Korea's Economy 2008

Korea's Economic Achievements and Prospects

The Graying of Korea: Addressing the Challenges of Aging

Financial Asia Rising: Asian Stock Markets in the New Millenium

Korea's Money Market

Ingredients for a Well-functioning Capital Market

The Capital Market Consolidation Act and the Korean Financial Market

Progress in Corporate Governance

Tax Issues Affecting Foreign Invested Companies and Foreign Investors

U.S.-Korea Economic Relations: View from Seoul

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Peering into the Future: Korea's Response to the New Trading Landscape

North Korea's External Resources and Constraints

The Roles of China and South Korea in North Korean Economic Change

Realistic Expectations of the Future Role of the IFIs on the Peninsula

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TAX ISSUES AFFECTING FOREIGN-INVESTED COMPANIES AND FOREIGN INVESTORS

By Henry An and David Jin-Young Lee

Korea's regulatory environment is often cited as being one of the most difficult aspects of doing business in Korea. Among the various regulations that foreign-invested companies and foreign investors must contend with, Korea's tax laws tend to draw particular disdain, especially with respect to the enforcement of tax compliance through tax investigations. The ongoing tax dispute between the U.S. private equity group, Lone Star Funds, and the Korean tax authorities has put Korea's tax enforcement policies in the international spotlight and has made Lone Star the poster child for what can happen to foreign companies making money in Korea.

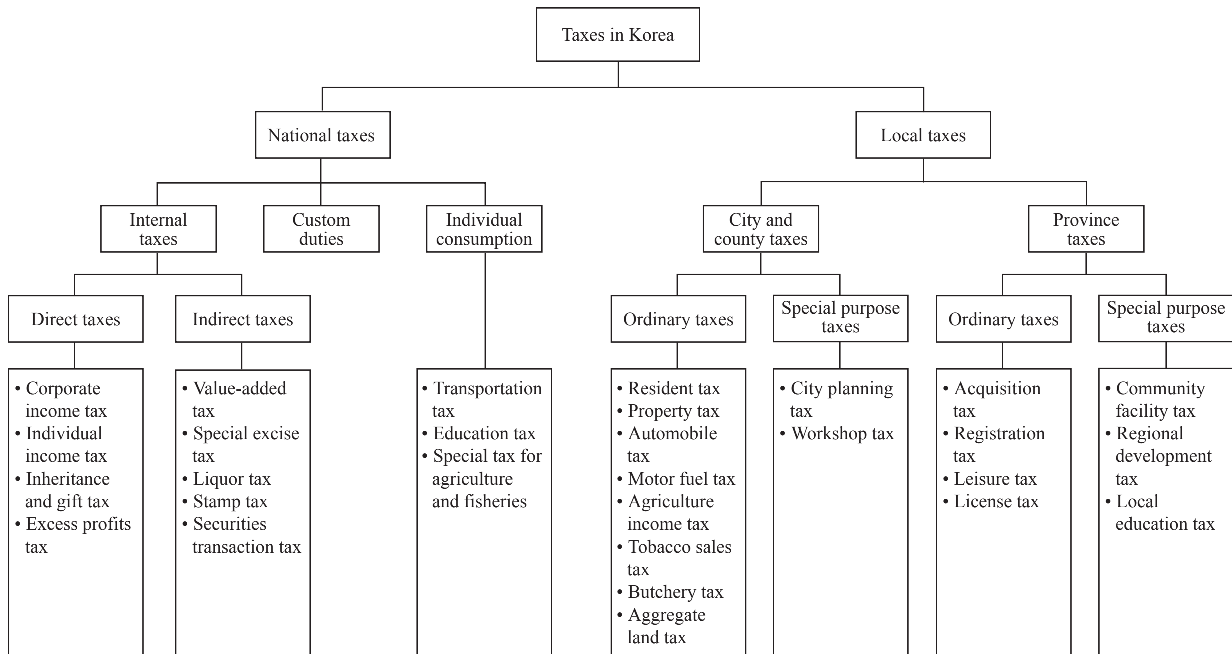
Although tax controversies involving foreign-invested companies or foreign investors tend to receive heavy media coverage, they do not necessarily portray a full and accurate picture of Korea's tax regime or the tax issues that are under examination. This article is intended to provide an overview of key aspects of Korean taxation from a foreign perspective; it reviews the major tax issues that can affect foreign-based multinational companies doing business in Korea as well as foreign investors investing in Korean assets.

