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Who Gains Benefits from Tax Incentives for Foreign Direct Investment in Korea?

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Executive Summary

Tax incentives for FDI in Korea have been extended after the financial crisis of 1997. With the newly implemented tax incentives, foreign investors have been able to reduce the tax burden of their Korean business activities. However, not all foreign investors receive the same level of tax benefits. In this paper the varying tax benefits accorded to the different situations of foreign investors are thoroughly analyzed. The paper first distinguishes foreign investors on the basis of major factors, which can have an influence on the tax benefits of the incentives, and then compares the effects of tax reductions and exemptions. This analysis includes taxation not only in Korea' s jurisdiction but also in the jurisdiction of the countries where investors have their residence. The analysis shows that the tax benefits of incentives provided by the Korean government may not be maintained by foreign investors to the extent intended by the Korean government. According to various factors, such as the existence of a tax treaty, the dividends attributed to PEs, and the application of different methods for double taxation relief, the provision of tax reduction and exemption can either become ineffectual or the tax benefits can be diminished considerably. All these results of the analysis suggest important matters of consequence both to foreign investors and the Korean government. Foreign investors who are qualified for tax incentives need to build appropriate tax strategies by a thorough understanding of their situation. Meanwhile, the Korean government needs to reconsider the tax incentives system for FDI to enhance its effectiveness.

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I. Introduction

The Korean government began a series of strong foreign direct investment[1] (FDI) inducement policies in order to overcome the financial crisis of 1997. Various policy instruments were implemented to attract FDI. Among these, the core instrument has been the expansion of tax incentives for FDI, which in the past were very limited. Tax incentives for FDI in Korea have been extended by broadening the range of qualifying projects, extending the tax exemption period, and increasing the tax exemption level.

With the newly implemented tax incentives, foreign investors have been able to reduce the tax burden of their Korean business activities. However, not all foreign investors receive the same level of tax benefits. In this paper the varying tax benefits accorded to the different situations of foreign investors will be thoroughly analyzed, followed by a discussion of policy implications and recommendations.

This paper consists of the following. In chapter II, the newly implemented tax incentives for FDI will be explained. Also, statistics regarding foreign investors who get tax benefits, as well as the trends of FDI in Korea will be presented. Chapter III will analyze the tax benefits of incentives for FDI focusing on corporate taxes. Here, the paper will first distinguish foreign investors on the basis of major factors, which can have an influence on the tax benefits of the incentives, and then compare the effects of tax reductions and exemptions. This analysis includes taxation not only in Korea' s jurisdiction but also in the jurisdiction of the countries where investors have their residence. Finally, based upon the results of the analysis in chapter III, chapter IV

[1] According to the Foreign Investment Promotion Act, FDI refers to the acquisition by foreigners of a 10% or higher share in Korean firms. This rule applies to all foreigners who own at least a 10% share in

presents the paper's conclusions and offers some policy recommendations to enhance the effectiveness of the newly implemented tax incentives for FDI. Additionally, this chapter suggests tax strategies for foreign investors to maximize their tax benefits.

II. Tax Incentives for Foreign Direct Investment in Korea

A. Legal Sources of Tax Incentives for FDI in Korea

The law that specifies tax exemptions for FDI is the Special Tax Treatment Control Act (STTCA).[2] Article 121-2 and Article 121-3 of the STTCA state, in detail, information about the tax exemptions. The articles regulate exemptions and/or reductions of the corporate tax, income tax, customs duties, special excise tax, value-added tax, property tax, aggregate land tax, acquisition tax and registration tax.[3]

There are several other laws that define requirements for eligible businesses, although they do not directly prescribe tax exemptions as does the STTCA. Businesses within a Foreign Investment Zone (FIZ), Free Trade Zone (FTZ), and Customs Duties Free Zone that meet certain requirements can enjoy the tax exemptions. Such special investment areas are provided by various laws. For example, FIZs are regulated by the Foreign Investment Promotion Act (FIPA), FTZs by the Act on the Establishment of Free Trade Zones, and Customs Duties Free Zones by the Act on the Establishment of Customs Duties Free Zones.

Korean firms regardless of whether they are newly established or already existing.

[2] The STTCA regulates relevant subjects of all tax exemptions in addition to the exemptions by each tax law (corporate tax law, income tax law, etc.).

[3] These nine taxes are related significantly to the main activities of companies in Korea. At present, there

B. Contents of Tax Incentives for FDI in Korea

1. Details of Tax Incentives

Tax incentives for FDI in Korea can be classified into three types. The first type is exemption or reduction of the income or corporate tax on business income. The second is exemption or reduction of local taxes such as the acquisition tax, registration tax, property tax and aggregate land tax on business properties. The third is exemption or reduction of customs duties, special excise tax and the value-added tax on imports of capital goods for projects. Meanwhile, the exemptions (reductions) can be divided into two categories, based on the status of the beneficiaries. The first type of exemption applies to foreign-invested enterprises (FIEs) and the second to foreign investors (Table 1). The tax incentives for FDI are granted only to greenfield investments and not to M&As by foreign investors. In other words, the benefits for FDI are applied only to an acquisition of newly-issued stocks and are not permitted for already-issued stocks of existing Korean companies.

(a) Income and Corporate Taxes

The exemption from or reduction of the income or corporate tax can be applied to the business income of FIEs. In the case of normal taxation without any exemptions, income or corporate taxes on an FIE are as follows. If an FIE is a sole proprietorship,

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are thirty-three types of taxes in Korea. For details of the Korean tax system, see Ministry of Finance and Economy, *Korean Taxation*, 2001.

the income tax is levied on its business income. The income tax rate is progressive, from 9% to 36%.[4] If an FIE is a corporation, the corporate tax is applied at a rate between 16% and 28%.[5] When an FIE pays dividends to foreign investors, the withholding tax rate of 25% is applied. Furthermore, the inhabitant tax is levied on the amount of income and corporate taxes due, as a surtax at a rate of 10%. Therefore, the effective tax rate is 30.8% when the higher marginal corporate tax rate of 28% is applied. The effective withholding tax rate on dividends is therefore 27.5%.

