Time For A Change: Toward A New Korea-U.S. Income Tax Treaty - Tax

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The United States has 66 bilateral income tax treaties in place. Under these treaties, residents (not necessarily citizens) of foreign countries are generally taxed at a reduced rate or are exempt from U.S. tax on some items of income they receive from sources within the United States. Similarly, residents (or, sometimes, nonresident citizens) of the United States are generally taxed by the treaty partner country at a reduced rate or are exempt on some items of income they receive from sources within the foreign countries.

The current income tax treaty between the United States and the Republic of Korea was signed on June 4, 1976, and entered into force on October 20, 1979. This treaty reflects the economic climates of the two countries at the time of treaty negotiations in the 1970s. Korea was at an early stage of economic development and relied heavily on foreign technology and investment to propel its growth. Like other treaties negotiated by Korea around that time, the U.S. treaty was designed to encourage an infusion of foreign capital into Korea amid its process of economic growth.

Much has changed since the 1970s. Korea has dramatically transformed its economic condition from a nation reliant on foreign resources to a recognized force in the advancement of modern technology and international commerce.[1] The focus of Korean businesses is no longer saturation of local markets, but global expansion. Several Korean companies, including Hanwha, Samsung, Doosan, and LG International, have been ranked by Forbes as among the "world's biggest public companies." On the other side of the Pacific, the United States, while remaining a powerful force in the world economy, is keen on attracting foreign investment and proliferating international commerce through mutual exchange of resources. Just as importantly, as a result of changing economies and the global marketplace, the governments of both Korea and the United States have significantly altered their internal and external policies regarding international taxation and international tax agreements.

Despite these changes, the current treaty has yet to be modified, and as a result, it fails to address the current economic requirements of the two countries. This is generally recognized by both Korea and the United States, and there have been continuing discussions regarding possible negotiations for a new treaty. For example, in March 1998 the U.S. Treasury Department announced that negotiations toward a new treaty would begin at the end of 1998. Negotiations were intended to be based on then-U.S. and Korean model treaties, both of which drew heavily from the OECD model treaty. Negotiations never took place in 1998, however, and 11 years later Treasury has once again announced that the United States will be negotiating with Korea for a new tax treaty, in 2009.[2]

In anticipation of those negotiations, this article examines certain provisions of the current treaty and suggests possible amendments based on the 2006 U.S. model treaty and the 2008 OECD model treaty. It also examines additional provisions that might be added to the new treaty to prevent abusive transactions and to encourage mutual exchange of information. The article is not intended to provide a comprehensive analysis of all possible amendments to the current treaty, but rather to encourage Korea and the United States to negotiate, and perhaps to serve as a platform for the initial consideration of amendments.

I. Ability to Tax

The relationship between Korea and the United States is intricate but exceptionally important for both countries. Over time, the countries have developed into major social and economic partners. Since the early 1980s, the number of Koreans living in the United States has grown immensely. Before 1980, there were approximately 248,920 Koreans living in the United States as citizens or residents.[3] By the end of 2007, there were approximately 1.4 million Korean- Americans living in the United States,[4] with an additional 1,028,253 Koreans temporarily residing in the United States as students, employees, tourists, or for other purposes.[5]

International commerce between the countries has also grown substantially. Over the past 10 years, the trading relationship between the United States and Korea has nearly doubled.[6] Exports and imports between the countries amounted to around $48 billion in 1998 with a fairly even trade balance.[7] By 2008, trade conducted between the countries amounted to over $82.8 billion, with the trade balance in favor of Korea.[8] Many large companies in Korea (including various divisions of LG International, Samsung Group, and Hyundai Group) also maintain substantial connections to the United States, generally operating their U.S. businesses through local branches, subsidiaries, or affiliates.

Similarly, many U.S. multinational companies (including General Electric Co., Microsoft, Citigroup, and J.P. Morgan Chase & Co.) maintain extensive operations in Korea through local branches, subsidiaries, or affiliates. In light of the substantial interaction between the United States and Korea, it will be important for the revised treaty to clearly define and limit the taxing rights of the two countries. In particular, the revised treaty might provide more refined definitions of treaty terms, including "corporation" (particularly what constitutes a "head or main office" to qualify as a Korean corporation), "resident," "industrial or commercial activity," "international traffic," and "pension." Also, the revised treaty might consider the following amendments to taxing rights.

