



KOREA

At the end of December 2008, Korea's National Assembly approved proposed amendments to a range of Korean tax laws, followed by the amendments to the tax enforcement decrees in February 2009. Most of the latest amendments became effective from 1 January 2009 or apply to fiscal years starting on or after 1 January 2009 unless specified otherwise. Provided below is a summary of the significant changes contained in the amended tax laws and regulations.

CORPORATE INCOME TAX LAW

Tax rate cuts

The corporate income tax rates are 11% on the taxable income of up to KRW200 million and 25% on the excess in the fiscal year which includes the date of enforcement (i.e. 26 December 2008). The rates are adjusted to 11% and 22% in the fiscal year immediately following the year of the enforcement date, and are further reduced to 10% and 20% afterwards. For example, for calendar year corporations, the tax rates for fiscal year 2008 is 11% and 25%, the tax rates for fiscal year 2009 is 11% and 22%, and the tax rate for fiscal year 2010 and thereafter will be 10% and 20%.

In cases where a tax liability of a small and medium size enterprise (SME) exceeds KRW10 million, such SME is able to pay the liability in two instalments and the second instalment will be due within two months from the original payment due date instead of 45 days as under the existing law. There is no change to the due date for the second instalment payment (i.e. one month) for non-SME companies.

Net operating loss carry-forward

The currently allowed net operating loss (NOL) carry-forward of five years will be extended to ten years. This change would be applicable for the NOL generated from fiscal years beginning on or after 1 January 2009.

In line with the extended NOL carry-forward from five years to ten years, a change is made to the rules of the statute of limitations. Where a taxpayer uses the NOL incurred more than five years ago (up to ten years), the statute of limitations shall be one year from the filing due date of the fiscal year when the NOL is utilised. In general cases, the statute of limitations is five years (seven years in the case of non-filing) from the statutory filing due date of a fiscal year.

NOL carryover in a merger

Under the current Corporate Income Tax Law (CITL), the NOL of a surviving company after a merger can be utilised against any taxable income generated from either the original business of the surviving company or the new business taken over from the merged company. The NOL of a merged company can only be offset against the taxable income from its business when the merger meets all the specified conditions. The utilisation of the merged company's NOL is to be recaptured if the surviving company ceases the business taken over from the merged company within 3 years from the merger date.

A change to the CITL no longer allows the NOL of the surviving company to be utilised against the taxable income from the business taken over from the merged company. The NOL of the surviving company will only be used to offset against the taxable income of its original business. There is no change on the utilisation of the disappearing company's NOL in a qualified merger.

This change applies to mergers taking place on or after 1 January 2009.

Deduction for in-kind contributions

A new provision is included in the amended CITL to allow corporations to defer the taxation on the gains from certain in-kind contribution until the shares are deposited. The conditions for such a tax deferral are as follows:

1. The contributing company shall have operated for more than five years as of the registration date of a new company created with the in-kind contribution.
2. Shares or property directly used in the contributor's business as specified in the Presidential Decree must be contributed.

3. The new company shall operate the contributed business at least through the end of the fiscal year when the in-kind contribution occurs.
4. In the case of a joint contribution with a domestic or a foreign corporation, the joint contributor shall not be a related party as prescribed in the Presidential Decree.

In addition, if the new company ceases the contributed business within three years from the fiscal year immediately following the year of the registration date, the excluded gain shall be recaptured and added to the taxable income of the contributor in the fiscal year the business is closed. In this regard, if the new company is subsequently merged with a domestic company, it would not be seen as a business closure as long as the merging company keeps running the contributed business.

Dividend deduction for investment banks

Under the CITL, certain investment companies are allowed to claim deductions for dividends in computing their tax base for the concerned tax year if 90% or more of their distributable income is distributed as dividends to shareholders. Under the revised provision, the dividend deduction will be given to investment companies, investment vehicles and investment limited companies and investment hapja companies under the Act on Capital Markets and Investment Banking Business. Private equity funds as defined under this Act, however, are excluded and not eligible for this dividend deduction.