Table 1. Tax Incentives for FDI in Korea

Tax \ Beneficiaries	Foreign-Invested Enterprises (FIEs)	Foreign Investors
Income and Corporate Tax	➢ Applicable to business income ➢ Initial 7 years of full exemption, 50% reduction thereafter for 3 years ➢ Source: Article 121-2, Paragraph 2, STTCA	➢ Applicable to dividend income ➢ Initial 7 years of full exemption, 50% reduction thereafter for 3 years ➢ Source: Article 121-2, Paragraph 3, STTCA
Local Taxes: acquisition tax, registration tax, property tax, aggregate land tax	➢ Applicable to acquired properties on invested businesses ➢ 8 years (5 years of full exemption, 3 years of 50% reduction), another possible maximum 7 years of reduction (decided by each local government) ➢ Source: Article 121-2, Paragraph 4, STTCA	➢ Not applicable
Customs duties, special excise tax, value-added tax	➢ Applicable to imported capital goods necessary for the invested businesses ➢ Full exemption on imported capital goods for 3 years from the date of notification of FDI ➢ Source: Article 121-3, Paragraph 1, STTCA	➢ Applicable to imported capital goods for objects of investment ➢ Source: Article 121-3, Paragraph 1, STTCA

[4] Income tax rates are as follows: 9% for taxable income up to 10 million won (about US $8,000); 18% from 10 ~ 40 million won, 27% from 40 ~ 80 million won, and 36% over 80 million won.
[5] Corporate tax rates are as follows: 16% for taxable income up to 100 million won, and 28% for taxable income over 100 million won.

If an FIE is designated as a qualifying project for the STTCA's tax exemption, it can be exempted from the corporate or income tax on the project's business income for 7 years and get a 50% tax reduction for the next 3 years. These tax reductions can be different depending on foreign investors' share of the total capital of an FIE. The tax reduction on FIEs is not fully applied to their whole profit. Only the shares owned by foreign investors are accepted for the reduction.

The 10-year period for tax benefits begins with the first year showing positive earnings, reflecting the fact that during the initial stages of investment, earnings tend to be negative. If an FIE does not yield positive earnings in 5 years, the 10-year tax benefits period begins in the fifth year. That is to say, after the start-up date, the tax exemption period for FIEs begins in the first profitable year of the first five years. Once the period begins, it continues for ten years even if the firms are not regularly profitable afterwards. Thus, after the exemption period begins, the profit flow of FIEs can affect the tax reduction.

Moreover, if a foreign-invested company pays a dividend to a foreign investor, the foreign investor can also be exempted from the corporate or income withholding tax on the dividend for 7 years, and enjoy the same 50% reduction for the next 3 years. Therefore, tax reductions can differ depending on the dividend policy of an FIE. However, the reductions differ only in terms of the liquidity effects. The corporate tax on the dividend income of foreign investors is reduced equally in terms of the corporate tax reduction period and exemption rate for the profits of FIEs (100% for 7 years, 50% for 3 years). The reduction period and exemption rate on the dividend income are not decided by the period in which the dividend is actually paid. It is rather determined by the period in which the tax exempted or reduced source profits of the FIE for the dividend are generated. In other words, the fully exempt profits of FIEs are also fully exempt at the level of foreign investors regardless of the time of distribution. Accordingly, dividends from the 50% tax-reduced profits of FIEs are exempt in the same way. Since the timing of receipt of tax-exempt or reduced dividends to foreign investors is the problem, dividend policy has only liquidity effects on tax benefits.

(b) Local Taxes

Local tax incentives can be applied to the acquisition tax, registration tax, property tax and aggregate land tax on properties acquired or held by FIEs for the management of qualifying projects. Generally, the acquisition tax is levied on the acquisition of real estate, motor vehicles, vessels, aircraft and heavy equipment. The tax rate is 2% of the acquisition price of the taxable objects. The registration tax is applied when a person registers applicable assets or incorporation. The tax rate on the registration of applicable assets is 0.01-5% of the acquisition price of applicable assets. The tax rate on the registration of incorporation is 0.4% of the value of total shares. The property tax is levied annually on buildings, vessels and aircraft. The tax base is the standard value of applicable assets annually determined by the local government. The tax rate is 0.6% in the case of factory buildings and 0.3% in the case of vessels and aircraft. The aggregate land tax is levied on all types of land. The tax base is the total taxable land value, which adds up to the standard value of all lands which the tax payer owns. The standard value of land is annually determined by the Korean government. The progressive rate of 0.2-5% is applied to this tax base.

According to the provisions of the STTCA for the basic range of local tax incentives, full tax exemption is granted for the first 5 years (from the start-up day of the business) and 50% tax reduction thereafter for 3 years.[6] However, local governments can offer additional exemption from local taxes after the basic eight-year exemption/reduction period for an additional seven years. If such extra exemptions are provided, local governments can also set the reduction rate higher than the previous 50%.

(c) Customs Duties, Special Excise Tax, and VAT

The value-added tax in Korea follows the general VAT system, and this tax rate is 10%. The special excise tax is a consumption tax levied on some luxury goods, cars, equipment, etc. The tax base for manufactured goods is the sale price, while for imported goods, it is the sum of the customs value and customs duties. The tax rate is different for each taxable object, but it is approximately 7-35%.

Customs duties, the value-added tax and special excise tax on imported capital goods to be used for qualifying projects are fully exempted. The exemption of these levies is good for 3 years from the date of notification of FDI, when the FIEs or foreign investors import capital goods for their qualifying projects. This exemption is applied when the FIEs import capital goods with foreign or domestic means of payment which foreign investors pay to FIEs as objects of investment. Also, the exemption is applicable if the foreign investors directly bring in their capital goods to FIEs for investment in kind. Here the capital goods usually mean equipment, fixtures, tools,

[6] The aggregate land tax has a progressive rate. Hence, exemptions and reductions follow a system in which the taxable value of qualifying land is deducted to the same extent as the reduction rate from the

components, etc.

2. Qualifying Projects

The STTCA regulates three categories of qualifying projects for FDI tax exemption.[7] The first category includes projects in advanced technology businesses or special service businesses that support the international competitiveness of domestic industry. The second includes all businesses located in the Foreign Investment Zone by rules of FIPA[8], and the third refers to some qualifying projects of businesses located in Free Trade Zones or in Customs Duties Free Zones.

(a) Advanced Technology Businesses or Special Service Businesses

Advanced technology businesses are businesses with advanced technology that is only in an initial stage of development (if not developed at all) in Korea and thus can significantly contribute to the international competitiveness of domestic industries. Special service businesses are high value-added businesses which support the manufacturing industry and promote other industries and thereby contribute to the global competitiveness of Korean industries.[9]

Both types of businesses are required to utilize the following technology:

- technology that has large economic or technological spillover effects on the whole economy and can strengthen the development of industrial structure and industrial

total taxable land value.

[7] Art. 121-2 Para. 1 STTCA.

competitiveness;

- technology that has not exceeded three years from the first day of domestic introduction or technology brought in over three years earlier but has large economic effects or technological capacity; and
- a technological process (in which the technology is used) that is mainly carried out in Korea.

