Recent Issues Regarding Permanent Establishments in Korea

In this article, the author considers recent developments with regard to various issues relating to permanent establishments in Korea, with emphasis on Korean legislation and case law, and the implications of the revised provisions of article 5 of the OECD Model (2017).

1. Introduction

Even though Korea became an OECD member country in 1996, its tax rules and practices regarding permanent establishments (PEs) are not necessarily the same as the taxation guidance included in article 5 of the OECD Model and the related Commentary on Article 5 of the OECD Model. This is because, first, the Korean taxation rules on PEs had already been established in Korea in its Corporate Tax Law (CTL) long before Korea became an OECD member country and, second, Korea had frequently adopted the provisions on PEs from the UN Model when it concluded tax treaties with other states before joining the OECD. In addition, even after becoming an OECD member country in 1996, Korea adopted some provisions regarding PEs from the UN Model when it concluded tax treaties with non-OECD countries, even though Korea’s original position on PEs was broadly in line with the (then) OECD Model.

Since 1996, Korea has revised a number of tax treaties with other OECD member countries that follow the OECD Model. Consequently, the rules on PEs that apply with these states are largely consistent with the OECD Model and the Commentaries on the OECD Model. This is because Korea has adopted the principle that a tax treaty takes precedence over relevant domestic law when they conflict. It should also be noted that the Korean government agreed with the US government to follow OECD taxation guidance in interpreting the Korea-United States Income Tax Treaty (1976), even though the language in this tax treaty regarding PEs is not the same as that in the OECD Model.

Even though the exact term used for a PE in the CTL is “Domestic Place of Business”, the language regarding PEs and “Domestic Place of Business” is generally interchangeable. That said, article 94(1) of the CTL provides that, where a foreign entity has a fixed place through which it conducts all or part of its domestic business, this constitutes a PE of the foreign entity. It can generally be said that the fundamental concept of a PE in the CTL follows that of article 5(1) of the OECD Model, which reads as follows:

For the purpose of this Convention, the term “permanent establishment” means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

However, considering that the wording of the concept of a PE articulated in article 5(1) of the UN Model is exactly the same as that in the OECD Model, it may not be significantly meaningful that the basic concept of PE as stipulated in the CTL is the same as that of the OECD Model.

As is the case with other countries, the issue of whether there is a PE of a foreign entity in Korea has a significant meaning in that a foreign entity with a PE in Korea must file its corporate income tax in Korea by aggregating all of the Korean-source income attributable to that PE, while a foreign entity without a PE in Korea has no such filing obligation and, instead, may or may not be subject to withholding taxes in Korea in respect of Korean-source income, the character of which as well as the withholding tax rate and methods is determined by the CTL, the relevant tax treaty, or both.

It goes without saying that a foreign entity has no tax liability in Korea if it does not have a PE in Korea and its resident state has concluded a tax treaty with Korea. However, even though a foreign entity has no PE in Korea, if its resident state has not concluded a tax treaty with Korea, the business profits of that company are still subject to a 2% withholding tax as long as the relevant business profits are treated as having a Korean source as stipulated in the CTL.
A PE in Korea falls under one of the following four different categories: (1) a fixed place of business PE (FPOB PE); (2) a construction PE; (3) a dependent agent PE (DAPE); and (4) a service PE. Section 2, discusses these categories in detail.

2. Relevant Provisions in the CTL and Important Tax Treaties Regarding PEs

2.1. Introductory remarks
As noted in section 1., the provisions of a tax treaty prevail where there are conflicts or inconsistencies between the provisions of that tax treaty and domestic law, as a treaty is considered to be a "special law" in Korea. However, even if there is a conflict, the domestic PE rules must still be reviewed as they cast light on how the Korean tax authorities should approach the issue. However, to the extent that domestic law provisions and interpretations do not conflict with the provisions of a tax treaty, the Korean tax authorities can apply the domestic law provisions.

2.2. Tests for FPOB PEs

2.2.1. Provisions in the CTL

Article 94(1) of the CTL provides that, where a foreign enterprise has a fixed place in Korea from which it conducts all or part of its business in Korea, that fixed place constitutes a PE in Korea. Article 94(2) of the CTL also provides that an FPOB PE includes the following places:

1. Branches, offices, or business offices;
2. Shops and other fixed places for selling;
3. Workshops, factories, or storage areas;

[...]

5. Places falling under any of the following items where services are provided by employees:
   (a) Place where services are provided for not less than 6 months in total during a period of 12 months in which such services continue to be provided; and
   (b) Place where services are provided for not more than 6 months in total during a period of 12 months in which such services continue to be provided, and

There are two conflicting views with regard to the effect of this provision. The first view is that, where a tax treaty that adopts the language of OECD Model, article 94(2) of the CTL cannot be applied. This is because provisions on PEs in the relevant tax treaty, such as Convention between the Government of Australia and the Government of the Republic of Korea for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (12 July 1982), Treaties IBFD [hereinafter Austrl.-S. Kor. Income Tax Treaty (1982)] and Agreement between the Government of the Hong Kong Special Administrative Region of the People's Republic of China and the Government of the Republic of Korea for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (8 July 2014), Treaties IBFD [hereinafter H.K.-S. Kor. Income Tax Agreement (2014)], prevail over the corresponding domestic provisions, such as article 94 of the CTL, and the Austrl.-S. Kor. Income Tax Treaty (1982) and the H.K.-S. Kor. Income Tax Agreement (2014) do not contain any provision similar to provisions of article 94(2). The second view is that article 94(2) of the CTL applies regardless of the actual language of a tax treaty, as article 94 is the Korean way of interpretation on para. 6 of OECD Model. Commentary on Article 5 (2017). Detailed discussion on this second viewpoint is contained in section 2.2.3. Guidance is also included in the OECD Model. Commentary on Article 5 (2017).

