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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.

Changes to Korean Tax Laws for 2008 (2)

Following the approval of new tax laws at the end of December 2007, proposed amendments to the enforcement decrees of tax laws have been announced by the Ministry of Finance & Economy on January 16, 2008. This newsletter includes some of the important changes contained in the proposed amendments to the enforcement decrees, which are expected to be approved at the end of February with few changes upon the MOFE's proposal. Most of these changes will be effective from January 1, 2008 or the tax year beginning on or after January 1, 2008 unless otherwise specified.

Securities Transaction Tax on Related Party Share Transfer at Arm's Length Price

According to the amended enforcement decree of the Securities Transactions Tax Law (STTL), when a share transfer is made between related parties, either or both of which are foreign corporations or nonresidents, and the actual transfer price is identifiable, the share transfer will be taxed on the amount greater of the actual transfer price or an arm's length price. Such share transfer is currently taxed on the amount greater of the actual transfer price or its fair market value.

The amendment is intended to eliminate an existing disparity in the tax base of such share transfer between the STTL and the Corporate Income Tax Law (CITL).

The amended securities transaction tax base will be applicable to the transfer to be made on or after April 1, 2008.

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Changes to Deregulate Business Management

Independence Criteria for Small and Mid-sized Enterprise

The Special Tax Treatment Control Law (STTCL) sets out three major requirements to qualify for tax benefits available for small and mid-sized enterprises (SME) under the law. To qualify, a SME must be engaged in one of the specified 33 industries, meet the size requirement (the number of employees, capital stock or gross sales), and meet the ownership or management independence requirement. A change will only be made to the independence criteria for this purpose.

In order to qualify for tax incentives under the amended rule, a SME must meet the following independence requirement (in addition to the existing requirements in terms of industry and size):

I) a corporation shall not belong to any business conglomerate as regulated by the Monopoly Regulation and Fair Trade Act; and

II) a parent company, having total assets of 500 billion Korean Won, shall not own 30% or more interest (including an indirect ownership as specified in the Law for Coordination of International Tax Affairs) in the corporation.

If a corporation, qualified as a SME under the existing rule, fails to meet the amended independence requirement, such company may retain the SME status during a three-year grace period and continue to receive tax benefits available for SMEs during the grace period.

This change to the independence criteria will apply from tax years ending on or after January 1, 2009.

Allocation of Common Expenses

In the absence of capital contributions to a joint business, there are separate guidelines for determining how advertising expenses and other common expenses incurred in relation to such joint business are allocated to the concerned parties.

The amended rule will contain two changes on the allocation of common expenses of a joint business. One of the changes will adopt single guidelines for the allocation of advertising as well as other common expenses of a joint business.

Separate from the single guidelines, however, the other change will use a different approach to determine the allocation base, depending on whether a joint business is operated with unrelated parties or related parties. In case of joint business with unrelated parties, common expenses will be allocated based on an agreement between the unrelated parties. In case of joint business with related parties, common expenses will be allocated based on the gross sales of each party. The cost of sales approach and the salary approach will no longer be used.

Accordingly, an amount of allocated common expenses in excess of a ratio specified in an agreement with unrelated parties or the gross sales ratio (the percentage share of gross sale of each party to that of the joint business) will be disallowed a deduction in calculating each party's taxable income for the concerned tax year.

This change will apply from the tax year beginning on or after January 1, 2008.

Dividend Received Deduction

An equity ratio a holding company should hold in a subsidiary for dividend received deduction (DRD) purposes will be changed as seen in the

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table below. This change will be applicable to dividends to be received in tax years beginning on or after January 1, 2008.

Subsidiary \ parent	Holding company		
	Equity ratio	Amended Equity ratio	DRD rate
Listed entity	100%	100%	100%
	Over 40%~less than 100%	Over 40%~less than 100%	90%
	Over 30% ~ 40%	**Over 20% ~ 40%**	80%
	30% or less	**20% or less**	30%
Unlisted entity	100%	100%	100%
	Over 80%~less than 100%	Over 80%~less than 100%	90%
	Over 50%~80%	**Over 40%~80%**	80%
	50% or less	**40% or less**	30%

Impairment Loss on Unlisted Shares

According to the existing CITL, in principle, the book value method should be used for the valuation of securities. As an exception, however, impairment losses are recognized in the cases as prescribed in the enforcement decree of CITL. Under the amended rule, impairment losses on securities issued by unlisted companies which are not related parties will be additionally recognized if the issuer becomes insolvent or is determined to be rehabilitated.

Currently, exceptions are only given in respect to securities issued by listed companies, start-up companies or new technology ventures owned by venture capital companies financing small and mid-sized start-up companies or new technology financing companies if the issuer becomes insolvent or is determined to be rehabilitated.

This change will be applicable to shares to be appraised for tax years beginning on or after January 1, 2008.

