to the U.S. LLC and that the Hong Kong corporation could not be regarded as a beneficial owner, because the U.S. LLC is a foreign "corporation" under the Corporate Tax Act, considering that is the legal nature of the U.S. LLC's legal nature, and though the U.S. LLC has selected taxation on its shareholders under the U.S. taxation law, the fact that it is a foreign corporation cannot be changed.[210] In other words, while the Administrative Court found that the Korea-U.S. Tax Treaty couldn't be applied to the Hong Kong Corporation's shares, the High Court found that the NTS couldn't impose capital gains taxes on the Hong Kong Corporation, which is a shareholder of the U.S. LLC, under the Korea-U.S. Tax Treaty.

Regarding this, the Supreme Court held that if a U.S. corporation, which is a foreign corporation in Korea, obtains income from Korea, the treaty could be applied insofar as the members of the corporation bear the duty of taxation in the U.S. Therefore, this means that the income attributed to the Hong Kong corporation, as the shareholder of the U.S. LLC, can't get benefits of the Korea- U.S. tax treaty. This interpretation is based on the comprehensive consideration of the purposes of the Korea-U.S. Tax Treaty, which

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[209] Seoul Administrative Court [Seoul Admin. Ct.], 2009Gu-Hap3538, Feb. 18, 2011 (S. Kor.).

[210] Seoul High Court [Seoul High Ct.], 2011Nu11336, Apr. 27, 2012 (S. Kor.).

are “the avoidance of double taxation of income and the prevention of fiscal evasion and the encouragement of international trade and investment”[211], and preventing inconsistency between Korean tax law and the Korean-U.S. Tax Treaty, which arises when the partnership is regarded as a corporation for Korean tax purposes.[212] In other words, it is likely that the Supreme Court’s decision is to avoid the contradiction that an entity, treated as a foreign corporation in Korea is not applied to the tax treaty between its country and Korea.

4) Evaluation

As we have seen in the previous case, the Korean Supreme Court is firmly stating that it will not consider how income, which originated in Korea, is taxed in the country of entity establishment or its member’s residence. Instead, the Supreme Court held that the corporation tax should be imposed in accordance with the Korean Corporate Tax Law, if an entity is classified as a “corporation” under the Korean civil law.

However, the Commentaries of the OECD Model Tax Convention and Partnership Report proposes that source country follow the way of the establishment or residence country. Therefore, if the Supreme Court continues to maintain the same position as in the previous case, but the resident status of the entity is denied because it is treated as transparent in the establishment country under the Commentaries, a problem that a tax

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[211] Korean.Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income, Kor.-U.S. Oct. 20, 1979, S. TREATY DOC. No. 94-27 (1979).

[212] Similarly, in 2013, German Federal Fiscal Court decided that an S corporation qualifies for German purposes as a “body corporate” under the US-Germany treaty in the range of its income is taxed in the hands of its US resident shareholders. BFH Judgment of June 26, 2013, IR 48/12; EY GLOBAL TAX ALERT, http://www.ey.com/gl/en/services/tax/international-tax/alert--german-federal-fiscal-court-rules-on-s-corporation-treaty-protection-under-2006-german-us-tax-treaty (2 Dec. 2013).

treaty cannot be applied to such entities and problems, can arise.

As noted above, there are some weaknesses to the approach of the Supreme Court, such as the practical difficulty of finding a legal entity in Korea similar to a foreign entity. Logical incompleteness of decisions as to whether a tax treaty, concluded by the country of establishment and Korea can be applied when calculating income of a foreign entity which is treated as a corporation in Korea but treated as transparent in the establishment jurisdiction, is another disadvantage. If the tax treaty does not apply, inconsistency arises between the Korean tax law and the tax treaty, and if the tax treaty is applied, there is possibilities of inconsistency between the establishment country's tax law and the tax treaty or double non-taxation. The current Korean Supreme Court's position in the *Dongwon Enterprise* case is that the treaty could be applied insofar as the members of the corporation bear the duty of taxation in the establishment country. However, there may be a criticism that the tax treaty is not applied according to the proportion of the members without any specific grounds for varying from that.[213]

### 2. Rules to Prevent Double Non-Taxation Using Hybrid Entities in Korea

Currently, Korea does not have a special rule relevant to preventing double non-taxation problems using hybrid entities. However, Article 52 of the Korean Corporate Tax Act can apply to the calculation of the income of hybrid entities. This article is called the "Repudiation of Wrongful Calculation" provision. Under this article,

> [t]he head of the tax office having jurisdiction over the place of tax payment

[213] Pilyong Kim, *2014nyeondo gukjejose pallyehoego* [Review of 2014 Court Decisions on International Taxation] 31 JOSEHAKSULLONJIP [J. OF IFA KOR] 101, 117-8 (2015).

> or the commissioner of the competent regional tax office deems that the tax burden of a domestic corporation has been unjustly reduced through the wrongful calculation of the amount of income of the domestic corporation in transactions with a related party prescribed by Presidential Decree ….[214]

The Repudiation of Wrongful Calculation provision also applies when calculating the foreign corporation's income under the Article 92(1) of the Korean Corporate Tax Act.[215]

In general, however, the tax authority bears the burden of proof of the "Wrongful Calculation", and it would be hard to prove that D/D, D/NI, and indirect D/NI outcomes are unjust since transactions relevant to the outcomes are themselves are "reasonable".[216] Also, practically the tax authority has difficulty to obtain how incomes are reported in the establishment or source country of the hybrid entity. Therefore, it is difficult to prevent the D/D and D/NI outcome of Hybrid Entity only with the "Repudiation of Wrongful Calculation" provision.

## IV. Hybrid Instruments

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[214] Beobinsebeob [Corporate Tax Act], Act No. 62, Jul. 15, 1949, *amended by* Act No. 14386, Dec. 20, 2016, art. 52 (S. Kor.), *translated in* KLRI online database, http://www.law.go.kr/DRF/lawService.do?OC=mofe&target=elaw&MST=141083&type=HTML&mobileYn=.

[215] Beobinsebeob [Corporate Tax Act], Act No. 62, Jul. 15, 1949, *amended by* Act No. 14386, Dec. 20, 2016, art. 92(1) (S. Kor.), *translated in* KLRI online database, http://www.law.go.kr/DRF/lawService.do?OC=mofe&target=elaw&MST=175719&type=HTML&mobileYn=.

[216] "Wrongful calculation refers to the calculation of an act that alleviates or eliminates the burden of taxation that occurs when a taxpayer adopts a normal rational form of transaction, by taking a form of diverted, multi-stage, or other strange transaction…." Supreme Court [S. Ct.], 95Nu18697, May 28, 1997 (S. Kor.).

