Tax News Flash

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Korea's Tax Reform Proposals for 2019

In Brief

The Ministry of Economy and Finance (MOEF) released the government's tax reform proposal for 2019 on July 25, 2019. The proposal encompasses some key focus areas – it aims to support economic resilience and innovative growth, promote inclusive growth to alleviate social inequalities and continue to expand tax revenue sources by rationalizing the tax system. The proposal includes changes to increase the capacity of collecting tax revenue such as the adjustment of employment income tax deduction and the expansion of tax base on retirement pay of directors or officers. The proposed expansion of tax credits for certain facility investment and small- and medium-sized startups may decrease the tax revenue. Consequently, the tax reform proposal if enacted may result in a decrease in the total tax revenue of KRW470 billion (on a cumulative basis) over the next five years.

The government's proposal will be finalized with modifications, if any, before being submitted to the National Assembly on September 3, 2019. Provided below is a brief summary of selected significant tax reform proposals that may affect domestic corporations as well as foreign investors.

In Detail

Proposed Changes in Tax Incentives for Certain Facility Investment

To help facilitate economic growth and increase corporate investment, the government's proposals include the following changes.

- Currently, for qualifying investment in certain facilities to enhance productivity, the amount of 1% of such investment can be deducted from corporate income tax payable of a large corporation (3% for middle-scale companies and 7% for small- and medium-sized enterprises (SMEs)). The credit rates would temporarily increase to 2%, 5% and 10%, respectively, with respect to investments made from January 1 through December 31, 2020.

- The tax credit for investment in productivity enhancement facilities would newly apply to (i) high-tech facilities used to manufacture

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pharmaceutical goods and (ii) high-tech facilities for the logistics industry. In addition, the sunset date for the investment tax credit for safety facilities and productivity-enhancing facilities would be extended until the end of December 2021, a two-year extension from the original sunset date which is December 31, 2019.

- The existing tax incentive for start-up SMEs and venture businesses (i.e., a reduction in individual and corporate income taxes for the first five taxable years after a start-up) which applies to 31 categories of businesses including manufacturing business would be expanded to 97 additional categories of service businesses such as translating and interpreting, management consulting, call centers, telemarketing, etc. which would start from January 1, 2020. Currently, the income tax reduction rate ranges from 50% to 100% depending on the startup location, contribution to job creation or advanced technology or service growth, etc., as prescribed in the Presidential Decree of the Special Tax Treatment Control Law (STTCL).

Securities transaction tax rate cut for unlisted shares

The securities transaction tax rate on unlisted shares or stocks or listed shares or stocks traded over-the-counter would be lowered from 0.5% to 0.45%, effective April 1, 2020. The securities transactions tax rates on listed shares or stocks traded on a stock exchange such as the Korea Stock Exchange, KOSDAQ, KONEX and the K-OTC have been reduced, effective June 3, 2019.

Tatalization of a 'net capitgal gain' from the transfer of foreign shares

While income tax is levied on the gains arising from the transfer of certain taxable securities (including listed Korean shares or stock traded by a large shareholder, unlisted Korean shares, listed Korean shares or stocks traded over the counter), the capital gains arising from the transfer of certain taxable securities has not been allowed to be offset against the capital losses arising from the transfer of foreign shares or stocks or vice versa. The proposal would allow a taxpayer to totalize the net capital gains for the transfer of certain taxable securities and the transfer of foreign shares or stocks from an income tax perspective. In addition, a basic income deduction of KRW 2.5 million per annum would apply to the totalized net capital gains.

R&D Tax Credits for New Growth-Engine and Core Technologies

The proposal contains three changes in relation to the existing research and development (R&D) tax credit for new growth-engine and core technologies:

- For the purpose of supporting R&D activities in innovative growth areas including system semiconductor and bio-healthcare, the proposal would extend the existing R&D tax credit for qualifying new growth-engine and core technologies including: i) system semiconductor design/manufacturing technology; and ii) bio-beta clinical trial technology. Details on the scope of technologies eligible for the R&D tax credit would be set forth in the Presidential Decree. Currently, the R&D tax credit is available for 173 technologies in 37 different areas within 11 industries.

