ETF taxation report for investors 2019

South Korea

Commissioned by:

HKEX
香港交易所

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Introduction

Exchange Traded Funds (ETFs) continue to gain popularity by investors as an efficient mechanism to gain a broad array of desired market access. Whilst return on investment (ROI) is a key priority, costs play an important role in maximizing ROI. One significant yet lesser understood cost with investing in ETFs is taxation. This is especially true for any cross-border investment which are normally subject to multiple instances of taxation.

In this report we will examine the impact of different types of ETFs on South Korea based investor returns across key markets, ETF types and domiciles.

Multiple instances of taxation on ETFs

An investor's ETF returns can generally be subject to tax at three levels:

Investment

- Withholding tax (WHT) on interests, dividends and capital gains
- Stamp duty/transaction taxes on investments

ETF

- Taxation of the fund (if any)
- WHT on distributions by the fund

Investor

- Taxation of the investor
  - Tax on income, capital gains, estate tax, etc.
  - Dependent on investor profile
- Availability of foreign tax credits

The extent of tax costs will vary widely depending on:

1. Domicile of the investor
2. Domicile and type of ETF*
3. Jurisdiction of the underlying portfolio investments

* Especially important because this should have an impact on the following:

- The applicable WHT rate at both the investment and investor levels
- The applicable taxes at the fund level
- Access to any available tax treaty benefits

Types of ETFs compared

Common forms of ETFs compared in this report include the following:

- Hong Kong domiciled fund, listed on the HKEX
- Irish Collective Asset-management Vehicle (ICAV) authorized as an Undertaking for Collective Investment in Transferable Securities (UCIT)
- Luxembourg Société d'Investissement à Capital Variable (SICAV)/Société d'Investissement à Capital Fixe (SICAF)
- US Regulated Investment Company (RIC)
- South Korea Trust (South Korea Fund)

Basis of analysis

1. General in nature
2. Only consider the impact of tax on dividend and interest income
3. Also important to consider the impact of tax on exit giving rise to capital gains and the availability of foreign tax credits

Assumptions

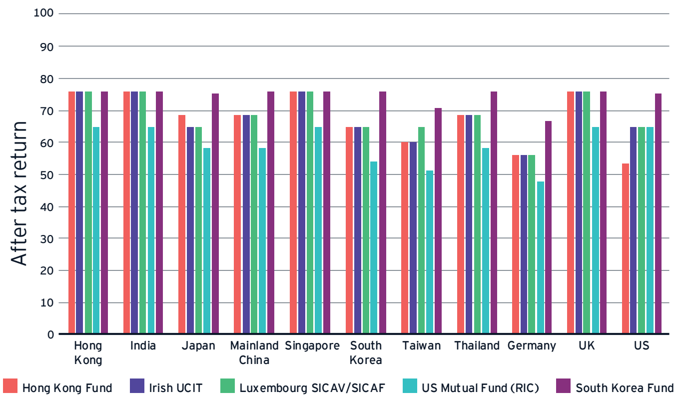
- The US ETF will qualify as a RIC for the relevant year and satisfy the relevant annual distribution requirements such that it should not be subject to US federal income tax on its investment company taxable income distributed to stockholders
- The Irish UCIT's principal class of shares is substantially and regularly traded on a recognized stock exchange
- All funds are eligible to enjoy the portfolio interest exemption in the US
- All the ETFs are beneficial owners of the relevant income and therefore entitled to treaty benefits accordingly
- The distribution from the underlying investment to the South Korea Fund is distributed to the South Korea Fund in the name of the South Korea Fund itself
- All investors are institutional corporate investors and tax residents in South Korea**
- South Korea corporate investors will be subject to corporate income tax on the relevant ETF income at a rate of 24.2%

** Ultimately, the ability to claim treaty benefits by South Korea investor or the ETF will depend on their individual facts and circumstances, e.g., whether they can demonstrate to the local tax authority that they are the beneficial owners of such income. These requirements should be assessed in detail.

South Korea investor after tax returns compared

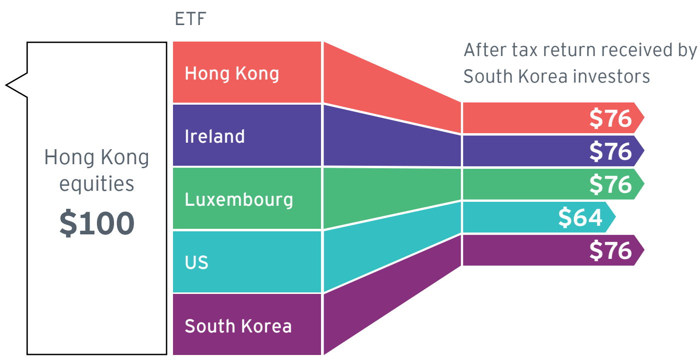
Figure 1. Dividends from equities

(The chart is for illustration purpose only.)



