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Samil Commentary
Korean Tax Update

Samil PricewaterhouseCoopers

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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.

Korean Tax Law Changes for 2009

The latest amendments to the Korean tax laws include corporate and individual income tax rate cuts, reduction in withholding tax on interest and dividends paid to non-residents and foreign corporations, deduction for R&D reserve and details of consolidated tax return to be adopted in 2010. Most of the changes will become effective starting January 1, 2009 unless specified otherwise.

Provided below is a brief summary of major changes, which have passed the National Assembly in December 2008.

CORPORATE INCOME TAX LAW (CITL)

NOL Carry-forward: The presently allowed net operating loss (NOL) carry-forward of 5 years will be extended to 10 years. This change would be applicable from the NOL generated from the fiscal year beginning on or after January 1, 2009.

Eased Restrictions on DRD: Dividend received deduction (DRD) of 30% to 100% is currently granted based on the shareholding ratio, but there is a limitation in DRD amount when a dividend paying subsidiary invests in an affiliate company. This limitation will be eliminated to ensure that DRD should be granted with no restriction on an investment into an affiliate.

NOL Carryover in a Merger: Under the current Corporate Income Tax Law (CITL), the NOL of a surviving company after a merger can be utilized 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 be offset only against the taxable income from its business when the merger meets all the conditions below. The utilization 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.

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

The conditions for the NOL carryover of a merged company are as follows:

- Assets and liabilities are transferred at book value
- The two companies shall have operated for more than 1 year prior to the merger
- 95% or more of the consideration paid for the merger shall be the shares of the merging company
- The surviving company shall continue the business of the merged one at least to the end of the fiscal year in which the merger occurs
- The shares given in consideration for the merger shall account for 10% or more of the merging company's outstanding shares as of the merger registration date
- The accounting book of the merged business shall be separately recorded and managed from the business of the surviving company.

This change will apply to mergers that take place on or after January 1, 2009.

Deduction for In-kind Contributions: A new provision is included in the amended CITL to allow corporations to deduct the gains from a certain in-kind contribution. The conditions for such a tax deduction are as follows:

- 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.
- Shares or property directly used in the contributor's business as specified in the Presidential Decree must be contributed.
- The new company shall operate the contributed business at least through the end of the fiscal year when the in-kind contribution occurs.
- 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 deducted gain shall be recaptured to be 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.

This change will apply to in-kind contributions made after the amended rules are enforced.

Dividend Deduction for Investment Banks: Under 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.

Tax Rate Cuts: The corporate income tax rates will be 11% on the taxable income of up to KRW200M and 25% on the excess in the fiscal year which includes the date of enforcement. The rates will be adjusted to 11% and 22% in the fiscal

year immediately following the year of the enforcement date, and further be reduced to 10% and 20% afterwards.

In the case where a tax liability of an SME exceeds KRW10 million, such an SME is able to pay the liability in two installments and the second installment 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 in the second installment payment (i.e. in 1 month) for non-SME companies.

Corporate Income Tax on the Income Earned by Foreign Corporations

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

(a) Gain from a transfer of the assets or the rights stipulated below (only where such assets or rights are present in Korea):

- Land, buildings, rights to acquire, lease or create superficies of property located in Korea;
- Goodwill transferred along with business assets;
- Rights or memberships given in exclusive or preferential arrangement for members of certain organizations; and
- 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.

(b) 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, but not in Korea.

Withholding Tax: Withholding tax rates for dividends, interests, royalties or other income paid to nonresidents or foreign corporations will be reduced from 25% to 20% from the payments to be made on or after January 1, 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 case 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.

Consolidated Tax Return

A consolidated tax return system will be introduced from the fiscal year starting on or after January 1, 2010, allowing taxpayers to elect the current separate tax return filing system or the proposed new 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 on 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-company transactions, recalculation of the tax limit on donations and entertainment expenses, etc.