Such advanced technology businesses or special service businesses have regularly been reviewed by the Ministry of Finance and Economy. The Ministry has announced that, so far, the Foreign Direct Investment Committee[10] has approved 436 businesses in the advanced technology category and 97 businesses in the special service category.[11]

(b) Businesses Located in FIZs

Foreign Investment Zones are designated after each provincial governor receives approval from the Foreign Direct Investment Committee to attract large amounts of foreign capital. FIZs are not existing restricted zones but can be designated at the location in which a foreign investor wishes to invest. FDI eligible for FIZs can largely be divided into three types.

The first category includes FDI in the manufacturing industry which meets one of the following conditions:

- FDI amount exceeds US$50 million;

[8] Art. 18 FIPA.
[9] Art. 116-2 Decree of STTCA.
[10] The Foreign Direct Investment Committee, chaired by the Minister of Finance and Economy, is the supreme organization making decisions on FDI policy.
[11] See http://www.mofe.go.kr/mofe/kor/fdi/html/add1.htm

- foreign share exceeds 50% and new permanent employment exceeds 1,000 persons, regardless of the FDI amount; or
- in the case of FIZ within existing partially or fully designated national or local industrial parks, the FDI amount exceeds US$30 million and new permanent employment exceeds 300 persons.

The second category includes FDI of more than US$20 million, used to establish one of the following types of tourism industry-related facilities:

- tourist hotels;
- international conference facilities; and
- general resort complexes. (In this case, the FDI amount must exceed US$30 million.)

The third category includes FDI of more than US$30 million, used to establish logistics industry-related facilities, such as distribution centers or port facilities.

(c) Businesses Located in Free Trade Zones or Customs Duties Free Zones

Business projects in which the FDI amount exceeds US$30 million and which are located in Free Trade Zones or Customs Duties Free Zones can qualify for FDI tax exemption. In the case of FIEs in Free Trade Zones, businesses in the manufacturing and logistics industries are eligible as qualifying projects, but the manufacturing businesses must create new permanent jobs for at least 300 persons in addition to providing US$30 million of FDI. In the Customs Duties Free Zone, only businesses related to international logistics can qualify for tax exemption if the amount of FDI exceeds US$30 million.

3. Trends of FDI in Korea and Designated Projects for Tax Incentives

Table 2 shows that FDI in Korea has been rapidly increasing since the financial crisis. Such a prompt increase of FDI since 1998 is due both to the aggressive liberalization for FDI and the positive FDI inducement policy that took place after the financial crisis broke out. The total amount of FDI between 1998 and 2001 was US$ 52 billion, which equals 67.8% of Korea's total FDI since 1962 which amounts to US$ 76.6 billion.

Table 2. FDI Trends in Korea

(Unit: US$ Million)

	Number of Notification Cases	Number of Invested Cases	Number of Withdrawn Cases
1962-1990	7,874	5,863	678
1991	1,396	1,177	47
1992	894	804	240
1993	1,044	728	193
1994	1,316	992	205
1995	1,947	1,362	114
1996	3,203	2,310	308
1997	6,971	3,088	450
1998	8,852	5,229	250
1999	15,542	10,659	1,371
2000	15,697	10,134	1,616
2001	11,870	n.a.	n.a.
*Total	76,606	42,346	5,472

* Total number of invested and withdrawn cases includes cases only up to the year 2000.
Source: Ministry of Commerce, Industry and Energy, Trends in Foreign Direct Investment, 2001.

Table 3 shows the number and the amount of investments for which the application for tax incentives has been accepted, out of the total of FDI from 1996 to 1999. From 1996 until 1998, less than 10% of the total FDI or investments through the acquisition of newly issued stocks qualified for tax incentives. However, this situation changed greatly in 1999 when FDI started to increase genuinely, so that tax incentives have been allowed for a considerable number of recently accomplished investments. In the case of 1999, the amount of investment accompanied by tax incentives was US$3.58 billion, an amount equivalent to 50% of the US$7.28 billion of the total FDI through the acquisition of newly issued stocks for the year.

Table 3. Investments for which Applications for Tax Incentives Were Accepted

(Unit: Cases, US$ Million)

		1996		1997		1998		1999	
		Cases	Amounts	Cases	Amounts	Cases	Amounts	Cases	Amounts
Acquisi-tion of Newly Issued Stocks	New Investments	595	1,813	605	3,705	716	3,709	1,349	7,277
	Increased Amount	372	1,390	339	2,502	390	2,815	486	5,293
	Total	967	3,203	944	6,207	1,106	6,524	1,835	12,570
Total FDI		967	3,203	1,055	6,971	1,400	8,852	2,104	15,541
Desig-nated Project For Tax Incen-tives	New Investments	31	136	14	382	23	123	58	3,581
	Increased Amount	21	177	18	62	24	262	45	1,833
	Total	52	313	32	444	47	385	103	5,414
Ratios	New Investments	5.21%	7.50%	2.31%	10.31%	3.21%	3.32%	4.30%	49.21%
	Increased Amount	5.65%	12.73%	5.31%	2.48%	6.15%	9.31%	9.26%	34.63%
	Total	5.38%	9.77%	3.39%	7.15%	4.25%	5.90%	5.61%	43.07%
Ratio to Total FDI		5.38%	9.77%	3.03%	6.37%	3.36%	4.35%	4.90%	34.84%

Source: Ministry of Commerce, Industry and Energy, Reference Book for FDI Administration, 2000.

III. Who Gains Benefits from Tax Incentives for FDI in Korea?

It is worthwhile to analyze the effects of corporate or income tax exemption, for the most important tax exemption among those described above is the exemption on business income. For convenience, both FIEs and foreign investors are assumed to be corporations and paying the corporate tax in Korea or in their resident country. This chapter analyzes corporate tax reduction effects on FDI, not only in Korea' s jurisdiction but also in the jurisdiction of the country where the investors have their residence, since taxation in the country of the parent company must also be considered in order to accurately evaluate the overall tax benefits of incentives for FDI.

When a foreign investor establishes an FIE in Korea and receives dividends from the FIE, the taxation procedures both in Korea and in the resident country of the foreign investor are as follows: In Korea, the FIE must pay the corporate tax on their profits. In addition, when the FIE distributes dividends to foreign investors with its profits after tax, the recipient foreign investors must also pay corporate tax on those dividends in Korea. However, such tax payments are made by the FIE, by withholding the corporate tax when distributing dividends and paying the Korean Tax Authority on behalf of its foreign investors. Thus, taxation on FDI in Korea consists of corporate tax on the profits of FIEs and withholding tax on the dividend income of foreign investors.