The German dividend withholding tax rate reflected above is the statutory withholding tax rate at source, i.e., 26.4%. A better outcome may be achieved where tax treaty relief can be availed.

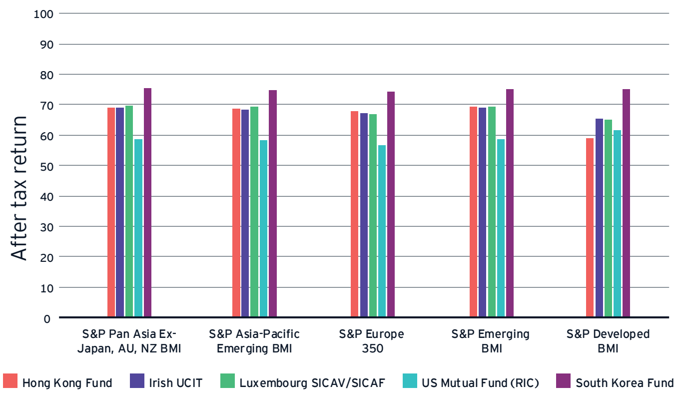
Illustrative diagram for Hong Kong equities (Figure 1)



By investing in Hong Kong equities through a Hong Kong Fund, South Korea investors would receive 76% after tax return for dividends versus 64% using an US Mutual Fund.

Figure 2. Dividends from indices

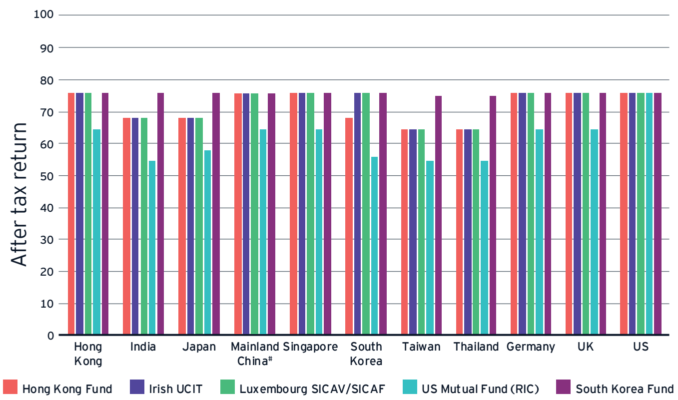
(The chart is for illustration purpose only.)



Based on index constituents' jurisdiction domicile as of 31 December 2018

Figure 3. Interest from corporate bonds

(The chart is for illustration purpose only.)



Non-resident institutional investors are temporarily exempt from WHT with respect to interest income derived from Mainland China corporate bonds (up to 6 November 2021).

Key findings

In general, South Korea Funds are comparatively the most tax efficient ETF vehicles for South Korea investors across all jurisdictions as a result of the availability of foreign tax credit refunds at the fund level.

Notwithstanding the above, South Korea investors may seek to invest into ETF vehicles domiciled outside of South Korea for a number of non-tax reasons. For examples, potentially lower fees for investing into ETF vehicles offered in larger markets (e.g., Hong Kong, Ireland, Luxembourg and US) and wider range of underlying investments in these markets (e.g., access to Mainland China A-share and Asia through investing into Hong Kong domiciled ETFs).

Compared to other popular vehicles, Hong Kong ETFs generally remain competitive for South Korea investors to access popular overseas markets.

Conclusion

Hong Kong domiciled ETFs have traditionally been recognized for their unique access to the domestic market of Mainland China. However, with the HKEX now carrying over 130 ETFs[1] representing a wide range of global markets, investors now have an enhanced ability to use Hong Kong ETFs to achieve their desired market exposures.

Furthermore, Hong Kong's expanding treaty network and domestic tax rules offer significant benefits for South Korea based investors seeking to invest via Hong Kong ETFs to gain exposure to other Asian and global markets.

South Korea investors should however be aware of the potential costs of investing into certain markets through a Hong Kong domiciled fund, such as the US.

1. Source: HKEX official webpage (March 2019)

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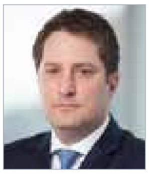

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