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Consolidated NOL carry-over, non-taxable income and income deductions will be subtracted to calculate the consolidated tax base. In this context, NOL of an entity in the consolidated group, which were incurred prior to the election to use the consolidated tax filing, shall be utilized 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 by each entity in the consolidated group, which shall be summed up to be 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 to test its eligibility. For a company graduating from SME due to the election to use the consolidated tax return system, a four-year grace period (the first tax year under the new system and the following three consecutive years) shall be given before the termination of 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.

VALUE ADDED TAX LAW (VATL)

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 (ERP) system

This change is effective from January 1, 2010. A taxpayer that wants to apply the taxpayer-based VAT system from January 1, 2010 shall register with the relevant tax office until December 11, 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 January 1, 2010.

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TAX PREFERENCIAL CONTROL LAW (TPCL)

R&D Reserve: R&D reserve will be deductible up to 3% of the sales revenue in the income statement prepared in accordance with the Korean GAAP. To the extent of the R&D costs paid out of this reserve for the following three years from the end of the fiscal year in which the R&D reserve was tax deducted, the amount will be included in the taxable income in three yearly installments from the third fiscal year. Any balance unpaid by the end of the third year will be added back to the taxable income in that third fiscal year along with the interest calculated as stipulated by the law. The new law is effective from the fiscal year starting on or after January 1, 2009 through the fiscal year that ends on or before December 31, 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. 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

Tax Credit on Investment in Environmental Facility: The tax law currently provides for a 7% tax credit with respect to investment in facilities designed to preserve the environment. Under the change, a 10% credit will be applied to such investment for the fiscal year whose tax liability is due on or before December 31, 2009 and after that, an 8% credit will be applicable to the investment made until the end of December 2010.

Tax Incentive for Relocation: The amended law grants a tax incentive for relocation of factories in government administration-functioned cities to rural areas. The tax incentives include a 50% reduction in individual or corporate income tax earned from the relocated business for up to four years. Application shall be properly filed to benefit this tax incentive.

Inventory Sales by a Non-resident from a Bonded Area: When assets produced or acquired outside Korea are transferred or sold in Korea by a foreign corporation without a permanent establishment in Korea, 2% withholding tax is currently imposed at the time payment is made. Under the amended law, such withholding tax will be waived in case where such assets are transferred or sold in Korea after being stored in a bonded warehouse. Application shall be properly filed to benefit this tax relief

Relocation to Rural Areas: The existing tax relief for the relocation of a head office or a factory into non-metropolitan areas or rural areas will be available for three more years until the end of December 2011. The tax reliefs include the 100% exemption from corporate or individual income taxes for the first five years and 50% reduction for the two subsequent years in case where a factory or a head office is relocated from a metropolitan area to a rural area. In addition, capital gains tax arising on the sale of head office buildings or factories in a large city may be paid in annual installments or capital gains will be included in their taxable income in a prescribed manner.

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Alternative Minimum Tax: In line with the two-phase reduction in corporate income tax rates, alternative minimum tax rates will also be lowered. Under the change, the alternative minimum tax will be 13% for the tax base of up to KRW100 billion (15% for the excess and 8% for small and mid-size companies (SME)) before applying various tax credits and attributes in the fiscal year which includes the date of enforcement. The rates will be adjusted to 11% (14% for the excess and 8% for SME) in the fiscal year immediately following the year of the enforcement date, and further reduced to 10% (13% and 7% for SME) afterwards.

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 Corporate Income Tax Law (i.e. the excess of 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 installments for three years.

Changes to Partnership Taxation; Tax rates on income allocated by a partnership to non-resident partners or foreign corporate partners will be adjusted. Under the amendment, 20% income tax will be levied on income allocated to passive partners, while the maximum corporation tax or individual income tax rates under Individual Income Tax Act 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 CITL and taxed as such rather than being treated as dividends under Individual Income Tax Law.

LAW FOR COORDINATION OF INTERNATIONAL TAX AFFAIRS

Changes to the Law for Coordination of International Tax Affairs ("LCITA") are made to improve the transfer pricing scheme, provide a penalty relief for taxpayers maintaining contemporaneous transfer pricing documentation and ease anti-tax haven rules for wholesale business and overseas holding companies.