2.2.2. Provisions in important tax treaties

The provisions in respect of an FPOB PE that Korea has included in most of the tax treaties that it has concluded follow either the OECD Model or the UN Model. The language of article 5(1) and (2) of both the OECD Model and the UN Model is the same, as can be seen in the following:

1. For the purposes of this Convention, the term “permanent establishment” means a fixed place of business through which the business of an enterprise is wholly or partly carried on.
2. The term “permanent establishment” includes especially:
   a) a place of management;
   b) a branch;
   c) an office;
   d) a factory;
   e) a workshop, and
   f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

Similarly, article 9(1) of the Korea-United States Income Tax Treaty (1976), which entered into force in 1979, states that a "fixed place of business through which a resident of one of the Contracting States engages in industrial or commercial activity" constitutes a PE. Under article 9(2) of this tax treaty, the following are regarded as PEs in Korea:

(a) a branch;
(b) an office;
(c) a factory;
(d) a workshop;
(e) a warehouse;
(f) a store or other sales outlet;
(g) a mine, quarry, or other place of extraction of natural resources;

2.2.3. Guidance in the Commentary on Article 5 of the OECD Model

The Korean tax authorities and courts often use the recent Commentary on Article 5 of the OECD Model in interpreting the criteria or elements with regard to FPOB PEs. Some phrases of the Commentary on Article 5 of the OECD Model (2017) quoted or summarized below provide useful guidance in interpreting the meaning of article 5(1) and (2) of the OECD Model:

6. [...] This definition, therefore, contains the following conditions:
   - the existence of a "place of business", i.e. a facility such as premises or, in certain instances, machinery or equipment;

7. There are two conflicting views with regard to the effect of this provision. The first view is that, where a tax treaty that adopts the language of OECD Model, article 94(2) of the CTL cannot be applied. This is because provisions on PEs in the relevant tax treaty, such as Convention between the Government of Australia and the Government of the Republic of Korea for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (12 July 1982), Treaties IBFD [hereinafter Austrl.-S. Kor. Income Tax Treaty (1982)] and Agreement between the Government of the Hong Kong Special Administrative Region of the People's Republic of China and the Government of the Republic of Korea for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (8 July 2014), Treaties IBFD [hereinafter H.K.-S. Kor. Income Tax Agreement (2014)], prevail over the corresponding domestic provisions, such as article 94 of the CTL, and the Austrl.-S. Kor. Income Tax Treaty (1982) and the H.K.-S. Kor. Income Tax Agreement (2014) do not contain any provision similar to provisions of article 94(2). The second view is that article 94(2) of the CTL applies regardless of the actual language of a tax treaty, as article 94 is the Korean way of interpretation on para. 6 of OECD Model. Commentary on Article 5 (2017). Detailed discussion on this second viewpoint is contained in section 2.2.3. Guidance is also included in the OECD Model. Commentary on Article 5 (2017).

8. This and all subsequent translations of Korean into English are the author's unofficial translations.

9. The S. Kor-U.S. Income Tax Treaty (1976) has not been revised despite several rounds of negotiations between the competent authorities since 1999.
Paragraph 15 of the Commentary on Article 5 of the OECD Model (2017) also states that a “place of business” may exist where, for example, an employee of a company, for a long period of time, uses an office in the headquarters of another company. In this example, the employee carries on:

activities related to the business of the former company and the office that is at his disposal at the headquarters of the other company will constitute a permanent establishment of his employer, provided that the office is at his disposal for a sufficiently long period of time so as to constitute a “fixed place of business.”

In addition, the Commentary on Article 5 of the OECD Model (2017) provides that the place of business may exist where no premises are available or required for carrying on the business of the enterprise and the enterprise simply has a certain amount of space at its disposal. It is immaterial whether the premises, facilities or installations are owned or rented by or are otherwise at the disposal of the enterprise. The mere fact that an enterprise has a certain amount of space at its disposal which is used for business activities is sufficient to constitute a place of business. Whether a location may be considered to be at the disposal of an enterprise in such a way that it may constitute a “place of business through which the business of [that] enterprise is wholly or partly carried on” will depend on that enterprise having the effective power to use that location as well as the extent of the presence of the enterprise at that location and the activities that it performs there. This will also be the case where an enterprise is allowed to use a specific location that belongs to another enterprise or that is used by a number of enterprises, and performs its business activities at that location on a continuous basis during an extended period. Where an enterprise does not have a right to be present at a location and, in fact, does not use that location itself, that location is clearly not at the disposal of the enterprise.

Further, the Commentary on Article 5 of the OECD Model (2017) provides the following guidance on the issue of “permanency”, especially in cases where the business activities conducted are of a temporary nature:

Since the place of business must be fixed, it also follows that a permanent establishment can be deemed to exist only if the place of business has a certain degree of permanency, i.e. if it is not of a purely temporary nature. A place of business may, however, constitute a permanent establishment even though it exists, in practice, only for a very short period of time because the nature of the business is such that it will only be carried on for that short period of time. It is sometimes difficult to determine whether this is the case. Whilst the practices followed by member countries have not been consistent in so far as time requirements are concerned, experience has shown that permanent establishments normally have not been considered to exist in situations where a business had been carried on in a country through a place of business that was maintained for less than six months (conversely, practice shows that there were many cases where a permanent establishment has been considered to exist where the place of business was maintained for a period longer than six months). One exception has been where the activities were of a recurrent nature: in such cases, each period of time during which the place is used needs to be considered in combination with the number of times during which that place is used (which may extend over a number of years). Another exception has been made where activities constituted a business that was carried on exclusively in that country; in this situation, the business may have a short duration because of its nature but since it is wholly carried on in that country, its connection with that country is stronger. For ease of administration, countries may want to consider these practices when they address disagreements as to whether a particular place of business that exists only for a short period of time constitutes a permanent establishment.