## A. Introduction

A corporation decides on the means of capital raising, considering the circumstances such as the financial market situation and regulations. The means a company uses to finance its business are largely classified as equity and debt securities.[217] Basically, debt is based on the contractual relationship between a debtor and a creditor, while equity is based on the relationship between a company and a shareholder.[218] However, this dichotomous distinction is broken by the emergence of various financial products that have both characteristics of debt and equity, because of demands on diversification of financing and investment instruments and the development of financial techniques.[219] These finance instruments are called "hybrid" instruments because they have complex characteristics.[220] Originally, hybrid instruments were created to increase the bank's capital adequacy ratio.[221] In recent years, however, they have been widely used as a means of financing for general companies, for purposes like maintaining debt/equity ratios or credit ratings, and business succession techniques.[222]

Generally, the interest on debt can be deducted as costs to the issuer, but dividends can't. Therefore, debt financing is preferred to equity in taxation, since the total

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[217] Gyuhwan Choe, *Sebeopsang buchaewa jabonui bullyue daehan yeongu* [*A Study on Distinction between Debt and Equity for Tax Purposes - Focused on Hybrid Securities and International Comparison*], 31 JOSEHAKSULLONMUNJIP [COLLECTION OF TAX L. ART.] 149, 151 (2015).

[218] *See* Gu, *supra* note 48, at 121

[219] MARJAANA HELMINEN, THE DIVIDEND CONCEPT IN INTERNATIONAL TAX LAW 121 (1999).

[220] *See* Gu,*supra* note 48, at 160.

[221] Seunghwan Lee, *Haibeurideujeunggwon balhaenge gwanhan yeongu* [*A Study in Hybrid Securities*], 16 BIGYOSABEOP [COMPARATIVE L.] 39, 40 (2009).

[222] *See* Gu, *supra* note 48, at 160

tax amount when using debt can be lower than with equity.[223] If a particular instrument is recognized as capital in the credit evaluation but the tax law recognizes it as a debt and interest can be deducted, the corporation can have the effect a tax cut and give positive signs to the market.[224] Therefore, if there is a difference in treatment of hybrid instruments between the accounting system and the tax law, the issuer or the investor may choose the hybrid instruments as capital raising means.[225]

In international transactions, differences in the tax treatment of hybrid instruments between countries may lead to the problem of tax base erosion such as D/D or D/NI.[226] Moreover, differences in treatments of the same financial instrument are more likely to occur in international transactions than in domestic.[227] If a financial instrument is treated as debt in the issuing country, but treated as equity in the recipient country, the related payment will be deducted from the taxable income in the issuing country, will not be included in the taxable income in the recipient country as a dividend. The OECD's BEPS project Action Plan 2 also deals with those hybrid instruments that are especially treated differently by countries.[228]

In this part, I will review examples of the classification of overseas hybrid instruments and the rules for preventing tax avoidance using hybrid instruments. Then, I will examine the current Korean regulations relevant to hybrid instruments and possible

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[223] HELMINEN, *supra* note 219, at 251.

[224] *Id.*

[225] *Id*.

[226] OECD, HMAS REPORT, *supra* note 13, at 7.

[227] *See* Gu, *supra* note 48, at 122.

[228] OECD, RECOMMENDATIONS ON HMAS, *supra* note 22.

problems with them. Finally, I will suggest a proposal to revise the Korean Corporate Income Tax Act considering the OECD's BEPS recommendations.

## B. Approaches to Classification of Hybrid instruments

### Approaches to Classifying Foreign Instruments for Tax Purposes

#### a. The U.S.

1.

In 1969, the U.S. Congress enacted Code section 385[229] to further clarify the problem of classification of hybrid securities, which was a concern because of the increase in corporate mergers, which used debt as a means of raising capital rather than stocks in the late 1960s.[230] Code section 385(a) delegates the issue of classification of capital and debt to Treasury regulations.[231] Code section 385(b) provides criteria to distinguish whether there is a debtor-creditor relationship or a corporation-shareholder relationship under particular circumstances, and these criteria guide the content of regulations.[232]

In 1981 and 1982, the U.S. Treasury Department issued proposed regulations under Code section 385[233] that "address[ed] whether a debt instrument will be treated as

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[229] 26 U.S.C. § 385 (1992), https://www.law.cornell.edu/uscode/text/26/385.

[230] Donald R. Ames, *Debt-Equity Financing Guidelines: Capital Problems for Closely Held Businesses* 9 FORDHAM URBAN L.J. 1019 (1980).

[231] 26 U.S.C. § 385(a) (1992).

[232] "(1) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest, (2) whether there is subordination to or preference over any indebtedness of the corporation, (3) the ratio of debt to equity of the corporation, (4) whether there is convertibility into the stock of the corporation, and (5) the relationship between holdings of stock in the corporation and holdings of the interest in question." 26 U.S. C. § 385(b) (1992), https://www.law.cornell.edu/uscode/text/26/385.

[233] 46 FR 24945, 47 FR 147 & 47 FR 28915; https://www.irs.gov/irb/2016-17_IRB/ar07.html.

debt for U.S. income tax purposes or re-characterized, in whole or in part, as equity."[234] Under the proposed regulations, i) debt instruments were treated as stock if issued in certain disfavored transactions, ii) documentation was needed to treat "related-party debt" as true debt for tax purposes, and iii) the I.R.S. could re-characterize certain debt as part debt and part equity.[235] However, the Treasury Department and the IRS withdrew these regulations on July 6, 1983.[236] In 1992, Congress enacted Code section 385(c).[237] For more than 30 years, no regulations were published under Code section 385, but, in 2016, new Treasury regulations 1.385-1 to 1.385-4T were promulgated.[238] Treasury regulation section 1.385-1 is a general provision that includes "general rule for determining the treatment of an interest based on provisions of the Internal Revenue Code and on common law"[239] and "definitions and rules of general application for purposes of the regulations."[240] Section 1.385-2 provides the preparation, maintenance and operating rules "for the minimum documentation for the determination to be made under general federal tax principles."[241] Section 1.385-3 provides "factors that control the determination of whether an interest is treated as stock or indebtedness."[242] This

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[234] Philip R. Hirschfeld & Stanley C. Ruchelman, *Uproar Over Proposed §385 Regulations: Will Treasury Delay Adoption*, 3 INSIGHTS 40 (2016), http://publications.ruchelaw.com/news/2016-09/Code-385-pushback.pdf.

[235] *Id*. at 41.

[236] IRS, https://www.irs.gov/irb/2016-17_IRB/ar07.html

[237] *See* Gu, *supra* note 48, at 125.

[238] 26 C.F.R. § 1.385-1 (2017).

[239] 26 C.F.R. § 1.385-1(a) (2017).

[240] 26 C.F.R. § 1.385-1(a) (2017).

[241] 26 C.F.R. § 1.385-2(a) (2017).

