2007

Korean Tax Law Changes

This is a brief summary of amendments to Korean tax laws, including the Corporate Income Tax Law (CITL), the Individual Income Tax Law (IITL) the Special Tax Treatment Control Law (STTCL) and the Value Added Tax Law (VATL) that were approved by Korea's National Assembly at the end of December 2006. Most of these changes are generally effective from January 1, 2007 unless otherwise specified.

This summary also includes proposed amendments to the Presidential Enforcement Decree of these laws which are to be finalized. The changes should not generally be acted upon without first obtaining appropriate professional advice.

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Samil PricewaterhouseCoopers

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Income Tax for Nonresidents

- **Lower Withholding Tax Rate on Bond Interest**

  The Korean withholding tax rate on interest earned by nonresidents or foreign corporations from investment in bonds or debentures will be lowered from 27.5% to 15.4% (including resident surtax). This change will benefit tax residents residing in foreign countries lacking income tax treaties with Korea, such as Hong Kong and Taiwan.

  The lower tax rate will be applicable to income earned on or after January 1, 2007.

  Nonresidents from a foreign country with which Korea has entered into an income tax treaty continue to be subject to a 0~16.5% withholding tax on such income according to the treaties.

- **Request for Downward Adjustment of Income Tax Base or Tax Due by Nonresidents**

  Nonresidents and foreign corporations will be allowed to file a request for downward adjustment of withholding taxes on certain types of income if a duly-filed withholding tax receipt showed overstatement of tax base. The request must be made within three years from the due date for the payment of withholding tax.

  This measure will become effective from the taxable year in which January 1, 2007 falls.

- **Taxation of Capital Gains Earned by Foreign Partnership**

  Gains earned by a nonresident or a foreign corporation, without a permanent establishment (PE) in Korea, from the sale of shares issued by a Korean company is taxed in Korea on the lesser of 11% of total sales proceeds, or 27.5% (including surtax) of any capital gains. However, such gains will not be taxed in Korea if the seller and its related parties own less than 25% of the total shares issued by a listed Korean company during the year in which the share transfer is effected and for five immediately preceding years.

  In applying this rule to a foreign partnership owning shares issued by a domestic company, the 25% ownership test shall be applied to the level of ownership held by the partnership as a whole rather than its individual partners.

  This change will apply to gains on sales that occur on or after February 2007.

- **New Provision to Impose Branch Tax after Liquidation**

  Where an income tax treaty includes a provision retaining the right to tax on branch profits or remittances, the branch tax shall be imposed on the residual profits of the foreign company's Korea branch in addition to the corporate income tax. Korea has concluded tax treaties with eight foreign countries levying such a tax, including Canada, Australia, Brazil, Indonesia, the Philippines, France, Kazakhstan and Morocco.

  Even in case where a foreign company's Korea branch is liquidated, a new provision clarifies the right to impose the branch tax on the residual profits of the liquidated Korea branch.

  The new provision will apply to fiscal years beginning in or after February 2007.

Income Tax for Nonresidents, *continued*

- **Sunset Clauses on Income Tax Incentives for Advanced Technology**

  The Korean tax law exempts foreign engineers or technicians from earned individual income tax on wages and salaries for five years from the date of employment (or the date the service contract is registered with the relevant authority) in Korea as long as they are either (i) qualified foreign engineers or technicians pursuant to the Presidential Enforcement Decree of the STTCL, or (ii) employed by Korean companies under technology inducement agreements as prescribed in the Foreign Investment Promotion Act. The exemption shall apply to qualified wages and salaries where the commencement of employment starts (or where the date of contract registration falls) on or before December 31, 2009.

  In addition, the tax law provides an exemption from corporate or individual income tax on royalties derived from advanced technology inducement agreements as prescribed in the Foreign Investment Promotion Act. The incentive shall be made available for five years from the date of first payment of royalties occurring on or before December 31, 2009.

