# Tax Treaties:

Understanding Double Taxation on International Income

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### What are Tax Treaties?

Tax treaties, also known as double taxation agreements or tax conventions, are formal written agreements between two countries. Their primary purpose is to prevent you from getting taxed twice on the same income earned abroad.

Key Points of Tax treaties:

- **Bilateral Agreements:** Tax treaties involve agreements between just two countries.
- **Resident Benefit:** These agreements benefit people and businesses considered "residents" of those countries for tax purposes, regardless of nationality.
  - If Korea and India have a tax treaty, this Korean subsidiary could benefit from provisions such as reduced withholding taxes on dividends, interest, royalties, or fees paid by Indian entities. Additionally, the treaty might provide relief from double taxation on income earned in India.
  - However, the tax treaty between Germany and India would not apply to the Korean subsidiary, as it is not a resident of Germany. Similarly, the tax treaty between Germany and Korea would not be relevant to the subsidiary's activities in India, as it concerns only transactions between entities based in Germany and Korea.
  - This framework ensures that the subsidiary's tax obligations are governed by treaties that involve its country of residence and the country where it operates, streamlining international taxation and avoiding double taxation.

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- **Focus on Income Taxes:** Tax treaties mainly cover direct taxes on income, such as corporate income tax and personal income tax. They typically don't apply to indirect taxes like VAT (Value Added Tax) or excise taxes.
- **Treaties vs. Domestic Law:** While both have equal legal weight, tax treaties act as special laws for residents of the treaty countries. This means, following the principle of "special law precedence," tax treaties can override conflicting domestic tax laws in specific areas, such as determining taxable income or setting tax rates. However, domestic tax laws still provide the general framework for how taxes are collected.

### How Tax Treaties Work:

Imagine you're working or doing business in a different country than your home country. Tax treaties help avoid double taxation by:

- **Dividing Up the Tax Pie:** The treaties decide which country gets to tax what income. The source country (where the income is earned) might have some right to tax it, but the treaty might limit that right. The residence country (where you live) might also tax the income, but the treaty might give you a credit to avoid paying double taxes.

### Types of Income Covered by Tax Treaties:

Tax treaties act like detailed instructions for how to tax different types of income earned abroad. Here are some common categories:

- **Rental Income from Property:** This is usually taxed in the country where the property is located.

- **Business Profits:** If you have a business operating in another country, the profits might be taxed in that country, especially if you have a permanent establishment there (like a physical office).
- **Shipping and Airline Income:** The income earned by airlines and shipping companies is often taxed in the country where they are registered (their country of residence).
- **Money Between Businesses (Dividends, Interest, Royalties):** Tax treaties address two key issues here:
    1. **Profit Shifting:** They aim to prevent companies from artificially moving profits to countries with lower taxes. This ensures a fairer distribution of tax revenue across nations.
    2. **Fair Taxation:** They also establish clear rules for taxing cross-border payments like interest on investments held abroad.
- **Capital Gains (Selling Investments) and Personal Services (Work):** Tax treaties aim to:
    1. **Discourage Hidden Income:** They aim to make it harder to hide income earned from selling investments or working abroad.
    2. **Ensure Fair Share:** They ensure everyone pays their fair share of taxes, preventing individuals from exploiting loopholes or avoiding taxes altogether.

### Additional Features of Tax Treaties:

Tax treaties also include some provisions to promote fairness and cooperation:

- **Non-Discrimination:** This principle ensures that residents of either country aren't subject to harsher tax treatment in the other country.
- **Dispute Resolution:** If there's a disagreement about how the treaty applies, there's a process for countries to settle.

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- **Information Exchange:** Countries can share tax information with each other to help catch tax evaders.
- **Diplomatic Protection:** Diplomats and embassy staff are usually exempt from local taxes to avoid conflicts between countries.

## Tax Treaties in Korea

In the specific case of Korea, if there is a conflict between a tax treaty and a Korean tax law, the treaty takes precedence. This legal weight demonstrates South Korea's commitment to international business and operating under mutually agreed-upon terms. However, it's important to remember that these treaties don't replace Korea's domestic tax laws entirely. The government still uses its own tax legislation to determine your tax obligations.

Beyond the scope of income tax conventions, South Korea has secured Tax Information Exchange Agreements (TIEAs) to prevent the complications of dual taxation, partnering with several countries, including jurisdictions recognized as tax havens and those under provisional arrangements.

Additionally, as of April 2019, South Korea stands among the 128 nations that have joined the Multilateral Convention on Mutual Administrative Assistance in

Tax Matters, showcasing its commitment to international cooperation in tax regulation.

## What Documents are needed when applying for Tax Treaty Benefits?

As of January 1, 2023, Korea increased its requirements when applying for tax treaty benefits. Authorities now have the right to request additional documentation if they deem your initial submission insufficient.

For claims exceeding 1 billion KRW (either in a single instance or cumulatively over the past year), companies will need to provide more in-depth documentation.

This includes proof of formation (records verifying directors' and shareholders' statuses) and operational evidence (like the last three years' audit reports).

If your claim involves royalty payments subject to tax, be prepared to present evidence confirming ownership of the intangible assets. This could include licensing agreements and proof of intellectual property (IP) ownership and registration location.

Finally, companies engaged in transactions with affiliated groups (transfer pricing) should note that, since January 1, 2023, they are required to maintain detailed accounts and relevant documents related to these transactions. These documents must be readily available for inspection at a designated location.

## Conclusion

Tax treaties are complex but crucial agreements that help ensure a fair and efficient international tax system. By understanding how they work, you can navigate potential tax issues when conducting business abroad, especially in a dynamic economy like South Korea. ABK has a network of tax specialists with extensive experience in international tax law and tax treaties, who can help you:

- Understand how tax treaties apply to your specific situation.
- Claim any tax benefits or credits available under applicable tax treaties.
- Minimize your risk of double taxation when operating in or with Korea.

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