[242] 26 C.F.R. § 1.385-3(a) (2017).

provision is focused specifically on the classification of "a covered debt instrument to a related person as part of a transaction or series of transactions that does not result in new investment in the operations of the issuer."[243] Section 1.385-3T (temporary) provides rules for certain partnerships, and section 1.385-4T (temporary) provides rules for consolidated groups and the application of the factors in section1.385-3 as the transition rules.[244]

Many cases regarding the distinction between debt and equity have been decided by the U.S. courts.[245] In *Fin Hay Realty Co. v. United States*, 398 F.2d 694 (3d Cir. 1968), listed sixteen factors for classification of debt and equity:

> (1) the intent of the parties; (2) the identity between creditors and shareholders; (3) the extent of participation in management by the holder of the instrument; (4) the ability of the corporation to obtain funds from outside sources; (5) the 'thinness' of the capital structure in relation to debt; (6) the risk involved; (7) the formal indicia of the arrangement; (8) the relative position of the obligees as to other creditors regarding the payment of interest and principal; (9) the voting power of the holder of the instrument; (10) the provision of a fixed rate of interest; (11) a contingency on the obligation to repay; (12) the source of the interest payments; (13) the presence or absence of a fixed maturity date; (14) a provision for redemption by the corporation; (15) a provision for redemption at the

243 26 C.F.R § 1.385-3(a) (2017).

244 26 C.F.R § 1.385-1(a) (2017).

245 INTERNAL REVENUE BULLETIN: 2016-17 (April. 25, 2016), https://www.irs.gov/irb/2016-17_IRB/ar07.html.

> option of the holder; and (16) the timing of the advance with reference to the organization of the corporation.[246]

In *Estate of Mixon v. United States*, 464 F.2d 394 (5th Cir. 1972), the U.S. Court of Appeals for the Fifth Circuit identified thirteen debt-equity classifying factors "that are similar to, but not the same as those used in *Fin Hay*":[247]

> (1) the names given to the certificates evidencing the indebtedness; (2) The presence or absence of a fixed maturity date; (3) The source of payments; (4) The right to enforce payment of principal and interest; (5) participation in management flowing as a result; (6) the status of the contribution in relation to regular corporate creditors; (7) the intent of the parties; (8) 'thin' or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) source of interest payments; (11) the ability of the corporation to obtain loans from outside lending institutions; (12) the extent to which the advance was used to acquire capital assets; and (13) the failure of the debtor to repay on the due date or to seek a postponement.[248]

In *John Kelley Co. v. Commissioner*, 326 U.S. 521 (1946), the court stated that

> [T]here is no one characteristic, (…) which can be said to be decisive in the determination of whether the obligations are risk investments in the corporations or debts."[249] In *Mixon*, the court also stated that "the approach of

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[246] Fin Hay Realty Co. v. United States, 398 F.2d 694, 696 (3d Cir. N.J. June 20, 1968).

[247] INTERNAL REVENUE BULLETIN, *supra* note 244.

[248] Estate of Mixon v. United States 464 F. 2d 394, 402 (1972).

[249] John Kelley Co. v. Commissioner 326 U.S. 521, 530 (1946)

> this court has been to consider all the factors and weigh the evidence favoring characterization of the advance as debt or equity, while realizing that the various factors are not of equal significance and that no one factor is controlling.[250]

In addition to the general classification rules for debt and equity, in 1989, Congress enacted rules in Code section 163, such as "Limitation on deduction disqualified portion of original discount for the high yield obligation"[251] or "Limitation on deduction for excess interest relevant to excessive debt/equity ratio."[252]

b. The Netherlands

Under the Dutch tax laws, interest expenses are deducted, but dividends are not. In principle, a 15% withholding tax is imposed on the payment of dividends, but no withholding tax is imposed on the payment of interest. Tax exemptions are applied to equity investments in subsidiaries that meet certain requirements in the Participation Exemption (deelnemingsvrijstelling) Clause of the Dutch Corporate Income Tax Act (Wet op de vennootschapsbelasting 1969).[253] The Dutch Corporate Tax Act does not include provisions on the classification of capital and debt, but instead these criteria have been developed in case law.[254] According to a number of cases, the classification of debt and equity is, in principle, determined by classification under the Civil Code.[255] In the

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[250] Estate of Mixon, 464 F. 2d, at 402.

[251] 26 U.S.C. § 163(e)(5) (2015).

[252] 26 U.S.C. § 163(j) (2015).

[253] MF FISCAL ADVISEURS, http://www.mffa.nl/netherlands-tax-advice/dutch-participation-exemption-netherlands/?lang=en.

[254] Anton Louwinger & Alexander Fortuin, *Dutch Supreme Court provides further clarity on tax classification of the provision of funds*, HOGAN LOVELLS INT'L LLP (2014).

[255] Roderik Bouwman, *Netherlands: tax treatment of hybrid finance instruments in the wake of two*

*Caspian Sea* case, the Dutch Supreme Court stated that the essential characteristic of a loan is the repayment obligation of the debtor.[256] This means that if the recipient of certain financing is not obliged to repay the amount, principally, the financing is not considered a debt.[257] Since the classification of hybrid securities in other countries is not related to the Dutch Civil Code classification, securities classified as capital in other countries may be classified as debt for Dutch tax purposes and vice versa.[258] Therefore, even if the company receives payments that were already deducted in other countries under their tax law, there is a possibility that the Participation Exemption can be applied.[259]

In general, where Germany is a country of origin, payments from financial instruments classified as liabilities can be fully deducted from taxable income. Conversely, payments made from financial instruments classified as capital are not deductible.[260] Generally, dividends are subject to withholding tax, but interest is not withheld except for certain cases.[261] Also, the German tax law does not provide for the general classification of hybrid securities.

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*landmark cases* https://www.dlapiper.com/en/us/insights/publications/2014/03/international-tax-news-march-2014/tax-treatment-of-hybrid-finance-instruments/ 25 MAR 2014.

256 *Id*.

257 *Id*.

258 *Id*.

259 *Id*.

260 GERMANY TRUST & INVEST, https://www.gtai.de/GTAI/Navigation/EN/Invest/Investment-guide/The-tax-system/tax-deductions.html#overviewAnker.

261 Deloitte, Taxation *and Investment in Germany 21* (2016), https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-germanyguide-2016.pdf.

Generally, in Germany, matters that are not specified in the tax law are treated according to German GAAP (Generally Accepted Accounting Principles) for the purposes of simple taxation and consistency.[262] However, German GAAP does not apply to foreign-based corporations, so it is judged according to foreign civil law, which is applicable to the issuing institution.[263] The tax law generally follows GAAP or civil law, but there are provisions to adjust or reclassify the classification of financial instruments for tax purposes.[264] Basically, these provisions are to replace hybrid financial instruments, which are classified as liabilities under the German Civil Code, with capital tax purposes, if that instrument is met the capital under the German Corporate Income Tax Act.[265] The problem of classifying debt and capital is also indirectly solved by revising taxable income, such as by capping interest deductions.[266]

b. Australia

In Australia, the double taxation problem of corporate and personal income taxes on dividends is solved through a tax credit to the recipient's income tax amounts.[267] The tax deduction may be applied to the taxable portion of the portion of the dividend

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262 *Id*. at 8.

263 *See* Seonghun Hong et al, *Buchaewa jabone daehan gwasechegye yeongu* [*Study of Taxation System on Debt and Capital*] 75, KIPF (2015).