Monetary Assets and Liabilities Denominated in Foreign Currency

Currently, monetary assets and liabilities denominated in foreign currency are translated at the exchange rate at the end of a fiscal year, and differences in the book values arising from such translation of monetary items are recognized as foreign exchange translation gain or loss in the income statement of the concerned fiscal year.

However, the amended rule will no longer allow the recognition of such translation gain or loss, but with an exception to this rule for companies which carry on banking business pursuant to the Bank Act (banks).

For banks, translation gain on all the assets and liabilities denominated in a foreign currency will be recognized regardless of whether they are classified as either monetary or non-monetary items.

This change will be applicable from the tax year in which the enforcement date of the amended rule falls.

Valuation of Currency-related Derivatives

Under a proposed amendment of CITL, in general, gain or loss on valuation of currency-related derivatives of companies will no longer be allowed for tax purpose since it is viewed as unrealized gain or loss.

However, as an exception to the general rule, banks may opt to recognize gain or loss on the valuation of foreign currency forwards and currency swap contracts. Meanwhile, even banks will no longer be allowed recognition of gain or loss on valuation of financial derivatives other than foreign currency forwards and currency swaps.

According to the existing law, financial service companies such as banks, investment banks

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and securities companies are allowed to recognize such gain or loss from all currency derivatives. For non-financial service companies, this recognition has been limitedly allowed in respect of currency derivatives as a means to hedge against foreign exchange risk of monetary assets and liabilities denominated in a foreign currency.

This change will be applicable to tax returns to be filed on or after the enforcement date of the amended rule.

Interest arising from Bonds received by Financial Institutions

Financial institutions will no longer be subject to withholding tax on interest income arising from bonds. Currently, financial institutions are exempt from withholding tax on most interest income but not the interest income arising from bonds.

This change will be applicable to interest income to be received on or after June 1, 2008 or bonds to be transferred on or after June 1, 2008.

Changes to Rules for Tax Exemption or Reduction

Tax Credit in relation to R&D Activities Outsourced to SME

The tax law currently allows large corporations to credit a certain portion of expenditures in relation to their research and development (R&D) activities performed in their own capacities as well as R&D activities outsourced to qualified universities or small and midsize enterprises (SME) engaged in the R&D industry against their corporate income tax.

According to a proposed amendment, R&D expenditures will be additionally allowable in relation to R&D activities outsourced to SMEs in the R&D service industry, which combines R&D activities and R&D supporting activities. In such case, the amount to be credited is limited to 50% of an increment in R&D expenditures incurred in relation to R&D outsourcing for the concerned tax year from the average amount of such expenditures for the four preceding years.

The tax credit will be available for expenditures made on or after January 1, 2008.

Investment Credit for New or Renewable Energy Facilities

The tax law currently provides for 10% tax credit in respect to investments in facilities designed to save energy. The 10% investment credit will be extended to solar and optical energy production facilities and parts including tri-cholro silane (TCS) chlorinators, TCS purifiers, poly silicon chemical vapor deposition reactors, TCS vent gas recycling units, etc. The tax credit will be available for investments made on or after January 1, 2008.

Tax Credit for Investment in the Pharmaceutical Industry

A tax credit will be given to strengthen the quality control system of pharmaceutical manufacturers in anticipation of the free trade agreement with the US. Pharmaceutical companies will be allowed to credit 7% of their investment in the following facilities against their corporate income tax due for the concerned tax year:

- Support facilities including climate control and water treatment system;
- Facilities and equipment to manufacture and package pharmaceutical products
- Quality control equipment and apparatus including validation and calibration measurement equipment and censors; and
- New or additional buildings or structures in accordance with the Good Manufacturing Practice regulations.

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The tax credit will be made available for investments made on or after January 1, 2008.

Reassessment of Reduced Local Tax on Property Owner

In a bid to facilitate the relocation of a metropolitan-based company into a suburban area, the tax law has recently been amended to ease the tax burden of property owners by applying the separate taxation of local taxes to the owners of obsolete factories. Such separate taxation method will apply for five years from the date on which the factory is relocated into a suburban area in its entirety.

However, the separate taxation of local tax will be ceased in the following cases as set out by the amended rule:

- a company ceases its operations or is dissolved within a three-year period after the relocation
- a company will have purchased a factory site in a suburban area by December 31, 2008 and yet will not commence operations until the end of December 2011; or
- a company builds another factory in a metropolitan area which has the same production lines with the relocated factory.

In such cases, the amount of tax reduced under the separate taxation of local taxes shall be reassessed in the manner as prescribed in the amended rule.

This change will be applicable to the case occurring on or after January 1, 2008.

Indirect Foreign Tax Credit

The Korean tax law presently allows a domestic company to enjoy an indirect foreign tax credit to the extent of a deduction limit as prescribed under the enforcement decree of CITL if the company owns 20% or more of shares in its foreign subsidiary (or 25% or more of shares if there exists an income tax treaty between Korea and the country in which the foreign subsidiary is located) and the company receives dividend income from its foreign subsidiary.

