27 January 2018

By Electronic Delivery

Mr. Youngrok Choi
Deputy Minister for Tax and Customs
Ministry of Strategy and Finance
Sejong Government Complex, 477, Galmae-Ro, Sejong-Si, 30109
Republic of Korea
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RE: *Impact of Korean Capital Gains Tax on non-Korean CIVs*

Dear Mr. Choi,

The asset management and banking associations signing this letter[1] represent collective investment vehicles (CIVs)[2] organized in North America, Europe, Australia, and Asia. The total market value of regulated and publicly-offered CIVs, at the end of the third quarter of 2017, totaled US$47.37 trillion.[3]

We have profound concerns, on behalf of our members' non-Korean CIVs and their investors, with the proposed reduction in the ownership threshold at which capital gains withholding tax will be triggered on listed securities. Most specifically, we are concerned that the proposal would result in these CIVs (and other non-Korean investors) losing 11 percent of their total sales proceeds to inappropriate withholding. Given the expected administrative burden of seeking refunds, and the uncertain prospect of timely success, the impact on foreign demand for Korean listed securities could be substantial.

Our concerns are not diminished by the MOSF's 22 January statement addressing "concerns about the backlash from the financial investment industry." We understand that the MOSF believes that "the proposed change will only apply to investors who do not have tax treaties with Korea or non-

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[1] These organizations, as listed at the end of this letter, are: Association Française de la Gestion financière (AFG); Association of Global Custodians; Association of the Luxembourg Fund Industry; Assogestioni; EFAMA - European Fund and Asset Management Association; Financial Services Council (Australia); Hong Kong Investment Funds Association; ICI Global; The Investment Association; The Investment Funds Institute of Canada; Irish Funds Industry Association; and SIFMA AMG. Support also has been received from other organizations.

[2] We use the term "CIV" as it was used by the Organisation for Economic Co-Operation and Development (OECD) in its 2010 Report on "The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles" (the "CIV Report"). http://www.oecd.org/dataoecd/59/7/45359261.pdf. This Report, approved by the OECD's Committee on Fiscal Affairs in April 2010, limits the term CIV to funds that are widely-held, hold a diversified portfolio of securities and are subject to investor-protection regulation in the country in which they are established.

[3] https://www.ici.org/research/stats/worldwide/ww_q3_17.

residents who are subject to levy according to tax treaties." This statement, however, does not address unique CIV industry issues. Most specifically, the statement does not announce, as the CIV industry repeatedly has requested, that CIVs will be recognized by Korea as treaty-entitled.

Our most significant concerns with the proposal,[4] as explained in detail below, are that:

- no clarity is provided regarding whether the ownership threshold is applied at the level of (i) the CIV or (ii) the CIV's investors;
    - applying the ownership threshold rule at the CIV investor level in any meaningful way is neither possible nor appropriate;
    - applying the ownership threshold rule at the CIV level could cause some CIVs to incur capital gains tax (even though no CIV investor's indirect interest would meet any ownership threshold);
- substantial uncertainty exists regarding the related party and aggregation rules—whether those rules are applied at the level of either the CIV or the CIV investor;
- the information required to calculate the gain or loss on any CIV portfolio security—whether at the CIV or CIV investor level—is not available to the broker;
- substantial implementation time would be required if the proposal were advanced in any form;
- implementation for previously-acquired shares is not feasible as the cost basis information for these shares is not readily available and cannot be reconstructed; and
- because the 80 percent reduction in the ownership threshold (from a 25 percent ownership interest to a 5 percent ownership interest) would increase substantially brokers' liability concerns about potential under-withholding penalties, the potential for extensive over-withholding will be substantial—and damaging to the Korean market.