264 Körperschaftsteuergesetz [KStG] [Corporate Income Tax Act] § 8 (Ger.) http://www.gesetze-im-internet.de/kstg_1977/index.html#BJNR025990976BJNE002120140.

265 *See* Gu, *supra* note 48, at 145.

266 *See* Hong, s*upra* note 263, at 76.

267 *Id.* at 52.

received by the shareholder corresponding to the franked dividend on which the corporation paid taxes.[268]

In 2001, Australia revised its tax law in a way that classifies debt and equity according to economic substance rather than legal formalities , and at that time the debt versus equity tests were introduced.[269] The purpose of the introduction of the debt/equity tests were to estimate the liability amounts for distinguishing between deductible interest and franked dividend classification.[270] However, there were tax disputes with respect to the classification, and the courts solved them by interpreting regulations.[271]

There are separate requirements for debt tests[272] and equity tests,[273] and in order to be recognized as a debt, all requirements of the debt test must be met, and if all are not satisfied or if part of the capital test is satisfied, that instrument is classified as equity.[274] Transactions between one or more companies are considered as a group and

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268 AUSTRALIAN TAX OFFICE, https://www.ato.gov.au/forms/you-and-your-shares-2013-14/?page=5

269 *See* Hong, s*upra* note 263, at 53.

270 AUSTRALIAN TAX OFFICE, https://www.ato.gov.au/Business/Debt-and-equity-tests/In-detail/Guides/Debt-and-equity-tests--guide-to-the-debt-and-equity-tests/?page=14#Part_B__Applying_the_tests_for_debt_and_equity_interests

271 *See* Hong, s*upra* note 263, at 53.

272 Five essential elements are required to satisfy the debt test: "[1].There must be a scheme; 2.The scheme must be a financing arrangement; 3.There must be a financial benefit received; 4.The issuing entity must have an effectively non-contingent obligation to provide a future financial benefit, and 5.It must be substantially more likely than not that the value of the financial benefit to be provided will be at least equal to or exceed the financial benefit received." Debt and equity tests: guide to the debt and equity tests, AUSTRALIAN TAX OFFICE, https://www.ato.gov.au/Business/Debt-and-equity-tests/In-detail/Guides/Debt-and-equity-tests--guide-to-the-debt-and-equity-tests/?page=4#Determining_whether_an_interest_is_a_debt_interest.

273 The capital test divides capital into four items. "[a] membership interest (such as a share) [item 1], an interest providing returns that depend on the issuer's economic performance [item 2], an interest providing returns at the discretion of the issuer [item 3], or an interest that may or will convert into such an interest or share [item 4]."

274 AUSTRALIAN TAX OFFICE, https://www.ato.gov.au/Business/Debt-and-equity-tests/In-detail/Guides/Debt-and-equity-tests--guide-to-the-debt-and-equity-

the tax authorities determine who is an issuer.[275] Equity that is classified as equity according to the debt/equity tests but doesn't have the legal form of equity, is classified as a non-share equity interest only for tax purposes.[276] The debt/equity rules will be applied when imposing a withholding tax on Australian sourced dividends, interest and royalties paid to non-residents.[277]

c. Evaluation

Except for Australia, the countries mentioned above do not have explicit debt-equity classification criteria in the tax laws. In the U.S., the precedents provide important criteria for the classification of debt and equity, but in the Netherlands and Germany, the Civil Code plays a decisive role in the classification. Mostly, it is likely that the U.S. places great emphasis on economic substances in distinguishing between debt and equity, and the Netherlands and Germany view legal forms as important judgments.[278]

As in the U.S., when classifying criteria are set in case law, there is an advantage that facts can be reflected more accurately on a case-by-case basis. However, the classification of debt and equity can be different in each sector such as law, corporate finance, accounting, and bank regulation. Generally, considering that a corporation has an

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tests/?page=3#Tests_for_debt_and_equity.

275 *See* Hong, s*upra* note 263, at 76.

276 AUSTRALIAN TAX OFFICE, https://www.ato.gov.au/Business/Debt-and-equity-tests/In-detail/Guides/Debt-and-equity-tests--guide-to-the-debt-and-equity-tests/?page=8#Non_share_equity_interest.

277 AUSTRALIAN TAX OFFICE, https://www.ato.gov.au/Business/Debt-and-equity-tests/In-detail/Guides/Debt-and-equity-tests--guide-to-the-debt-and-equity-tests/?page=12#Provisions_relating_to_international_taxation.

278 "However, some scholars have an opinion that the argument based on the principle of economic substance related to the classification of financial products, is not likely to be admitted in the U.S. court in litigation." Hong, *supra* note 263, at 43.

incentive to design financial instruments that are treated as liabilities for tax purposes but can be treated as capital for accounting purposes or for regulatory purposes, the approaches of the Netherlands and Germany can solve the problem of classification difference depending on the application area, since the tax law classification is consistent with the civil law. However, there is also the disadvantage that the substance of the product cannot be properly reflected when the categorization is only dependent on the civil law. Australia has a liability-capital-classification criterion in the tax law, so that can enhance taxpayers' predictability. However, there is still a possibility that companies will be able to use these differences in classification between sectors, since this classification test is only used for tax purposes.

### 2. Examples of Countermeasures against Double Non-Taxation

#### a. The U.S.

Through the Controlled Foreign Corporation ("CFC") Rule and Notice 98-5, the U.S. prevents receiving excess foreign tax credits by using hybrid securities that are treated as debt in foreign and treated as capital in the U.S. If a U.S. parent company lends money to a CFC after financing from outside, it is subject to the offsetting provisions of CFC in Treasury Regulation 1.861-10(e).[279] Under the CFC Rule, when calculating the Foreign Tax Credit, the interest expense paid to the creditor, not a member of the affiliated group of the U.S. parent company, is directly attributed to the foreign source income received from the CFC.[280]

[279] 26 C.F.R § 1.861-10 (2017).

[280] 26 C.F.R § 1.861-10 (e) (2017).

The CFC rule is applicable when the requirements of excess related group indebtedness and excess U.S. shareholder indebtedness are satisfied at the same time.[281] By applying the CFC rule, the foreign-source income of the U.S. taxpayers will be reduced, so excessive foreign tax deductions will be prevented. If the CFC claims a deduction for interest on the distribution of CFC shares held by a parent company in the United States, the U.S. parent company must consider the shares in the CFC held as related group indebtedness.[282] However, interest income from a related group of indebtedness does not include earnings related to U.S. parent company shares.[283] Therefore, payments made in hybrid securities that are treated as capital in the U.S. but are treated as liabilities for foreign tax purposes are not considered as sources of income outside of the country, so they will not be able to increase their foreign source income and foreign tax credits. Thus, the incentive for a U.S. parent company to issue hybrid securities to foreign subsidiaries may be reduced.

Notice 98-5 addresses transactions involving asset acquisition transactions and certain structures, designed to exploit inconsistencies between U.S. and foreign tax laws that generate income subject to foreign withholding tax in a very short period of time. Notice 85 treats those transactions as an abusive tax-motivated transaction with foreign tax credit.[284]

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[281] 26 C.F.R § 1.861-10 (e)(1) (2017).