Income from Korean sources

The relevant provision (Item 7, Article 93) on the Korean sourced income of a foreign corporation in the CITL will be revised to include the following:

1. Gain from transfer of the assets or the rights stipulated below (only where such assets or rights are present in Korea):
 - (1) Land, buildings, rights to acquire, lease or create superficies of property located in Korea;
 - (2) Goodwill transferred along with business assets;
 - (3) Rights or memberships given in exclusive or preferential arrangement for members of certain organisations; and
 - (4) Shares or other securities issued by a domestic company where 50% or more of its total assets are made up of real estate as of the beginning of the fiscal year which includes the transfer date. The capital stock and other securities must not be traded on the Korean stock market.

2. Regarding the royalty income, the income from a transfer of patents, design rights, trade marks, etc, will be deemed as a Korean source income as long as those rights are used to manufacture and sell products in Korea. This will be true even if such rights are registered in a foreign country rather than in Korea.

Withholding tax

Withholding tax rates for dividends, interest, royalties or other income paid to non-residents or foreign corporations will be reduced from 25% to 20% for payments made on or after 1 January 2009. Withholding tax rate on capital gains will be lesser of 10% of the total sales proceeds or 20% (reduced from 25%) of the capital gain. A reduced rate or exemption may be applicable if there is an effective tax treaty between Korea and the residing country of the non-resident recipient.

Payment of tax on personal service income

In cases where 20% withholding tax rate is applied to the income derived by a foreign corporation from the provision of personal services by entertainers, sportsmen, professionals (lawyers, accountants, etc.) and scientific engineers in Korea, the foreign corporation will be allowed to file a return and make a payment of tax on such income (less any business expenses incurred to the extent that can be proven as relevant to such service provision) within three months from the completion date of those services. Any tax withheld by the payer on the same income can be credited against the tax payable.

Stock option expense

With regard to the stock options granted by a listed foreign parent company to the employees of its non-listed Korean subsidiary, the relevant costs arising from the local employees' exercise of the stock options would be allowed as a deductible expense for the Korean subsidiary's corporate income tax purposes if such costs are charged back to Korea.

Entertainment expense

Sales related costs such as sales incentives or sales allowances (including cases where there is no pre-arrangement) may be treated as a deductible expense rather than entertainment expense subject to certain deduction limit.

Consolidated tax return

A consolidated tax return system will be introduced from the fiscal year starting on 1 January 2010, allowing taxpayers to elect either the current separate tax return filing system or the new consolidated tax filing system.

Consolidated tax base: For the calculation of consolidated tax base, book-to-tax adjustments shall first be made for each entity in the consolidated group and additional tax adjustments for the consolidated group shall also be made to calculate the consolidated tax base. Additional tax adjustments are triggered by the consolidation to reflect the eliminated profits or losses from intra-group transactions, recalculation of the deduction limit on donations and entertainment expenses, etc.

Consolidated NOL carry-over: non-taxable income and allowable deductions will be excluded to calculate the consolidated tax base. In this context, NOL of an entity in a consolidated group, which has been incurred prior to the election of consolidated tax filing, shall be utilised only against the taxable income from the concerned entity. Where a company becomes a 100% consolidated subsidiary through the acquisition of shares owned by others, the losses from such subsidiary shall be deductible only from its taxable income over the next five years following the acquisition.

Calculation of consolidated tax liability: The amount of tax shall be computed by applying the corporate income tax rates to the consolidated tax base. In this context, additional corporate income tax on any gain from the sale of certain real property (e.g. non-business purpose land, houses, etc.) shall be computed for each entity in the consolidated group, which shall then be summed up and added to the consolidated income tax liability. Tax exemptions or reductions shall be computed by each respective consolidated entity to be summed up before being subtracted from the consolidated income tax liability.

In determining the qualification as an SME, the consolidated group as a whole will be seen as a single entity. For a company no longer being considered as an SME due to election to use the consolidated tax return system, a four-year grace period (the first tax year using the new system and the following three consecutive years) shall be given before the termination of the SME status.

Tax return and payment: The parent company in the consolidated group shall be liable to file the consolidated tax return and make the tax payment, but the consolidated subsidiaries shall have secondary liability for the tax payment.

LAW FOR COORDINATION OF INTERNATIONAL TAX AFFAIRS (LCITA)

Transfer pricing rules

Documents for relief in transfer pricing penalty: Under the existing law, underreporting penalty can be waived on transfer pricing (TP) adjustments when the results of

the competent authority procedures demonstrate that the taxpayer is not liable for a gap between the filed transaction prices and the arm's length prices. Under the amended rule, underreporting penalty will also be waived if a taxpayer properly prepares and maintains TP documentation at the time of filing the corporate income tax return, and it is recognised that the TP method has been reasonably selected and applied. The Presidential Decree provides the details of such documents (see below) that a taxpayer shall maintain and submit within 30 days at the request of the tax authorities in order to receive the relief.