- A proposal would allow a domestic company to claim a tax credit for R&D expenditures incurred by a foreign company performing subcontracted R&D activities or co-R&D activities, which is directly or indirectly controlled by the domestic company and whose main business is R&D business. Specifics on the direct or indirect ownership of a domestic company would be set forth in the enforcement rules of the STTCL. Currently, the R&D tax credit is granted to the expenditure incurred for in-house R&D activities or certain R&D institutions performing subcontracted R&D activities or co-R&D activities such as non-profit corporations, corporate R&D centers (including dedicated R&D department) or third-party R&D service entities which are located in Korea.

- Currently, the unused R&D tax credit can be

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carried forward up to 5 years (note that the carry forward period can be extended to 10 years in case of SMEs for the first five years of incorporation). The proposal would apply the 10-year carryforward period to the R&D tax credit for qualifying growth-engine and core technologies.

Income tax exemption for venture capital or angel investment

Currently, qualifying venture capital investors are exempt from income tax on capital gains or dividend income earned from direct investment in venture businesses or indirect investment via a qualifying venture capital investor. They include small- and medium-sized startup investment companies (or associations), new technology venture capital firms, startup planning and investment businesses and others specialized in investing venture businesses as prescribed in the Law for Special Measures for the Promotion of Venture Businesses. The income tax exemption only applies to shares or equity acquired for new investment in venture businesses. The proposal would extend the income tax exemption to the qualifying venture capital investor's acquisition of the shares or equity owned by an angel investor in a venture business with the following additional requirements that: i) the angel investor has held the shares or equity for at least three years; and ii) the acquisition does not exceed 10% of the capital injected by the qualifying venture capital investor for the capital increase of a venture business.

Income tax reduction for Korean talents returning from overseas

In order to help attract Korean talent, a new rule is proposed to allow an individual income tax reduction for qualifying individual taxpayers returning to Korea from a foreign country. Eligible individuals would include Koreans with a PhD (including a PhD received from a domestic university) in the field of science and engineering who have worked at foreign R&D institutions in the science and technology area for at least five years. The income tax reduction rate would be 50% for five years if they are employed by a corporate R&D center or a dedicated R&D department of a domestic company. To qualify for the income tax reduction, they should be employed for a period from January 1, 2020 through the end of December 2022.

Expansion in application period for VAT credit

Under the Value Added Tax Law (VATL), where account receivables become uncollectible due to certain reasons including a bankruptcy, etc., a VAT credit is allowed for such bad debt at the amount as computed by multiplying the bad debt amount (including VAT) by 10/110. Currently, the VAT credit can be claimed as a deduction from the output VAT per the final VAT return for the taxable period when the fifth anniversary from the date of supplying the underlying goods or services relating to the uncollectible account receivable belongs to. Under a proposal, the application period for VAT credit would increase from five years to 10 years from the date of supplying the underlying goods or services subject to VAT.

Special tax scheme for establishment of holding companies

Currently, if a domestic shareholder of a domestic company sets up a holding company or converts an existing domestic company into a holding company as specified in the STTCL through a qualifying in-kind contribution of the shares in the domestic company no later than December 31, 2021, the capital gains arising from the in-kind contribution can be deferred from income taxation until the shares acquired from a holding company in consideration of the in-kind contribution are sold. Instead of the tax deferral, the proposal would introduce a scheme of instalment tax payment for three years after a grace period of four years. Also, the preferential tax treatment would be extended to a qualifying in-kind contribution by a domestic shareholder until December 31, 2024, that is, a three-year extension from December 31, 2021.