Meanwhile, in the resident country of a foreign investor, the dividends received from an FIE in Korea are fully taxable for the purpose of corporate tax. That is, foreign investors who have already paid withholding tax on dividends must also pay the corporate tax of their resident country. However, in order to prevent this international double taxation, Korean withholding tax may be considered in taxation of dividends in the resident country of the foreign investor. Specifically, international double taxation can be prevented either by a tax treaty signed between Korea and the country of the investor, or by the National Tax Law of the investor’s country.

Considering this process of taxation, there are various factors that affect the benefits of tax incentives for FDI in taxation both in Korea and in the investor's country. First of all, the following questions are important in relation to taxation in Korea:

- Is FDI a greenfield investment or an M&A investment?
- Is there a tax treaty between Korea and the investor's country?
- Is the FDI an investment by a permanent establishment (PE)? And if so, can the branch profit tax be levied on the PE?

Taxation in the investor's country can vary according to how international double taxation on dividends is prevented. Regarding this, it is important to ask the following two questions:

- Which is used, the exemption method or the tax credit method?
- Is the tax sparing system applied?

In this chapter, the paper will distinguish between different types of foreign investors and anaylze the varying effects of tax benefits on the basis of the above questions. First, it will address each question, explaining the significance of the factors mentioned above, and then illustrate the degree to which these factors affect tax benefits through a quantitative analysis of a model investment case. Table 4 shows the basic assumptions related to the model investment case.

Table 4. Assumptions for Model Investment Case

①	FIEs and foreign investors are all corporations (i.e., liable to pay the corporate tax in Korea as well as in the resident countries of the foreign investors).
②	Foreign investors own a 100% share in the FIEs.
③	All the business of FIEs can be considered to be qualifying projects
④	The FIE creates annual profits of 100 for ten years from the start-up date of the business.
⑤	FIEs fully and immediately distribute after-tax profits.

A. Greenfield or M&A Investments?

As explained previously, the tax benefits for FDI are granted only for greenfield investments. That is, foreign investors can apply for reduction and exemption from taxes only when their investments are in the form of setting up new business in Korea. In other words, the benefits are applied only to FDI regarding the acquisition of newly issued stocks. On the other hand, M&As are not eligible since they are investments in already-issued stocks of existing Korean corporations.

However, if a foreign investor establishes an FIE in Korea, pays an investment fund to the FIE, and allows the FIE to acquire all or part of the business of a domestic company, the investor can then enjoy the tax reduction under the conditions of the STTCA. This form of investment is known as the purchase and assumption (P&A) investment. A considerable amount of foreign investments in Korea since the financial crisis have been achieved through this method.[12] In fact, many foreign investors who had planned to invest in Korea through M&As changed to use the purchase and assumption (P&A) method just to receive the tax benefits.

Table 5. Tax Benefits of Incentives for FDI in Korea

	M&A Investments or without Tax Incentives	Greenfield or P&A Investments with Tax Incentives	
	Year 1-10	Year 1-7	Year 8-10
Profits before Tax of FIE	100.0	100.00	100.00
Corporate Tax of FIE	28.00	0.00	14.00
Inhabitant Tax of FIE	2.80	0.00	1.40
Subtotal Tax of FIE	30.80	0.00	15.40
Dividend to FI	69.20	100.00	84.60
Corporate Tax of FI	17.30	0.00	10.58
Inhabitant Tax of FI	1.73	0.00	1.06
Subtotal Tax of FI	19.03	0.00	11.63
Total Tax Burden in Korea	49.83	0.00	27.03
Tax Benefits of Incentives	0	49.83	22.80

Table 5 shows the difference in tax burdens of FDIs with and without and incentives based on the above mentioned assumptions for the model case. If FDI projects do not qualify for tax incentives, the annual corporate and inhabitant taxes at the FIE level are 30.8. The withholding tax on the dividend at the foreign investor level is 19.03. Thus, the total tax amount of FDIs without exemptions is 49.83. This tax burden is applicable to all M&A investments, even if a project meets all other conditions for tax incentives.

[12] Official statistics on P&A investments are not yet available. According to a survey of the Ministry of Commerce, Industry and Energy on foreign investments through acquisition of newly issued stocks amounting to US$6 billion, greenfield investments amounted to US$3.1 billion and P&A investments to

When tax incentives are provided, there is no tax payable for seven years since the corporate taxes on the profits of FIEs and on the dividends of foreign investors are fully inapplicable, as in Table 5. In addition, for the following three years, these taxes are each reduced by 50%, so the tax amount becomes 27.03. This does not exactly correspond to 50% of the previous non-exempt amount of 49.83. The reason for this difference is that the amount of distributable profits after the 50% reduction at the FIE level is greater than in cases without exemptions. Tax benefits of the incentives are 49.83 for the first seven years and 22.80 for the following three years.

B. Tax Treaty Beneficiary or Not?

If Korea has signed a tax treaty with the country where a foreign investor has his residence, this can affect the tax reduction. A tax treaty provides a reduced withholding tax on dividends. As mentioned above, the Korean Corporate Tax Law (CTL) mandates a withholding tax rate of 25% on dividends paid to foreign recipients. However, this withholding tax can be lowered if there is a tax treaty between Korea and the country where the foreign investor has his residence.[13]

When dividends are paid from the profits of FIEs which are fully exempt, the treaty rates are meaningless. The treaty rates do not apply since the dividends are already fully exempt under the STTCA. However, the treaty rates can be applied if the dividends are attained from the 50% tax-reduced profit of FIEs. The National Tax Administration (NTA) follows the interpretation that the STTCA and the tax treaty are

US$2.9 billion. See Jang (2000), p. 9.

[13] For the reduced tax rates on dividends in the Korean tax treaties, see Lee (2000), p. 201.

separately applied.[14] Hence, foreign investors can choose the more favorable taxation. The tax burden under the tax treaty can be lower than the 50% tax reduction on dividends under the STTCA. In this case, the tax reduction under the STTCA has virtually no effect since the tax treaty case is more advantageous.[15]

In the case of a tax treaty, the tax burden is also zero for seven years. However, for the next three years, the tax burden differs depending on the reduced tax rate provided by the applicable treaty. In Table 6, the tax amount has been calculated assuming that the tax treaty rate on dividends is 10%. If this rate is applied, the tax burden on dividends is 8.46 (84.6*10%). Since this amount is lower than the 11.63 without the tax treaty in Table 6, the tax reduction on dividends by the STTCA has no effect. Therefore, when the treaty rate is lower than 13.75% – the effective reduced tax rate by the STTCA (27.5%*0.5) – the tax reduction on dividends under the STTCA is ineffectual.