A. Capital Gains

Under the current treaty, the source country's ability to tax capital gains is generally limited to gains derived from the sale of real property located in that country. Capital gains from the sale of capital assets other than real property, including stock, can only be taxed by the taxpayer's country of residence, unless the gain can be attributed to a permanent establishment in the source country or the taxpayer maintains a fixed base in the source country or otherwise remains in the source country for a specific period during the tax year. Thus, article 16 of the current treaty provides that a resident of one country will be exempt from tax by the other country on gains from the sale, exchange, or other disposition of capital assets, unless:

- the gain is derived by the resident regarding real property located in the other country (dealt with in article 15);
- the recipient of the gain has a PE in the other country and the property giving rise to the gain is effectively connected with that PE (dealt with in article 8); or
- the recipient of the gain:
    - maintains a fixed base in the other country for a period or periods aggregating 183 days or more during the tax year and the property giving rise to the gain is effectively connected with that fixed base; or
    - is present in the other country for a period or periods aggregating 183 days or more during the tax year.[9]

Since at the time of treaty negotiations Korea was in need of foreign capital, article 16 was likely the result of Korea's willingness to forgo capital gains taxation in exchange for a greater influx of capital. Indeed, under most of Korea's bilateral tax treaties, Korea is barred from collecting capital gains taxes on property other than real property. However, in the current environment of increased mutual investments between the United States and Korea, article 16 can be viewed as overly restrictive regarding the taxing rights of the source country. It could also lead to abusive practices.[10]

Accordingly, article 16 of the current treaty may be altered. Consistent with the OECD model treaty, the revised treaty could provide that gains derived by a resident of a contracting state from the alienation of immovable property situated in the other contracting state may be taxed in that other state.[11] Furthermore, gains from the alienation of movable property forming part of the business property of a PE that an enterprise of a contracting state has in the other contracting state, including gains from the alienation of such a PE (alone or with the whole enterprise), may be taxed in that other state.[12] The revised treaty might further extend the taxing rights of the source country by providing that gains derived by a resident of a contracting state from the alienation of shares deriving more than 50 percent of their value directly or indirectly from immovable (real) property situated in the other contracting state may be taxed in that other state.[13]

B. Attribution of Business Profits

Article 8(1) of the current treaty sets forth the general rule that the industrial or commercial profits of a resident of one country are exempt from tax by the other country unless the resident is engaged in an industrial or commercial activity in the other country through a PE situated therein. In determining the proper attribution of industrial or commercial profits to a PE, article 8(2) provides that both countries will attribute to the PE those profits that would be attributable to it "if it were an independent entity engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the resident of which it is a permanent establishment."[14]

Consistent with the U.S. model treaty and the current trend in U.S. treaty policy, the revised treaty might add that: The business profits to be attributed to the permanent establishment shall include only the profits derived from the assets used, *risks assumed*, and activities performed by the permanent establishment. [15] [Emphasis added.]

As is made clear in the Treasury Department technical explanation to the U.S. model treaty, although U.S. domestic law (specifically Treasury reg. section 1.882-5) does *not* take into account that some assets create more risk for an enterprise than others, the treaty allows a taxpayer "to apply a more flexible approach that takes into account the relative risk of its assets in the various jurisdictions in which it does business."[16]

The revised treaty could apply the principles of the OECD transfer pricing guidelines for purposes of determining the profits attributable to a PE, taking into account the different economic and legal circumstances of a single entity.[17] Any of the methods described therein as acceptable ways of determining an arm'slength result could then be used to determine the income of a PE as long as those methods are applied in accordance with the guidelines. Further, in determining the amount of attributable profits, the PE would be treated as having the same amount of capital that it would need to support its activities if it were a distinct and separate enterprise engaged in the same or similar activities. Similar to the fifth protocol to the Canada- U.S. treaty, the revised treaty might provide that:

In calculating the business profits of a permanent establishment, deductions would not be limited to expenses incurred exclusively for the permanent establishment but would also include expenses incurred for purposes of the enterprise as a whole, regardless of which accounting unit of the enterprise books the expenses.[18]

Finally, the revised treaty might provide greater detail regarding PE profit calculations for financial institutions and insurance companies.

C. Royalties

Article 14(1) of the current treaty provides that the tax imposed by the source country on royalties derived by a resident of the other country generally will not exceed 15 percent of the gross amount thereof, unless the royalty is effectively connected with the taxpayer's PE in the source country.[19] Royalties derived from copyrights, or rights to produce or reproduce any literary, dramatic, musical, or artistic work, as well as royalties received as consideration for the use of, or the right to use, motion picture films, including films and tapes used for radio or television broadcasting, are subject to a 10 percent tax by the source country, unless the royalty is effectively connected with the taxpayer's PE in the source country.[20]

Under the current treaty, royalties are sourced according to the use of the underlying intangible.[21] Although this is generally consistent with U.S. domestic law on sourcing royalties (that is, generally sourced to the location of use of the underlying intangible),[22] it is inconsistent with both the OECD and U.S. model treaties, which extend exclusive taxing rights to the country of residence of the beneficial owner of the royalty.[23] Under Korean law, royalties paid by a Korean resident and royalties paid for the use of intangibles in Korea are generally treated as Korean-source income.[24] However, Korean domestic law on sourcing of royalties cannot override the treaty provision.[25] Accordingly, the Korean government generally must concede taxation of royalties paid by its residents if the underlying intangibles are used in the United States. From a practical perspective, article 16 may not be disadvantageous for Korea, as it is possible that more royalties are paid for use of intangibles in Korea, in which case, under the current treaty, Korea would have the ability to impose tax, even if the royalties were paid by non-Korean residents.