With regard to this issue, the Korean tax authorities often take a view that article 94(2)5 of the CTI is a particular rule regarding FPOB PEs, which specifically refers to a 6-month period as a certain degree of permanency based on paragraph 28 of the Commentary on Article 5 of the OECD Model (2017) (see the foregoing quotation), where services are provided by employees of a foreign entity in a specific place in Korea.

In the context of e-commerce, a PE may be considered to exist where the automated equipment is situated. A distinction must be made between computer equipment, which may be set up at a location so as to constitute a PE under certain circumstances and the data and software that is used by, or stored on, that equipment, and which should not constitute a PE. For instance, an Internet website, which is a combination of software and electronic data, does not in and of itself constitute tangible property. It, therefore, does not have a location that can constitute a “place of business”, as there is no “facility such as premises or, in certain instances, machinery or equipment” as far as the software and data constituting that website is concerned. On the other hand, the server on which the website is stored and through which it is accessible is a piece of equipment that does have a physical location, and such a location may, therefore, constitute a “fixed place of business” of the enterprise that operates that server.

In addition, the distinction between a website and the server on which the website is stored and used is important, as the enterprise that operates the server may be different from the enterprise that carries on business through the website. For example, it is common for the website through which an enterprise carries on its business to be hosted on the server of an Internet Service Provider (ISP). Although the fees paid to the ISP under such arrangements may be based on the amount of disk space used to store the software and data required by the website, these contacts typically do not result in the server and

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11. Id. at para. 15.
12. Id. at para. 10.
13. Id. at para. 11.
14. Id. at para. 12.
15. Id. at para. 28.
16. Id. at para. 123.
its location being at the disposal of the enterprise, even if the enterprise has been able to determine that its website should be hosted on a particular server at a particular location. In such a case, the enterprise does not even have a physical presence at that location since the website is not tangible. In these cases, the enterprise cannot be considered to have acquired a place of business by virtue of that hosting arrangement. However, if the enterprise carrying on business through a website has the server at its own disposal, for example it owns (or leases) and operates the server on which the website is stored and used, the place where that server is located could constitute a permanent establishment of the enterprise if the other requirements are met.\footnote{Id., at para. 124.}

Further, no PE may be considered to exist where the e-commerce operations carried on through computer equipment at a given location in a country are restricted to the preparatory or auxiliary activities. Examples of activities that generally will be regarded as preparatory or auxiliary include:

(a) Providing a communications link – much like a telephone line – between suppliers and customers;
(b) Advertising of goods and services;
(c) Relaying information through a mirror server for security and efficiency purposes;
(d) Gathering market data for the enterprise; or
(e) Supplying information.\footnote{Id., at para. 128.}

However, these exceptions do not apply if the aforementioned functions form an essential part of the business activity of the enterprise as a whole or where other core functions of the enterprise are carried on through the computer equipment.

2.3. Tests for construction PEs

Article 94(2)(4) of the CTL provides the following as one example of constituting PE:

Places used for building, construction and assembly sites, foundation construction sites, or places used for management and direction of such sites continuously for more than 6 months...

This provision is quite similar to article 5(3)(a) of the UN Model, which reads as follows:

3. The term “permanent establishment” also encompasses:
   (a) A building site, a construction, assembly or installation project or supervisory activities in connection therewith, but only if such site, project or activities last more than six months.

However, article 5(3) of the OECD Model has the following provision:

A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.

As the Commentary on Article 5 of the OECD Model (2017) includes the following paragraph, it can be stated that Korea’s treaty policy with regard to construction PEs is to use the language of the UN Model in its treaty negotiations:

Korea reserves its position so as to be able to tax an enterprise which carries on supervisory activities for more than six months in connection with a building site or construction or installation project lasting more than six months.\footnote{UN Model Double Taxation Convention between Developed and Developing Countries: Commentary on Article 5 para. 203 (1 Jan. 2011), Models IBFD.}

2.4. Tests for DAPEs

2.4.1. Provisions in the CTL

The Korean domestic provisions regarding DAPEs are contained in article 94(3) of the CTL and article 133 of Presidential Decree of the CTL.\footnote{KR. Presidential Decree of the CTL.}

Article 94(3) of the CTL reads as follows:

Where a foreign corporation without any fixed place under the provisions of paragraph (1) runs the business in Korea through a person who has the authority to repeatedly conclude contracts on its behalf or a similar person as prescribed by the Presidential Decree, the location of that person’s place of business (where he does not have any place of business, it shall be his address, and where he does not have any address, it shall be the location of his residence) shall be deemed the domestic place of business of the foreign corporation.