[282] 26 C.F.R § 1.861-10 (e)(8)(vi) (2017).

[283] 26 C.F.R § 1.861-10 (e)(8)(vi) (2017).

[284] IRS, NOTICE 98-5 FOREIGN TAX CREDIT ABUSE (Jan. 20, 1998), https://www.irs.gov/pub/irs-utl/notice_98_5_l4.pdf.

In addition, the U.S. Tax Court requires proof of the taxpayers' claims that they are stocks in form, but in substance are debt. In other words, the taxpayer is responsible for proving that hybrid securities are debt.[285]

b. The Netherlands

The Netherlands has no specific provisions to prevent tax evasion using hybrid financial instruments. However, there are provisions indirectly related to hybrid securities in the Participation Exemption Rule.[286] In order for a parent company to be eligible for the Participation Exemption, it must own at least 5% of the subsidiary's shares.[287] For this rule to be applied, the parent company must actively seek to increase the value of the subsidiaries, such as participating in the subsidiary's business or performing essential functions for the group's business (Purpose Test). If participation does not meet this purpose, one of the following tests must be satisfied to apply for Participation Exemption; "the 'asset test' (the assets of the subsidiary may not consist for more than 50% of passive assets);the 'subject to tax test' (subject to a profit tax at an effective rate of at least 10%)."[288]

The Dutch Corporate Income Tax Act has an anti-base erosion rule.[289] According to the anti-base erosion clause, interest on debt within the group is not

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[285] Full Service Beverage Company v. Commissioner, 69 T.C.M. 2221 (1995). http://www.leagle.com/decision/1995229069dvtcm2221_12165/FULL%20SERVICE%20BEVERAGE%20COMPANY%20v.%20COMMISSIONER

[286] Participation Exemption system provides incentives for MNEs to establish holding companies in the Netherlands.

[287] PWC NETHERLANDS CORPORATE - INCOME DETERMINATION, http://taxsummaries.pwc.com/ID/Netherlands-Corporate-Income-determination.

[288] *See* CORPORATE TAX ALLIANCE, http://www.corptax.org/images/publicaties/dutch-participation-exemption-in-2012.pdf; Gu, *supra* note 48, at 208, 9.

[289] *See* Christophe Waerzeggers & Cory Hillier, *Introducing a General Anti-Avoidance Rule (GAAR)*, TAX

deductible unless both the debt and equity transactions are due to business reasons, and the interest is taxable at a tax rate of at least 10%in the foreign jurisdiction.[290] The "Anti Tax Avoidance Directive", released by EU Commission in January 2016, which members must implement beginning January 2019,[291] includes a similar rule with the name of "Switch-over", but the minimum effective tax rate for exemption in EU country would be increased to 40%.[292]

### c. Germany

Section 8b (1) of the German Corporate Income Tax Act stipulates that corporate shareholders are fully exempted from taxation on dividends received.[293] Thus, dividends do not increase corporate taxable income. However, as long as the payment is deducted from the income of the payer, tax exemption from dividend income is not granted.[294] Therefore, domestic tax exemption on dividends depends on foreign tax laws. This provision is considered to have made more progress than the OECD recommendations in terms of including all dividend payments as well as for hybrid securities.

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L.TIMF TECH. NOTE (Jan. 2016).

290 Arco Bobeldijk & Tim Hendriks, *Interest Deduction in the Netherlands: Tax Aspects of the Different Interest Deduction Limitation Rules*, 45 INTERTAX 322 (2017).

291 TAX AND CUSTOMS UNION, http://ec.europa.eu/taxation_customs/business/company-tax/anti-tax-avoidance-package/anti-tax-avoidance-directive_en.

292 *See* Bill Dodwell, International Tax EU Tax Alert Deloitte 28 (Jan. 2016), https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-alert-european-union-28-january-2016.pdf.

293 Körperschaftsteuergesetz [KStG] [Corporate Income Tax Act] § 8b(1) (Ger.); *See* Gu, *supra* note 48, at 211.

294 Körperschaftsteuergesetz [KStG] [Corporate Income Tax Act] § 8b (1)(Ger.); *See* Gu, *supra* note 48, at 212.

However, if a taxpayer asserts a tax exemption, there is a question as to who is responsible for proving that the payment is not deducted in the foreign jurisdiction. Article 88(1) of the German Basic Tax Code stipulates that the tax authorities must investigate all facts and circumstances related to taxation. However, in Article 90(2), about international transactions, taxpayers must prove all favorable facts and circumstances. Therefore, the tax authority may require the taxpayer to prove that the deduction for the payment related to the dividend has not been deducted, and that may increase the cost of tax cooperation.

In the case of transactions between subsidiaries, Germany generally limits the deduction of the interest expense to 30% of earnings before interest, taxes, depreciation and amortization (EBITA). This provision reduces the incentives for companies to use hybrid instruments for tax purposes.

### C. Recommendations in OECD BEPS Action 2

The OECD has issued recommendations through the BEPS Action 2 to address the issue of inconsistency resulting from hybrid financial instruments that have both equity and debt characteristics.[295] The OECD report states that the causal relationship between a hybrid instrument and a mismatch in tax treatment is clear, but that it is impossible to define a comprehensive component of hybrid financial instruments.[296] Instead, it focuses on suggesting ways to solve the problem, assuming hybrid mismatches have occurred.[297]

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[295] OECD, RECOMMENDATIONS ON HMAS, *supra* note 22.

[296] *Id*. at 18.

[297] *Id*. at 37.

### a. Linking Rule

The OECD Action 2 report proposes adjusting appropriately the amount of deductions allowed in the country of the payer's jurisdiction or the amount of income included in the recipient's country of jurisdiction in order to eliminate any consequences of the hybrid mismatch.[298] To neutralize the D/NI outcome, the OECD recommends a linking rule that denies a deduction "to the extent to it gives rise to a D/NI outcome."[299] If the payer's jurisdiction doesn't deny the deduction, then the payee's jurisdiction can include the payment into income (Defensive rule).[300] Timing difference in recognition of the payment is not treated as D/NI outcome and proofs would be requested.[301] A linking rule and defensive rule are also applied to D/D and indirect D/NI outcome.[302] In D/D outcome, deduction would be allowed if it is "set-off against dual inclusion income"[303], but the taxpayer need to be able to explain dual inclusion to the tax administration.[304]

### b. Exclusion of tax exemption for deductible payments

Another measure to prevent D/NI outcome of hybrid instruments, the OECD recommends not to allow tax exemption or equivalent relief provided for double taxation relief purposes to the extent that the dividend payment is deducted by the payer.[305] Also

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298 *Id*. at 25.

299 *Id*. at 37.

300 *Id*.

301 *Id*.

302 *Id*. at 53.

303 *Id*.

304 *Id*.