However, consistent with the trend for taxing royalty income, the revised treaty might adopt the rules contained in the OECD and U.S. model treaties and limit the taxation of royalties to the beneficial owner's country of residence.

II. Eligibility for Benefits

Perhaps one of the greatest shortcomings of the current treaty is its failure to clearly limit treaty benefits to genuine residents of the two countries. The current treaty does not contain adequate antiavoidance rules either requiring beneficial ownership or adequately addressing treaty shopping.

A. Limitation on Benefits

The only limitation on benefits provision in the current treaty is article 17,[26] which provides that a corporation resident in one country deriving dividends, interest, royalties, or capital gains from sources within the other country will not be entitled to the benefits of articles 12 (dividends), 13 (interest), 14 (royalties), or 16 (capital gains) if, by reason of special measures, the tax imposed on the corporation by the residence country regarding those dividends, interest, royalties, or capital gains is substantially less than the tax generally imposed by the residence country on corporate profits, and 25 percent or more of the capital of the corporation is held of record or is otherwise determined, after consultation between the competent authorities, to be owned, directly or indirectly, by one or more persons who are not individual residents of the residence country (or, in the case of a Korean corporation, who are citizens of the United States).[27] For purposes of applying this article, direct or indirect ownership is tested at the individual shareholder level.[28]

As explained in the technical explanation, the purpose of article 17 is preventing the potential abuse that can occur if one of the contracting states provides preferential rates of tax for investment or holding companies. The treaty partners feared that, in the absence of this article, third-country residents could organize a shell corporation in one country for the purpose of enjoying preferential rates on investments in the other country. The combination of low tax rates in the first country and reduced rates or exemption in the other country would enable the third-country residents to realize unintended benefits.

Although article 17 attempts to prevent such abuse of the treaty, the article is brief and unsophisticated. It applies only to some types of income (that is, dividends, interest, royalties, and capital gains), and only to corporations. It does not deal at all with the possible stripping of the residence country tax base. Accordingly, article 17 of the current treaty does not adequately address the problem of third-country residents, and the revised treaty might adopt more effective approaches to preventing treaty abuse.

B. Beneficial Ownership

The current treaty provides for reduced rates of withholding by the source country on some items of income, including dividends, interest, and royalties.[29] However, in contrast to the OECD and U.S. model treaties and many other recent treaties, the current treaty does not use the concept of beneficial ownership as a qualification for reduced rates of withholding. For example, article 12(1) of the current treaty affords reduced rates on dividends "derived from sources within one of the Contracting States by a resident of the other Contracting State." By contrast, similar provisions in the OECD and U.S. model treaties limit reduced rates to dividends "beneficially owned by a resident."[30] To curb abusive practices and ensure that benefits are granted to persons who are taxable on the income, the revised treaty might employ the concept of beneficial ownership. This amendment would comport with the general principle that the substance of the transaction, rather than merely its form, should govern the transaction's consequences.

The notion of beneficial ownership is a controversial area, and the United States and Korea might consider the implications of the following recent international tax cases: the Canadian case of *Prévost Car Inc. v. The Queen*,[31] the U.K. case of *Indofood International Finance Ltd. v. JPMorgan Chase Bank N.A., London Branch*,[32] and the French case of *Société Bank of Scotland*.[33]

In *Prévost*, the Canadian Tax Court held that a Dutch holding company (Dutch Holdco) was the beneficial owner of dividends received from its Canadian subsidiary (Canadian Sub) for purposes of the Canada- Netherlands income tax convention.[34] Under the treaty, Canadian Sub had withheld 5 percent tax on dividend payments to Dutch Holdco. Dutch Holdco then distributed the dividends to its shareholders resident in the United Kingdom and Sweden. The Canada Revenue Agency argued that the shareholders of Dutch Holdco who ultimately received the dividends were the beneficial owners of the dividends. However, Canadian courts agreed with the taxpayer that Dutch Holdco was not a mere conduit for the shareholders and, therefore, qualified for benefits under the Canada-Netherlands treaty.