Under article 133 of Presidential Decree of the CTL, there is a PE in Korea if any of the following conditions are satisfied:

1. Where a foreign enterprise has a person [i.e., agent] in Korea with the authority to conclude contracts on the foreign enterprise’s behalf and habitually exercises such contract concluding authority;
2. Where a person regularly keeps custody of and primarily distributes or delivers the assets of a foreign enterprise; or
3. Where a person performs important business functions, such as concluding contracts for particular foreign enterprises as an intermediary, general consignee salesperson, or other independent representative (including where such activities are performed in the normal course of the person’s business).

It can be generally said that the scope of DAPEs as defined in the CTL is much wider than in the OECD Model.

2.4.2. Provisions in important tax treaties

Provisions in respect of DAPEs included in most of the tax treaties that Korea has concluded with OECD member countries, and that have been revised following Korea becoming an OECD member country in 1996, broadly follow those included in the OECD Model (2014).\footnote{OECD Model Tax Convention on Income and on Capital Art. 9(3) (10 May 2014), Models IBFD.} while those included in the tax treaties concluded with states...
other than OECD member countries vary between tax treaties. Some old tax treaties even have provisions that are included in neither the OECD Model nor the UN Model.

For instance, a DAPE exists if a US enterprise has a person acting on its behalf, i.e. an agent, in Korea that has the authority to conclude contracts in the name of the US enterprise and the person regularly exercises such authority, unless the exercise of the authority is limited to the purchase of goods or merchandise for the account of the US enterprise. A US enterprise is also treated as having a PE if it maintains in Korea a stock of goods or merchandise belonging to that enterprise from which it regularly fills orders or makes deliveries. For this purpose, the term “goods” is interpreted as meaning tangible goods. In addition, under article 9(5) of the Korea-United States Income Tax Treaty (1976), if a US enterprise has a fixed place of business in Korea and its goods or merchandise are either: (i) subjected to processing in Korea by another person, regardless of whether they are purchased in Korea, or (ii) though purchased in Korea, the goods or merchandise are not subjected to processing outside Korea, such a US enterprise is considered to have a PE in Korea if all or part of the goods or merchandise are sold by or on behalf of the US enterprise for use, consumption or disposal in Korea.

As can be seen from the foregoing, the provisions relating to DAPEs under domestic law apply a wider standard in determining whether such a PE exists. Based on the technical wording of article 9(4) of the Korea-United States Income Tax Treaty (1976) and article 94(3) of the CTIL, a PE in Korea can be avoided if the Korea-based person does not have the authority to conclude contracts in the name of the non-resident enterprise. According to the Commentary on Article 5 of the OECD Model (2014), the phrase “authority to conclude contracts in the name of the enterprise” can also apply to a person who concludes contracts that are binding on the enterprise, even if the contracts are not in the name of the enterprise. The lack of the active involvement by an enterprise in transactions may be indicative of a grant of authority to an agent. In this context, it should be noted that the term “contract concluding” has been broadly interpreted in Korea to include active solicitation, negotiation, and signing of contracts. For instance, if a Korean agent did much of the work and the off-shore foreign entity was just a mere signatory, a Korean PE may exist. In this sense, it can be said that the current tax practice in Korea is conducted as if Korea had already adopted the language of article 5(5) of the OECD Model (2017) as quoted below:

Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person is acting in a Contracting State on behalf of an enterprise and, in doing so, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, these contracts are:

a) in the name of the enterprise, or

b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or

c) for the provision of services by that enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business (other than a fixed place of business to which paragraph 4.1 would apply), would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

An exception to the finding of a PE is provided under most tax treaties and the domestic laws in respect of an “independent” agent acting in the ordinary course of its business. For an agent to be “independent”, the agent must be legally and economically independent. An agent can be considered to be dependent where the agent is subject to control from the foreign enterprise with regard to the manner in which the agent carries out the work for the foreign enterprise. For instance, if the agent is subject to detailed instructions from the foreign enterprise in the conduct of the agent’s work, this indicates a lack of independence. With regard to economic independence, the agent should have the freedom and the ability to use its own discretion in carrying out its responsibilities to the foreign enterprise. In this regard, the reliance by the foreign enterprise on the agent’s special skill and knowledge in carrying out its duties is an indication of independence.

2.5. Tests for service PEs

2.5.1. Service PE provisions in some tax treaties

The China-Korea Income Tax Treaty (1994),23 the India-Korea Income Tax Treaty (2015)24 and some other tax treaties concluded with non-OECD countries have a service PE provision adopted from article 5(3)(b) of the UN Model, which reads as follows:

3. The term “permanent establishment” also encompasses:

   b) The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than 183 days in any 12-month period commencing or ending in the fiscal year concerned.

The service PE provision has a unique feature in that only the provision of services by employees or other personnel for more than 183 days constitutes a PE, regardless of whether there is a fixed place of business in the country in which the services are provided.

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2.5.2. **Service PE provisions in the CTL**

There are no provisions in the CTL or the related Enforcement Decrees that exactly match with those in the UN Model cited in section 2.5.1. However, a similar provision can be found in article 94(2)5 of the CTL (see section 2.2.1. on FPOB PEs):

Places falling under any of the following items where services are provided by employees:

(a) Place where services are provided for not less than 6 months in total during a period of 12 months in which such services continue to be provided, and
(b) Place where services are provided for not more than 6 months in total during a period of 12 months in which such services continue to be provided, and similar services are repeatedly provided for not less than 2 years.

Tax officials who believe that this is a kind of service PE provision in the CTL have generally held a view that the common factors of these two provisions are effective in assessing the risk of a PE in respect of Chinese or Indian companies conducting businesses in Korea. Consequently, they take the view that the furnishing of services, including consultancy services, by a Chinese or an Indian enterprise through its employees engaged by the enterprise for such purpose constitutes a service PE, but only if the activities of that nature continue, on the same or a connected project, in a given place in Korea for a period or periods aggregating more than 183 days in any 12-month period commencing or ending in the relevant fiscal year.