Table 6. Tax Benefits of Incentives for FDI in Korea with a Tax Treaty

	Without Tax Treaty		With Tax Treaty	
	Year 1-7	Year 8-10	Year 1-7	Year 8-10
Profits before Tax of FIE	100.00	100.00	100.00	100.00
Corporate Tax of FIE	0.00	14.00	0.00	14.00
Inhabitant Tax of FIE	0.00	1.40	0.00	1.40
Subtotal Tax of FIE	0.00	15.40	0.00	15.40
Dividend to FI	100.00	84.60	100.00	84.30
Corporate Tax of FI	0.00	10.58	0.00	7.69
Inhabitant Tax of FI	0.00	1.06	0.00	1.77
Subtotal Tax of FI	0.00	11.63	0.00	8.46
Total Tax Burden in Korea	0.00	27.03	0.00	23.86
Tax Benefits of Incentives	49.83	22.80	49.03	25.97

It is assumed that the reduced tax rate on a dividend in a treaty is 10%.

[14] See NTA (2001), p. 90.

C. Investment through Permanent Establishment or Not?

When a permanent establishment (PE) which a foreign investor has in Korea acquires the stocks of an FIE, the dividend income from the FIE is attributed to the PE. This is the case when the PE of a foreign investor owns the stocks of an FIE in the perspective of economic substance. In this case, the withholding tax on dividends cannot be applied. Rather provisions of CTL on the taxation of the PE of foreign corporations are applied. Taxation on income of PEs is similar to that of resident corporations. When dividend income to be exempted or reduced according to the STTCA is attributed to the PE, the statutory corporate tax rate of 27% is applied and the tax amount can be fully exempted or halved. Hence, the tax reduction on dividends attributed to PEs can be different from the withholding tax on dividends.

In case of investment through PE, a branch profits tax can be levied. Korea introduced a branch profits tax in 1995. However, it is not applied to all PEs of foreign corporations. The branch profits tax can be levied on the after-tax profits of the PEs of foreign corporations from a contracting partner country if this contracting partner country levies the branch profits tax in its jurisdiction.[16] The contracting partner countries in this case at present are Australia, Brazil, Canada, France, Indonesia, Kazakstan and the Philippines. If dividends of FIEs are attributed to the PEs of Canadian investors, for example, branch profits tax can additionally be levied on the after-tax profits of the PEs, after the corporate tax on eligible dividend income is exempted or reduced according to the STTCA.

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[15] See Lee Seong-Bong (1995), p. 213.
[16] Art. 96 CTL.

The National Tax Administration has not provided any confirmation of whether tax exemption/reduction according to the STTCA is applicable to the branch profits tax. Considering that the branch profits tax is basically levied according to the applicable tax treaty and that after-tax profits of PEs are different from the dividends of FIEs from a legal perspective, tax exemption/reduction according to the STTCA does not seem to be applicable to the branch profits tax. According to the CTL, branch profits tax is 25% of the after-tax profit of a PE, but it is lowered by the applicable tax treaties (for instance, 5% in the Korea-France treaty, 10% in the Korea-Philippines treaty, and 15% in the Korea-Canada treaty). Hence, the tax reduction effects can differ if this branch profits tax is additionally levied.

Table 7. Tax Benefits of Incentives for FDI in Case of Investment through PE

	Without a PE		In Case of PE		In Case of Branch Profit Tax	
	Year 1-7	Year 8-10	Year 1-7	Year 8-10	Year 1-7	Year 8-10
Profits before Tax of FIE	100.00	100.00	100.00	100.00	100.00	100.00
Corporate Tax of FIE	0.00	14.00	0.00	14.00	0.00	14.00
Inhabitant Tax of FIE	0.00	1.40	0.00	1.40	0.00	1.40
Subtotal Tax of FIE	0.00	15.40	0.00	15.40	0.00	15.40
Dividend to PE	100.00	84.60	100.00	84.60	100.00	84.60
Corporate Tax of PE of FI	0.00	7.69	0.00	11.84	0.00	11.84
Inhabitant Tax of PE of FI	0.00	0.77	0.00	1.18	0.00	1.18
Subtotal Tax of FI	0.00	8.46	0.00	13.03	0.00	13.03
Profits After Tax of PE	-	-	100.00	71.57	100.00	71.57
Branch Profit Tax of PE	-	-	-	-	10.00	7.16
Total Tax Burden in Korea	0.00	23.86	0.00	28.43	10.00	35.59
Tax Benefits of Incentives	49.83	25.97	49.83	21.40	39.83	14.24

It is assumed that the reduced tax rate on the dividend and the branch profit tax rate in a treaty are both 10%.

Table 7 shows the tax benefits of incentives when dividends are attributed to PEs. The tax benefits change since the statutory corporate tax rate of 28% is applied in lieu of the withholding tax. A "tax holiday" is also applied for seven years even when dividends are attributed to PEs, but for the next three years, the rate of 15.4% (half the effective tax rate of 30.8%) is applied to dividends. The tax payable by the PE on dividends becomes 13.03 (84.6*15.4%). This is higher than 11.63 in Table 3, the tax payable in the case of the withholding tax reduction without tax treaty (or even higher than 8.46 in Table 6, the tax payable in case of with tax treaty). The difference is due to the fact that the corporate tax of 28% on PEs is higher than the withholding tax of 25%. However, the corporate tax rate is progressive; therefore, the average tax rate applied to PEs can be lower than the withholding tax rate of 25%. In this case, dividends attributed to PEs can be more favorable.

Table 7 also gives examples of tax reduction effects in the case of the branch profit tax. When it is levied, the taxation cannot be exempted even for the first seven years. The branch profit tax with different rates between the applicable treaties can be levied on after-tax profits of PEs, namely 100, which is the amount after exemption. For the next three years, the tax on FDI also increases by the amount of the branch profit tax. If the branch profit tax rate in a treaty is 10%, the tax benefits of the incentives are 39.93 for the first seven years and 14.24 for the next three years. Those benefits are lower than those in the simple case of PE. These results arise from the fact that the branch profit tax is not included in the tax exemption.

D. Double Taxation Relief on Dividends: Exemption or Foreign Tax Credit?

When foreign investors receive the tax-reduced dividends from their FIEs in Korea, their resident countries can also levy corporate tax on those dividends. The reason for this is that these dividends are included in the taxable base for corporate tax purposes of the foreign investors in their resident countries. This taxation on the dividends in the resident countries of foreign investors can have influence on the overall benefits of tax incentives with which the foreign investors are provided by the Korean government. Namely, depending on the taxation method taken by the resident country of a foreign investor, the foreign investor may either maintain the tax benefits constantly, or lose at least a portion of them. The main factor affecting the tax benefits in the resident country of a foreign investor is the method of double taxation relief applied by the government of the resident country.