Amendment of late tax return filing and adjustment to penalties for late tax return filing

Currently, a taxpayer who has filed a tax return by a statutory due date is allowed to file an amended tax return for additional tax payment or tax refund within a specified period. In order to provide an opportunity for a taxpayer to voluntarily correct tax

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base or tax payable, the proposal would allow a taxpayer who has filed a tax return after a statutory due date to file an amended tax return.

The penalty for the failure to file a tax return by a due date is currently reduced by 50% if the tax return is filed within one month from the due date and by 20% if the tax return is filed after one month but within six months from the due date. Under the proposal, for the tax return filed after one month but within three months from the due date, the penalty reduction rate would further increase to 30% from the current 20%.

Adjustment to penalties for unpaid customs duties

Penalties for unpaid customs duties would be adjusted as follows.

Current	Proposed
Financial sanctions against unpaid customs duties • (Before tax assessment notice is made: penalty for unpaid customs duties (ⓐ) – Unpaid customs duties × the number of days of non-payment from the date following original payment due to date of amended return or customs duty assessment) × 0.025% per day • (After tax assessment notice is made: additional charge) – (Unpaid customs duties x 3%) (ⓑ) + 0.75% per month for each month (ⓒ)	Combined into a single penalty scheme for late payment (① + ②) ① Penalty for late payment (ⓐ + ⓒ) – Unpaid customs duties × the number of days of non-payment from the date following original payment due to the payment date) × 0.025% per day ② Penalty for taxes in arrears (ⓑ) will remain unchanged at: – Unpaid customs duties × 3%

Increased threshold for deductible business car expense without car mileage log

Currently, the entire amount of expenses incurred for the use of business cars are deductible unless they exceed the threshold of KRW 10 million during a year where a mileage log of the business car is not prepared. For deductible business car expenses without the preparation of a car mileage log, the existing threshold would increase from KRW 10 million to KRW 15 million.

Adjustment to premium ratio considered in share valuation for the largest shareholder

For the valuation of the shares or stocks held by the largest shareholder, a certain premium ratio is added to the share value assessed as prescribed in Article 62(1)(1), Article 60(2) and Article 60(2) of the Inheritance and Gift Tax Law (IGTL). Under the proposal, the premium ratio would be adjusted as follows:

<table>
<tr><th>Current</th><th>Proposed</th></tr>
<tr>
<td>Different ratio based on ownership ratio and company scale
<table>
<tr><td>Ownership ratio</td><td>Non-SMEs</td><td>SMEs</td></tr>
<tr><td>50% or less</td><td>20%</td><td>10%</td></tr>
<tr><td>Over 50%</td><td>30%</td><td>15%</td></tr>
</table>
* The above ratio for SMEs would not apply until the end of 2020 according to the STTCL.</td>
<td>Different ratio based on company scale (not based on ownership ratio)
<table>
<tr><td></td><td>Non-SMEs</td><td>SMEs</td></tr>
<tr><td>Premium ratio</td><td>20%</td><td>0%</td></tr>
</table>
* The special treatment would be reflected in the IGTL after being deleted from the STTCL.</td>
</tr>
</table>

Partial notification of tax audit results

Currently, tax auditors are required to notify tax audit results to a taxpayer within 20 days from the date when a tax audit is closed. The notification letter for tax audit results shall include: types of taxes and tax years subject to tax audit; tax base, the amount of tax liability and how the amount is calculated; and information concerning a pre-assessment protest.

Under a proposal, where there is taxpayer's agreement and reasonable causes, a tax auditor would be allowed to make a partial notification for tax audit results excluding the relevant part that has been agreed with the taxpayer. Proposed causes for a partial notification would include: i) the case where negotiations with foreign tax authorities are in progress for the purpose of collecting or submitting overseas data or due to the commencement of mutual agreement procedures; and ii) the case where a tax ruling request has been

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filed with the MOEF or the National Tax Service. When one of above reasons is resolved, the notification for the part which was not included in the preceding partial notification would be required to be made within 20 days from the date when the reason is resolved.