By contrast, in *Indofood*, the U.K. Court of Appeals held in favor of the government and disallowed treaty benefits on a beneficial ownership analysis. Following termination of the Indonesia-Mauritius income tax convention, which reduced source-country taxation of interest to 10 percent, the Indonesian company Indofood proposed bonds issued by its Mauritius subsidiary to be redeemed. The bond holders objected, arguing that a Dutch special purpose vehicle (SPV) might be interposed in the structure to take advantage of reduced withholding under the Indonesia-Netherlands income tax convention (also 10 percent on interest), and noting that redemption was unjustified if "reasonable" measures could be taken to preserve the favorable rate of taxation at source. A U.K. court, interpreting the beneficial ownership and residence provisions of the Indonesia-Netherlands tax treaty, concluded that a Dutch SPV would not be the beneficial owner of interest paid by Indofood. The court explained that beneficial ownership means the full privilege to enjoy the benefit of income. The Dutch SPV would not be the beneficial owner because it would be obligated to pay out interest on the same day it received interest, and it would be precluded from using any other source of funds.

Similarly, in *Société Bank of Scotland*, the French Supreme Court held that the Royal Bank of Scotland, which had acquired dividend coupons under a usufruct agreement with a U.S. company, was not the beneficial owner of dividends distributed by a French subsidiary of the U.S. company. Accordingly, the Royal Bank of Scotland was not entitled to the 15 percent reduced withholding on dividends and other benefits under the France-U.K. income tax convention.

C. Fiscally Transparent Entities

Since the conclusion of the current treaty, the United States has adopted entity classification regulations that, in addition to providing default rules for classification, allow some eligible entities to elect to be treated in a manner different from their legal classification. [35] Provided an entity is not a per se corporation, it can make an election to be treated as disregarded (if there is only one owner) or a partnership (if there is more than a single owner). Accordingly, it is possible (for example) for an entity to be treated as a corporation for Korean tax purposes, but a disregarded entity for U.S. tax purposes. The Korean *chusik hoesa* is treated as a per se corporation and is therefore ineligible to make an election; however, the Korean *yuhan hoesa* is an eligible entity. Korea has also recently adopted new rules regarding the taxation of partnerships, which may prove important for cross-border structures.

The current treaty does not adequately address the taxation of fiscally transparent entities. Continuing with the trend in recent agreements, including the U.S. model treaty, the revised treaty could provide that an item of income derived through an entity that is fiscally transparent under the laws of a contracting state should be viewed as derived by a resident of that state to the extent that the item is treated for purposes of the tax law of that state as the income of a resident.[36]

Also, similar to recent U.S. income tax treaties with Japan and the United Kingdom, the revised treaty might deny treaty benefits to payments in conduit financing arrangements, in which financing is structured to route economic benefits of the applicable treaty to residents of third countries that have less favorable tax rates. The anticonduit rules generally apply to provisions regarding dividends, interest, royalties, and other income.[37] Similar to the U.K.-U.S. treaty, the revised treaty might deny the benefit of reduced rates to a transaction or series of transactions:

(i) which is structured in such a way that a resident of a Contracting State entitled to the benefits of this Convention receives an item of income arising in the other Contracting State but that resident pays, directly or indirectly, all or substantially all of that income (at any time or in any form) to another person who is not a resident of either Contracting State and who, if it received that item of income direct from the other Contracting State, would not be entitled under a convention for the avoidance of double taxation between the state in which that other person is resident and the Contracting State in which the income arises, or otherwise, to benefits with respect to that item of income which are equivalent to, or more favourable than, those available under this Convention to a resident of a Contracting State; and (ii) which has as its main purpose, or one of its main purposes, obtaining such increased benefits as are available under this Convention. [38]

D. Comprehensive Limitation on Benefits

To further address tax avoidance, the revised treaty might contain a comprehensive LOB provision. With increasing global interactions, there has been a proliferation of tax avoidance strategies involving the use of entities in tax-favorable jurisdictions by third-country residents to gain advantages under tax treaties between the United States and those jurisdictions. This practice, referred to as treaty shopping, commonly involves tax havens or low-tax jurisdictions and has become problematic not only for the United States but also for many other nations around the world. Korea experienced this problem firsthand when, in recent years, several U.S. private equity funds avoided paying Korean taxes on enormous profits from selling stock of Korean companies by structuring transactions through companies resident in Labuan, a tax haven in Malaysia. [39] Under a tax agreement between Korea and Malaysia, the country of residence has the sole right to tax profits from stock sales.