For income from international business activities, double taxation can take place. While the country from which the source of income arises may tax the income, the country in which a taxpayer has his residence may do the same. As previously explained, both Korea, which is the country of the source of dividend income, and the resident country of the foreign investor which receives the dividend income can levy corporate tax respectively when an FIE in Korea distributes dividends to a foreign investor. Such overlapping assertions of tax jurisdictions may result in double taxation.

In general, the resident countries of taxpayers apply several different methods in order to avoid such double taxation on the foreign source income. These methods are legally based upon both the tax treaties and the National Tax Laws of the resident countries. For instance, if there is a tax treaty between Korea and the resident country of a foreign investor, potential double taxation for the dividends from an FIE in Korea can be avoided through the methods of double taxation relief stipulated within the tax treaty which has legal priority over the domestic National Tax Law. However, if there are provisions for the methods in the domestic National Tax Law, which bring about more advantageous consequences than the tax treaty with Korea, those favorable methods of double taxation relief are applied.

The methods of double taxation relief can be divided into two categories: the *exemption method* for foreign dividend income and the *credit method* for foreign tax payments. Currently, each country takes one of these two methods, or applies a mixture according to the type of income.

When the exemption method is applied, the foreign source income can be exempted from taxation in the investor's country of residence. If the resident country of a foreign investor applies this as the method of double taxation relief for the Korean source dividend income, the dividends are exempted from the foreign investor's taxation in his resident country, regardless of the provision, with tax benefits by the Korean government on those dividends. In this case, tax benefits received from Korea can be maintained without any change, as a consequence. In other words, the foreign investor can retain the benefits of tax reduction and exemption.

At present, among the countries which have concluded a tax treaty with Korea, only four - Germany, Belgium, Switzerland and New Zealand – stipulate the application of the exemption method for the dividend income of Korean source within their tax treaties. Even in the cases of these countries, the dividend income of Korean source is only exempted provided that it meets the special requirements described below in Table 8.

Table 8. Korean Tax Treaties and Their Requirements for Application of the Exemption Method

Country	Requirements
Germany	Direct holding of at least 25 % of capital of the Korean company 1)
Belgium	Accordance with the requirements applied to tax exemption of inter-corporate dividends between Belgian resident corporations 2)
Switzerland	Accordance with the requirements applied to tax exemption of inter-corporate dividends between Swiss resident corporations 3)
New Zealand	Accordance with the requirements applied to tax exemption of inter-corporate dividends between New Zealander resident corporations 4)

1) *Korea-Germany Tax Treaty, Art. 22, Para. 2, Subpara. (a)* - According to German Corporate Tax Law, foreign dividends can be exempted if the participation exceeds 10% of the foreign corporation which distributed the dividends. See *Jacobs (1999), p. 455*.
2) *Korea-Belgium Tax Treaty, Art. 22, Para. 2, Subpara. (c)* - According to Belgian Corporate Tax Law, the requirements for tax exemption of inter-corporate dividends between Belgian resident corporations are as follows: the minimum participation of 5%; or the participation of which the acquisition value is at least 50 million Belgian francs. See *IBFD (1999), p. 60*.
3) *Korea-Switzerland Tax Treaty, Art. 22, Para. 5* - According to Swiss Corporate Tax Law, the requirements for tax exemption of inter-corporate dividends between Swiss resident corporations are as follows: the minimum participation of 20%; or the participation of which the acquisition value is at least 2 million Swiss francs. See *IBFD (1997), p. 454*.
4) *Korea-New Zealand Tax Treaty, Art. 23, Para. 2, Subpara. (b)* – "..being dividends which, in accordance with the taxation law of New Zealand in existence at the date of signature of this Convention, would be exempt from New Zealand tax."

When the credit method is applied, the foreign income is included in the taxable income of the investor in his resident country, in order to compute the total amount of taxes to be paid. Then the taxes payable are reduced by the amount of taxes that the investor has already paid to the country of the source of dividend income.

When the foreign investor's resident country applies the credit method for double taxation relief of the dividend income from the FIE in Korea, the foreign investor may not be able to enjoy benefits from tax reduction and exemption provided by the Korean government. The reason for this is that the foreign investor has not paid the amount of taxes in Korea, that equal the benefits from tax reduction and exemption, and that amount is not considered for double taxation relief. In other words, the tax incentives received in Korea cannot contribute to the benefits of the foreign investor, only to increase the tax revenues of his resident country.

The following analysis gives numeric examples of tax benefits when the taxation in the resident countries of foreign investors is also considered. In addition to the above-mentioned assumptions, it is assumed that the corporate tax rate in a resident country is 27.5%, which is the same as the Korean withholding tax rate on dividends. This allows the tax benefits effects to stand neutral to the corporate tax rate difference between Korea and the resident country.

Table 8. Tax Benefits Difference between the Exemption and Credit Methods

	In Case of Exemption Method		In Case of Credit Methods	
	Year 1-7	Year 8-10	Year 1-7	Year 8-10
Profits before Tax of FIE	100.00	100.00	100.00	100.00
Corporate Tax of FIE	0.00	14.00	0.00	14.00
Inhabitant Tax of FIE	0.00	1.40	0.00	1.40
Subtotal Tax of FIE	0.00	15.40	0.00	15.40
Dividend to FI	100.00	84.60	100.00	84.60
Corporate Tax of FI	0.00	7.69	0.00	7.69
Inhabitant Tax of FI	0.00	0.77	0.00	0.77
Subtotal Tax of FI	0.00	8.46	0.00	8.46
Subtotal Tax in Korea	0.00	23.86	0.00	23.86
Taxable Income in the Country X	100.00	84.60	100.00	84.60
Tax Exempted Income	100.00	84.60	-	-
Tax Base for FI in the Country X	0.00	0.00	27.50	84.60
Tax Payable in the Country X	0.00	0.00	27.50	23.27
Foreign Tax Credit	-	-	0.00	8.46
Subtotal Tax in the Country X	0.00	0.00	27.50	14.81
Total Tax Burden	0.00	23.86	27.50	38.67
Tax Benefits of Incentives	49.83	25.97	22.33	11.17

It is assumed that the reduced tax rate on a dividend in a treaty is 10% and the corporate tax rate in the resident country is 27.5%.

Table 9 shows the overall tax benefits of incentives when the exemption method and credit method are applied respectively for avoiding double taxation in the resident country of a foreign investor.