1. An overview of the taxpayer's business, including an analysis of the factors that may affect the prices of assets and services.
2. A description of the taxpayer's organisational structure covering overseas related parties and others that may affect transfer prices.
3. The following documents that could support why a particular method was selected:
 - (1) Economic analysis and forecast data supporting the selection of the most reasonable transfer price method;
 - (2) Profitability of the selected comparables and the descriptions of adjustments made in the course of the analysis;
 - (3) Potentially applicable transfer pricing methods and explanation of why such methods were not used; and
 - (4) Additional relevant documents compiled during the period from the fiscal year-end to the time the relevant tax return is filed.

Reasonableness test: The amended Presidential Decree specifies that the following three factors should be considered in determining whether a taxpayer's selection and application of a transfer pricing method is reasonable:

1. Whether the profitability of the comparable companies collected at the end of the tax year can be seen as representative.
2. Whether the collected data was systemically analyzed in selecting and applying the transfer pricing method.
3. Reasonableness of the selection and application of the transfer pricing method when the taxpayer used a transfer pricing method that is different from the one determined through an advanced pricing agreement or the one used by the tax authorities during the course of a tax audit.

Exemption from transfer pricing method declaration

requirement: The LCITA requires a taxpayer to report the transfer pricing method used and provide explanation of why that particular method was selected at the time of filing the corporate income tax return. The declaration requirement is currently exempt if a taxpayer's total international transactions in goods for the concerned tax year amount to KRW5 billion or less and international transactions in services amount to KRW500 million or less. Under the amended decree, additionally exemption from the requirement will be where the transactions of goods with each overseas affiliate amount to KRW1 billion or less and the transactions in services amount to KRW100 million or less in total for the concerned tax year.

TNMM based on the Berry ratio: Consistent with the OECD guidelines, the Berry ratio would be treated as one of measurements under the transactional net margin method (TNMM), which is quite frequently used.

Anti-tax haven rules

Currently, the anti-tax haven rule applies to a company engaged in wholesale business if the following condition exists: sales revenue or purchase for the wholesale business accounts for 50% or more of the total revenue or the total purchase; and the sales to or purchase from related parties exceeds 50% of the total sales or purchase in the wholesale business. There is an exception if such a wholesale company purchases from a related party manufacturer located in the same region or country for over 50% of its total purchase and sells to non-related parties for over 50% of its total revenue. The amended rule will eliminate the purchasing condition for the exemption from the anti-tax haven rule.

According to the anti-tax haven rule, accumulated earnings (distributable retained earnings) of a domestic corporation's affiliate located in a low tax jurisdiction, i.e. a tax haven where effective tax rate on the taxable income for the past three years averages 15% or less, are taxed as deemed dividends to the domestic corporation, which has direct and indirect interest of 20% or more in such affiliate.

To be exempt from the anti-tax haven rule, a holding company in a tax haven must meet the following two conditions: (i) the holding company must have shareholdings in a foreign affiliate for at least six months as of the cut-off date for dividend distribution; and ii) dividends received from foreign affiliates must account for 90% or more of the total sum of interest, dividends, royalties and capital gains from a share transfer, earned by the foreign holding company. While the first requirement remains intact, the second requirement will be eased in a way that the

combined amount of dividend and interest income received from foreign affiliates must account for 90% or more of the foreign holding company's total income (which excludes income from the operation of business through fixed facilities such as offices, shops or factories). In this context, a foreign affiliate must be located in the holding company's country of residence, 50% or more owned by the holding company and not subject to the anti-tax haven rules.

Thin capitalisation rules

Deductible interest expense on inter-company loans:

According to the LCITA, debts from a foreign affiliate which is owned 50% or more by the foreign controlling shareholder (FCS) are also subject to the thin capitalisation rule. In the case where a taxpayer has borrowings directly from its FCS and from such a foreign affiliate at the same time, it may sometimes happen that the disallowed interest expense portion for the foreign affiliate exceeds the portion for FCS even though the foreign affiliate has no direct ownership in the domestic company. The allocation under the latest change is intended to alleviate such disparity.