General Background on Korea's Taxation System

Korea's taxation system is administered by the Ministry of Finance and Economy (MOFE). MOFE is responsible for planning and drafting tax laws, while the National Tax Service (NTS) is responsible for the execution and enforcement of such laws.

The Korean tax system comprises national and local taxes. National taxes include internal taxes, customs duties, and earmarked taxes. Local taxes include provincial, county, and city taxes (***Figure 1***).

Figure 1: **Tax System in Korea**



In general, all forms of income are aggregated in a single corporate tax return. Foreign-invested companies (that is, companies established in Korea under domestic law with foreign investment) and branches of foreign corporations are taxed on Korean-sourced income only. ***Table 1*** provides an overview of the corporate income tax system in Korea.

Table 1: Tax System in Korea

Topic	Regulation
Annual corporate tax return	Must be filed within three months of the last day of taxable year.
Interim corporate tax return	Must be filed within two months of the last day of first half of taxable year.
Taxable year	Same as fiscal year, but cannot exceed one year.
Tax statute of limitations	Generally five years.
Consolidated filing	Not available.
Dividend received deduction	Up to 100 percent.
Net operating loss	Five-year carryforward; one-year carryback is generally allowed for small- and medium-size companies only, and a seven-year carryforward for start-ups.

Korea-source income includes capital gains from the disposal of real estate and stock. Such capital gains are subject to tax in Korea, either at domestic rates or at rates prescribed under relevant tax treaties. Withholding tax is also applied to certain payments (including interest, dividends, and royalties) made to a nonresident by a domestic company. Again, the withholding tax rates may vary depending on the applicable tax treaty; in the event that there is no applicable tax treaty, domestic rates will be applied. To reduce the likelihood of double taxation, Korea has an extensive tax treaty network—as of September 2007, it maintained tax treaties with 70 countries.

The current statutory corporate tax rates (effective for fiscal years beginning on or after 1 January 2005) are 13 percent on the first 100 million *won* of taxable income and 25 percent thereafter. Although a resident tax surcharge of 10 percent on income tax liability raises Korea's top statutory corporate tax rate to 27.5 percent, it is still among the lowest in the OECD. A value-added tax (VAT) is levied at a rate of 10 percent on sales and transfers of most goods and services, with the exception of exports, and VAT returns should be filed on a quarterly basis.

Foreign-invested companies, which are treated as domestic companies, are eligible for the same tax exemptions and reductions as domestic companies. In addition, in its efforts to attract foreign investment, the Korean government grants various tax incentives to foreign-invested companies under the Foreign Investment Promotion Act. Some examples are tax incentives for foreign direct investment in the high-technology business or industry supporting business and tax incentives for foreign direct investment in special zones designated by the government. Corporate income tax, certain local taxes, customs duties, and VAT for such foreign-invested companies will be exempt or reduced for a period ranging from three to seven years.

Although branches of foreign corporations are not eligible for the tax exemptions, reductions, and various tax incentives available to foreign-invested companies, a branch may induce the remittance of operating funds from its head office and repatriate profits back to the head office without being subject to withholding tax, depending on the applicable tax treaty.

Under recent tax reform proposals, Korea will introduce new partnership rules applicable to existing forms of unlimited liability companies and certain types of limited liability companies (which include certain types of foreign-invested companies). These entities may elect to be treated as partnerships, whereby income and losses will be allocated to the partners for a period of five years. The enactment of the new partnership taxation rules is expected to increase investment and planning opportunities for foreign investors by granting flexibility in income-loss allocation and eliminating double taxation. The new rules will come into effect on 1 January 2009, after a one-year grace period.

