



August 31, 2007

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.

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MOFE's Tax Reform Proposal for 2008

The Ministry of Finance and Economy (MOFE) announced its tax reform proposal for 2008. Among the items included in the proposal are clarification of the substance over form rule intended to prevent tax avoidance, expansion of tax incentives for research and development (R&D) expenditure, increased tax relief for incorporation or relocation in specific areas and amendment of the thin capitalization rule for the financial services industry.

In general, the proposed rules would become applicable for fiscal years beginning on or after January 1, 2008 if they are approved by the National Assembly at the end of December 2007.

The following is a brief summary of key elements that are of interest to businesses in Korea.

Substance over Form Principle

Under the proposed new provision of the Basic National Tax Act, any transaction that a company makes through a third party ("routed transaction" or "step-transaction") in an attempt to unreasonably reduce tax burden would be viewed as tax-avoidance transaction and such practice would be treated as a direct transaction or a series of interdependent transactions or activities based on its economic substance. The proposed provision would thwart attempts to avoid capital gain tax through barter contracts or corporate income tax through deviate transactions of derivatives.

The proposed rule would extend the economic substance test to cover domestic transactions, being introduced in the Basic National Tax Act. The economic substance rule for cross-border transactions has been in place under the Law for Coordination of International Taxation Affairs.

Proposed Changes to Tax Credits

Proposed changes to expand the existing tax incentives include the following:

R&D Manpower Development

Large corporations would be able to elect the newly proposed method or the existing method in computing the amount of tax credit for expenditure incurred to develop R&D manpower. Under the proposed new method, a certain proportion ($3\% + \alpha$) of R&D expenditure would be deducted from the taxable income for the year and this method can be taken only when the proportion of R&D expenditures to gross sales exceeds the comparable ratio of the immediately preceding year. The tax credit for R&D expenditure is presently limited to 40~50% of an increment in R&D expenditure for the concerned tax year from the average amount of R&D expenditure for the four preceding years.

Tax Relief for Incorporation in or Relocation to Specific Areas

A proposed change calls for dividing 231 municipal districts nationwide (denoted in Korean as *si, gun, gu*) into four categories (Category I through IV) where different exemption rates on income taxes (i.e. 70%, 50%, 30% and 0%) apply.

Presently, companies relocating their head offices or factories from the metropolitan areas to non-metropolitan area are eligible for 100% exemption on income tax for the first five years and 50% exemption for the following two years. Under the proposal, by relocating to areas of Category I, II or III, large corporations may be eligible for tax exemption of 70%, 50% or 30%, respectively, for the first 10 years and 35%, 25% or 15% for the following 5 years. Small and med-sized companies incorporated, relocated or operated in Category I, II, or III areas are eligible for tax exemption of 70%, 50%, or 30% respectively without periodic limitation.

Large corporations incorporated in Category I, II, or III areas would be eligible for tax exemption of 70%, 50% or 30%, respectively, for the first 7 years and 35%, 25% or 15% for the following 3 years.

- Large corporations relocating from Category IV areas to Cheju Island would be granted 70% income tax exemption for the first 10 years and then 35% for the following 5 years.

- Large corporations newly incorporated in Cheju Island would be eligible for 70% income tax exemption for the first 7 years and then 35% for the following 3 years.

These benefits on incorporation or relocation to Cheju Island would be available until the end of December 2012.

Proposed Changes for Specific Industries

Financial Services Industry

Under the proposal, the financial services industry would be subject to a 3:1 debt to equity ratio like other industries, reduced from the existing 6:1 for the purpose of enforcing the thin capitalization rule. Interest paid or payable on the borrowings by a financial service company from its foreign controlling shareholder ("FCS") that exceeds three times the equity capital attributable to such FCS would be disallowed from tax deduction.

The existing rule classifies solicitation expenses incurred by financial institutions for the sale of financial instruments or the collection of premiums as entertainment expenses. As the rule would be deleted, it would have the effect of increasing deductible entertainment expense limits for financial services companies.

Logistics Industry

Under the proposal, a new tax credit would be granted when a manufacturing company outsources logistics to an unrelated external service provider and such outsourcing accounts for 50% or more of the company's total logistics expenses.

The credit amount shall be calculated at 3% of the

increased logistics outsourcing cost from the previous year and it cannot exceed 10% of the company's corporate income tax for the concerned year.

Overseas Natural Resources Exploration

A domestic company investing in an overseas natural resources exploration project would be eligible for a tax credit to the amount of 3% of its investment amount.

Manufacturing & Trade Industry

Companies to be adversely affected by imports under a free trade agreement that Korea enters into would be eligible for trade adjustment assistance under the Law for Trade Adjustment Assistance enacted in April 2007. The latest tax reform proposals include tax benefits for companies eligible for trade adjustment assistance ("TTA company") in respect of their change in business lines. Corporate income tax would be reduced by 50% for four years from the date the change in business is registered.