Changes to taxation on payment for patents registered outside Korea

Domestic income tax laws would be amended to secure the taxing rights for payment by a domestic entity for the use of patents registered outside Korea.

- Of a particular note, the Corporate Income Tax Law (CITL) stipulates that if patents (whether registered in Korea or not) are used in manufacturing or sales in Korea, the patents are treated as being used in Korea and therefore, the payment for the use of the patents is classified as Korean sourced royalty income. However, the Supreme Court ruled that payment for the use of patents registered outside Korea would not constitute Korean sourced royalty income received for the use of the patents in Korea on the grounds that rights in patents are effective only in the country of the patent registration (Please refer to our monthly tax newsletter, 'Samil Commentary', 2019 February issue). For the purpose of securing Korea's taxing rights on the payment by a domestic entity for patents registered outside Korea based on the Court decision, a proposal is included to categorize the payment for the use of patents registered outside Korea as the Korean sourced royalty payment for the use of 'other similar properties or rights', rather than the use of patents.

- Also, it is proposed under Article 93 of the CITL and Article 119 of the Individual Income Tax Law (IITL) that compensation paid by a domestic entity to a holder of patent rights for the infringement of patents registered outside Korea would be treated as Korean sourced other income (not royalty income received for the use of patents) subject to Korean withholding tax. Under the proposal, the compensation would encompass all kinds of payment made for the infringement of patents, etc. held by a resident of a contracting state having an income tax treaty with Korea which determines the country of source of income based on the place of use of patents, etc. as long as manufacturing methods, technologies, or information contained in patents are used in manufacturing or production activities in Korea. While 20% withholding tax rate applies to Korean sourced other income of a nonresident of Korea or a foreign corporation under existing tax laws, such compensation would be subject to 15% withholding tax rate under the proposal.

Proposed changes under the Law for Coordination of International Tax Affairs

Interpretation of tax treaty terms & document submission for international transactions

In an effort to enhance a certainty in the interpretation and application of income tax treaties, it is proposed to specifically stipulate the principle of interpretation and application of tax treaty provisions under domestic tax laws. Under the proposed principle, any terms or phrases not defined in an income tax treaty would be interpreted as the terms or meaning adopted under domestic tax laws.

In order to alleviate taxpayers' burden in the duplicate submission of documents or information relating to international transactions, it is proposed that taxpayers would be exempt from the requirement of submitting (i) the statement of international transactions and (ii) the application to disclose a method used for the determination of an arm's length price if they comply with the requirement of submitting master/local files, effective from the fiscal year beginning on or after January 1, 2020. Currently, the application to disclose a method used for the determination of an arm's length price is exempt if (i) the total amount of international transactions involving goods is KRW5 billion or less and the total amount of international transactions involving services is KRW1 billion or less or (ii) the amount of the international transactions involving goods by each foreign related party is KRW 1 billion or less and the amount

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of the international transactions involving services by each foreign related party is KRW 200 million or less.

New requirements under intergovernmental agreements on information exchange

In order to help prevent offshore tax avoidance or evasion and reflect the OECD peer-review guidelines to evaluate the compliance with intergovernmental agreements on financial information exchange, it is proposed to add the following new provisions:

- The current Law for Coordination of International Tax Affairs (LCITA) allows the competent authority of Korea to ask a financial institution to provide certain financial information of a Korean resident or non-resident as well as a Korean company or a foreign company upon a request from the competent authority of the other contracting state according to the tax treaty between Korea and the other contracting state or for the purpose of an automatic information exchange agreement with the other contracting state on a reciprocal basis. Under a proposal, where a nonresident, etc. who is a party to a financial transaction fails to comply with the requirement for providing personal information including tax identification number to the financial institution as requested by the competent authority, the financial institution would be allowed to refuse to open a financial account of the nonresident.

- It is also proposed that the LCITA would newly provide the competent authority with a right to inquire or inspect a financial institution relating to the financial information submitted by the financial institution in accordance with intergovernmental agreements concerning a periodic financial information exchange. Under the proposal, the failure to respond to the competent authority' question or inspection or the provision of false responses would be subject to the fine up to KRW 20 million.