These concerns, we submit, illustrate why the proposal should be reconsidered. If the proposal is advanced, the CIV industry's concerns can be largely addressed by industry-specific modifications as well as changes of general applicability (such as prospective-only application after a reasonable implementation period). Our most-pressing "high-level" CIV-industry-specific requests are for guidance that:

- Korea will apply the guidance included in the OECD's CIV Report for treating CIVs as treaty-entitled and allow CIVs to demonstrate their treaty entitlement by providing Certificates of Tax Residence;
- any threshold for non-treaty-entitled CIVs, consistent with OECD guidance, will be based upon how the CIV is organized and operated (either as opaque or as transparent);

[4] This letter, because of its CIV focus, does not discuss in detail global financial industry issues such as (i) the need to develop market infrastructure and (ii) the administrative burdens, difficulties, and uncertainties associated with requesting and obtaining tax refunds.

- treats every CIV, for related party purposes, as unrelated to its investment manager and to every other CIV or investment pool—whether or not offered by its investment manager; and
- brokers may rely upon (i) CIV attestations regarding treaty entitlement and satisfaction of applicable ownership thresholds absent actual knowledge that the attestations are false or (ii) Certificates of Tax Residence.

These recommendations, and the supporting rationales, are developed in greater detail below.

Background

CIVs are retail products that provide investors with professional management and asset diversification at reasonable cost. Because CIVs are widely-held, any one investor's indirect interest in any portfolio security held by the CIV is likely to be *de minimis.*

CIVs typically invest in tens or hundreds of different companies. Because CIVs are making portfolio investments, and typically not investing for control, they typically do not hold substantial positions in any one company.

CIVs, as explained in the OECD's CIV Report, present unique issues for which administrable rules must be provided if withholding tax procedures and treaty relief are to be applied effectively.

- First, a CIV's investor base changes frequently, typically daily.
- Second, CIV interests typically are acquired through intermediaries that either purchase the interests from the CIV or, in the case of exchange traded funds (ETFs),[5] on a stock exchange. CIVs typically have little or no information regarding the identities of those investors who acquire their shares "indirectly" through these intermediaries.[6] Instead, this information is known to the intermediaries through which the CIV interests are purchased. The intermediaries perform all procedures necessary to comply with applicable anti-money laundering/know your customer rules and treat the identities of their customers as confidential.
- Third, a CIV's portfolio changes frequently. Many CIVs buy and sell portfolio securities every day—to meet changing market conditions and to manage cash coming in as new investment purchases or going out as payments to redeeming investors.
- Finally, for residence-country tax reporting purposes, the CIV—rather than any CIV investor—is treated as owning the CIV's portfolio securities. CIVs do not calculate (and indeed could not calculate for their frequently-changing investor base) any investor's cost basis in any security held by the CIV.

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[5] ETFs are a form of CIV. The US$47.37 trillion total market value figure for regulated and publicly-offered CIVs, appearing on page 1, includes ETF assets.

[6] CIVs in all cases know the identities of investors who acquire their interests directly from the CIV.

Applying these rules to CIVs would create enormous burdens

CIV Investor-Level Application

These rules cannot be applied in any meaningful way at the CIV investor level because:

- since CIVs are widely held, any CIV investor's indirect interest in any Korean company held by the CIV will be *de minimis;*[7]
- to the extent that CIV interests are acquired through intermediaries, the CIV typically would not know the identities of their investors for the reasons explained above;
- even if the CIV knew the identities of its investors, the CIV would not know if its investors owned other interests (directly or indirectly) in any Korean companies; and
- even if the CIV had complete knowledge about its investors and about its investors' direct and indirect interests in Korean companies, the CIV could not know any investor's own gain or loss on any security sold by the CIV—as gain or loss is not calculated at that level.

Nevertheless, to the extent that a particular CIV properly is treated as transparent, these difficulties are irrelevant—so long as the MOSF makes one very important pronouncement.

Specifically, the MOSF should clarify that CIV investors are exempt from capital gains withholding—absent *actual knowledge* by the broker (serving as withholding agent) that the investor holds more than the applicable percentage of a Korean company's stock. This clarification is appropriate since it would be practically impossible for a CIV investor to meet any applicable threshold on an indirect basis.

Absent this guidance, a broker might well be concerned that a CIV cannot "prove" that an investor—with respect to his or her entire stock portfolio—does not meet an applicable threshold. Even the possibility that a risk-averse broker might withhold 11 percent of a CIV's gross proceeds could have a detrimental impact on the attractiveness of the Korean stock market.