305 *Id*. at 40.

tax administrations need to be consider whether such recommendations can be applied to "other types of double tax relief granted for dividend income."[306]

OECD Action 4 recommends allowing the deduction of interest expense only to a certain percentage of EBITDA (Earnings Before Interest, Tax, Depreciation and Amortization), in order to prevent tax avoidance through the transaction of hybrid financial products among related parties.[307] This has already been adopted by some countries, such as the U.S. and Germany.[308] The OECD recommends that the percentage range lie between 10% and 30%.[309]

## D. Approaches to Hybrid Instruments in Korea

### 1. Classification of Hybrid instruments.

Since 2012, in Korea, non-financial sector companies have been able to issue hybrid securities, which were only issued by bank sector before then.[310] The Korean Corporate Income Tax Act does not specify the classification criteria or definitions for debt and equity. Only the costs and profits are prescribed in the Corporation Tax Law. Instead, however, accounting standards could be used as criteria for debt and equity, since Article 43 of the Korean Corporate Tax Act stipulates that corporate accounting standards

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306 *Id*.

307 OECD, LIMITING BASE EROSION INVOLVING INTEREST DEDUCTIONS AND OTHER FINANCIAL PAYMENTS, ACTION 4-2016 UPDATE (2017) [hereinafter, OECD, LIMITING INTEREST DEDUCTIONS]

308 *See* ADAPTING TO CHANGING ENVIRONMENT BEPS https://www.pwc.com/ca/en/tax-insights/publications/pwc-beps-action-4-2016-03-en.pdf

309 OECD, LIMITING INTEREST DEDUCTIONS, *supra* note 307 (2017).

310 *See* Hong, *supra* note 263, at 11; Gyuhwan Choi, *Sebeopsang buchaewa jabonui bullyue daehan yeongu* [*A Study for Classification of Debt and Capital in the Tax Law*], 30 JOSEHAKSULNONJIP [J. OF IFA KOR.] 150 (2015).

should be supplemented to those that are not stated in the Corporate Tax Act.[311]

Under Korean GAAP (K-GAAP), which applies to unlisted companies that did not select Korean International Financial Reporting Standards (K-IFRS),[312] debt is an economic obligation that the entities currently bear, and equity is the total amount of assets minus the total liabilities.[313] In other words, equity is the right to claim residual assets.[314] On the other hand, under the K-IFRS, the issuer of financial instruments classifies those instruments as debt or equity when initially recognizes the instrument, according to the definition of debt and equity in in K-IFRS No. 1032.[315] The most important parts of the classification between debt and equity are the rights and obligations under conditions in the contract, and the terms and content of the contract.[316] One of the most important criteria to distinguish between debt and equity in K-IFRS is whether the issuer is obliged to transfer cash and other financial assets. Therefore, if the issuer has the right to unconditionally avoid the obligation to deliver cash or other

311 In calculating the amount of income of a domestic corporation for each business year, where the corporation applies corporate accounting standards which are generally acknowledged as fair and proper, or continuously applies the relevant practices with respect to the business year during which gross income and deductible expenses accrue, and to the acquisition and evaluation of assets and liabilities, such corporate accounting standards or practices shall be followed, except as otherwise expressly provided in this Act and the Restriction of Special Taxation Act.

312 "Korean Accounting Standards Board (KASB) adopted the Korea International Financial Reporting Standards (K-IFRS) beginning in 2009. The standards were phased in from 2009 to 2011. Beginning in 2011 financial companies and listed companies under the Korean Composite Stock Price Index (KOSPI) and Korea Securities Dealers Automated Quotation (KOSDAQ) were mandatorily required to prepare their financial reports in accordance with K-IFRS. The adopted standards are nearly identical to IASB IFRSs except for timing differences for newly published IFRS and several other provisions." http://ucfinternationalsouthkorea.weebly.com/accounting.html

313 K-GAAP, JAEMUHOUGYE GAENYEUM CHEGEI [CONCEPT OF FINANCIAL ACCOUNTING] par.104 (2003).

314 *Id*.

315 K-IFRS, GEUMYUNGSANGPUMUI PYOSI [DISPLAYING FINANCIAL INSTRUMENTS] par.15-32 (2016).

316 *See* Hong, *supra* note 263, at 11.

financial instruments in the contract, the instrument is classified as equity.[317] For the distinction between debt and equity, it is likely that K-GAAP considers the legal form more important, but K-IFRS puts more weight on the economic substance. For example, under K-GAAP, preferred stock with redeemable rights is considered as equity following its form, but under K-IFRS it is treated as debt considering its economic substance.[318]

Because, in Korea, stocks and bonds are issued based on the Commercial Act, that may be the classification basis for debt and equity.[319] The Korean Supreme Court also stated that the judicial effect of issuing bonds cannot be ignored,[320] so it is highly likely to classify debt and equity according to legal form.

In this way, there is a difference between the standards used in the classification of debt and equity in the accounting standards and Commercial Act, so the Korean tax authority can be confronted with the issue of which to follow. Unclear criteria for the classification of debt and equities may hinder taxpayers' predictability. For example, in 2010, the Ministry of Strategy and Finance make a decision that preferred stock with redeemable rights[321] was capital based on the legal form. However, in 2012, the Korean NTS determined that it was debt according to its economic substance.[322] Also, the Korean Supreme Court has ruled that subordinated bonds, issued for the purpose of

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[317] *See* Hong, *supra* note 263, at 19.

[318] *Id*.

[319] Sangbeob [Commercial Act], Act No. 1000, Jan. 20, 1962, *amended by* Act No. 13523, Dec. 1, 2015, art.469 (S. Kor.), *translated in* KRI online database, http://elaw.klri.re.kr/kor_mobile/viewer.do?hseq=32692&type=sogan&key=9/

[320] *See* Supreme Court [S. Ct.], 97Nu18462, Sept. 29, 2000 (S. Kor.).

[321] BEOBGYUBEOBIN [KOR. NAT'L TAX SER. CORP. TAX DIV.] 2010-0015, Feb. 11, 2010. (S. Kor.).

[322] BEOBINSEGWA [MINISTRY OF STRATEGY AND FIN. CORP. TAX DIV.]-522, Aug. 28, 2012. (S. Kor.).

improving long-term funding and asset soundness (enhancing the BIS ratio), are debt, though the plaintiff reported them as equity under K-IFRS.[323]

Countermeasures against double non-taxation

Article 28(1)4 of the Korean Corporate Tax Act addressed the kinds of interest that are not admitted as costs.[324] For example, the interest amount paid to a related party can't be deducted as interest cost. However, there is no deduction clause specifically for hybrid instruments' interest.

Article 52 of the Korean Corporate Income Taxation Act, "Repudiation of Wrongful Calculation" provision, can apply to the calculation of the income of hybrid instrument. This provision is applied only for tax purposes and recalculate the company's taxable income.[325] However, the tax authority have the burden of the proof that taxable income is wrong for recalculating. It would be hard to persuade that the hybrid instruments' outcomes are unjust.

## V. Recommendations

### A. Hybrid Entities

In order to solve the tax problems caused by hybrid entities, first of all, it is necessary for the Korean tax administration to improve the rules on hybrid entities by revising the classification criteria for foreign entities in the current Enforcement decree of

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323 Supreme Court [S. Ct.], 2007NDu20867, Mar. 25, 2010 (S. Kor.).