To prevent treaty shopping, the United States has insisted on the inclusion of detailed LOB provisions in all of its recent tax treaties. These provisions generally require that an entity seeking treaty benefits must be a resident of the treaty country and also satisfy additional ownership requirements. The requirements are generally designed to limit benefits to entities that have a solid nexus with the alleged country of residence. Under the LOB provision, a foreign corporation may not be entitled to a reduced rate of tax at source unless a minimum percentage of its owners are residents of the residence country. Moreover, LOB provisions generally limit treaty benefits to entities that do not erode their residence country tax base through deductible payments to third-country persons. Recently, LOB provisions have become increasingly complex and detailed, and in some cases quite restrictive, although there is some flexibility afforded to public companies and a recognition of derivative benefits (benefits granted when the treaty partner resident is owned by investors from countries that have their own equally favorable treaties with the United States).

As a result of U.S. insistence, recent U.S. tax treaties all contain a comprehensive LOB provision, and many old treaties have been renegotiated. The current treaty is one of the few remaining U.S. treaties from any period without any such provision. The United States and Korea should mutually agree to align their agreement with contemporary international tax policy on the prevention of treaty abuse.

Similar to the LOB provision of the U.S. model treaty and recent treaties with other major trading partners, the revised treaty could provide that a company may be eligible for treaty benefits if the company is publicly traded in the country where it is a resident. More specifically, and similar to the U.S. model treaty, the revised treaty could limit benefits to a publicly traded company:

if the company's principal class of shares (and any disproportionate class of shares) is regularly traded on one or more recognized stock exchanges, and either: (A) its principal class of shares is primarily traded on a recognized stock exchange located in the Contracting State of which the company is a resident,[40] or (B) the company's primary place of management and control is in the Contracting State of which it is a resident.[41]

The revised treaty could further provide that a company will qualify for benefits if at least 50 percent of the aggregate vote and value of the shares (and at least 50 percent of any disproportionate class of shares) in the company is owned directly or indirectly by five or fewer publicly traded companies described above.[42] It might also provide that a company will qualify for benefits if it is owned at least 50 percent by qualified residents, and less than 50 percent of its gross income is paid or accrued as deductible payments to persons who are not qualified residents.[43]

Consistent with the U.S. model treaty and other recent treaties, the revised treaty could also generally state that a company may qualify for treaty benefits regarding an item of income if the company is engaged in the active conduct of a trade or business (other than, generally, the business of making or managing investments for the resident's own account, unless these activities are banking, insurance, or securities activities carried on by a bank, insurance company, or registered securities dealer) in its country of residence, and the income for which treaty benefits is sought is derived in connection with or is incidental to that trade or business.[44] If a resident of one country derives an item of income from the other country either directly or from a related person, the revised treaty could allow benefits for such item of income only if the trade or business conducted in the resident's home country is, based on all facts and circumstances, substantial in relation to the trade or business activity conducted in the source country.[45]

Finally, the revised treaty could provide as a safe harbor that a resident of one country that is not entitled to the benefits of the treaty under other LOB provisions will nevertheless be granted benefits if the competent authority of the source country determines that the establishment, acquisition, and maintenance of such resident and its operations did not have as a principal purpose the obtaining of benefits under the treaty.[46]

III. Mutual Cooperation

The revised treaty might contain more robust provisions regarding mutual cooperation and resolution of disputes. Although the current treaty provides for mutual exchange of information, the scope of information that can be requested is limited. In conformity with the current trend of increasing international cooperation between trading partners, the revised treaty might broaden the scope of mutual exchange of information. Further, to promote trade and prevent tax avoidance, the revised treaty might provide for an effective and prompt method of resolving international tax disputes.

A. Mutual Exchange of Information

With the explosion of international scandals involving banking giants UBS of Switzerland and the LGT Group of Liechtenstein, there is tremendous pressure on all countries to engage in mutual cooperation to combat tax evasion through comprehensive exchange of information. On December 8, 2008, the governments of the United States and Liechtenstein entered into a bilateral tax information exchange agreement to facilitate the exchange of information regarding tax matters between the countries. The Liechtenstein TIEA is likely to have ripple effects on other nations, as the United Kingdom and Germany may follow suit with similar exchange of information agreements of their own with Liechtenstein. From a policy perspective, a remarkable feature of the Liechtenstein TIEA is the evidence it provides that the current climate affords a unique opportunity for independent nations to rely on each other in combating tax evasion.

The current treaty contains a limited provision regarding exchange of information. In particular, article 28 provides:

The competent authorities shall exchange such information *as is necessary* for carrying out the provisions of this Convention or for the prevention of fraud or for the administration of statutory provisions concerning taxes to which this Convention applies provided the information is of a class that can be obtained under the laws and administrative practices of each Contracting State with respect to its own taxes.[47] [Emphasis added.]