CIV-Level Application

Applying these rules at the CIV level would not be problematic for a CIV located in any country with which Korea has an income tax treaty that exempts capital gains. Treating the CIV as the beneficial owner of its income and as treaty-entitled—which indeed is the accepted treatment for many countries' CIVs—would result in a full capital gains tax exemption. Any CIV located in a non-treaty country would incur tax only if its holding exceeded the applicable threshold—and only

[7] If, for example, a CIV investor owns one percent of the CIV and the CIV owns one percent of a Korean company, the CIV investor's indirect interest in the Korean company would be one hundredth of one percent.

if tax were imposed irrespective of the *de minimis* interest that any one CIV investor might have in the Korean company.[8]

Substantial uncertainty regarding how the related party and aggregation rules would apply to CIVs

Should the capital gains threshold be reduced from 25 percent, guidance must be provided regarding the related party and aggregation rules. This guidance, we submit, should clarify that CIVs cannot be related and their interests cannot be aggregated absent *actual knowledge* that an ownership threshold has been exceeded.

A CIV exemption from the related party and aggregation rules is appropriate because:

- CIVs, even those offered by the same manager, do not have common ownership;
- CIV investors do not own majority interests in CIVs or otherwise control them;
- CIVs typically do not know the identities of investors who acquire interests through intermediaries for the reasons explained above;
- CIVs, even those offered by the same manager, do not act in concert but instead pursue their distinct investment mandates independently;
- CIVs that are "sub-funds" in an umbrella structure have different owners and investment mandates, and pursue those distinct mandates independently;
- CIVs—whether offered by the same manager or not—typically will not know the identities of investors in other CIVs;
- CIVs offered by different managers do not know what portfolio securities are held by each other; and
- even if a CIV knew that a CIV offered by another adviser held the same Korean security, it would not know the amount of that security held on any specific day.

Absent the requested exemption, clear guidance will be required regarding precisely how the related party and aggregation rules should be applied in the CIV context.

No tax policy would support treating CIVs as related simply because they (i) had an overlapping minority-stake investor and (ii) held interests in the same Korean company—*unless* the CIV selling the security or the broker had actual knowledge that the minority-stake investor's indirect interest in the Korean company exceeded the applicable threshold.

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[8] Should the MOSF respect the opaque nature of a CIV for capital gains tax purposes, they likewise should respect the CIV's opaque nature for dividend purposes. As you may know, the CIV industry in 2012 engaged with the MOSF following the Presidential Decree regarding the procedure by which CIVs are to claim treaty relief for dividends. The industry effort—including the 2012 coalition submission, the lengthy in-person meeting that was held the following week, the additional materials provided by Korean counsel, and a follow-up letter by a coalition member—was extensive. Despite this effort, the only relief provided from the unadministrable rules implementing the Decree was the 2016 change from quarterly to semi-annual reporting. Thus, CIVs and their investors today effectively are denied treaty relief on dividends from Korean companies.

Brokers do not know, and cannot calculate, gain or loss on stocks sold by a CIV

Brokers today do not calculate gain or loss when a customer sells a security. To calculate gain or loss, under Korea's mandatory "moving average price" methodology, a broker must know the purchase price for every share held by the customer.

A broker might not have direct or ready access to the information necessary to calculate a moving average price. First, if the client moved his or her entire securities account from one broker to another, the second broker might not have been provided with the moving average price of the previously-acquired shares. Second, if a client uses two different brokers to execute transactions, each broker might not have information regarding the client's transactions with the other broker; indeed, the brokers might not even know that their client uses multiple brokers. Third, even if the broker executed every purchase transaction, this information might not be in readily-retrievable form.

Substantial implementation time would be required and grandfathering is essential

Even if clarification were provided today, there would be insufficient time to implement the lower threshold. Moreover, any such change could be implemented effectively only for securities acquired after some future date.