3. **Tax Rulings Regarding PEs**

3.1. **Introductory remarks**

Sections 3.2. to 3.4. provide details of some important tax rulings, especially regarding e-commerce or provision in respect of digital products or services issued by Ministry of Strategy and Finance or the National Tax Service (NTS) to date.

3.2. **Soemyun 2 team-177 (26 January 2005)**

This case involved a foreign company that performed certain activities in Korea, i.e. it ran a product sales business online. The activities in Korea were confined to advertising for potential customers. The Korean tax authorities ruled that such activities did not constitute a Korean PE under article 94 of the CTL. The tax authorities noted that, if main or essential functions relating to the sale of products, including the conclusion of contracts with customers, the collection of payments or the delivery of a product were located on a server of an ISP and were performed continuously and repeatedly through that server, the place where the server was situated constituted a PE in respect of the foreign company under article 94(1) to (3) of the CTL.

3.3. **International Tax Resource Management Office-278 (7 August 2013)**

A domestic company K established a wholly-owned subsidiary PE in the United Kingdom and company E planned to carry on its business of online wine sales through servers owned by a company KS, which was a domestic affiliate of company K. The website for company E's online wine sales were to be hosted on a domestic server owned by the affiliated company KS, and company E's website address would be used. The information stored on the server would include purchase orders relating to the online sales business and the duration of such storage was to last to the end of the business, and not up to a specific point of time. In this case, if the main and essential function of a foreign company carrying on sales business of its product through the Internet is hosted on a server in Korea and such a function is performed continuously and repeatedly, the place in which the server was situated constituted a PE in Korea.

3.4. **Soemyun 2 team-1390 (29 August 2005)**

Where a Japanese corporation, which sold equipment to Korean manufacturers, installed a warehouse in Korea for purposes of storage of parts for use in after-sales services, regularly stored a certain amount of parts in the warehouse, and supplied the same for and/or without consideration, the warehouse constituted a PE as prescribed under article 5 of the Japan-Korea Income Tax Treaty (1998).

4. **Case Law Regarding PEs**

4.1. **Introductory remarks**

Sections 4.2. to 4.5. consider some landmark court cases that are frequently used when there are disputes involving PEs.

4.2. **Bloomberg**

Bloomberg provides important guidance on the determination of a PE in the context of internet-based information services. In Bloomberg, the Supreme Court of Korea (SCK) suggested the following three elements as determinants of an FPOB PE: (1) that a foreign enterprise has a fixed place of business with a certain degree of permanence; (2) that a foreign enterprise has the right to dispose of or use such a place, i.e. substantive control over or right to use the place; and (3) a that the foreign enterprise's employee or a person under the direction of the enterprise carries out "essential and important" business activities that are not preliminary or auxiliary through the place of business. The SCK stated that whether business activities are "essential and important" should be determined by holistically considering the nature and size of the business activities as well as their magnitude for the business.

Bloomberg's business activities included: (1) the processing in respect of the US headquarters and an analysis of the information collected from intelligence-gathering agents worldwide on several subjects, for example,

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financial information; (2) confirmation of the accuracy of such information provided by the headquarters; and (3) the entering of the information into the main computers, located in the United States, which was then transferred to clients through node equipment and a Bloomberg receiver, etc. on the sale of the information.

Under the premise that the most fundamental parts of this business were the collection of information, the processing and/or analysis of such information, which maximized the value of the information, and the subsequent sale of the information, the SCK concluded that the activities performed in Korea could not be regarded as an essential and important part of the entire business activities of Bloomberg, which was a US corporation. In order to be able to reach this conclusion, the SCK relied on the facts that the node equipment installed in Korea merely transferred the information that had been processed and/or analysed by US computers to clients and that the main function of Bloomberg’s receiver in question was to transfer the information. Consequently, the SCK held that a PE did not exist in Korea by virtue of the location of the node equipment and Bloomberg’s receiver.

Contrary to the SCK’s position, the NTS argued that the node equipment not only transferred information to clients, but also carried out the essential and important part of its business activities of the US corporation. This was based on the following reasoning: (1) the equipment permitted the transfer of the information collected by the Korean subsidiary to the US headquarters; (2) it enabled the clients in Korea to manage the information; and (3) it made transactions with clients possible. However, the SCK ruled that: (1) even if the information collected by the Korean subsidiary was transferred to the US headquarters via the node equipment in question, there was no evidence that there was an additional function of the node equipment that was essential to the information-gathering activity of the US corporation in addition to its function as a way of transferring information; and (2) there was no evidence that the node equipment at issue has a special function that enabled clients in Korea to manage the information and that the node equipment made transactions between Bloomberg and clients possible. As a result, the SCK determined that the defendant’s arguments could not be accepted.

With regard to marketing support activities, the US corporation’s employees stationed at the Hong Kong branch, which was in charge of Korea, visited Korea to advertise and promote services offered by the US headquarters at the offices of clients and informed the clients of the terms of agreement, such as the information usage fee. The employees also conducted educational training on how to use equipment, etc. for clients at the Korean affiliate’s office. Although the NTS argued that such activities constituted an essential and important part of the business of the headquarters, the SCK disagreed. The SCK concluded that, as such activities could not be considered to be essential and important business activities of the US corporation, it could not be said that a Korean PE of the US corporation existed at the Korean subsidiary’s office. Consequently, the SCK held that the tax assessment based on the existence of a PE and issued by the NTS did not accord with the Korea-United States Income Tax Treaty (1976).