Under the recent amendment, two changes are made to this rule. One of the changes applies the same shareholding ratio of 20% for indirect foreign tax credit purposes regardless of the existence of an income tax treaty. The other change is to exclude shares without voting rights in testing the 20% ownership threshold.

If those requirements are met, a domestic company is entitled to an indirect foreign tax credit as follows:

- 100% of a portion of the corporate income tax due of the foreign subsidiary in the foreign country which is attributable to dividend income received by the domestic company if an income tax treaty has been entered into between Korea and the foreign country; and
- 50% of such amount if no income tax treaty has been entered into between Korea and the foreign country,

If a domestic company has a foreign subsidiary as well as a foreign grandson company (i.e., a subsidiary of the foreign subsidiary), the indirect foreign tax credit will be given at the same basis as the foreign sourced dividends a domestic company receives from its foreign grandson.

These changes will be applicable to dividends to be received on or after the enforcement date of the amended rule.

Tax Incentives for Foreign Direct Investment

There are two important changes in relation to tax incentives for foreign direct investment. One of the changes lowers the minimum capitalization requirements for a research and development (R&D) business located in an exclusive zone for foreign investment companies (foreign investment zone) from

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US$5 million to US$2 million. Any qualified company in a foreign investment zone shall enjoy tax incentives including the 100% exemption from corporate income tax for the first five years and 50% reduction for the two subsequent years.

The other change will extend the existing tax incentives for foreign investment in a free economic zone (FEZ) to a qualified R&D business meeting the following requirements:

- Minimum capitalization of US$1 million; and
- At least 10 full-time research staffs having a master's degree in a science and technology area and three-year research experience

Tax incentives for a qualified R&D business in FEZ will be given only to research facilities associated with pre-designated high technology or industry-support businesses. The tax incentives for qualified foreign investment in FEZ include the 100% exemption from corporate income tax for first three years and 50% reduction for the two subsequent years.

These changes will be applicable to investment to be made on or after the enforcement date of the amended rule.

Transfer of Tax-favored Foreign Invested Business

When a foreign invested company receiving tax exemption or reduction closes its business or ultimately fails to meet the requirements for tax reduction or exemption, the corporate income tax and other taxes previously reduced or exempt shall be collected in the manner as prescribed in the STTCL. However, an exception from the collection of previously exempted or reduced taxes is given if the two conditions exist:

i) A foreign investor transfers its shares in a foreign invested company to a Korean resident; and
ii) It is confirmed by the MOFE that the company transferred by a foreign investor is able to manufacture products or to supply services at its own domestic capacity which had been produced by qualified high technology or industry support business of the foreign invested company.

According to a proposed amendment, the foregoing exception rule may also apply in case where a foreign investor transfers its foreign-invested business, which previously received tax exemption or reduction, to a Korean resident if the above condition ii) is met.

The change will apply to the business transfer to occur on or after the enforcement date of the amended rule.

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 specific 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
Shin-Jong Kang	82-2-709-0578	sjkang@samil.com
Sang-do Lee	82-2-709-0288	sdlee@samil.com

IFRS

Background

Following the international trend of over 100 counties that have adopted or permit the use of International Financial Reporting Standards (IFRS), the roadmap to full IFRS adoption in Korea was announced by the Korean regulators on March 15, 2007. Based on this roadmap, all listed companies are required to fully adopt IFRS as their financial reporting language by year 2011 with early adoption permitted from year 2009.

The adoption of IFRS will become a new era for corporate reporting in Korea and will need to be supported by resources at all levels within the corporate environment. Such resources will need strong IFRS knowledge to adopt, embed and maintain the new reporting language in the organization.

Samil PricewaterhouseCoopers Learning and Education Services

The E-Learning course contains two modules, IFRS I (fundamentals) and IFRS II (intermediate), and runs for two months each. The modules have been designed to inform participants on specific IFRS topics and adoption issues with case studies and examples.

The modules are presented by the Samil PricewaterhouseCoopers IFRS CoE and IFRS Services team members. Samil PricewaterhouseCoopers' IFRS CoE was the very first established IFRS expert group in Korea and is lead by Kevin Kab Jae Lee who is an IFRS committee member of the Korea Accounting Standards Board (KASB) and the Korean Accounting Association (KAA), and a member of Regulatory Improvement Committee of Financial Supervisory Commission (FSC).

Participants and Requirements

Executives and officers responsible for finance and accounting in listed companies and financial institutions are strongly encouraged. Cost to participate in each module is KRW 180,000, of which a significant portion is refunded by The Ministry of Labor.

Samil PwC Contact

Rowena Lee Telephone : 82.2.709.8713 Email : rowena.lee@samil.com

Samil Academy
Samil PricewaterhouseCoopers
Kukje Center Building 6F, 191 Hangangno 2-ga, Yongsan-gu, Seoul 140-702, Korea

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