However, "no information shall be exchanged which would be contrary to public policy."[48] Thus, exchange of information under the current treaty imposes a high burden of proof on the country seeking information to establish that the information sought is *necessary* to carry out the provisions of the treaty, prevent fraud, or administer its domestic tax law. By contrast, both the OECD model treaty and the Liechtenstein TIEA provide for a much broader exchange of information "as is foreseeably relevant." The OECD model treaty states:

The competent authority of the Contracting State shall exchange such information as *foreseeably relevant* for carrying out the provisions of this Convention or to the administration or enforcement of the domestic laws concerning taxes of every kind and description imposed on behalf of the Contracting States, or of their political subdivisions or local authorities, insofar as the taxation thereunder is not contrary to the Convention. The exchange of information is not restricted by [(Persons Covered)] and [(Taxes Covered)].[49] [Emphasis added.]

To foster growing cooperation between the United States and Korea, the revised treaty might include an expanded exchange of information provision. The exchange clause might require, for example, that the competent authorities of the two countries exchange on request such information as is foreseeably relevant for carrying out the provisions of the treaty or of the domestic laws of the contracting states concerning taxes of every kind imposed by a contracting state insofar as the taxation thereunder is not contrary to the treaty. It might extend to information relating to the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to the taxes covered by the treaty.

B. Dispute Resolution — Mandatory Arbitration

One method of improving compliance with the law is ensuring that when disputes arise they are promptly and effectively resolved. Disputes in matters of taxation are inevitable. As the economy of a country grows and its affairs become more intertwined with those of other countries, issues proliferate. Disputes involving cross-border transactions are inevitably prolonged and often contentious, and this can cause significant problems for taxpayers and governments alike. With the involvement of two or more taxing sovereignties, taxpayers can face uncertainty over applicable tax laws, double taxation of the same income, and denial of benefits.[50] For governments, cross-border tax disputes can become highly politicized and result in significant delays (or concessions) in tax collection. For both taxpayers and governments, an added difficulty is that cross-border tax disputes generally require a great amount of time and resources. Though the instinct of legislators may be to adopt more rules to clarify, specify, and distinguish their respective positions, some countries, including the United States, have concluded that this approach is not adequate for resolving crossborder tax disputes. Instead, they have moved to adopt an expedited dispute resolution mechanism, which offers the possibility of resolving individual cases in a satisfactory manner within a reasonable amount of time.

Recent treaty negotiations between the United States and Germany, Belgium, Canada, and France[51] have resulted in mandatory arbitration provisions intended to allow for timelier resolution of tax disputes involving certain cross-border transactions. Under these agreements, mandatory arbitration is generally available after two years of impasse between the countries, unless the competent authorities agree otherwise. The technique adopted is based on baseball arbitration: Each country submits a proposed disposition of the specific amounts of income, expense, or tax in dispute, and a three-member arbitration panel chooses one of the proposals. The countries prepare position papers supporting their proposals and may, if they desire, prepare reply submissions to the other country's submission. Additional information may be submitted to the arbitration panel only at its request. The panel is enjoined to apply the provisions of the treaty, any agreed commentaries or explanations of the treaty, the laws of the countries to the extent they are not inconsistent with each other, and any OECD materials regarding relevant portions of the OECD model treaty. The resolution of arbitration proceedings is binding on the countries. The revised treaty might adopt a similar mechanism.

IV. Other Potential Amendments

The following additional amendments might be considered as conforming to recent trends in treaty policies.

A. Relief From Double Taxation

Consistent with the U.S. model treaty, the revised treaty could provide a general re-sourcing rule for gross income derived by a resident who, under the treaty, may be taxed in the other country.[52] Thus, if the revised treaty allows Korea to tax an item of gross income (as defined under U.S. law) derived by a resident of the United States, the United States would treat the item as gross income from sources within Korea for U.S. foreign tax credit purposes.

B. Reduced Tax Rates at Source

The revised treaty might further reduce sourcecountry tax rates on dividends, interest, and royalties. Several recent treaties, including the Japan-U.S. treaty, eliminate source-country tax on some parent-subsidiary dividends.[53] In lieu of eliminating source-country tax entirely, consistent with the U.S. model treaty, the revised treaty might reduce the dividend tax rate to 5 percent for dividends paid to a corporate beneficial owner that directly owns at least 10 percent of the voting shares of the company paying the dividends, and to 15 percent in other cases. The current treaty provides for 10 percent and 15 percent rates on dividends. [54]

The Japan-U.S. treaty also eliminates source-country tax on royalties paid by Japanese residents to a U.S. company, including payments from a Japanese subsidiary to its U.S. parent.[55] This provision has made doing business in Japan more attractive for U.S. software vendors. However, to ensure compliance with transfer pricing principles, a 5 percent tax will be levied on royalties paid by a Japanese subsidiary to its U.S. parent (or any other payments on which tax has been eliminated) if the payment exceeds the arm's-length amount determined by Japanese tax authorities.[56] The revised treaty might adopt similar rules.