Increased sanctions against non-submission of information relating to cross-border transactions

To address concerns regarding the effective and practical implementation of information requirements and effective allocation of burden of proof in cross-border transactions, the following changes are proposed:

- For the failure to submit certain documents or information by a due date without reasonable cause or the submission of false data, a maximum penalty would increase from KRW 100 million to KRW 300 million. While the penalty is currently charged once, it is proposed that the continued imposition of the penalty would be allowed every 30 days after the first penalty assessment until data are presented or submitted data are supplemented.

- For the non-compliance with the requirement for submitting master file, local file and other documents or information concerning a cross-border transaction as prescribed in the Presidential Decree of the LCTIA and requested by the tax authorities, the proposal would allow the tax authorities to reasonably estimate an arm's length price for the transaction based on the data collected from comparable companies in the same businesses, etc. and assess taxes based on the estimated arm's length price.

Allocation of burden of proof for 'diverted transaction'

Currently, if it is deemed that a cross border transaction has been indirectly made via a third party or two or more transactions have been conducted to unduly enjoy tax treaty benefits (so-called 'diverted transaction'), the provisions of a tax treaty and the LCTIA shall apply according to the economic substance of the transaction(s), assuming that such transaction(s) has been conducted directly by the actual transaction parties. A proposal would provide the allocation of burden of proof between a taxpayer and the tax authorities. Specifically, if the domestic tax burden of a taxpayer is reduced to less than a threshold as prescribed by the Presidential Decree of the LCITA (e.g., 50%) via

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diverted transaction(s), the taxpayer would assume the burden of proof in substantiating that there exist justifiable business reasons without an intention of tax avoidance via the transaction(s). Otherwise, it would be treated to unduly enjoy benefits under a tax treaty and the LCTIA and the substance over form principle would apply to the transaction. The specific threshold for a reduction in domestic tax burden or transaction amount which would be exempt from the proposed allocation of burden of proof is to be set forth by the Presidential Decree of the LCTIA.

Simplified withholding tax refund request and allocation of burden of proof

It is proposed to simplify the tax refund request procedures for Korean withholding tax on Korean sourced income of a foreign corporation or a nonresident of Korea and adjust the scope of reasons and causes for the tax refund request as presented in the table below.

Current

Tax refund request by a nonresident, or a foreign corporation subject to Korean withholding tax on Korean sourced income

Relevant tax laws (applicant)	**Reasons and causes**
Basic National Tax Law or BNTL (Nonresident, etc. subject to Korean withholding tax)	Overpayment of tax
	When an ex post facto reason (*) arises
CITL or IITL (Substantive owner of Korean sourced income)	Overpayment of tax relating to the application of a tax treaty
	- In case where tax treaty exemption is not applied
	- In case where a reduced treaty rate is not applied
	- NA

(*) Where an ex post facto reason (e.g., court decision, change to substantive owner, mutual agreement) occurs, the tax refund request may be filed within 3 months from the date of acknowledging that the reason occurs (as compared with five years from the tax return filing due in case of a normal tax refund request)

Proposed

Simplified refund request procedures and expanded scope of reasons and causes for refund request under the CITL and IITL

Relevant tax laws (applicant)	**Reasons and causes**
BNTL (Nonresident, etc. subject to Korean withholding tax)	To be deleted
	To be deleted
CITL or IITL (Substantive owner of Korean sourced income)(**)	Remain unchanged
	- Remain unchanged
	- In case where a reduced treaty rate is not applied or an incorrect reduced rate is applied
	- (Added) When an ex post facto reason arises

(**) Tax refund requests according to the CITL or IITL would require an applicant to submit relevant documents while providing the tax authorities with a right to supplement submitted documents. So, the applicant would assume the burden of proof for tax refund request.