When a TTA company sells its business assets and uses the sales proceeds for a changed business, gains on the asset sale would be added to its gross income in installments over three years after a three-year grace period. For a resident, income tax on such gain would be 50% reduced.

Introduction of Partnership Taxation

The proposed new partnership taxation rule will apply to the existing unlimited companies, *Hapmyong Hoesa* and *Hapja Hoesa* as well as limited companies as prescribed by the Presidential Decree. Companies will be allowed to make an election to be treated either as a partnership or corporation and taxed accordingly. Under the proposal, a partnership would be treated as a flow through entity, not subject to corporate income tax and each partner would be subject to corporate income tax or individual income tax on its share of profits or losses.

If enacted, the new partnership taxation rule would come into force for the fiscal years beginning on or after January 1, 2009.

Customs APA

The advance customs valuation agreement (ACVA) is proposed to determine the proper customs valuation method for related party transactions in advance of the actual transaction. The proposed ACVA is an agreement between a taxpayer and the Korean Customs Service (KCS) on the appropriate dutiable value of imported goods especially those traded between related parties.

The proposed ACVA is expected to make it possible for foreign-invested companies in Korea to reduce customs-related uncertainties by avoiding possible disputes with KCS or possible post audits on dutiable value of goods imported from related parties.

Proposed Change in Dividend Received Deduction Rule

Dividend received deduction (DRD) is restricted when a dividend-paying subsidiary invests in an affiliate. A proposed change would limit the disallowance of DRD to the case where the dividend-receiving company, the dividend-paying company and the invested company are all affiliates.

Proposed Changes for Family Business Succession

Currently, if the amount of inheritance and gift tax exceeds 10 million won, the tax payment can be made in installment for 3 years (for 15 or 5 years in the case of family business succession) as long as collateral is pledged with the concerned tax office. The gift and inheritance tax law would be amended to increase the threshold from 10 million won to 20 million won and extend the installment payment period by two additional years to 5 years.

For family business succession, the tax payment would be made in installments for up to 12 years after a 3-year grace period in the case where family business property consists 50% or more of the inherited property. In other family business succession cases, the tax payment can be made in installment for 5 years after a 2-year grace period would be allowed.

The tax office's prior approval for installment period would no longer be required but each installment shall be 10 million won or more.

Miscellaneous

Other proposed changes in MOFE's 2008 tax reform include the following:

- Marketing and advertising cost incurred by a joint venture business used to be allocated at equity investment ratio or sales/sales cost/salary cost ratio. Under the proposal, it would be allocable according to a written agreement between the companies as long as they are not related parties. Two of the three existing allocation criteria, *i.e.* the sales cost ratio and the salary cost ratio, would no longer be valid.
- A proposed exceptional provision to the statute of limitations would make it possible for the government to assess tax on the real trader within one year from the date a decision is delivered if any tax is found to be evaded using a false name, regardless of whether the statute of limitations is elapsed
- 2% penalty would be imposed on the receipt of fictitious tax invoices
- Increased ceiling on deductible expenses for personal donations
- Donations made by a taxpayer's spouse and descendants would be added to the scope of the taxpayer's deductible expenses
- External audit mandated for public organizations having three billion won or more in total assets (excluding religious or academic entities)
- Eased filing requirements for changes in the

shareholding for companies listed on the Korea Stock Exchange or KOSDAQ. The filing requirements would be limited to include controlling shareholders and their related parties, rather than all shareholders other than small-lot shareholders under the existing law.

Korea, Azerbaijan Sign an Income Tax Treaty

Korea and Azerbaijan have signed an income tax treaty in Baku on August 17, 2007. The agreement is the first income tax treaty concluded between Korea and Azerbaijan.

The treaty provides that a building site, construction/installation project or supervisory activities in connection therewith constitutes a permanent establishment only if it lasts twelve months or more.

According to the treaty, capital gains derived by a company of a contracting state from the sales of shares issued by another company in the other contracting state will be taxable in the company's country of residence. However, capital gains from the sale of shares of a company where real property consists 50% of its assets will be taxable in the country where another company is situated pursuant to the OECD Model Tax Convention on Income and Capital.

Dividends will be taxable at a rate not to exceed 7 % and interest will be taxable at a rate not to exceed 10%. Royalties received as the consideration for the use of patent, design or model, secret formula and process, or know-how will be taxable at 5%. In all other cases, royalties will be taxable at a rate not to exceed 10 %.

The treaty contains limitation on benefit, which is intended to prevent the application of the treaty benefits to treaty shopping structures. It also includes rules on foreign tax credit and exchange of financial information between the two countries.

The treaty is expected to come into force after the governments of the two countries ratify and officially sign the agreement at the end of this year.

Seoul Administrative Court Decision on Permanent Establishment Test

The Seoul Administrative Court delivered a judgment pursuant to an appeal filed by Bloomberg Partnership Ltd. to protest against corporate income tax and value added tax assessed by a Korean district tax office. The district tax office treated Bloomberg Telecom as having a permanent establishment (PE) in Korea as a consequence of financial information it supplied in the country. The court ruled that if Bloomberg Partnership was simply engaged in the activities of supplying financial information in Korea (far from the activities of analyzing or processing the information) the activities shall not result in the creation of a PE.