Building the systems necessary to make cost basis calculations most likely would take years. In this regard, the experience of the United States is instructive. Legislation requiring brokers to report customers' gains and losses on securities sales was enacted in 2008 and applied only to securities acquired more than three years later (beginning 1 January 2012). The legislation, for two reasons, was effective only for securities purchased after this much-delayed future date. Specifically, the legislators understood that (i) brokers would need considerable time to build cost basis reporting systems and (ii) they did not have retrievable records of the purchase prices of their customers' previously-acquired securities. Moreover, certain aspects of these requirements were postponed because of delays in issuing the necessary regulatory guidance. Even today, ten years later, many regulatory questions remain unanswered.

Shares of Korean listed companies held before the implementation date should be "grandfathered" similarly to how cost basis reporting was implemented in the United States.[9] Specifically, shares of Korean listed companies should be placed in two separate accounts (or "buckets"). Shares acquired before the implementation date should be placed in a "pre-implementation date bucket" and subject to the existing 25 percent ownership threshold. Shares acquired thereafter should be placed in a "post-implementation date bucket" subject to the lower ownership threshold.

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[9] In the United States, the legislation enacted in 2008 effectively provided for "pre-2012 shares" not subject to the cost basis reporting regime and "post-2011 shares" for which cost basis reporting is required.

Substantial implementation time and grandfathering are particularly important for CIVs because they must calculate frequently (generally daily) the net asset value (NAV) of their interests. NAV calculations take into account the current value of the portfolio securities and both receivables (including tax refunds) and payables (including taxes owed but not yet paid).

Without grandfathering, a CIV might incur a tax liability on the date the proposal becomes effective for shares held over the five preceding years. This tax liability could result in a substantial change in a CIV's NAV. Investors could avoid this drop in the value of their CIV interests by selling their CIV interests before the proposal becomes effective. Any mass selling of interests in CIVs investing in Korea could result in further market disruption.

Potentially massive over-withholding and substantial negative market reaction may result

A capital gains withholding regime that applied only to 25-percent owners is a much different regime than one that applies to 5-percent owners. This 80 percent reduction in the ownership threshold would increase substantially brokers' liability concerns about potential under-withholding penalties.

We are particularly concerned that brokers might address these potential liability concerns by taking extraordinarily rigid positions regarding any legal ambiguities and any factual uncertainties. The result could by extensive over-withholding. This over-withholding could have a substantial negative impact on a CIV's NAV. Specifically, a CIV would not include the over-withheld amount in its NAV if it determined that it would not recover the withheld tax. The current refund procedures in Korea are sufficiently cumbersome that CIVs might conclude that the over-withheld amounts should not be included in NAV. An NAV reduction equal to 11 percent of any proceeds from the sale of Korean securities would be devastating for the CIV's investors.

Conclusion

To prevent extensive over-withholding, and the resulting damage to the Korean stock market, we urge reconsideration of the proposed change. Should the proposal nevertheless advance, as explained above, we urge that:

- Korea apply the guidance included in the OECD's CIV Report for treating CIVs as treaty-entitled and allow CIVs to demonstrate their treaty entitlement by providing Certificates of Tax Residence;
- any threshold for non-treaty-entitled CIVs, consistent with OECD guidance, be based upon how the CIV is organized and operated (either as opaque or as transparent);
- if the proposal is applied at the CIV investor level, CIV investors are exempt from capital gains withholding—absent *actual knowledge* by the broker that the investor holds more than the applicable percentage of a Korean company's stock;
- every CIV be treated, for related party purposes, as unrelated to its investment manager and to every other CIV or investment pool—whether or not offered by its investment manager;

- in the alternative, CIVs be treated as related and their interests aggregated only when the broker has *actual knowledge* that an ownership threshold has been exceeded;
- brokers may rely upon (i) CIV attestations regarding treaty entitlement and satisfaction of applicable ownership thresholds absent actual knowledge that the attestations are false or (ii) Certificates of Tax Residence;
- sufficient time be provided to implement the lower threshold; and
- the change be implemented only for securities acquired after some future date.

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If we can provide you with any additional information, please feel free to contact the representatives at the associations signing this letter.

With kind regards,

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