

# Samil Commentary

## Korean Tax Update

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### Tax Law Changes for 2010

On December 23, 2009, the Strategy and Finance Committee of the National Assembly approved the government's tax reform proposal for 2010 with some revisions. Subject to the finalization by the Legislation and Judiciary Committee of the National Assembly, most of the changes will become effective starting January 1, 2010 unless specified otherwise.

Provided below is a brief summary of changes passed in the Strategy and Finance Committee.

#### Corporate Income Tax

##### Highest Income Tax Rate to be Lowered Two Years Later than Scheduled

Although the highest corporate income tax rate was scheduled to be lowered from 22% to 20% in the tax year commencing on or after January 1, 2010 ('FY2010') under the previous tax reform approved at the end of December 2008, the decrease may be postponed for another two years until the end of 2011. But the lower tax rate applicable to the tax base of up to KRW200 million would be reduced to 10% as scheduled.

Tax base (KRW)	FY2009	FY2010	FY2012
Up to 200 million	11%	10%	10%
Over 200 million	22%	22%	20%

##### Easing of Indirect Foreign Tax Credit Requirements

The tax law allows a domestic corporation to obtain an indirect foreign tax credit for the underlying foreign corporate income taxes on dividends paid by its overseas subsidiary as long as the domestic corporation holds 20% or more shares in the subsidiary. The 20% threshold will be lowered to 10% to facilitate inbound remittance of funds from overseas subsidiaries to domestic companies and to encourage the outbound investment by local companies.

### **Tax Withholding Requirement Revived on Bond Interest Received by Financial Institutions**

Unlike the case where the recipients are individuals or non-financial companies, interest income received by financial institutions is not subject to tax withholding by the payer. For bond interest earned by financial institutions, tax withholding (14%) may be applicable from the income arising on or after January 1, 2010.

### **Stimulation of Corporate Restructuring**

Three major changes are provided to stimulate corporate restructuring starting July 1, 2010. First, types of transactions considered as M&A will be extended, enabling companies engaged in transactions will be eligible for tax benefits or deferrals. Comprehensive share exchanges and comprehensive asset transfers will be eligible for the existing M&A taxation, i.e. corporate income tax and dividend income tax will be deferred and taxed later on and securities transaction tax will be exempt.

Second, assets eligible for tax deferrals on its capital gains will be extended to all assets, while the tax deferrals are limited to tangible fixed assets used for business purposes in the current merger and split-off taxation regime. However, in order to prevent possible tax evasion through M&As, requirements for corporation's substantial consistency after M&A, which is key in determining eligibility for tax deferral, will be strengthened as follows: 1) shareholder of the merged company will be required to hold the shares for a certain period; and 2) the merging company will be required to hold 50% of the assets acquired in the merger for a certain period.

Third, the existing tax deferral on capital gains arising on in-kind contributions will be available in the event of capital increases through in-kind contributions and in-kind contributions by means of all assets. The current taxation limits the tax deferral to the event of corporate establishment and in-kind contributions by means of shares, tangible fixed assets used for business purposes.

### **Extension of Income Tax Filing Period**

With proper application, the income tax filing period can be extended by up to month from the statutory filing due date for companies subject to the statutory external audit (i.e. companies listed on the

Korea Stock Exchange and KOSDAQ and those having total assets worth KRW10 billion as at the immediately preceding fiscal year-end). A daily 0.03% rate of interest will be charged for the extended period.

## **Tax Incentives**

### **Higher R&D Tax Credit for Core Technologies and Strategic Growth Industries**

Companies presently claim a tax credit in relation to qualifying R&D expenditure to the extent of either (1) 3-6% (25% for SMEs) of the current R&D expenses or (2) 40% (50% for SMEs) of the incremental portion of the current R&D expenses over the average of the previous 4 years. The tax credit will be extended to include R&D in relation to core technologies as authorized by government ministries as well as pre-designated strategic growth industries until the end of December 2012 and for these industries, the credit rate for the current R&D expenditure would be 20% (30% for SME).

### **Temporary Investment Credit**

The sunset for temporary investment credit, 10% of the investment in the concerned year (3% in a metropolitan area) will be extended by one year until the end of December 2010 with a lower rate of 7% for non-metropolitan area. However, the incentive in relation to investment in a metropolitan area and an additional credit for incremental increase in investment will no longer be available from January 1, 2010.

### **Tax Deferral for Relocation of Logistics Facilities Due to Expropriation**

Capital gains from the relocation of qualifying logistics facilities may be added to the taxable income in three-year installments after a three-year grace period when it is caused by the government expropriation plan. Qualifying facilities include storage, assembly and repairing facilities of manufacturers or logistics companies' facilities as specified the logistics law, both of which should have been used for at least five years.

