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This publication contains information on selected current developments in Korean taxation, laws and regulations compiled by the tax service group of Samil PricewaterhouseCoopers, a network firm of PricewaterhouseCoopers.

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Update on Laws/ Treaties

Proposed Underreporting Penalty Relief through the Preparation of Contemporaneous Transfer Pricing Documentation

Currently, a transfer pricing adjustment will generally result in additional corporate tax of 25%, an underreporting penalty of 10% of the additional corporate tax, and an underpayment penalty of 10.95% per annum. The additional tax and penalties will also be subject to a 10% resident surtax and if the amount of the transfer pricing adjustment is not repatriated back to Korea, it will also be subject to a secondary adjustment which generally treats the amount of the transfer pricing adjustment as a deemed dividend depending on the contracting party. A proposed amendment to the Law for the Coordination of International Tax Affairs ("LCITA") provides relief on the underreporting penalty of 10% if the taxpayer maintains contemporaneous transfer pricing documentation.

Prior to this proposed amendment, taxpayers were granted penalty relief if the taxpayer has demonstrated the arm's length nature of its transfer prices through the mutual agreement procedures ("MAP") or an advance pricing agreement ("APA"). These conditions are prescribed under Article 13 of the LCITA and Article 23(1) of the Presidential Enforcement Decree ("LCITA-PED") of the LCITA. Specifically, the underreporting penalty may be waived if:

1. The taxpayer provided the documents showing the selection procedure of the most reasonable transfer pricing method to determine the arm's length price at the time of filing the corporate income tax return;
2. The taxpayer in fact applied the selected transfer pricing method; and
3. The taxpayer prepared and maintained documentation regarding the above.

The proposed amendment provides relief on underreporting penalty even in cases where the taxpayers have not gone through MAP or APA procedures as long as transfer pricing documentation is maintained contemporaneously.

Proposed Amendment

Article 13 of the LCITA [Exception to Penalty Application]

The following provision is anticipated to be included to Article 13 of the LCITA:

In case where the taxpayer (1) prepares and maintains documentation, as stipulated in the relevant LCITA-PED, on the transfer pricing method declared on its corporate income tax return and (2) that such method was reasonably selected and applied.

Assuming that the proposed amendments are ratified by the General Assembly, the penalty waiver provision will be effective on transfer pricing adjustments occurring on or after January 1, 2009.

Further clarifications on the required documentation and the appropriateness in the selection of the transfer pricing method will be included in the relevant LCITA-PED to be released following the amendment to the LCITA. However, the following is anticipated to be included as required documentation: company overview, inter-company transactions with foreign affiliates, functional analysis, industry analysis, process of selecting the transfer pricing method and reasons for eliminating methods that were not selected. The LCITA-PED will also provide the due date in the preparation of the contemporaneous documentation.

Insights

The new documentation requirements and the resulting underreporting penalty relief provision are anticipated to affect Korean taxpayers as follows:

① Domestic companies engaged in related party transactions with foreign affiliates

- In addition to providing penalty relief,

requiring the Korean parent to maintain documentation provides an opportunity to re-assess its global transfer pricing positions and identify potential risks areas. In other words, by looking at transactions from both sides of the transactions (as opposed to single-sided analysis has historically undertaken by many Korean companies), Korean parent companies would be able to assess overall transfer pricing risks and quite possibly, improvement areas.

- Documentation efforts by Korean parent will inevitably lead to reduced costs. More and more territories are requiring local transfer pricing documentation, and the preparation of transfer pricing documentation by the Korean parent will enable global affiliates to leverage from such efforts, streamline the documentation process, and maintain consistency.

② Foreign-invested companies or foreign companies

- For foreign-invested companies or foreign companies, transfer pricing has always been one of the main areas of investigation during a tax audit. By complying with the new transfer pricing documentation requirements under the proposed amendments to the LCITA, companies should be able to reduce the risk of assessment and if assessed, minimize the amount through the underreporting penalty relief.
- If available, transfer pricing documentation prepared by overseas parent/headquarters may be leveraged in the preparation of the transfer pricing documentation, saving costs and burden.

The benefits of maintaining transfer pricing documentation goes beyond penalty protection. Carefully planned and executed documentation reduces transfer pricing challenges and assessments.

Samil PricewaterhouseCoopers has been actively involved in the drafting of the new documentation requirements whereby representing the voice of taxpayers. With any new developments, we will inform promptly

along with our professional advice to help you manage your transfer pricing risks. If you have any questions related to the above, the following transfer pricing experts of Samil PricewaterhouseCoopers will be more than happy to answer your questions.