- **Request for Re-examination of Tax Exemption**

  Foreign investors will be allowed to raise an objection and file a request for re-examination with the relevant government ministries when their requests for tax exemption for investment in pre-designated high technology business are rejected. Final decisions and notifications to investors will not be rendered before the relevant government ministries re-examine the filed objections and notify investors of the results of the reexamination.

  This change will be applicable to requests to be filed for such tax incentives in or after February 2007.

Corporate Income Tax

- **Dividend Received Deduction**

Dividend received deduction (DRD) rates for a holding company will be increased as the government wants to facilitate the creation of holding companies as an effective tool to enhance the transparency of corporate governance. The adjusted DRD rates are seen in the table below.

Parent / Subsidiary	Holding company		
	Equity ratio (%)	**DRD rate(%)**	**Amended**
Listed entity	100%	100%	No change
	Over 40%~less than 100%	90%	100% from Jan 2009
	30%~40%	60%	70% from Jan 2007 80% from Jan 2008
	Less than 30%	30%	No change
Unlisted entity	100%	100%	No change
	Over 80%~less than 100%	90%	100% from Jan 2009
	50%~80%	60%	70% from Jan 2007 80% from Jan 2008
	Less than 50%	30%	No change

This measure will apply to dividends distributed on or after January 1, 2007.

- **Expenditures Classified as Entertainment Expenses**

Costs to manufacture premium goods for marketing purposes are regarded as entertainment expenses as long as those goods are manufactured for donation to a specific customer. With ceilings of 30,000 won per customer each year, such costs will be 100% tax-deductible.

A new provision is inserted in the rule for entertainment expenses. According to the new provision, sales allowances, rebates and discounts paid to a third party shall not be treated as entertainment expenses.

These changes will apply to expenditures to be disbursed on or after the date the revised law becomes effective.

- **Unfair Transaction Rule**

According to the Unfair Transaction Rule, if a corporation pays (receives) a higher (lower) price than fair market value for a transaction with its related party in a manner that is deemed to unreasonably reduce the corporation's tax burden, the government may re-assess the corporation's taxable income for the concerned taxable year.

This rule will no longer apply in the case where a difference between the paid (received) price and fair market value is less than 5% of fair market value, or 300 million won, except for transactions where the actual fair market value is ascertainable (e.g., the stock price of a listed company).

Corporate Income Tax, *continued*

The lending or borrowing of money between related parties shall generally be based on the market interest rate (currently 9%) designated by the National Tax Service (NTS). According to the amended Unfair Transaction Rule, however, the weighted average borrowing rate rather than the NTS rate may be used to calculate deemed interest income in some cases.

These changes will apply to transactions that take place on or after the date the revised law becomes effective.

- **Recognition of Gain or Loss from Evaluation of Currency Derivatives**

  When a corporation owns monetary assets and liabilities denominated in a foreign currency, the CITL presently recognizes those gains or losses for tax purposes arising only from the evaluation of currency swap contracts entered to hedge against possible foreign exchange rate fluctuations.

  According to the proposed Presidential Enforcement Decree of the CITL, companies will also be allowed to recognize gains or losses from the evaluation of these derivatives other than swap. For financial institutions, the recognition of such gains or losses will be permitted, regardless of the purpose of hedging foreign exchange risks.

  This change will be applicable to gains or losses from the evaluation on or after the date the revised law becomes effective.

- **Documentation Requirements for Expenditures**

  When a corporation pays for goods or services supplied or any other expenditures (including entertainment expenses) in an amount exceeding 50,000 won (including VAT) per event, the corporation must receive and retain for five years a VAT statement, VAT-exempt statement, credit card, pre-paid or debit card slip or cash receipt issued by the provider of goods or services.

  The documentation threshold will be lowered to 30,000 won in January 2008 and 10,000 won in January 2009.

  In addition, taxpayers subject to a penalty tax for failure to comply with the documentation requirements will include all taxpayers having revenues of 48 million won or more. The documentation requirements have applied to taxpayers liable for double-entry bookkeeping.