### **Extended Sunset for Tax Deferral for Forced Factory Relocation Due to Expropriation**

For a factory relocation forced by the government expropriation plan, the sunset for tax deferral, i.e.

inclusion of capital gain in the taxable income in three-year installments after a three-year grace period, will be extended by three years until the end of December 2012 with eased requirements.

## Value Added Tax

### Aggregated VAT Filing

The aggregated value added tax (VAT) filing will be allowed only by filing an application to the National Tax Service rather than the currently-required prior approval from NTS.

### One Year Grace Period for Electronic VAT Invoicing

The enforcement of compulsory electronic VAT invoicing system will be delayed by one year. Corporate taxpayers can use either the existing paper VAT invoicing or electronic VAT invoicing for the year of 2010, i.e. no penalty applicable for non-implementation of electronic VAT invoicing in 2010. Electronic VAT invoicing will be enforced as a compulsory requirement from 2011 and the relevant penalties for non-invoicing/non-reporting will be imposed in two phase (i.e. phase one with a lower rate for 2011-2012 and phase two with a higher rate from 2013). Also, electronic VAT invoicing will become compulsory to individual VAT business operators from 2012,

In an effort to encourage the early adoption of electronic VAT filing, certain tax incentives (i.e. KRW100 tax credit per case, which shall not exceed KRW 1 million per year, waiver of the submission of VAT invoicing summary) will be granted to those who early adopt the electronic VAT invoicing system and submit electronic VAT invoices to NTS.

## Taxation of Cross-border Transactions

### Foreign Exchange Rate in relation to Debt-to-Equity Ratio under Thin Capitalization Rule

For calculation of the debt-to-equity ratio in applying the thin capitalization rule in relation to foreign currency-denominated loans from the foreign head office, the Korea branch of foreign banks will now be allowed to elect (1) the KRW equivalent of such loans translated at the foreign exchange rate as of the fiscal year-end or (2) cumulative average of the

daily loan balances translated at the daily exchange rate. Once elected, the translation method shall be applied at least for five years. Non-financial companies, however, shall continue to use the foreign exchange rate as of the fiscal year-end. The change will be applicable to borrowings for the fiscal year 2009 (i.e. from the tax filing in 2010).

## Securities Transaction Tax

### Taxation of Financial Derivative Transactions

A new legislation is introduced to levy securities transaction tax (STT) on financial derivative transactions after a three-year grace period. For the first three years, such transactions will be subject to zero-rate STT and thereafter a basic rate of 0.01%, which may be reduced to a lower rate or zero by the Presidential Decree when needed to promote the growth of the capital market. Taxable financial derivative transactions will be defined by the Presidential Decree.

In addition, transactions of beneficiary certificates of exchange trade funds investing in Korean stocks will be subject to 0.1% STT starting January 1, 2012.

## Basic National Tax Law

### Restriction on Tax Audit Extension

Restrictions on the expansion of tax audit period or scope are codified in Basic National Tax Law. The new rules limit the audit duration to 20 days for taxpayers having revenue of less than KRW10 billion with certain exceptions. When an extension is determined necessary, the extension period shall not exceed 20 days per event. Also, it will be banned to expand the audit scope for reasons other than those specified by the Presidential Decree. If requested by the taxpayer, original books and documents taken for examination must be immediately returned to the requesting taxpayer, while the taxpayer must confirm that the submitted copies are taken from the original books and documents.

This change will be applicable to tax audits starting on or after April 1, 2010.

## Individual Income Tax

### Highest Income Tax Rate to be Lowered Two Years Later than Scheduled

Although the highest individual income tax rate was supposed to be lowered from 35% to 33% from 2010 under the prior year tax reform plan, the current rate will be retained for two more years until the end of 2011. The reduction in lower income tax rates, however, will be enforced as scheduled in 2010. The individual income tax rates will be as follows.

Taxable Income (KRW)	FY2009	FY2010	FY2012
Up to 12 million	6%	6%	10%
Over 12 million to 46 million	16%	15%	15%
Over 46 million to 88 million	25%	24%	24%
Over 88 million	35%	35%	33%

While the reduction in highest income tax rate is delayed by two years, the government has decided to suspend the planned reduction in earned income tax credit and earned income deduction for high income earners for two years until the end of 2011. Accordingly, for high income earners (i.e. KRW100 million in gross annual salaries and wages), the planned termination of earned income tax credit and the reduced earned income deduction (from 5% to 1%) will be enforced starting January 1, 2012.

### Carry Forward of Charitable Contributions

A new provision is created to allow legally-set contributions to be carried forward to the next year. The carry forward of an excess amount of designated contributions for social welfare, public interest, religion, arts, etc. will be extended to five years, compared with three years at present. Legally-set contributions are fully deductible, while designated contributions are deductible within the permitted limits under the tax law.