Indirect ownership for thin capitalisation purposes:

When there are borrowings from FCS as well as from a foreign affiliate which is owned 50% or more by the FCS, the debt to equity ratio shall consider their aggregate direct and indirect share ownership as prescribed in the Presidential Decree. The amount of non-deductible interest expense such calculated would be apportioned between FCS and the foreign affiliate based on the debt amount from each party.

VALUE ADDED TAX (VAT) LAW

Taxpayer-based VAT return

Under the changed law, application for a taxpayer-based VAT registration and compliance will be possible without any condition to be met as long as such an election is properly applied to the tax office. In general, when a taxpayer has several business places, separate VAT registration and VAT filing is required for each business place. Prior to the change, the taxpayer-based VAT system (where the taxpayer can collectively file and pay VAT for several business places under one VAT registration) was only permitted to a taxpayer with an enterprise resource planning system

This change is effective from 1 January 2010. A taxpayer who wants to apply for the taxpayer-based VAT system from 1 January 2010 shall register with the relevant tax office on or before 11 December 2009.

Mandatory filing of electronic tax invoices

Taxpayers of certain size and scale including corporate taxpayers and others who are subject to double-entry bookkeeping requirement would be obliged to issue VAT invoices electronically rather than manually with hard copies. Such taxpayers will have to send a summary sheet of invoices issued via online to the National Tax Service (NTS) by the 10th of a month following the month electronic invoices are issued. Failure to issue electronic VAT invoices would be subject to a penalty of 2% on the relevant supply amount and the failure to send the summary sheet to NTS as required by the law would also be subject to the penalty of 1%. With respect to the electronic invoices submitted online to the NTS, taxpayers will be exempt from the requirement of submitting the statements of VAT invoices by supplier and by purchaser at the time of filing VAT returns.

The mandatory electronic tax invoicing system would come into effect from the supplies on or after 1 January 2010.

TAX PREFERENTIAL CONTROL LAW

Research and development (R&D) reserve

R&D reserve of up to 3% of the sales revenue in the income statement prepared in accordance with the Korean Generally Accepted Accounting Principles will be deductible. The R&D costs paid out of this reserve in the following three years from the end of the fiscal year in which the R&D reserve was tax deducted will be included in the taxable income in three yearly instalments from the third fiscal year. Any balance unpaid by the end of the third fiscal year will be added back to the taxable income in that year along with the interest calculated as stipulated by the law.

Costs incurred for the following activities, however, would not be treated as qualified R&D expenses:

1. General administration and support
2. Market study, marketing promotion and routine quality test
3. Recurring information gathering
4. Survey and analysis of business and management efficiency
5. Legal and administrative service including application or protection of patents
6. Search and exploration of mines or sites of mineral resources
7. Research and development consigned by a third party

The new law is effective from the fiscal years starting on or after 1 January 2009 until 31 December 2013.

R&D expenditure tax credit

Qualified R&D expenditures are eligible for tax credit. Under the existing law, the tax credit for R&D expenditures by SME is granted to the amount of i) 15% of the relevant expenditures for the respective year or ii) 50% of an increment in R&D expenditures for the concerned tax year over the average amount of such expenditures for four preceding years, whichever is the higher. The 15% tax credit rate will be increased to 25% while no change is made to the limit in ii). This tax relief, originally expected to expire in December 2009, will be made available permanently.

Income tax rate for foreigners' salary income

Currently, 30% of the salary paid to foreign expatriates or employees working in Korea are not taxable in Korea. Alternately, foreign expatriates and employees can choose to apply a flat income tax rate of 18.7% (including resident surtax) on their salary income earned in Korea. If the flat tax rate is chosen, the 30% deduction of salary income, any other income deductions, tax exemption, and tax credit will not be applicable. Under the new law, the flat income tax rate of 18.7% will be lowered to 16.5% for income received from the year beginning after the enforcement date until the end of December 2013.