4.3. Magilink

In Magilink, the SCK confirmed the three elements in Bloomberg as determinants of an FPOB PE in Korea (see section 4.2). With regard to DAPEs, the SCK held that, in order to be able to treat a foreign corporation, in this case, a Singapore corporation, as having a DAPE in Korea, the dependent agent would have to habitually exercise a contract-concluding authority and such authority would have to go beyond preparatory and auxiliary elements and should be an essential and important part of the foreign corporation’s business activities. The SCK stated that whether the agent’s activities were “essential and important” should be determined by holistically considering the nature and size of the business activities as well as their magnitude and role.

Magilink Pte. Ltd. (“Magilink”), a Singapore company, acquired bonds issued by a Korean company from a Hong Kong branch of Credit Suisse. Magilink engaged in negotiations regarding the terms for the bonds in Hong Kong and paid for the acquisition of the bonds via a foreign financial institution. Decision-making related to the investment in the bonds took place in both Korea and abroad. Accounting materials related to the bonds were kept in Korea, while all other accounting materials were stored in Singapore. Magilink delegated two Korean companies with the authority to recover bonds in Korea. The two companies performed work relating to the recovery of the bonds. One of Magilink’s directors reported on the recovery and worked on public disclosure.

The SCK concluded that, even if two Korean companies recovered the bonds and one of Magilink’s directors reported on the recovery and worked on public disclosure, these activities constituted simple work that was mechanical and repetitive. The SCK, therefore, held that these activities should not be viewed as Magilink’s essential and important business activities relating to its investments in bonds. Consequently, the SCK held that the NTS’s DAPE tax assessment did not accord with the Korea-Singapore Income Tax Treaty (1979).

4.4. The Holiday case

Under the junket agreement, Holiday was required to provide various services to the customers for gaming at a casino in Korea. The amount of commission to be received by Holiday was directly linked to the amount of revenue generated at the casino, and there was a minimum revenue

28. Convention between the Republic of Singapore and the Republic of Korea for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (6 Nov. 1979) (as amended through 2010), Treaties IBFD.
requirement. Holiday’s employees at the Korea office provided various services to the customers, which were directly necessary for Holiday’s business. The exchange of money for chips accounted for a meaningful part of Holiday’s business activities.

The SCK maintained the legal principles in Bloomberg and found that a PE existed under the specific facts presented in the Holiday case. In this context, the SCK considered the following points to be important in making its decision:

- gaming at the casino was not possible without the exchange of money for chips and this activity was undertaken by the Korea office;
- the Korea office constantly checked casino revenue and confirmed the amount of commission; and
- the costs of complimentary services, i.e. travel, accommodation, meals, etc., were assumed by Holiday and this indicated that the provision of services to customers was an important element in Holiday’s business.

4.5. The Private Equity Fund case

In the Private Equity Fund (PEF) case, the issue was whether Korean subsidiaries providing services to an offshore private equity fund (PEF) constituted an FPOB PE or a DAPE. With regard to an FPOB PE, the SCK reiterated the three elements for an FPOB PE stated in Bloomberg. Consequently, the SCK did not find that the Korean subsidiaries constituted an FPOB PE of the offshore FPOB based on the following facts: (1) in the PEF’s process of profit generation, the major decisions relating to the raising of funds from the investors, deciding on the investments in shares of Korean targets and recovering the investment funds by selling the assets all took place in the United States through a Bermudan limited partnership (the “GP”); (2) although the three executives of the Korean subsidiaries (one of which was an executive of the GP) X, Y, and Z significantly intervened in PEF’s process of acquiring insolvent companies and intervening in their management to generate profits, it appeared that their roles were undertaken in their capacities as a representative director or an executive in the two Korean subsidiaries, both of which were corporations legally separate from the GP and, even if the subsidiaries had a close relationship with PEF and PEF’s chairman controlled them in substance, it was difficult to deny that, based on such circumstances alone, the Korean subsidiaries were entities with substance that had corporate personalities separate from PEF; (3) the executives X, Y, and Z were involved in the management of a Korean target and even manipulated the share price to reduce the costs of merging with another Korean company, but it was difficult to conclude that they intervened in the management of these targets in their capacity as agents or limited partners of PEF, based on such circumstances alone and, furthermore, they did not participate in the process of selling the shares of the Korean targets; and (4) in light of the activities and purpose of establishment of the Korean subsidiaries, participation in the process of acquisition and management of the Korean targets by the executives X, Y and Z could be regarded as ex-ante, preparatory activities for the GP to make investment decisions or auxiliary activities to assist in managing the assets and determining the time of their disposition. Based on the foregoing, the SCK indicated that the mere exercise of control over a Korean subsidiary by its foreign parent should not result in a finding of satisfaction of element (2) for purposes of the FPOB PE analysis.

In connection with the DAPE, the SCK stated that, in order to find that a foreign corporation has a DAPE in Korea: (1) the agent had to habitually exercise the authority to conclude contracts in the name of the foreign corporation in Korea; and (2) such authority could not be auxiliary and preparatory in nature but had to be essential and important for business activities. The SCK also concluded that the Korean subsidiaries did not constitute a DAPE of the offshore PEF. Even if one of the executives X was PEF’s manager in Korea and the three executives X, Y and Z were delegated the authority to negotiate and sign agreements by PEF during the acquisition process of Korean targets and exercised such authority, such an activity appeared to have been conducted in their capacity as a representative director or executive of the Korean subsidiaries, which were legally separate from the GP and had entered into service agreements with the GP, etc. In addition, there was no other evidence substantiating that the executives had the authority to conclude agreements on behalf of the PEF in Korea as agents and that they exercised such authority repeatedly.