Permanent establishments of foreign corporations in Korea will no longer be included in the definition of overseas related parties. Accordingly, where a foreign corporation's PE is the transaction counterpart of a domestic company, the relevant Korean source income arising from the related party transactions will no longer be subject to the tax adjustment based on the arm's length principle under LCITA. Instead, such transactions will be viewed as domestic transactions, subject to the rules for denial of unfair trade between related parties under CITL.

Anti-tax Haven Rule

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 parities 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 subsidiary 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 ("deemed dividends") to the domestic corporation, which has direct and indirect interest of 20% or more in such subsidiary.

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 subsidiary at least for six months as of the cut-off date for dividend distribution; and ii) dividends received from foreign subsidiaries 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 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 subsidiary 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.

Deemed dividends from a foreign subsidiary are added to the domestic shareholding company's taxable income. And when dividends are subsequently paid, any foreign tax paid on such dividend will be credited against the domestic shareholding company's corporate income tax liability for the year the deemed dividend was taxed. To obtain the foreign tax credit, a taxpayer may request a tax reassessment for the past fiscal year (when deemed dividend was taxed) within one year from the income tax filing due date for the year when the dividend was actually received, according to the amended rules.

Waiver of Underreporting Penalty

Under the existing law, underreporting penalty can be waived on transfer pricing 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 recognized that the TP method has been reasonably selected and applied

The above changes to LCITA will be applicable from the fiscal year starting on or after the enforcement date or the tax reassessment made on or after the enforcement date.

SECURITIES TRANSACTION TAX LAW

Changes to Securities Transaction Tax Law are intended to improve the tax payment and filing procedures. Effective January 1, 2009, a securities company will no longer have to file and make payments of securities transaction tax by each branch office. Instead, the head office of a securities company will be able to aggregate and make payments of taxes for its branches as long as the company is registered to use the taxpayer-based VAT filing system rather than the business place-based VAT filing system.

For transaction of securities occurring not in the market, the filing and payment due for securities transaction tax will be changed from "by the 10th of the following months" to "within 2 months from the end of calendar quarter which includes the date of transaction." This is intended to make the filing/payment schedule for securities transaction tax consistent with that of capital gains tax.

BASIC NATIONAL TAX LAW

Penalties on Amended Returns: Penalties imposed on underreported income is presently reduced by 50% if a corporation files an amended tax return and pays taxes within six months from the statutory filing due date for the tax return. Under the amended rules, the penalty relief will be

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extended to 50% for the amendment within 6 months, 20% for the amendment after 6 months but within 1 year, and 10% for the amendment after 1 year but within 2 years from the original tax filing due date. The penalties subject to this relief are the penalties for underreporting of taxable income and over-reporting of tax refund and the penalty for underreporting of zero-rate VAT revenue.

This change will apply to the amendment filed after the date of enforcement.

Reassessment Request-Applicable Income: Non-residents or foreign corporations are currently allowed to file a request for a tax refund when they disagree with the tax assessment on certain types of income such as income from rental of vessels or aircrafts, business income, personal service income, royalties and capital gains from a share transfer. Under the amended law, a refund request will additionally be applicable to interests and dividends.

Extended Statute of Limitations: In line with the extended NOL carry-forward from 5 years to 10 years under the amended income tax law, a change is made to the rules of statute of limitations.

Where a taxpayer uses the NOL incurred more than 5 years ago (which is limited to 10 years), the statute of limitations shall be one year from the filing due date of the fiscal year
when the NOL is utilized. 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.

When a taxpayer files a request for tax reassessment under the amended anti-tax haven rules, the statute of limitation will be 2 months from the date of reassessment request. According to the amended anti-tax haven rule in LCITA, a taxpayer may request a tax reassessment to obtain a foreign tax credit within one year from the income tax filing due date for the taxable year which dividends are actually are received.

Taxpayers are presently required to keep books and underlying records of all transactions for five years following the statutory corporate tax return filing due date. In the case, however, the NOL incurred more than 5 years ago (but limited to 10 years) are carried forward and utilized, the mandatory period for record keeping shall be until 1 year from the filing due date of the fiscal year when such NOL is used.

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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