



Samil Commentary

Korean Tax Update

February 10, 2009

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.

- Corporate Income Tax Rules
- Transfer Pricing and Thin Capitalization Rules
- Tax Incentive Rules
- Education Tax Rules
- Others

Korean Tax Law Changes for 2009 (2)

This newsletter includes some of the important changes to the tax enforcement decrees in the wake of the amendments to the tax laws announced at the end of December 2008. (Please see Samil Commentary, December 2008 issue) Most of the changes became effective from the date the amended rules were proclaimed (February 4) or the fiscal year including the effective date unless specified otherwise.

CORPORATE INCOME TAX RULES

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.

Deductible Promotional Gifts

The deductibility of promotional gifts to a specific person is limited to KRW30,000 per year. But gifts of goods with the value of KRW5,000 or less per piece are not subject to this annual deductible limit.

Deductible Cash Gifts

Tax deductible limit of cash gifts on personal events like marriages or funerals, which cannot be supported with credit card receipts or cash payment receipts, has been increased from KRW100,000 to KRW200,000 per event.

Exceptions to the Unfair Transaction between Related Parties Rule

Leasing or providing money, other assets or services at unreasonably lower rates or prices than market rates or prices is presently deemed as unfair transaction between related parties under the Corporate Income Tax Law. According to the amended decree, however, it will not be deemed as an unfair transaction between related parties when the employer pays in cash for the spread between the agreed purchase price and the market price of the stocks at the employees' exercise of stock options.

Benchmark Interest Rate for Loans with Domestic Related Parties

As the benchmark market interest rate for a domestic related party loans (including the loans to employees) in calculating any deemed interest income, a company can now choose between the weighted average financing rate at the time of the loan extension or the rate pronounced by the Ministry of Strategy and Finance(MOSF). Once selected, the same rate shall be consistently used for the following tax years.

Interest Expense of Deemed Capital

If the capital account of the Korea branch of a foreign corporation falls short of the amount calculated using one of the following methods (“estimated capital”), the interest expense relating to the insufficient capital (“interest paid on deemed capital”) would be disallowed from tax deduction:

- Total assets of the Korea branch x Ratio of the net equity to the total assets in the balance sheet of the foreign corporation (consolidating the head office and all its branches) as of the end of the fiscal year
- Amount calculated using the method determined by MOSF which takes into consideration the functions, assets and risks involving the branch

When the head office and the branch have different accounting treatments for capital, the head office’s accounting treatment can be adopted, in which case the local branch would have to maintain the adjusted financial data using the head office’s accounting treatment.

If the thin capitalization rule is triggered at the same time as this deemed capital rule, only the excess portion over the disallowed interest expense from the thin capitalization rule would be denied.

Extended Due Date for Filing Extension Application

Foreign corporations can extend the due date for the corporate tax return filing by submitting the

extension application within 60 days from the end of its fiscal year, rather than 45 days under the previous law.

Supporting Document for Expenditure

For every expenditure of over KRW30,000 (including VAT), a corporation must receive and retain for five years a VAT invoice or other legitimate supporting document issued by the provider of goods or services. The existing documentation threshold will be retained at KRW30,000, departing from the original plan to lower it to KRW10,000 from January 2009.

TRANSFER PRICING AND THIN CAPITALIZATION RULES

The Law for Coordination of International Tax Affairs (LCITA) has been recently amended to waive underreporting penalty provided that there is contemporaneous transfer pricing documentation kept on file and the basis for the selection of the transfer pricing method used is deemed reasonable. The amendment in the Presidential Decree is intended to provide for details on the transfer pricing documentation and some changes to the existing thin capitalization rule.

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. Before the amendment, the Berry ratio was ranked below other methods like CUP, resale price method, cost plus methods or TNMM in priority.

Exemption from Transfer Pricing Method Declaration Requirement

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 exempt from the requirement will be the case 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.

Documents for Relief in Transfer Pricing Penalty

As LCITA has been amended to waive underreporting penalty in the case there is contemporaneous transfer pricing documentation on file and the basis for the selection of the transfer pricing method used is reasonable, the Presidential Decree provides the details of such documents that a taxpayer shall maintain and submit within 30 days at the request of the tax authorities.