In relation to individual income tax, Korean residents for tax purposes are subject to Korean individual income tax on worldwide income. Nonresidents are generally subject to Korean individual income tax only

on their Korean-source income. A progressive tax rate will apply, ranging from 8.8 percent to 38.5 percent (including a 10 percent resident surtax) depending on the taxpayer's total taxable income.

With respect to individual income tax rules for foreign expatriates in Korea, foreign employees are allowed to choose between (1) a flat rate of 18.7 percent (including a 10 percent resident surtax) on gross salaries or (2) current progressive rates on taxable income (after allowable deductions). Although the amount equivalent to 30 percent of total salary would generally not be taxable in Korea, this deduction, along with any other income deductions, tax exemptions, and tax credits, would be forfeited if the taxpayer has chosen to apply the 18.7 percent flat rate.

Taxation of Foreign Corporations

Primarily governed by the Corporate Income Tax Law, the Special Tax Treatment Control Law, and tax treaties, the taxation of foreign corporations depends on whether a foreign corporation has a permanent establishment (PE) in Korea.

Broadly, Korea's PE rules are consistent with the Organization for Economic Cooperation and Development (OECD) rules:

- A foreign company will create a taxable presence—a PE—in Korea if it carries on its business either wholly or partly through a fixed place of business in Korea, such as an office, factory, or construction site.

- The presence of the foreign company's employees in Korea for more than six months out of a consecutive 12-month period will create a PE (this is the six-month test). Furthermore, where the six-month test is not breached but the employees are providing similar services in Korea continuously and repetitively over a period of two years or more, such presence will also constitute a PE (the two-year test). In applying the two-year test, however, there is currently no clear guidance on whether "similar services" should be determined by reference to a particular client, project, or by the nature of services.

- In addition, a PE may be created even if the foreign company has no fixed place of business in Korea if the foreign company has a "dependent agent" who habitually concludes contracts on behalf of the foreign company (dependent agent PE). The concept of a dependent agent is somewhat broader under the Korean tax laws in that a third-party service provider providing services in the ordinary course of its business may be deemed to be a dependent agent if it provides services mainly to a single foreign customer.

In practice, because of the lack of detailed guidelines, the application of the two-year test and dependent agent PE has created much debate, particularly in the funds and financial services industries where these issues are being raised by the Korean tax authorities.

Tax Audits

Similar to other developed countries, tax audits in Korea are routinely performed by the tax authorities to enforce tax compliance. In most cases, taxpayers are selected for a tax audit as a matter of course and not as a result of any specific wrongdoing. Barring unusual circumstances, foreign-invested companies are generally subject to a regular field tax audit every four to five years, which directly corresponds with Korea's five-year statute of limitations on tax matters. Audits may, however, come sooner or later depending on the facts and circumstances.

Despite being a routine aspect of monitoring tax compliance, tax audits tend to foster a high degree of taxpayer anxiety. In addition to the risk of receiving a potential tax assessment, several other unique aspects of Korean tax audits promote taxpayer apprehension. First is the element of surprise. Taxpayers are provided very limited advance notification of selection for audit, usually no more than 10 days. Second, the manner in which tax audits are conducted can be quite intense. Tax audits are generally performed by a team of four to six tax auditors who will conduct their audit on the taxpayer's premises over a period of eight to ten weeks. Tax auditors have the unenviable task of having to review all of the taxpayer's potential tax issues for all open tax years, which represents a significant amount of work that needs to be completed during a

relatively limited amount of time. Given these circumstances, it is clear that any perceived lack of taxpayer cooperation can quickly taint the relationship between the auditors and the taxpayer, further exacerbating an already tense situation.