C. Directors' Fees

Contrary to the OECD and U.S. model treaties and recent U.S. treaties with other major trading partners, the current treaty does not contain a separate provision addressing the taxation of directors' fees. Consistent with the U.S. and OECD model treaties, the revised treaty might provide that directors' fees and other compensation derived by a resident of one country for services rendered in his capacity as a director (including the managing board or supervisory board or a functionally similar body) of a company resident in the other country may be taxed in the latter country.[57]

D. Independent Personal Services

The OECD and U.S. model treaties have eliminated the separate article dealing with independent personal services, and the revised treaty might take that same approach.[58] Income from the performance of professional services and other activities of an independent character would then be covered by the ''Business Profits'' article. Article 3(1)(e) of the U.S. model treaty provides that "business" includes the performance of professional services and other activities of an independent character.

E. Entertainers and Athletes

The current treaty does not have a separate provision regarding taxation of entertainers and athletes. Similar to the U.S. model treaty, the revised treaty might provide that income derived by an individual resident of a country from activities as an entertainer or athlete performed in the other country may be taxed in that other country if gross receipts derived by the performer exceed $20,000 (or the equivalent in won) for the tax year, including expenses reimbursed to the individual or borne on his behalf.[59] If gross receipts exceed $20,000, the full amount, not just the excess, may be taxed in the country of performance. Also, the revised treaty might provide that when income accrues to a person other than the entertainer or athlete, the income may be taxed in the country where the performer's services are rendered, without regard to the provisions concerning PEs and business profits; this would only apply when the contract under which the performance is rendered designates the entertainer or athlete or allows a person other than the performer or the person to whom the income accrues to designate the individual who is to perform.[60] These principles are generally embraced in the OECD model treaty.[61] They might be particularly appropriate in a revised treaty in light of the number of Korean and U.S. athletes and entertainers that cross borders to perform or entertain.

V. Conclusion

The current tax treaty between the United States and Korea is long overdue for a complete makeover. Since the conclusion of the current treaty in 1976, both countries have experienced significant changes to their economic conditions and international tax policies, and the world has changed dramatically. Revisions to the current treaty should be aligned with recent trends in international commerce and the attendant policies regarding international agreements, and should also be consistent with the objectives of both countries to promote bilateral commerce and cooperation.

In addition to amendments to the income tax treaty, the United States and Korea might also contemplate entering into an agreement regarding estate and gift taxation. As individuals increasingly become global and transitory, it is inevitable that the countries' taxation of such individuals' estates and gifts will become more complex and overlapping. Taxation involves not only income, but also estates and gifts — and the United States and Korea would do well to contemplate a separate agreement that would effectively acknowledge that fact.

Footnotes

1 Korea became a member of the OECD in 1996. This may signal greater Korean acceptance of OECD concepts and language regarding income tax treaties.

2 Michael Mundaca, Treasury Deputy Assistant Secretary for International Affairs, Remarks Before the U.S. Branch Meeting of the International Fiscal Association, Feb. 16, 2009.

3 *See* U.S. Census Bureau, "Table FBP-1. Profile of Selected Demographic and Social Characteristics: 2000," *available at* http://www.census.gov/population/cen2000/stp-159/STP-159-korea.pdf

4 *See* U.S. Census Bureau, "Selected Social Characteristics in the United States: 2007," *available at* http://www.census.gov .

5 *See* "Yearbook of Immigration Statistics: 2007," *available at* http://www.dhs.gov/xlibrary/assets/statistics/publications/ois_ni_fr_2007.pdf .

6 *See* U.S. Department of Agriculture (Foreign Agricultural Service), "Fact Sheet: U.S.-Korea Free Trade Agreement," *available at* http://www.ustr.gov/assets/Document_Library/Fact_Sheets/2007/asset_upload_file649_11034.pdf .

7 *See* U.S. Census Bureau, "Foreign Trade Statistics: Imports, Exports and Trade Balance with Korea, South," *available at* http://www.census.gov/foreign-trade/balance/c5800.html .

8 *See id.*

9 Article 16(1), current treaty.

10 Recently, several major U.S. private equity funds (for example, Newbridge Capital, Lone Star Funds, and Carlyle Group) have avoided paying Korean taxes on the sale of Korean company stock by structuring sales through companies located in

Malaysia. Under the tax treaty between Korea and Malaysia, Korea can collect taxes on stock sales by a company only if the company is resident in Korea.

11 Article 13(1), OECD model treaty. For purposes of article 13: [the term] "immovable property" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting

landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits,

sources and other natural resources; ships, boats and aircraft shall not be regarded as immovable property. Article 6(2), OECD model treaty.

12 Article 13(2), OECD model treaty.

13 Article 13(4), OECD model treaty. This would bring the treaty provision closer to the Foreign Investment in Real Property Tax Act of 1980, currently under section 897 of the U.S.