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 organizational 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:
 - Economic analysis and forecast data supporting the selection of the most reasonable transfer price method
 - Profitability of the selected comparables and the descriptions of adjustments made in the course of the analysis
 - Potentially applicable transfer pricing methods and explanation of why such methods were not used
 - 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 the application of the transfer pricing method when the taxpayer used another transfer pricing method different from the method determined through an advanced pricing agreement or the one used by the tax authorities during the course of a tax audit

Deductible Interest Expense on Inter-company Loans

According to LCITA, debts from a foreign affiliate which is owned 50% or more by the foreign controlling shareholder (FCS) are also subject to the thin capitalization rule. In the case a taxpayer has borrowings directly from its FCS and from such a foreign affiliate at the same time, and it sometimes happens 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 Capitalization 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.

Tax Incentive Rules

Scope of Small and Medium Size Enterprise

Currently, an enterprise on 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 small and medium size enterprise (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 a 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.

Qualified R&D Costs

R&D reserve will be deductible up to 3% of the sales revenue in the income statement prepared in accordance with the Korean GAAP from the fiscal year starting on or after January 1, 2009 through the fiscal year that ends on or before December 31, 2013. Costs incurred for the following activities, however, would not be treated as qualified R&D expenses.

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

Quasi Liquidation Income Tax Base

When a company elects to be taxed as a partnership, quasi-liquidation income tax will be calculated in the similar way as the liquidation income under the existing Corporate Income Tax

Law. In other words, the tax base will be the excess of the remaining value of the assets over the net equity as of the end of the last fiscal year immediately preceding the first year of the partnership taxation. The remaining value of the assets would be the excess of the total assets over the total liabilities on book.

Indirect Foreign Tax Credit

In the case a foreign subsidiary is located in a jurisdiction where the local subsidiary 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% indirect foreign tax credit would be applicable instead of 50%. The revision is intended to seek the same tax benefit as the 100% direct foreign tax credit on foreign withholding tax.

Inventory Sales by Non-resident from Bonded Warehouse

When assets produced or acquired outside Korea are transferred or sold in Korea by a non-resident having no permanent establishment in Korea, a 2% withholding tax is currently imposed at the time payment is made. Under the amended law, such withholding tax will be waived if such assets are transferred or sold in Korea after being stored in a bonded warehouse.

To benefit this tax relief, the non-resident shall file an application for tax exemption to the district tax office governing the bonded warehouse by the end of the next month following the end of each calendar quarter. The application must be accompanied with details of inventory ins and outs.

Education Tax Rules

Under 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 July 1, 2009.

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

- Gain (or loss) from a financial derivative during a period would be offset against any loss (or gain) during the same period from corresponding financial derivatives entered to hedge the underlying risk
- Gain (or loss) from a derivative linked securities (“DLS”) would be offset against any loss (or gain) during the same period from a 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:

- Commissions from the investment advisory and discretionary investment management services by merchant banks, trusts, collective investment vehicles and investment brokers established under Capital Market and Financial Investment Business Act
- A portion of commissions from the joint brokerage services of financial instruments to be allocated to the other companies
- 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
- 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-specialized financial business.

Others

Books and Supporting Documents in Electronic Forms

Taxpayers are required to keep books and supporting documents for five years from the filing due date. From April 1, 2009, it will be allowed to keep books and records in electronic form (i.e. scanned copies of paper documents) and store them in one of the three existing electronic document repositories certified by MOSF. Certain paper documents, however, shall still be kept in original such as signed copies of documents for the acquisition or sale of assets and litigation, license or certification-related documents.

NTS and Customs Service Sign MOU on TP Audit

MOSF announced that the National Tax Service (NTS) and the Customs Service (CS) have signed a memorandum of understanding (MOU) to cooperate in conducting a tax audit on foreign invested companies. The MOU calls for the two agencies to perform a joint examination and exchange information as well as technical methodology in respect of their transfer pricing audits. Details of the MOU are yet to be finalized.

The MOU is in response to the complaints about redundant document submissions concerning international transactions with foreign related parties in a series of tax audits involving customs valuation, transfer pricing and other national taxes.

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.

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