(For more information or inquiry on this TP article, please contact our TP partners, Heui-Tae Lee htlee@samil.com or Henry An henryan@samil.com)

Proposed Changes to Criteria for Small and Medium-Sized Enterprises

The Small and Medium Business Administration has announced a bill to amend the enforcement rules of the Basic Act for Small and Medium Enterprises (SME) that would simplify the classification of SMEs to be consistent with the Korean Industrial Standard Classification (KISC), add new criteria for definitions of SME for more extensive coverage and applicability and apply a stricter identifier for SME affiliated with a large business group.

Korean tax laws presently provide a variety of tax incentives for SMEs including a 10% to 30% tax credit for small companies.

Provided below is a summary of the proposed changes.

- The current 32 categories for SME based on industry types are simplified to 18 large categories.
- Two additional criteria, i.e. revenue and net equity thresholds, are added in the definition of SME for stricter coverage. An enterprise will not be classified as SME if its annual sales turnover averages 100 billion won or more for the three immediately preceding years or if its net equity amounts to 100 billion won or more. Currently, an enterprise will not be classified as SME if any of the

following conditions exists: i) the number of full-time employees is 1,000 or more; or ii) total assets amount to 100 billion won or more.

- Currently, an enterprise where a large company having total assets of 500 billion won holds at least 30% direct ownership is not classified as SME. According to the proposed plan, an indirect ownership will also be included in determining 30% threshold to make sure that the benefits are provided to true SMEs whose management is separated from ownership in substance.
- For an entity invested by a large company, the determination of SME qualification (in terms of the number of employees, annual sales turnover, and net equity) will consider the aggregate of the parent company's and the subsidiary's (to the extent of such large shareholder's share ratio).
- An entity failing to meet the criteria such as number of employees, total assets, annual sales turnover or net worth and the threshold on an subsidiary-parent aggregate basis shall graduate from SME qualification without a three-year grace period which is available in other cases

Korea-Kyrgyzstan Sign an Income Tax Treaty

Korea and Kyrgyzstan signed an income tax treaty in Seoul on November 18, 2008. The agreement will come into force after it is ratified by the parliaments of both countries.

Under the treaty, dividends will be subject to 5% withholding tax if the recipient is the beneficial owner holding at least 25% direct ownership of the dividend distributing company. 10% withholding tax rate will apply in other cases. For royalties, withholding tax will be limited to 5% for income from the right to use the industrial, commercial and scientific equipment. 10% withholding tax rate will apply in other cases.

For taxation of permanent establishment (PE), income only attributable to the PE through which an enterprise of a contracting state carries on a whole or portion of business in the other contracting state will be taxable in that other contracting state.

Under the Agreement, off-shore income would not be treated as attributable to a construction PE, i.e. income generated from activities performed off-shore but in relation to construction site in a contracting state would not be taxed in that contracting state of construction PE.

Rulings

Transaction Qualified for Zero Rate VAT

In this inquired case, a Korean company 'X' purchases goods from another Korean company 'Y' for a supply to a foreign company 'W'. The Korean company Y enters into a supply agreement with another foreign vendor Z and the goods are directly delivered from Z to W. There was a question about value added tax implications on this case concerned and the answer to the ruling is as follows:

- The transaction between the Korean company X and the foreign Company W constitutes "exports" as prescribed in the Presidential Decree of the Value Added Tax (VAT) Act, Article 24, which qualifies for zero rate VAT.
- The supply of goods by the Korean company Y to X involves the delivery of goods outside Korea, which is not subject to Korean VAT (i.e. non-VATable event).
- Even if the Korean company Y issued a zero-rate VAT invoice to the company X for the foregoing non-taxable transaction and both filed their VAT returns accordingly, penalty shall not be applied against the filing of these incorrect input/output VAT statements (*Buga-4449, 2008.11.27*)

The information contained in this publication is for general guidance on matters of interest only and is not meant to be comprehensive. The application and impact of laws can vary widely based on the particular facts involved. For more information, please contact your usual Samil PwC client service team or professionals listed below.

David Jin Young Lee	82- 2-709-0557	jylee@samil.com
IlHwan Oh	82-2-709-0897	ih_oh@samil.com
Dong-Keon Lee	82-2-709-0561	dklee@samil.com
Dong-Bum Kim	82-2-709-7900	dbkim@samil.com
Sang-Keun Song	82-2-709-0559	sksong@samil.com
Alex Joong-Hyun Lee	82-2-709-0598,	alexlee@samil.com
Henry An	82-2-3781-2594	henryan@samil.com
Shin-Jong Kang	82-2-709-0578	sjkang@samil.com
Sang-do Lee	82-2-709-0288	sdlee@samil.com