In case of exemption, regardless of whether a treaty exists or not, there is no more taxation in the resident country on the Korean source dividend income. Therefore, the tax benefits of the incentives are equal to those in Table 6 that showed the tax benefits of the incentives in taxation of only the Korean jurisdiction. Hence, the tax incentives provided by the Korean government can be maintained without any change.

However, tax benefits can be changed, if the credit method is applied for avoiding double taxation in the resident country. Compared to the results from the application of the exemption method, the tax benefits in the case of the credit method decrease considerably. Those results can be attributed to additional taxation in the resident country, owing to the application of the credit method. Compared to the case of exemption method, the additional tax burden in case of credit method is 27.5 for the first seven years, and 14.9 for the next three years.

E. Tax Sparing System Beneficiary or Not?

The tax sparing system is a variant of the credit method. As previously discussed, there is a possibility that the foreign investor may not be able to enjoy benefits from tax reduction and exemption when the credit method is applied for double taxation relief. The tax sparing system has been devised as a solution to such problems. Under the tax sparing system, the resident country treats foreign income as if it were fully taxed without benefiting from the tax incentives provided by the country of the source of income.[17]

The deemed paid tax, which is calculated by assuming that the dividends of the FIE were fully taxed in Korea, is then deducted from the foreign investor's tax payables in its resident country. This ensures that the benefits of tax incentives provided by the Korean government go to the foreign investor and not the foreign investor's resident country as tax revenues. The tax sparing system is usually included in the tax treaties. Among the 54 tax treaties Korea has signed with other countries thus far, 33 of them include provisions for the tax sparing system.

The tax sparing system stipulated in the tax treaties can be grouped into two large categories: one is the *tax sparing method*, and the other is the *matching credit method*.

The tax sparing method treats the amount of taxes reduced or fully exempted in Korea as being deductible Korean taxes under the application of the credit method. For example, if the dividends are fully exempted from taxation in Korea, the deductible Korean tax payable is 27.5% of the total amount of dividends. The 27.5% of the total amount of dividends that is fully exempted from taxation is considered to have been paid in Korea, and therefore, is deducted from taxation in the resident country of the foreign investor. To sum up, in case of the tax sparing method, the Korean tax payables that are tax-exempted can be deducted from the foreign investor's tax payables in its resident country.

Among the countries that Korea has signed tax treaties with, the following ten

[17] See OECD (1995), p. 51. For the recent trends of tax sparing provisions, see OECD (1998), pp. 31-33.

countries include the provisions for the tax sparing method: Japan, the U.K.,[18] Denmark, Finland, New Zealand, Israel, Papua New Guinea, Portugal, Greece and Kuwait. Foreign investors from these 10 countries can constantly maintain their benefits from tax reduction and exemption for dividends in Korea.

On the other hand, the matching credit method regards only a certain portion of reduced or exempted Korean taxes as being deductible Korean taxes. That certain portion is specified in each tax treaty by the specific percentage.

Among the countries that have signed tax treaties with Korea, more than 26 apply provisions for the matching credit method. These countries are as follows: Germany, Belgium, Canada, Singapore, the Netherlands, Sweden, New Zealand, Ireland, Norway, Bangladesh, Luxembourg, Sri Lanka, India, Turkey, Egypt, Austria, Indonesia, Malaysia, Brazil, Pakistan, Tunisia, Italy, China, Bulgaria, Czech Republic, the Republic of Malta, Uzbekistan and Malaysia.[19] In case of the matching credit method, the maximum amount of deductible Korean taxes can be 5%, 7.5%, 10%, 15% or 20% of the total amount of dividends (Table 10).

Table 10. Amount of Matching Credit in the Tax Treaties Signed by Korea

Amount of Matching Credit	Relevant Countries
7.5% of the total amount of dividends	Italy
10% of the total amount of dividends	Sri Lanka, Indonesia, China, Bulgaria, Egypt
5 or 10% of the total amount of dividends	Czech Republic
5 or 15% of the total amount of dividends	Uzbekistan, Malta
10 or 15% of the total amount of dividends	Singapore, Bangladesh
15% of the total amount of dividends	Canada, the Netherlands, Ireland, Austria, Pakistan, Tunisia

[18] This will not be applied to the dividend income received after Dec. 31, 2003, according to *the Korea-U.K. Tax Treaty, Art. 23, Para. 5*.
[19] In the cases of Germany, Belgium and New Zealand, the matching credit method is applied only to those dividends in which the FIE's participation is lower than 25%. If the participation exceeds 25%, the exemption method is applied as mentioned previously.

15 or 20% of the total amount of dividends	India, Turkey
20% of the total amount of dividends	Germany, Belgium, Sweden, Malaysia, Norway, Luxembourg, Brazil

Those foreign investors that come from countries other than the four countries applying the exemption method and 36 countries[20] applying the tax sparing system, may not be able to enjoy the benefits of tax incentives provided by the Korean government at all if there are no provisions in their domestic laws for tax deduction on their dividend income.

Table 11. Tax Benefits in Case of Tax Sparing System

	In Case of Normal Tax Credit*		In Case of Tax Sparing Method*		In Case of Matching Credit Method**	
	Year 1-7	Year 8-10	Year 1-7	Year 8-10	Year 1-7	Year 8-10
Profits before Tax of FIE	100.00	100.00	100.00	100.00	100.00	100.00
Corporate Tax of FIE	0.00	14.00	0.00	14.00	0.00	14.00
Inhabitant Tax of FIE	0.00	1.40	0.00	1.40	0.00	1.40
Subtotal Tax of FIE	0.00	15.40	0.00	15.40	0.00	15.40
Dividend to FI	100.00	84.60	100.00	84.60	100.00	84.60
Corporate Tax of FI	0.00	7.69	0.00	7.69	0.00	7.69
Inhabitant Tax of FI	0.00	0.77	0.00	0.77	0.00	0.77
Subtotal Tax of FI	0.00	8.46	0.00	8.46	0.00	8.46
Subtotal Tax in Korea	0.00	23.86	0.00	23.86	0.00	23.86
Taxable Income in Country X	100.00	84.60	100.00	84.60	100.00	84.60
Corporate Tax in Country X	27.50	23.27	27.50	23.27	27.50	23.27
Foreign Tax Credit	0.00	8.46	27.50	23.27	10.00	8.46
Subtotal Tax in Country X	27.50	14.81	0.00	0.00	17.50	14.81
Total Tax Burden	27.50	38.67	0.00	23.86	17.50	38.67
Tax Benefits of Incentives	22.33	11.17	49.83	25.97	32.33	11.17

* It is assumed that the reduced tax rate on a dividend in a treaty is 10% and the corporate tax rate in the resident country is 27.5%.
** It is assumed that the matching credit in a tax treaty is 10%.