Alternative minimum tax

In line with the two-phase reduction in corporate income tax rates, alternative minimum tax rates will also be lowered. The alternative minimum tax is 13% for tax base of up to KRW100 billion (15% for the excess and 8% for SMEs) before applying various tax credits and attributes in the fiscal year which includes the date of enforcement (i.e. 26 December 2008). The rates is adjusted to 11% (14% for the excess and 8% for SMEs) in the fiscal year immediately following the year of the enforcement date, and is further reduced to 10% (13% for the excess and 7% for SMEs) afterwards. For example, for calendar year corporations, tax rate of 13% (15% for the excess and 8% for SMEs) will apply for fiscal year 2008, tax rate of 11% (14% for the excess and 8% for SMEs) will apply for fiscal year 2009, and tax rate of 10% (13% for the excess and 7% for SMEs) will apply for fiscal year 2010 and thereafter.

Scope of small and medium sized enterprises

Currently, an enterprise of which a large company having total assets of KRW500 billion holds at least 30% direct or indirect ownership does not qualify to be treated as a SME. In the wake of the revision, an indirect ownership by a large company through a collective investment vehicle in between would be an exception.

For SME special tax credit purposes, the number of employees has been the sole factor in determining the qualification as a small company. Under the amendment, any company having KRW10 billion or more of annual sales turnover will no longer qualify as a small company irrespective of the number of full-time employees.

Indirect foreign tax credit

In the case where a foreign subsidiary is located in a jurisdiction where it is liable to pay income tax on its dividend payment to the foreign shareholder rather than withholding tax is imposed on the foreign shareholder, a 100% (instead of 50%) indirect foreign tax credit would be applicable. The revision is intended to provide the same tax benefit as the 100% direct foreign tax credit on foreign withholding tax.

Quasi-liquidation income taxation on election to partnership

The amended tax law provides for the quasi-liquidation income taxation when a company elects to be treated as partnership. Under the amendment, quasi-liquidation income will be calculated in the similar way as the liquidation income under the existing CITL (i.e. the excess of the remaining value of the assets over the net equity as of the liquidation date). Filing and payment of quasi-liquidation income tax shall be made within three months after the end of the last fiscal year before the conversion and the partnership is liable to such obligation. The tax amount shall be paid in instalments for three years.

Changes to partnership taxation

Tax rates on income allocated by a partnership to non-resident individual partners or foreign corporate partners will be adjusted. Under the amendment, 20% income tax will be levied on income allocated to passive partners whereas the maximum individual or corporate income tax rates under the Individual Income Tax Law (IITL) or CITL will apply to income allocated to non-passive partners. If it is found that a passive partner receives the income through another partnership in such a way to unreasonably reduce individual or corporate income tax liability, the classification of such indirectly distributed income would follow the classification under the CITL and taxed as such rather than being treated as dividends under the IITL.

EDUCATION TAX LAW

Under the Education Tax Law, those companies engaged in the financial business in Korea are subject to education tax on their gross receipts, including interest, dividend, commission, etc. and other income as prescribed in the Presidential Decree of the Law. The recently amended Presidential Decree includes a few changes on the tax base, which shall be effective on 1 July 2009.

One of the changes is that education tax shall be assessed on the net profit realised in the following cases:

1. Gain (or loss) from a financial derivative during a period would be offset against any loss (or gain) during the same period from the corresponding financial derivatives entered to hedge the underlying risk.
2. Gain (or loss) from a derivative linked security (DLS) would be offset against any loss (or gain) during the same period from the corresponding DLS entered to hedge the underlying risk.

This change is expected to mitigate the education tax burden arising from derivative transactions that could otherwise escalate disproportionately.

Another change is to exclude from the education tax base the commissions earned by investment brokers from brokerage services performed offshore. This is to eliminate disparity in taxation of offshore income between banks and investment advisory companies. In addition, the following categories of income earned by investment advisory companies shall be excluded from the education tax base:

1. Commissions from the investment advisory and discretionary investment management services by merchant banks, trusts, collective investment vehicles and investment brokers established under the Capital Market and Financial Investment Business Act.
2. A portion of commissions from the joint brokerage services of financial instruments to be allocated to the other companies.
3. Where a credit card issuer and a credit card business operator are separate parties, the portion of the commissions received from customers to be paid to the card issuer.
4. Guarantee fees and interest arising from the re-discount of trade bills received by the Korea Exim Bank and the interest and commissions paid by non-residents to the Bank.

Also excluded from the education tax base is the principal portion of an operating lease payment received by a company engaged in credit-specialised financial business.