Internal Revenue Code, which overrides U.S. income tax treaties and thus gives greater rights to the United States than Korean tax authorities have under the current treaty. In addition to the Korean cases involving U.S. funds, the United States and Korea will want to give some thought to the Indian case of *Vodafone International Holding B.V. v. Union of India and Assistant Director of Income-tax*. (For more information, see *Tax Notes Int'l*, Dec. 8, 2008, p. 752, *Doc 2008- 25402*, or *2008 WTD 234-2*.)

14 Article 8(2), current treaty.

15 A footnote to article 7(3) of the U.S. model treaty states that a protocol or notes to a treaty should provide that in determining attributable profits, the PE "shall be treated as having the same amount of capital that it would need to support its activities if it were a distinct and separate enterprise engaged in the same or similar activities."

16 Treasury Department Technical Explanation of the U.S. Model Treaty (Nov. 15, 2006).

17 This approach was adopted in the 2008 fifth protocol to the Canada-U.S. income tax convention.

18 Fifth Protocol, Treasury Department Technical Explanation (July 10, 2008).

19 Article 14(1) and (3), current treaty.

20 Article 14(2) and (3), current treaty.

21 Article 6(3), current treaty.

22 IRC sections 861(a)(4) and 862(a)(4).

23 Article 12(l), OECD model treaty; article 12(1), U.S. model treaty.

24 Corporate Tax Act article 93(9).

25 Id.

26 Article 17 is based on a similar provision in the 1976 U.S. model income tax convention.

27 Article 17, current treaty.

28 Treasury Department Technical Explanation of the Current Treaty (July 19, 1977).

29 *See* articles 12 (dividends), 13 (interest), and 14 (royalties), current treaty.

30 Article 10(2), U.S. model treaty; article 10(2), OECD model treaty.

31 Court Files 2004-2006(IT)G and 2004-4226(IT)G.

32 2006 EWCA Civ 158.

33 Case 283314.

34 On February 26, 2009, the Canadian Federal Court of Appeal upheld the Tax Court's decision.

35*See generally* Treas. reg. section 301.7701-2 and -3.

36 *See, e.g*., article 1(6), U.S. model treaty.

37 The anticonduit rules under the Japan-U.S. treaty were added at the request of Japan and are significantly narrower than the rules of U.S. domestic law. *See generally* Treas. reg. Section 1.881-3.

38 Article 3(n), U.K.-U.S. treaty. 39*See supra* note 10.

40 This test first appeared in the Barbados-U.S. income tax convention as modified by the 2004 protocol. The Barbados-U.S. treaty, as well as other subsequent treaties incorporating this test, did not define the term "primarily traded." However, the technical explanation to the 2004 protocol explained that any term not

specifically defined will be defined under the domestic laws of the affected country, and, in the case of the United States, the term "primarily traded" will be understood to have the meaning it has under Treas. reg. section 1.884-5(d)(3). It would be helpful

for the revised treaty to provide a more refined definition of the term "primarily traded."

41 Article 22(2)(c)(i), U.S. model treaty.

42 Article 22(2)(c)(ii), U.S. model treaty.

43 Article 22(2)(e), U.S. model treaty.

44 Article 22(3)(a), U.S. model treaty.

45 Article 22(3)(b), U.S. model treaty.

46 Article 22(4), U.S. model treaty.

47 Article 28(1), current treaty.

48 Article 28(3), current treaty.

49 Article 26(1), OECD model treaty.

50 For example, under section 874 of the code and Treasury regulations thereunder, the United States can disallow the benefit of otherwise deductible expenses if a foreign taxpayer fails to timely file his U.S. income tax return. This disallowance of deductions is applicable only to nonresident aliens of the United States and foreign corporations (under a parallel provision in section 882 of the code), and there is no comparable provision for U.S. citizens or residents.

51 On January 13 the United States and France signed a new protocol making several significant changes to the France-U.S. income tax convention, including a new mandatory arbitration provision. Once ratified, the France-U.S. income tax convention will be the fourth U.S. bilateral income tax treaty to provide for mandatory arbitration.

52 *See* article 23(4)(c), U.S. model treaty.

53 This result is also obtained under U.S. treaties with the United Kingdom, Australia, Mexico, the Netherlands, Japan, and Sweden.

54 *See* article 12(2), current treaty.

55 Article 12(1), Japan-U.S. treaty.

56 Article 12(4), Japan-U.S. treaty.

57 See article 16, OECD model treaty; article 15, U.S. model treaty.

58 See article 15, OECD model treaty; article 14, U.S. model treaty.

59 Article 16(1), U.S. model treaty.

60 Article 16(2), U.S. model treaty.

61 See article 17, OECD model treaty.