[20] Germany, Norway and New Zealand, which apply both the exemption method and the tax sparing , system are not included in this number. In their cases, the tax sparing system is applied to the dividends that have been reduced or exempted in taxation in Korea, as the dividends to which the exemption method is not applicable.

Table 11 shows tax benefits of incentives when the tax sparing system is applied as a credit method for avoiding double taxation. When the tax sparing method is applied, the taxes that would have been paid if there were no tax exemptions in Korea are deducted. Therefore, assuming that the tax rate in the resident country is the same 27.5% as in Korea, there is no additional tax burden in the resident country. Tax benefits in Table 11 are equal to those of Table 9 in which the exemption method is applied. As a consequence, the tax benefits of the incentives provided by the Korean government can be maintained.

The tax benefits of the incentives are decreased if the matching credit method is applied as the method for avoiding double taxation, compared to cases in which the tax sparing method is applied. This is due to the fact that the tax amount assumed to have been paid in Korea is limited by the amount stipulated in the tax treaty in the case of the matching credit method. If the matching credit in a tax treaty is 10% of the total amount of dividends, the tax benefits are 32.33 for the first seven years and 11.17 for the next three years.

IV. Conclusions

This paper has provided an analysis of the tax benefit effects for FDI in Korea. The analysis shows that the tax benefits of incentives provided by the Korean government may not be maintained by foreign investors to the extent intended by the Korean government. According to various factors, such as the existence of a tax treaty, the dividends attributed to PEs, and the application of different methods for double taxation relief, the provision of tax reduction and exemption can either become ineffectual or the tax benefits can be diminished considerably. All these results of the analysis suggest important matters of consequence both to foreign investors and the Korean government. Foreign investors who are qualified for tax incentives need to build appropriate tax strategies by a thorough understanding of their situation. Meanwhile, the Korean government needs to reconsider the tax incentives system for FDI. With this analysis as a basis, several strategies for foreign investors can be suggested, which can minimize the tax burden and maximize the tax benefits of incentives. Several policy implications for the Korean government can also be suggested to enhance the effectiveness of the tax incentives system.

A. Tax Strategies for Foreign Investors

First of all, foreign investors planning to buy existing Korean companies can find a way to benefit from the tax incentives. As explained previously, the tax benefits for FDI are granted only for greenfield investments. M&A investments are not eligible since they are investments in already-issued stocks of existing Korean corporations. However, if a foreign investor adopts the form of a P&A investment in Korea (paying an investment fund to the FIE and allowing the FIE to acquire a domestic company with the fund), the investor can then enjoy the tax reduction under the conditions of the STTCA. Therefore, foreign investors planning to invest in Korea through M&As

should project to invest through the purchase and assumption (P&A) method to receive the tax benefits.

Secondly, it is important to construct a revenue structure which concentrates the profit flow of FIEs into the ten-year tax exemption period. Accordingly, a strategy in which all losses are incurred in the first five years and profits generated for the next ten years can maximize the tax benefits. Especially, most of the profits should be made within the first seven years of the tax exemption period. For the next three years, the reduced tax rate is not only lowered from 100% to 50%, but the 50% reduction on dividends may even at times have no effect due to the reduced rate stipulated in a tax treaty.

In relation to the last three years of profit distribution during the tax reduction period, dividends attributed to PEs can lead to a low tax burden depending on the average tax rate of the PEs. If the average tax rate is lower than the general withholding tax rate of 27.5%, or lower than twice the treaty tax rate on dividends, it is always more advantageous to attribute dividends to the PEs. However, a higher tax burden is likely to result if the branch profit tax is levied on the PEs. Therefore, foreign investors from the countries that apply the branch profit tax (e.g., France, Australia, Canada, etc.) should not attribute dividends to their PEs in Korea.

In the meantime, foreign investors should sufficiently examine what methods are applied to prevent double taxation on dividends in their resident countries. First of all, they need to find out if the exemption method can be applied. It requires specific examination because even if the exemption method cannot be applied according to tax treaties, there is still a possibility that it can be applied by domestic National Tax Laws. If the credit method is applied, then foreign investors should examine whether or not the tax sparing system in tax treaties can be applied. Especially, they must confirm if the tax sparing method is applied instead of the matching credit method. Because the tax benefits provided by Korea are maintained only in the cases applying the exemption method or the tax sparing method, foreign investors can have more discretion on the dividend policy of FIEs. As most of the tax benefits for dividends are liable to vanish in the other cases, various situations of foreign investors and FIEs should be considered to decide whether the tax-benefited profits of FIEs should be distributed to foreign investors or retained within FIEs.

B. Policy Implications for the Korean Government

Firstly, it is desirable for the Korean government to abolish or reduce tax incentives for P&A investments. As analyzed previously, M&A investments and P&A investments are not significantly different in economic substance though they may differ in legal terms. Since the two forms of investment are derived from similar economic substance, they should be taxed equally. The major reason that tax incentives are not granted to M&A investments is that they do not accompany new facilities or new employment unlike the greenfield investments. P&A investments do not acquire already-issued stocks of existing Korean corporations but take over their facilities or employees. Therefore, tax incentives should not be granted to P&A investments. Only when an FIE has established new facilities or created new employment in the P&A investment should tax benefits be available.

The second policy implication is related to the interpretation of the NTA that the

STTCA and tax treaties are separately applied. According to the interpretation, the 50% tax reduction under the STTCA has no effect if the reduced rate on dividends in a tax treaty is lower than 13.75%. Practically, most of the tax treaties concluded by Korea stipulate a reduced rate below 13.75%. Hence, the policy goal of reducing the withholding tax by 50% for profits distributed in the last three years during the tax reduction period cannot actually be accomplished. The goal of the Korean government's policy of adopting a tax reduction and exemption system for FDI is to reduce 50% of the withholding tax which would have been paid in Korea if there had not been any tax reduction and exemption by the STTCA. Therefore, in order for the Korean government to truly achieve its policy goal, the 50% reduction on the withholding tax by the STTCA should be interpreted as being applicable to the amount which is to be paid in Korea whether or not the withholding tax is reduced by any tax treaty.

The last policy implication is relevant to the solutions for tax incentives that the Korean government provides to be maintained continuously in foreign investors' resident countries. At present, only in 13 resident countries of foreign investors that apply the exemption method and tax sparing method can tax incentives provided by the Korean government be totally maintained. In the other cases, such tax incentives from the Korean government just vanish or decrease in part. In order to prevent these mishaps, it is urgently necessary to start tax treaty revision negotiations to enact provisions related to the tax sparing method in the tax treaties between Korea and other countries. Such tax treaty revision negotiations should first be started with the countries that have large investments in Korea.

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