  Failure to comply with the documentation requirements leads to a penalty tax equal to 2% of the total amount of unsupported expenses. Entertainment expenses in excess of the threshold and unsupported by documents (a VAT-exempt statement, a credit card, pre-paid or debit card slip or cash receipt issued by the provider of goods or services) will not be deductible in calculating the taxable income.

Corporate Income Tax, *continued*

- **Tax Credit for R&D Expenses**

  Tax credit for research and development (R&D) costs which was supposed to expire on December 31, 2006 will be extended by three additional years until December 31, 2009. Such credit is granted for R&D investments that exceed the preceding four-year average of a company's R&D expenses for technology and manpower. Currently, 40% of the exceeding R&D expenses can be tax-credited for large corporations.

  The current credit ratio will be raised to 50% in case of disbursements to be made by a large corporation to a small and medium size company (SMC), a university or other external R&D centers. In other cases, however, no change is made to the existing reduction rates (40% of the amount of excess investment).

  The higher credit ratio will apply to R&D expenses to be incurred on or after January 1, 2007.

Value Added Tax

- **A Single Business Registration Number for Head Office and Branch**

For a trader having more than two places of business, the trader's head office and branch will be allowed to issue their invoices at a single registration number as long as the criteria for the aggregated VAT filings are met. The criteria include the two following conditions: 1) the trader shall operate an enterprise resource planning system or other computerized system that automates functions such as procurement, production, sales, accounting and inventory control; and 2) a prior authorization of the aggregated VAT filings is obtained from the tax offices having jurisdiction over its head or main office.

If a trader elects aggregated VAT filings, the trader will be banned from opting out of aggregated VAT filings for five consecutive years.

This change will be effective from January 1, 2008.

- **Details on the Issuance of Revised VAT Invoice**

A new provision in the VATL clarifies the conditions that need to be met for tax invoices to be revised and re-issued. Such conditions are as follows: 1) goods supplied are returned; 2) goods or services are not supplied due to the cancellation of agreement; 3) there is an amount to be added or subtracted from the original value of supply; 4) a local letter of credit is opened or the approval of purchase is issued within 20 days from the end of taxable period in which the date of supply or transactions falls; and 5) there is an error to be corrected or any matter to be revised on the particulars of a tax invoice after its issuance.

The new provision shall be applicable to the transactions to be made on or after January 1, 2007.

- **VAT Tax Base Exclusion**

Any discounts on the supply price for early payment on the goods or services that have already been rendered will no longer be included in the VAT tax base. Currently excluded from the tax base are such items as the discounts for bulk sales, damaged, broken or lost goods, and government subsidies.

This change will apply to supplies made on or after the effective date of the revised VATL or December 30, 2006.

- **Input VAT Deduction**

If depreciable assets which have been used in a VAT-exempt business are later used in a VATable business, any input VAT incurred on purchasing the assets will be deductible.

This change will apply on or after December 30, 2006.

Value Added Tax , *continued*

- **Exclusion of Business Transfers from VAT Taxable Transactions**

  Comprehensive business transfers are currently not subject to the VAT. However, such transfers are regarded as taxable transactions in cases where a transferor of the business issues a VAT invoice to the transferee and files/pays VAT collected from the transferee. This exception will no longer apply.

  This change will apply to transfer of businesses on or after December 30, 2006.

- **Penalty for Non-issuance of VAT Invoices**

  Where VAT invoices fail to be issued, fraudulent VAT invoices are issued, or VAT invoices are issued in the name of sham traders, the penalty imposed for such cases will be increased from 1% to 2% of the value of the supplies for which the VAT invoices were issued.

  In addition, a 1% penalty tax will be newly imposed against the fraudulent registration of a business with the tax authorities.

  The penalty tax rates will apply on or after December 30, 2006.

