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In this article, the authors discuss the use of will-substitute trusts in South Korea, looking at trust law and mandatory inheritance rules, two key issues in a recent district court ruling, and the complex web of rules regarding the taxation of trusts in Korea.

On January 10 a first-level court in the Republic of Korea ruled that property transferred by a decedent to a trust during her lifetime is not subject to Korea's long-standing mandatory inheritance rule.[1] This ruling is important because the district court appears to be strengthening the will-substitute trust by putting form above substance and potentially giving individuals a tool that allows them to circumvent Korea's inheritance laws. While the decision may make will-substitutes more attractive, the rules regarding the taxation of trusts have traditionally been quite complicated and the impact of recently proposed changes should be closely monitored before these trusts are added to estate plans.

Legal Background

To understand this case and the district court's decision, it is necessary to understand the Korean rules regarding will-substitute trusts and the mandatory inheritance rule.

Will-Substitute Trusts

In 2011 the Korean government amended the Trust Act, making extensive changes to the existing law and adopting the will-substitute trust rule. A will-substitute trust allows the grantor to transfer assets to a trust during her lifetime and prescribe the disposition of the assets and income therefrom after her death in the same way that a will would allow. For example, the grantor could receive income from and have the benefit of the trust's assets during her lifetime and could name a beneficiary who would receive the income and benefits after her death.

The Mandatory Inheritance Rule

While the will-substitute trusts seem to extend property rights, the mandatory inheritance rule restricts a person's freedom to dictate the distribution of her assets after death because it protects the rights of some heirs to receive at least a specified minimum portion of the estate. Generally speaking, the rule covers the decedent's

[1] Suwon District Court, Sungnam Jiwon, 2017 Gahap 408489 (Jan. 10, 2020).

spouse and immediate family members; namely, it covers the same relatives who would inherit statutorily prescribed portions of the decedent's assets in the absence of a will. If a will does not comply with the mandatory inheritance rules, an heir can file a claim to recover his minimum share from the recipients of the inheritance. For purposes of this discussion, the term "heir" refers to those individuals entitled to a mandatory inheritance.

The decedent's gross estate — the basis from which the mandatory inheritance shares are calculated — includes all property owned in the decedent's name, and it also recaptures some property that was transferred to another person as a gift during the decedent's lifetime. If the decedent gave property to an heir, that property must be included in the gross estate for these purposes regardless of the timing of the gift. If the decedent gifted property to a third party (non-heir), ordinarily it would only be included in the estate if the gift occurred within one year before the commencement of the inheritance procedure — that is, the time of death. However, if the parties to the gift knew that the gift would harm the heirs' interest, then property gifted more than one year before the death is also included in the gross estate and subject to the mandatory inheritance rule.

The District Court Case

This case involved a woman who had transferred three pieces of real property and cash with a cumulative value of KRW 300 million (approximately $250,000) to a bank trustee. The woman, who had one son and two daughters, designated herself as the trust's beneficiary during her lifetime and, thereafter, her second daughter would become the beneficiary. The woman died three years later, and the younger daughter withdrew the cash and converted the title of the property in the trust in her name. The other siblings objected, claiming that the trust's contents should be returned to the estate and they should receive their shares under the mandatory inheritance rule.

In the case at hand, the first issue in dispute was whether the property in the trust should be regarded as property owned in the decedent's name. Although the bank that acted as a trustee held the title to the property in form, it could have been possible to view the decedent — who was both the grantor and also a lifetime beneficiary of the trust — as the owner of the trust's assets in substance.

Even if the decedent did not own the trust assets at the time of her death, a question remained regarding whether to treat the trust assets as property gifted to another person such that they could potentially be recaptured and included in the gross estate for the purpose of the mandatory inheritance rule. If so, another question arose: Who should be viewed as the donee in that gifting transaction? As noted above, the scope of recapture (inclusion in the gross estate) would differ depending on whether the donee was one of the heirs or was a third party.

The district court held that the trust assets were not owned by the decedent at the time of her death because the trustee held the title to the property at issue. Further, the court ruled that the trust assets qualified as gifted assets and the donee was the trustee. The court also found that the decedent had gifted the trust assets to the trustee more than one year before her death, and recapture was not required for purposes of the mandatory inheritance rules because there was no evidence indicating the decedent and the trustee knew that the gift would harm the interest of the heirs.

The district court's decision is meaningful because it is the first ruling to hold that the property of a will-substitute trust is not subject to the mandatory inheritance rule. Previously, most commentators and practitioners believed that a will-substitute trust was subject to the mandatory inheritance rule in the same manner as inheritance by will. However, in negating the application of the mandatory inheritance rule, the district court gave more credence to the strict, formal legal relationships formed by the will-substitute trust rather than looking to the substance of the relationship created — or that the donor intended to create — using the trust.

Korean Taxation of Will-Substitute Trusts

Despite the overhaul of the Trust Act in 2011 to facilitate the use of trusts as will substitutes, it is difficult to say the will-substitute trust has been widely used in Korea. This is partially because of the uncertainty surrounding the taxation of trusts in general.

A will-substitute trust typically specifies one or more individuals as beneficiaries who can only receive income and benefits from the trust after the grantor's demise. The tax treatment of the transactions and parties involved in these trusts — especially if a foreign trust is involved — has been inconsistent or ambiguous at best, because the statutory rules are not clear and sometimes render seemingly inconsistent results. Very little case law exists to shed light on the relevant points.

The initial transfer of property to the trust is generally not considered a taxable event. Depending on the interpretation of the relevant rules and the trust instrument, upon the grantor's death, the beneficiary might be considered to have received a gift in the form of a beneficial interest in the trust and, if so, would be subject to gift tax thereon. In that case, a Korean estate tax recapture rule may come into play to recapture property gifted during the 10 years before the decedent's death — or five years, if the gift is to non-heirs. Thus, the beneficial interest (deemed to have been gifted to the beneficiary at the time of death) would be recaptured, included in the gross estate, and subject to estate taxation. Although a credit would usually be given for any gift tax payable to prevent double taxation, navigating the circuitous tax rules is painful in itself.

Turning to income taxation, the general principle applies of taxing the beneficial owner of the income at the time the income arises. Although there is no clearly stipulated rule, it appears that the beneficiary should be subject to income taxation on income arising from the trust assets during the grantor's lifetime even if he is not entitled to receive any income until the grantor's demise. However, in accordance with the gift and estate tax rules discussed above, it also seems possible that the beneficiary would be subject to gift and estate taxation on the income and the trust assets upon the grantor's death; this would appear inconsistent with the treatment of the beneficiary as the owner of income before the grantor's death for income tax purposes. Property taxation, in contrast, focuses on nominal ownership and would tend to tax the trustee as the title owner of the trust assets.

Recognizing these uncertainties and inconsistencies, the Korean Ministry of Economy and Finance recently included several measures regarding the taxation of trusts in the proposed tax law changes for next year. The enactment of the proposed rules and the practical implications of the changes should be carefully monitored to determine the genuine benefits of using a trust as a will substitute.

Conclusion

The district court decision discussed above may spread the perception that the will-substitute trust could be an effective means of bypassing restrictions imposed by the mandatory inheritance rule. However, it is important to note that the decision is from the court of the first instance, which means its continued effect remains to be seen and it could be reversed or overturned by the High Court or the Supreme Court of Korea.

Before including a trust instrument in any estate plan involving a grantor or heirs who are Korean residents or any property that is located in Korea, one should evaluate the comprehensive merit of the use of a trust (whether Korean or foreign) by carefully considering the interplay of the Korean mandatory inheritance rule and the Korean rules of taxation. ■