The decision is expected to have significant impact as similar appeals are pending in other courts.

In the decision delivered on August 20, the court stated that:

A foreign corporation may be exempt from tax under Korean tax law unless the foreign corporation is engaged in business activities through a PE. The PE must perform essential and intrinsic business activities of its head office. Bloomberg Korea Ltd. (BKL) installed general communications equipment, nodes and Bloomberg receivers through which it supplied information, rather than performing an analysis and processing collected information to be sold in Korea. Although Bloomberg performed a portion of business activities in Korea, the activities are deemed preparatory and auxiliary, and thus these activities fail to result in the creation of a PE of Bloomberg in Korea pursuant to the Korea-US income tax treaty.

Bloomberg is a US-based news media group providing real-time financial information to 140,000 customers in 91 countries worldwide for 24 hours. In a regular tax audit, the Korean tax office determined BKL constituted a PE of Bloomberg Holdings in Korea and assessed corporate income tax and value added tax on a portion of operating profits which the tax office regarded as attributable to the PE.

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.

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2007년 9월의 교육프로그램

신입사위경리실무 9월 3일 (월) ~ 2007년 9월 7일 (금), 5일간 총 35시간

회계보드게임을 통한 경영활동의 입체적인 이해와 재무제표의 연관성에 대한 종합적 학습, 계정과목별 회계처리 및 결산서 작성, 원가·관리회계 및 세무회계에 대한 기본개념

회계기초실무 (야간) 9월 3일 (월) ~ 9월 19일 (수), 8일간 총 24시간

회계보드게임을 통한 회계흐름 및 기업경영에 대한 이해, 복식부기원리에 대한 해설 및 사례연구, 계정과목별 회계원리 및 결산서 작성 실무

소비성경비지출 증빙에 따른 세무회계처리 9.4 (화) 총 1 일 (7시간)

접대비 개념, 판례와 해석상 접대비로 본 주요 사례, 50만원 이상 접대비 업무관련성 입증, 신용카드 매출전표와 매입세액 공제 등

자금관리 실무 9.4 (화) ~ 9.7 (금) 총 4 일 (24시간)

종합적인 자금관리를 위한 조달 및 운용, Project financing, 직,간접금융시장을 통한 자금조달 자산유동화증권(ABS)을 이용한 자금조달, 금리 및 환위험 관리전략 등

법인세 실무 9.4 (화) ~ 9.7 (금) 총 4 일 (24시간)

법인세법 핵심내용의 사례 및 쟁점 별 해설, 실무에서 자주 발생하는 최신 예규, 국세심판사례, 대법원판례 해설, 기업회계와 세무회계의 차이분석

원가 및 관리회계입문 9월 5일 (수) ~ 9월 7일 (금), 3일간 총 21시간

원가 및 관리회계에 대한 기본이론, 관리회계정보를 활용한 의사결정 및 성과평가방법 사례

부가가치세실무 9월 10일 (월) ~ 9월 14일 (금), 5일간 총 31시간

부가가치세 전반에 걸친 사례중심별 해설, 쟁점별 최신 예규, 국세 심판례, 대법원 판례 등 실무대책 해설, 세무조사에 대비한 부가가치세와 법인세 설명

Game으로 배우는 건설업회계 9월 11일 (화) ~ 9월 12일 (수), 2일간 총 14시간

회계보드게임을 통한 회계의 흐름에 대한 입체적인 이해, 건설업 회계에 특화된 체계적이고 상세한 해설 및 사례연습, 게임을 통한 건설업 회계의 기초적인 지식과 재무제표분석을 위한 Check Point

기업회계실무 9월 11일 (화) ~ 9월 14일 (금), 4일간 총 24시간

기업회계기준 및 기업회계기준서의 계정과목별 해설, 기업회계기준관련 해석적용 및 질의회신 사례해설, 재무회계 핵심 논점에 관한 실무중심 해설

사례 중심 별 원천징수실무 9월 13일 (금) ~ 9월 13일 (목), 1일간 총 7시간

소득종류에 따른 원천징수방법 및 절차의 사례, 원천징수관련 규정을 회계처리와 세무처리로 구분하여 비교 설명

위의 교육과정은 이론 및 실무, 그리고 사례 연구 등 실무능력향상에 중점을 둔 교육으로 「고용보험법 및 근로자 직업훈련촉진법」에 의해 교육훈련비의 일부를 정부로부터 지원 받는 교육과정으로 지정되어 있으며 (일부 과정은 제외) 교육 7일 전까지 신청하셔야 교육훈련비의 일부를 지원 받으실 수 있습니다. 자세한 사항에 대한 문의는 ☎: 02-3781-3429로 하시기 바랍니다.