- **Sunset Clause on Zero-rated VAT**

  Zero-rated VAT applies to the supply of social infrastructure facilities and related construction services that are built or performed on the basis of build-transfer-operate, build-own-transfer or build-transfer-lease and are delivered by the private sector's investors to governmental entities.

  Under the newly introduced sunset clause, this zero-rated VAT will apply to transactions which occur prior to December 31, 2009.

- **Introduction of Self-Billing**

  A new provision introduces a self-billing system whereby a purchaser of goods or services may issue a VAT invoice in cases where a VAT invoice is not issued by the supplier of those goods or services. This self-billing system will apply to purchasers who operate VAT taxable businesses and deal with suppliers who operate VAT taxable businesses. Under the self-billing system, a purchaser may issue a VAT invoice for the supplies, file it with the tax office and obtain an input VAT deduction.

  The self-billing will apply on or after July 1, 2007.

- **Investment Advisory Services as VAT-exempt Financial Services**

  Investment advisory services will be added to the existing list of financial and insurance services that are VAT-exempt.

  This change will apply on or after the effective date of the revised Enforcement Decree of the VAT Law.

Value Added Tax , *continued*

- **Eased Restrictions on the Issuance of Tax Invoices Prior to the Legally Designated Supply Date**
  Tax invoices issued without receiving payment for the supply of goods or services prior to the legally designated supply date will no longer be regarded as inappropriate as long as payment for the supplies is made within 7 days from the tax invoice issuance.

  Even though payment for such supplies is not made within the seven-day period, the VAT invoices issued prior to the supply date will still be acceptable if these three conditions are met: i) the billing and payment date is separately specified under the supply agreement between both contracting parties; ii) the VAT invoice is issued at the time of billing and kept in the enterprise resource planning system; and iii) the time difference between the billing and the payment date is less than 30 days.

Reform of Penalty Taxes

Penalty taxes against the non-compliance or inaccurate compliance with the filing requirements range from 10% to 30% according to the details set forth under the specific tax laws.

These penalty taxes will be imposed in a uniform manner as prescribed in the Basic National Tax Law (BNTL) as follows, effective from the taxable years beginning on or after December 30, 2006:

- A uniform 20% penalty tax will be imposed for failure to file a tax return, irrespective of the tax category (40% where the reasons for the failure to file are unreasonable);
- A uniform 10% penalty tax will be imposed for under-reporting (40% where the reasons for under-reporting are unreasonable);
- Penalty on the non-payment or under-payment will be calculated as follows: unpaid or under-paid tax x the number of days overdue x 0.03%;
- Penalty on excessive tax refunds, which currently applies to the VAT, special excise tax, transportation tax and liquor tax, will additionally apply to the corporate income tax and individual income tax;
- Taxpayers will be exempt from penalties if there is a justifiable reason (other than natural disaster or calamity) for the non-compliance or inaccurate compliance;
- Penalty taxes against the non-payment or under-payment by the due date will be reduced by 50% in case of late payment due to failure to provide notice of the pre-assessment proceedings results; and
- New ceilings on penalty taxes will be created so that a penalty tax shall not exceed 100 million won for 'unintentional' non-compliance as specified in the law.

Taxation of Joint Businesses

- **Applicable Scope**

According to the Individual Income Tax Law (IITL), the term 'joint business' is defined as a business having real estate income, business income or forestry income managed by two or more individuals for tax purposes. Under the revised IITL, this term shall apply to joint businesses as long as the gains or losses arising from the business are apportioned to owners of the joint business. Taxable income of such a joint business is calculated as if it were a sole proprietorship and apportioned to owners of the joint business for income tax purposes.

An "anonymous association" under the Commercial Code will be added to the applicable scope of the taxation of the joint business. The joint business taxation has covered associations under the Civil Law and organizations not treated as a corporation where details on the apportionment of income are set forth or income is actually apportioned to owners.

This change will apply to taxable years beginning on or after January 1, 2007. It should be noted that existing businesses affected by the revised law must file revised business registrations with the tax office as required for joint businesses by December 31, 2007.