324 Beobinsebeob [Corporate Tax Act], Act No. 62, Jul. 15, 1949, *amended by* Act No. 14386, Dec. 20, 2016, art. 28(1)4. (S. Kor.).

325 *Id*. at art. 52.

the Corporate Tax Act. To address the outcomes of hybrid entities, a linking rule, which denies the deduction of cost in D/D, D/NI, Indirect D/NI situations, has to be introduced to the Corporate Tax Act. It will only apply to schemes, such as structured arrangements or arrangements between parties in the same control group. To avoid the unfair application of the linking rule, taxpayers can argue that the arrangements are not the scheme.

### 1. Improvement of the Provision for the Classification of Entities

#### a. Definition of foreign corporations

In order to solve tax problems caused by entities, it is necessary to clarify the definition of a foreign corporation. Article1(3) of the Korean Corporate Tax Act defines "foreign corporation" as "an organization that has its headquarters or main office in a foreign country in the form of a corporation that meets the standards prescribed by Presidential Decree."[326] In order for a foreign entity to be regarded as a foreign corporation under the Corporate Tax Act, first of all it must be an "organization." However, the Corporate Tax Act has no specific definition for an "organization," so it is necessary to establish the clear definition in Corporate Tax Act.

Also, it is necessary to minimize the inconsistency by improving the foreign corporation classification criteria in the Presidential decree. Some scholars[327] have pointed out that the criteria for determination of a foreign corporation in the current

326 Beobinseneob sihaengryung [Enforecement Decree of the Corporate Tax Act], Act No. 238, Dec. 16, 1949, *amended by* Act No. 27828, Feb. 3, 2017, art. 1 2. (S. Kor.).

327 *See* Lee, *supra* note 174, at 173.

Corporate Tax Act are not systematic.[328] The fourth criterion in Article 1(2) of the Enforcement Decree of the Corporate Tax Act can be a general standard in consideration of the relationship among the criteria since it has a characteristic that covers other criteria.[329] However, as pointed out earlier, there was a problem that the characteristics of the foreign entity cannot be judged easily if there are two kinds of entities that are similar to the foreign entity, and one is treated as a corporation but the other is treated as transparent. So, supplementing the fourth criterion by stating the characteristics of corporations, such as legal reality; equity transfer; management concentration; and limited liability, can be helpful for taxpayers; tax authorities; and the courts to determine the characteristic of organizations.

It is also necessary to specify that the concept of a "corporation" in the definition of a foreign corporation in Korean Corporate Tax Act Article 1(3),[330] by stating the definition is established from the viewpoint of the tax law, not from viewpoint the civil laws.. For example, it may be clarified by putting in the phrase "in applying the corporate tax law," which distinguishes a foreign corporation from the concept of a corporation in defining a domestic corporation.[331]

### b. Harmonization with the OECD approach

The current Korean Supreme Court's approach to classifying foreign entities has

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[328] *See* Gu, *supra* note 48.

[329] Beobinseneob sihaengryung [Enforecement Decree of the Corporate Tax Act], Act No. 238, Dec. 16, 1949, *amended by* Act No. 27828, Feb. 3, 2017, art. 1 2. (S. Kor.).

[330] Beobinsebeob [Corporate Tax Act], Act No. 62, Jul. 15, 1949, *amended by* Act No. 14386, Dec. 20, 2016, art. 1 3. (S. Kor.)

[331] Lee, *supra* note 174, at 182.

the problem that the tax treaty cannot be applied to the entity as well as the member of the entity. The best way to resolve this is to follow the OECD's establishment approach by changing the present approach. This approach can be considered a long-term solution. However, the actual introduction is expected to be difficult because it requires cooperation between the treaty contracting countries and Korea since this is the reestablishment to the taxation rights. Also, it can bring considerable confusion to the domestic tax system while changing the classification approach.

One of the alternatives is to separate the taxation of income under domestic tax laws from the application of the tax treaty. In other words, in the classification of the foreign entity, a similarity approach is applied according to the Korean Supreme Court's precedents, but the treatment of the entity by the other country party to the tax treaty is respected. For example, a partnership in the U.S. is recognized as a foreign corporation in Korea, but when applying the treaty, following the U.S.'s treatment of partnerships, the U.S. partnership is treated as transparent, and does not apply the Korea-U.S. Tax Treaty.

Another option is to relax the interpretation of Article 4 of the OECD Model Tax Convention that a person who is not "liable to tax" cannot be recognized as a resident. Tax treaties only passively restrict the tax, imposing rights created under the domestic tax laws, but do not themselves create new tax obligations. Some scholars argue that the purpose of Article 4 of the OECD Model Convention is to establish a physical connection related to its territory, but is not to deny a tax treaty to a person who is not taxable under domestic law.[332] However, this position is contradictory to the position of the current

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[332] *See* Gu, *supra* note 48, at 100.

Supreme Court. A careful approach is needed, since the OECD Model Convention is expected to be revised according to BEPS Action 2.

c. Revision of Article 98-6 (2) of Corporation Income Taxation Act

It is considered to be desirable to apply the treaty only if the stakeholders of the hybrid entity asserts the application of the treaty only by proving that the income of the hybrid entity is derived directly for the interests of the stakeholders, not for the hybrid entity itself. Article 98-6 (2) of the current Korean Corporate Tax Act[333] can be used as procedure to prove that, but the current provision needs to be amended to prevent exploitation as a means of tax avoidance.

Article 98-6 (2) of the current Corporation Income Tax Act specifies the procedure for investors of foreign investment scheme to receive the tax treaty benefits of the resident country and Korea. However, this provision is a mere application procedure and it can be abused as a means of tax avoidance by private equity funds as mentioned in Chapter III D.1.a. Also this article can conflict with the Supreme Court's precedents that have treated private equity funds in the form of limited partnerships as the beneficial owners. In order to solve these problems, it is desirable to add details regarding the taxpayer's burden of proof and the discretion of the tax authority in Corporate Tax Act. In other words, it is necessary to add a provision that the taxpayer show whether the investor is actually paying in the investor's country when the taxpayer submits the request for application of restrictive tax rates to prevent taxpayers from using this article as a tool of treaty shopping. If such provisions are added, there will be much less room for conflicts

[333] Beobinsebeob [Corporate Tax Act], Act No. 62, Jul. 15, 1949, *amended by* Act No. 14386, Dec. 20, 2016, art. 98-6(2) (S. Kor.).

with the Supreme Court precedent of existing overseas investment organizations, and it will clarify the intention of the legislation.

### 2. Introduction of Linking Rule

It is necessary to make a provision that denies the deduction of payment if the payment is not included in the income of the payer, in source country, implementing the OECD linking rules. Specifically, it is necessary to insert provisions not to include the interest that is not included in the calculation of taxable income in the payer's country, in Article 28 "Non-Inclusion of Interest Expenses in Deductible Expenses" of the Corporate Tax Act.[334] However, the concept of a hybrid entity may occur at any time because the classification method for entities are not unified. Therefore, it will be undermine neutrality if the government denies the deduction for the cost just because of transactions with a hybrid entity.