### Elimination of Tax Credit for Pre-filing of Capital Gain

As an incentive to facilitate early filing of capital gain tax on the sale of real estate, a 10% tax credit is granted if the taxpayer files the capital gains tax return within two months from the date of sale. In general, capital gains tax shall be reported and paid

in filing the global income tax return in May of the following year. This pre-filing tax credit will be abolished and instead, the pre-filing will be a compulsory requirement, applicable to the transaction occurring on or after January 1, 2010.

The non-compliance with pre-filing requirements will be subject to penalties (10% against under-filing, 20% against non-filing and 10.95% per annum against the underpayment of capital gains tax). However, one-year grace period will be given before the elimination of tax credit, i.e. until the end of December 2010, a 5% tax credit will be given for pre-filings for the tax base up to KRW46 million.

## Update on Tax Administration

### NTS Guidance for Effective Enforcement of Tax Laws

The National Tax Service (NTS) has set out the practical guidance for the enforcement of Value Added Tax (VAT) Law and the relevant basic rulings. While the basic rulings (*Gibon Tongchik*) are rule-based guidance, the latest guidance is working-level guidance on how to effectively handle real life cases based on front-line experiences from written inquiries and answers covering a broader and more diversified range of issues.

According to NTS, the latest guidance represents the first of its kind and will be followed by a subsequent series of guidance for corporate income tax, individual income tax, gift and inheritance taxes. This practical guidance is aimed at enhancing the transparency and public trust in the enforcement of tax laws and thereby reduces tax administration cost while improving taxpayer's satisfaction about tax administration.

In December 2009, NTS has also issued a series of guidance to clear uncertainties on five selected issues as follows, which have been causing much controversy in the enforcement of the tax law.

- VAT Law: Allocation of common input VAT between VAT business and VAT exempt business
- Individual Income Tax Law: Classification of business profit or capital gains for the income

from the sale of real estate

- Corporate Income Tax Law: Distinction of entertainment expenses from similar expenses such as donations, advertising expenses, etc.
- Capital Gains Tax: Determination of acquisition cost, capital expenditure and transfer cost that are deductible in computing capital gains tax
- Gift Tax: Determining the tax liability for the deemed gift of trust assets

In addition to the latest guidance, the NTS plans to develop another series of guidance on 20 additional issues by the end of December 2010.

## Rulings

### Foreign Shareholder in Applying Independence Criteria for Small and Midsize Enterprise

The tax law provides for various tax benefits for small and midsize enterprises (SMEs) meeting criteria in terms of industry, size and independence. The independence criteria provide that a company, having total assets of KRW500 billion, shall not own 30% or more interest in a qualified SME. This criterion shall equally applicable to foreign companies. In case of a foreign shareholder, the total asset test will be based on the KRW equivalent of the foreign shareholder's total assets per balance sheet as of the immediately preceding fiscal year-end. (*Beopin-1172, 2009.10.20*)

### R&D Tax Credit in relation to ERP Development Outsourcing Cost

With respect to R&D activities outsourced to or jointly performed with organizations as specified in the tax law, a domestic company (except certain entertainment service companies) is entitled to a tax credit for manpower development and R&D expenditure as stated in Article 10 of the Tax Preferential Control Law (TPCL). When a company engaged in manufacturing or wholesales/retails industry outsources the

development of its enterprise resources planning (ERP) system to another company having an in-house dedicated R&D department, R&D credit shall not be available for the outsourcing cost of ERP system development. (*Beopin-1007, 2009.9.14*)

### Tax Benefit for Factory Relocation

A company has operated in Seoul for more than three years with a number of factories located in metropolitan as well as non-metropolitan areas to manufacture multiple kinds of products. If the company demolishes obsolete work-in-process machinery in a metropolitan factory and moves the factory's remaining machinery to a non-metropolitan area, the company will be eligible for tax benefit under Article 63-2 of TPCL (i.e. tax exemption or reduction for the qualifying relocation of a head office or a factory in a metropolitan area) with respect to income arising from the moved production lines in the non-metropolitan factory.

However, if the company leases the equipment in its metropolitan factory to another company's factory rather than removing it to its non-metropolitan factory, the tax benefit will not be available as it is not deemed as the relocation in its entirety. In this context, if a separate production line for one product is all relocated while other facilities including the factory building are all sold, it may be seen as relocation in its entirety. (*Beopin-1253, 2009.11.9*)

### Investment in Business Assets Acquired from Insolvent Company

In case where a company purchases business assets from another company, which have remained under construction in progress for over several years due to the insolvency of the seller company, the buyer company cannot claim the temporary investment tax credit under Article 26 of TPCL even if it completes the investment after the purchase. (*Beopin-1338, 2009.11.30*)

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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### Who are small companies ?

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- Manufacturing industry with 500 or less employees
- Construction, transportation, storage and telecommunication industry with 300 or less employees
- Other service industries with 100 or less employees

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