In brief, the SCK held the Korean subsidiaries, which provided various services of an offshore nature to PEF, to be a separate legal entity. This was despite the facts that: (1) the offshore PEF, or GP, controlled the subsidiaries in substance; and (2) the three executives regularly reported
their business activities to the offshore PEF or GP. The SCK, therefore, concluded that the Korean subsidiaries did not constitute either an FPOB PE or a DAPE.

5. VAT Issue Relating to PEs

Under the Value Added Tax Law (VATL),31 where a (1) “business person” having a (2) “place of business” (3) supplies goods and/or services in Korea, a liability to pay VAT arises. In order to impose VAT, all three of these requirements must be met. Consequently, a foreign company with a PE should bear all of the obligations under the VATL as a Korean VAT-able business. These obligations include the business registration of a PE, the issuing of a VAT invoice and the collection of VAT, and the obligation to pay VAT with regard to the PE in respect of each taxable period. Under article 8(6) of Presidential Decree of the VATL,32 where a PE is created under the CTL, the entity in question is also deemed to have a VAT PE and the PE must register its place of business for VAT purposes, issue VAT invoices and pay VAT as well as corporate income taxes.

In the event that a PE, which was not voluntarily registered by a foreign company as a VAT trader in Korea, is recognized as a VAT trader by tax authorities in the process of a tax audit, the business profits attributable to that PE are first imposed on the foreign enterprise under corporate income tax law. Further, in such a situation, VAT registration is usually made by the tax auditor based on their own discretion and VAT equal to 10% of the sales amount incurred by that PE as well as related penalties, i.e. 2% in respect of the failure to report penalty and interest of 10.95% a year is also imposed. In addition, in most cases, input VAT credits are not allowed, i.e. the VAT paid by the PE when it purchased goods or services from outside vendors does not qualify as deductible from the output VAT to be paid by the PE because the PE had not filed its VAT return in due course,33 as it purchased goods or services from outside vendors.

According to the VATL and its various Enforcement Decrees, it is not clear whether a DAPE should be treated as a place of business for the purpose of VAT, as the VATL does not have a provision that specifically excludes DAPEs from the scope of the place of business for VAT purposes. Consequently, tax auditors often register a DAPE, once it is recognized, for VAT purposes and impose VAT plus penalties without allowing an input VAT credit as is the case for an FPOB PE. As a result, this issue is considered to be one of the greatest PE risks for foreign companies providing goods or services to Korean consumers without establishing or registering a PE in Korea.

6. Effect of the OECD/G20 Base Erosion and Profit Shifting Initiative on PE issues in Korea

6.1. Introductory remarks

Korea did not adopt the recommendations included in the OECD/G20 Base Erosion and Profit Shifting (BEPS) initiative set out in Action 7, “Report on Permanent Establishment”,34 when it signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI)35 in June 2017. This was not because Korea’s position on PE issues was contrary to those recommendations, but rather because Korea only wishes to apply the minimum standards in the various Action Plans until the MLI comes into effect and proves itself to be an effective tool in superseding the relevant provisions of the existing bilateral tax treaties.

6.2. Korea’s expected adoption of the revised OECD Model (2017) in its domestic rules

6.2.1. FPOB PEs

With regard to whether Korea will modify its domestic PE rules to reflect the revised article 5(4) and (4)(1) of the OECD Model (2017), Korean lawmakers are likely to include these or similar provisions in the CTL sometime in the near future. This is because, by introducing such provisions into the CTL, the Korean tax authorities may circumvent possible legal disputes that could arise when Korea includes the same or similar provisions to article 5(4) and (4)(1) of the OECD Model (2017) in the tax treaties that it concludes with any foreign state sometime in the future. In other words, as the current scope of Korean rules in the CTL is narrower than that envisioned in article 5(4) and (4)(1) of the OECD Model (2017), Korean lawmakers are likely to amend the relevant domestic rules to prevent disputes arising regarding the application of treaty provisions.

6.2.2. DAPEs

Traditionally, the Korean tax authorities have adopted a very aggressive stance on PE issues. As such, in a sense, the Korean tax authorities have already implemented the content included in the modified version of article 5(5) of the OECD Model (2017) by way of their tax rulings. For instance, Basic Ruling 94-133…2 KGI36 of the CTL prescribes that:

the right to conclude contracts refers to the agent’s right to consult and negotiate the material elements of contracts that bind the foreign company [and that] if the agent has the right to conclude contracts, even if the foreign company or a third party residing in the residence country of the foreign company actually signs or seals the contract, it is considered that the agent has exercised its right to conclude the contract in Korea.

32. KR: Presidential Decree of the VATL.
33. Unser article 39 of the VATL, a VAT trader should submit to the relevant district tax offices all of the legitimate VAT invoices received from outside vendors to be able to claim the input VAT paid by that trader.
34. See, for example, OECD, Action 7 Final Report 2015 - Preventing the Artificial Avoidance of Permanent Establishment Status (OECD 2017), International Organizations’ Documentation IBFD.
35. Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (7 June 2017), Treaties IBFD.
This position stated in the Basic Ruling of the CTL appears to be in line with the modified principle of “habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise” that is included in revised article 5(5) of the OECD Model (2017).