- **Apportioning Principle**

A provision of the revised law sets forth details on the apportionment of gains or losses. If specific apportioning rates to which owners have agreed are available, the specified rates shall apply. In the absence of such an agreement, gains or losses shall be apportioned in proportion to the ownership ratio.

This change will apply to income arising on or after January 1, 2007.

- **Penalty for Registration of Joint Businesses**

Penalty tax will be newly imposed against inaccurate registration of businesses and the failure to comply with the registration requirements. Penalty taxes for inaccurate registrations range from 0.1% to 0.5% of the total revenues.

Other Changes

- **Capital Gains Tax on Sale of Korean SMC Shares traded on Foreign Stock Exchange**

  Gains earned by a Korean resident from the sale of shares traded in foreign stock exchanges are generally subject to a 22% capital gains tax (including surtax). However, for gains arising from the sale of shares issued by Korean SMCs listed on foreign stock exchanges, the capital gains tax is lowered to 11% (including surtax).

  The lower tax rate will apply to such sales on or after January 1, 2007.

- **Sunset Clause on Exemption from Capital Gains Tax**

  Taxes are currently not imposed on gains arising from the transfer of equity shares in SMC venture capital companies, SMC commercializing new technologies and other ventures as specified in the STTCL. Sunset clauses are inserted in the STTCL to terminate the tax exemption on December 31, 2009.

- **Characterization of Profit from Investment Trust**

  Profit from investment funds received from domestic corporations will be treated as dividends, irrespective of the proportion of investment portfolio assets. Previously, such profit was included in interest or dividends depending on the proportion of portfolio assets held by the funds. This change will be applicable to investment funds to be raised on or after January 1, 2007.

- **Tax Audit Procedures**

  The revised BNTL requires tax authorities to notify a taxpayer of a planned tax audit 10 days (rather than 7 days) before audit procedures commence.

  When a taxpayer files with the tax authorities a request for the delay of a tax audit, the BNTL requires the tax authorities to notify the taxpayer of their decision as to whether the request is accepted. The tax audit procedures shall not commence before such notice is given to the taxpayer.

  This change will apply on or after January 1, 2007.

- **Controlling Shareholder subject to Secondary Tax Liability**

  Pursuant to the Local Tax Law, controlling shareholders may be subject to secondary tax liability and deemed acquisition tax. In this context, "controlling shareholders" refer to shareholders who, together with related parties, hold more than 50% of the outstanding shares of an unlisted company, compared with the previous threshold of 51% or more.

Samil PricewaterhouseCoopers International & Tax Group
Kukje Center building 25th Flr., 191, Hangangro 2ga, Yongsanku, Seoul 140-702, KOREA

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Tax Leader

Soo-Hwan Park	82 2 709-0705	shpark@samil.com

International Tax Services

Sung-Chun Ko	82 2 709-0725	scko@samil.com
Dong-Keon Lee	82 2 709-0561	dklee@samil.com
Tae-Kyoon Choi	82 2 709-0284	tkchoi@samil.com
Sang-Keun Song	82 2 709-0559	sksong@samil.com
Dong-bum Kim	82 2 709-7900	dbkim@samil.com
Alex Joong-Hyun Lee	82 2 709-0598	joonglee@samil.com

Transfer Pricing

Heui-Tae Lee	82 2 3781-9083	htlee@samil.com
Henry An	82 2 3781-2954	henryan@samil.com
Jung-Il Joo	82 2 709-0722	jijoo@samil.com
Shin-Jong Kang	82 2 709-0578	sjkang@samil.com

World Trade and Customs

Sang-Keun Song	82 2 709-0559	sksong@samil.com

Human Resource Services

Younsung Chung	82 2 709-0538	yschung@samil.com

Financial Services

David Jin-Young Lee	82 2 709-0557	jylee@samil.com
Han-Jun Chon	82 2 3781-3489	hjchon@samil.com

www.samil.com

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