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Contacts

International Tax Services

Alex Joong-Hyun Lee
709-0598
alex.lee@pwc.com

Sang-Woon Kim
709-0789
sang-woon.kim@pwc.com

Sang-Do Lee
709-0288
sang-do.lee@pwc.com

Dong-bok Lee
709-4768
dongbok.lee@pwc.com

Chong-Man Chung
709-4767
chong-man.chung@pwc.com

Hyun-Chang Shin
709-7904
hyun-chang.shin@pwc.com

Chang-Ho Jo
3781-3264
changho.jo@pwc.com

Nam-Gyo Oh
709-4754
nam-gyo.oh@pwc.com

Baek-Young Seo
709-0905
baek-young.seo@pwc.com

Il-Gyu Cha
3781-3173
il-gyu.cha@pwc.com

Kwang-Soo Kim
709-4055
kwang.soo.kim@pwc.com

Seong-moo Ryu
709-4761
seongmoo.ryu@pwc.com

Young-Ok Kim
709-7902
young-ok.kim@pwc.com

Robert Browell
709-8896
robert.browell@pwc.com

Domestic Tax Services

Yeon-Gwan Oh
709-0342
yeon-gwan.oh@pwc.com

Young-Sin Lee
709-4756
young-sin.lee@pwc.com

Jin-Ho Kim
709-0661
jin-ho.kim@pwc.com

Chul-Jin Hwang
709-0759
chul-jin.hwang@pwc.com

Bok-Suk Jung
709-0914
boksuk.jung@pwc.com

Hyungsuk Nam
709-0382
hyungsuk.nam@pwc.com

Dong-Jin Nam
709-0656
dong-jin.nam@pwc.com

Seungdo Na
709-4068
seungdo.na@pwc.com

Youngsuk Noh
709-0877
yongsuk.noh@pwc.com

Sun-Heung Jung
709-0937
sun-heung.jung@pwc.com

Sung-Wook Cho
709-8184
sung-wook.fs1.cho@pwc.com

Yoon-Sup Shin
709-0906
yoon-sup.shin@pwc.com

Byung-Oh Sun
3781-9002
byung-oh.sun@pwc.com

Hyeonjun Jang
709-4004
hyeonjun.jang@pwc.com

Yu-Chul Choi
3781-9202
yu-chul.choi@pwc.com

Transfer Pricing & International Trade

Heui-Tae Lee
3781-9083
heui-tae.lee@pwc.com

Henry An
3781-2594
henry.an@pwc.com

Won-Yeob Chon
3781-2599
won-yeob.chon@pwc.com

Junghwan Cho
709-8895
junghwan.cho@pwc.com

Outbound planning and structuring

Michael Kim
709-0707
michael.kim@pwc.com

Tax health check and tax audit assistance

Sung-Young Kim
709-4752
sung-young.kim@pwc.com

M&A Tax

Min-Soo Jung
709-0638
minsoo.jung@pwc.com

Hye-Won Choi
709-0990
hyewon.choi@pwc.com

Global Mobility Services (GMS)

Jina Park
709-0797
jina.park@pwc.com

Inheritance & Gift Tax Services

Hyun-Jong Lee
709-6459
hyun-jong.lee@pwc.com

Local tax advisory

Young-Jae Cho
709-0932
young-jae.cho@pwc.com

Private Equity Tax Service

Jeong-Soo Tak
3781-1481
Jeongsoo.tak@pwc.com

Financial Tax Services

Taejin Park
709-8833
taejin.park@pwc.com

Hoon Jung
709-3383
hoon.gp6.jung@pwc.com

Nonprofit Corporation Service Center

YoungSun Pyun
3781-9684
youngsun.pyun@pwc.com

Small and Midsize Enterprise and Startups Service Center

Bong-Kyoon Kim
3781-9975
bong-kyoon.kim@pwc.com

Knowledge & Innovation

Han-Chul Cho
3781-2577
han-chul.cho@pwc.com

Samil Infomine

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

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