In addition, according to the rulings issued by the NTS, the author is of the opinion that the scope of DAPEs as assumed by the Korean tax authorities is similar to that in the OECD Model (2017). For instance, there is a tax ruling, which held that, where a Korean branch of a foreign corporation (B), being an associated enterprise of another foreign corporation (A), has the substantive authority to conclude contracts for the sale of corporation A’s products and habitually exercise that authority, the branch of corporation B constitutes a dependent agent PE of A. Another tax ruling held that where a UK corporation, with a worldwide database relating to financial and economic information, develops and maintains clients in Korea through a Korean corporation, which concludes contracts with Korean clients for the provision of information services, and receives consideration for the use of information, the UK corporation is deemed to have a PE in Korea and, therefore, the PE should file a tax return in Korea.

As a result of the foregoing, it is unlikely the Korean government will revise Korean domestic law to reflect the modified version of article 5(5) of the OECD Model (2017) in the near future. This is because Korean tax rulings, i.e. the formal interpretation of the tax authorities on Korean tax law or tax treaties, sufficiently reflect the purpose of the revised provisions in the OECD Model (2017).

On a separate issue, with regard to whether the Korean legislature will adopt the independent agent exception as set out in the revised article 5(6) of the OECD Model (2017), the current independent agent exception under the CTL does not limit its application to agents that are related parties to the enterprise, i.e. the current exception under domestic rules is less stringent than that under the revised article 5(6) of the OECD Model (2017). Consequently, the Korean government will most likely amend domestic law so that the exception is consistent with the amended version of article 5(6) of the OECD Model (2017).

6.3. Potential effect of Korea’s adoption of the revised OECD Model (2017) in Korean tax treaties and case law

A number of existing Korean tax treaties may be modified as a consequence of Korea’s signing of the MLI. On a related issue, the modifications made to the tax treaties may also influence the court decision if a case similar to Bloomberg (see section 4.2.) were to be considered again by the SCK. The main issue in Bloomberg was whether the plaintiff’s business activities were “preparatory or auxiliary” or “essential and important”. With regard to this issue, one of the arguments advanced made by the tax authorities, as stated by the first-level court decision in Bloomberg, was that, even if the node equipment and receiver or each individual business activity conducted at a third party (“A”)’s office did not form an essential and important part of Bloomberg US business, if all of the activities undertaken at such a physical facility were combined, these activities would form an essential and important part of Bloomberg’s business. Consequently, the Korean PE of Bloomberg US existed where the node equipment, etc. was located.

In this context, the Seoul High Court (SHC) in Bloomberg has held as follows with regard to this argument:

Although Article 5(4)(f) of the OECD Model Tax Convention prescribes that where the overall activity of the fixed place of business resulting from the combination of preparatory or auxiliary activities is not of a preparatory or auxiliary character, a PE can be deemed to exist, Article 9(3) of the Korea-U.S. Tax Treaty prescribes that “a permanent establishment shall not include a fixed place of business used only for one or more of the following’ and lists activities which do not constitute a PE. The above provision of the Korea-U.S. Tax Treaty is interpreted that even if several preparatory or auxiliary activities are combined, the overall activity resulting from such combination still does not constitute a PE. Therefore, as seen in the foregoing, as long as each individual business activity in this case, such as transferring information through the node equipment and receiver and educating clients at the A’s office, is considered as the activity having a preparatory or auxiliary character, the existence of a PE of BLP cannot be determined based on the combination of these activities. This decision of the SHC implies that the overall activity of Bloomberg US resulting from the combination of the activities of its subsidiaries and branches could have gone beyond preparatory or auxiliary activities. Nevertheless, regardless of this point, the SHC determined that, based on the current language in the Korea-United States Income Tax Treaty (1976), Bloomberg US did not have a PE in Korea.

However, according to the recommendation on the amendment to article 5(4) of the OECD Model (2017), the wording of this article has been strengthened, such that each activity listed under the article would not be automatically excluded from activities constituting a PE, but would, rather, be excluded only when such an activity satisfies a separate test as to whether the activity has a preparatory or auxiliary character. In addition, no PE would exist only when the overall activity of the fixed place of business is of a preparatory or auxiliary character. Assuming a case similar to Bloomberg were again to arise in relation to a company of which resident state had revised its tax treaty with Korea such that the current wording of article 5(4) had been replaced by the revised wording in the OECD Model (2017), a new decision of a court could differ from the precedent set in Bloomberg.

7. Conclusions

The aggressive approach adopted by the Korean tax authorities with regard to the issue of PEs is well known in the international tax community. Given the severe criticism

raised by other OECD member countries before Korea’s accession to OECD membership in 1996, the Korean tax authorities have changed their primary approach in assessing foreign companies from the perspective of a PE to transfer pricing after Korea had joined the OECD. However, the aggressive interpretation of the Korean tax authorities on various PE issues has remained the same, even though tax audits based upon PE issues did not occur frequently until the advent of the OECD/G20 BEPS initiative. Encouraged by Action 7 on PEs, the Korean tax authorities now frequently challenge foreign subsidiaries based on various PE concepts, including FPOB PEs, DAPEs and service PEs. The Korean tax authorities also appear to have become increasingly assured that Korea’s traditional aggressive interpretation of PE provisions in the OECD Model is broadly in line with the purpose of revised provisions on article 5 of the OECD Model (2017). Consequently, the various PE issues discussed in this article will become more important than before for foreign multinational enterprises that wish to expand their businesses in Korea.