Therefore, based on the OECD linking rule, it would be desirable to reflect the concept of scheme and minimum amount requirements, as in the UK legislation when the Korean tax administration adopts the liking rule.[335] The OECD limited the scope of the linking rule's application to structured arrangements or in the same controlled group. However, it is necessary to consider the intention of the parties through the concept of a scheme, as in the U.K. It may be difficult for the tax administration to verify the intention, so it is possible to shift the burden of proof to the taxpayer. The minimum amount requirement is also necessary for efficiency of tax administration since the tax

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[334] *Id*. at art. 28.

[335] Taxation (International and Other Provisions) Act 2010 art. 233 (Eng.).

authority cannot examine all transactions with hybrid entities. Establishment of administrative procedures is also introducible, which would require the person who asserts the deduction to submit the proof that the foreign corporation includes that payment in taxable income or the payment is not deducted in the other country.

## B. Hybrid Instruments

Companies have incentives to choose favorable capital-raising tools in light of regulations and the business environment. Therefore, companies are likely to utilize hybrid securities that have both equity and debt characteristics. Taxpayers can use this advantageously if the classification criteria in tax law and accounting differ, since that leaves room for taxpayers to treat hybrid instruments as equity for accounting purposes and as debt in their tax calculation. In addition, if the classification standard is unclear in the tax law, that may place another burden on taxpayers due to the increase in tax uncertainty when issuing hybrid securities.

In order to solve the tax problems caused by hybrid securities, first of all, it is necessary to establish classification criteria for hybrid instruments. Even considering the domestic legal classification criteria for equity and liabilities, there will still be differences in the distinction between countries due to differences in the approach to equity and debt between countries. As with hybrid entities, the basic countermeasure for a hybrid instrument's mismatch outcome is a linking rule that denies deduction in the country of the payer.

### 1. Establishment of Criteria to Distinguish between Debt and Equity

Generally, an entity has an incentive to design a financial instrument that is treated as a liability for tax purposes but can be treated as equity under accounting or other regulations.[336] And the different classification between debt and equity in countries may provide multinational corporations with channels of tax avoidance using international transactions.

With the amendment of the Korean Commercial Act in 2012, general companies became able to issue a variety of hybrid securities, and the necessity for setting standards for debt and equity increased. These criteria provide taxpayers with a basis for decision in issuing financial instruments, and for tax authorities the guidelines for the classification decision. However, as in the case of the U.S., it is not easy to establish general and specific standards for distinguishing between debt and equity. Therefore, presenting general guidelines rather than specific rules (as in Australia) would be helpful. Also, when applying guidelines to an individual case, it would be necessary to comprehensively consider the circumstances surrounding the taxpayer so as to make the classification reflect the economic substance.

It is also possible to respect companies' accounting classification as much as possible if the corporation classifies the instruments along with K-IFRS. This method has the merit of reducing the compliance cost to taxpayers by using the accounting as it is. However, since the economic substance concept in K-IFRS may not also be clear, it is difficult to see that as the ultimate solution to the distinction between debt and equity.

Considering all these points, the Advance Ruling,[337] which can review the

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[336] *See* HELMINEN, *supra* note 219, at 252.

[337] "On October 1, 2008, the (Korean) National Tax Service (NTS) introduced the 'Advance Ruling Service' to provide a clear and expedited ruling with regard to a 'specific transaction' of a taxpayer's business, provided that a ruling is requested by the legal due date for tax return filing with the disclosure of

individual matters preemptively, can be used as one of the solution in the process of accounting or at the time of issuance of the financial instruments, by providing the general criteria of debt and equity in the tax law. This can increase the taxpayers' predictability and legal stability, and also will cope with tax evasion behavior. Also, since issuance of stocks or bonds is also related to the Commercial Act and Securities Trading Laws,[338] it is necessary to take a more careful approach to the distinction between capital and liability considering relations with these laws.

### 2. Introduction of Linking Rule

It is appropriate to establish a clause on non-deductible payment of interest in Article 28 of the Corporate Tax Act. Such tax treatment does not affect the classification of the payment in Korean tax laws. In other words, the nature of interest and dividends does not change, but it only adjusts the tax treatment on the premise that the taxpayer is not taxed. In line with the recommendations of OECD Action 4,[339] setting a deduction limitation for interest expense on transactions with related parties is needed to prevent exploiting hybrid financial products for tax avoidance. It can be included in the provision in Article 28 of the Corporate Tax Act.

## VI. Conclusion

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the taxpayer's identity and the specific facts and circumstances of the transaction in question." https://www.nts.go.kr/eng/korean/korean_06.asp?top_code=K001&sub_code=KS06&ssub_code=KSA5

338 Jeunggwongeoraebeop [Securities Transaction Act], Act No. 3104, Dec. 5, 1978, *amended by* Act No. 13628, Dec. 29, 2015 (S. Kor.), *translated in* KRIS online database, http://elaw.klri.re.kr/kor_mobile/viewer.do?hseq=37230&type=sogan&key=5.

339 OECD, LIMITING BASE EROSION INVOLVING INTEREST DEDUCTIONS AND OTHER FINANCIAL PAYMENTS, ACTION 4 (2016).

This thesis has examined the OECD BEPS Action Plan, as well as court cases in the U.S. and Korea, in order to solve the problems of HMAs, especially double taxation using hybrid entities and securities. There are many factors that lead to HMAs. Therefore, we cannot solve the tax problems caused by HMAs solely by reviewing hybrid entities and hybrid instruments. However, the discussion in this thesis of hybrid entities and hybrid instruments should provide guidance for resolving the taxation problems caused by HMAs.

The OECD's BEPS Action Plan started with the problem that the international tax system had not responded to changes in the financial economy or technological development. So far, many countries are participating in the implementation of the BEPS project, but there is a great likelihood of conflicts of taxing authority between countries, in the process of implementation, since the BEPS Project will make fundamental changes in tax bases of the country. Many countries likely will introduce a linking rule under Action 2, since such a rule has a positive impact on a budget of the country by denying an interest deduction in the payer's country. However, it is not easy to estimate the effect of the introduction since the HMAs are not familiar to Korean tax administration.[340] Therefore, before introducing the OECD recommendations, the Korean tax administration needs to analyze the exact HMA situation.

Apart from the OECD's recommendations, it is necessary to refine the classification criteria for hybrid entities and hybrid instruments. In particular, there are problems, such as the fact that the Korean Corporate Tax Act has no provisions defining

[340] Until 2017, there were no released investigation cases from the Korean tax administration relevant to HMAs.

debt and equity, and the inconsistent interpretation of equity and debt by Korean tax authorities. These standards will need to be maintained and introduced as basic premises to minimize the confusion of taxpayers during the introduction of the OECD Recommendation. The Korean tax administration needs to focus more actively on these criteria.

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