Tax audits usually focus on verifying the accuracy of reported taxable income by reviewing reported income and the deductibility of expenses as well as issues pertaining to classification. Some common examples of items examined by the tax auditors are entertainment expenses (such as expenses for business purposes incurred to secure development of new business opportunities and to facilitate business with existing clients as well as activities directly related to earning profits) and bad debts—both of which are subject to strict guidelines and a threshold on deductibility—and classification of expenses made by the taxpayer.[1]

If as a result of a tax audit a taxpayer is found to have taxable income in excess of what was originally reported, the taxpayer will be subject to additional corporate tax and penalties on the underreported amount of taxable income. Namely, the taxpayer will be required to pay additional corporate tax at the current rate (25 percent), an underreporting penalty of 10 percent of the additional corporate tax liability, an underpayment penalty that is essentially interest on the underpaid tax liability of approximately 10.95 percent per annum of the tax liability, and a resident surtax of 10 percent on all of the aforementioned items. Also, depending on the classification of expenses, the taxpayer may be subject to additional withholding tax on dividends and royalties, among other categories.

Transfer Pricing

With the continuous globalization of business, it is not unusual for foreign-invested companies in Korea to engage in a wide variety of transactions with multiple foreign affiliates. Transfer pricing—prices charged on cross-border intercompany transactions—is one of the key tax issues examined during audits conducted on foreign-invested companies. Common intercompany transactions include the purchase or sale of products, commission payments, service fees, royalties, and interest payments on loans.

Similar to other developed countries, Korea has based transfer pricing regulations on the arm's length standard (that is, the price that would have been agreed to under similar circumstances between two unrelated parties), and Korea's regulations are generally consistent with the OECD guidelines. Nevertheless, given its significant impact on a taxpayer's taxable income, transfer pricing can easily become the most contentious issue between a taxpayer and the tax authorities during a tax audit.

The most common transfer pricing issue is the appropriate transfer price for products that are imported into Korea for subsequent resale to Korean customers. These discussions will usually focus on the appropriate resale margin or overall distribution profit margin that should be achieved by the taxpayer, with the tax authorities arguing for higher margins while the taxpayer takes the opposite position. Disagreements about the arm's length nature of transfer pricing are difficult to resolve given the inherently nebulous nature of transfer pricing analysis. For this reason, it is generally recommended that taxpayers engaging in significant intercompany transactions consider applying for an advance pricing agreement (APA).

An APA is basically an advance ruling with the tax authorities on the acceptability of transfer prices. While APAs are generally prospective, taxpayers may also request a rollback of the APA to cover open years as long as the APA application is submitted before the taxpayer is selected for a tax audit. By applying for an APA with rollback, a taxpayer can effectively take transfer pricing off the table. Results negotiated through an APA tend to be more favorable than results obtained during an audit.

Customs Audits

The Korean customs law and regulations on customs valuation are based on the World Trade Organization "Agreement on Implementation of Article VII of

1. For example, the tax auditors may disagree with a taxpayer's classification of a certain item that is fully deductible for tax purposes and argue that the item should be classified as an entertainment expense (deemed entertainment expense), which is subject to a limit on deductibility.

the General Agreement on Tariffs and Trade 1994." Customs audits are routinely conducted by the Korea Customs Service (KCS) on both foreign-invested and local companies. Taxpayers may be subject to a customs audit depending on their five-year statute of limitations, fluctuations in import prices, and characteristics specific to their industry that make them susceptible to customs issues.

Customs authorities routinely conduct audits on foreign-invested companies importing products into Korea. Customs audits may focus on many areas of customs compliance but particularly on the issue of valuation with respect to the imported goods. Although transfer prices between related parties can be accepted during a tax audit if consistent with the arm's length standard, the customs auditors focus on whether a special relationship between the exporting and importing companies has distorted the transaction value and determine the "correct" customs value through the application of certain methodologies.

For a taxpayer importing goods from a related party, customs is a tricky issue in that the customs authorities and the tax authorities tend to take opposite positions on the taxpayer's purchase prices: the customs authorities raise import prices, but the tax authorities lower transfer prices to increase the taxpayer's taxable income.

In an effort to provide the taxpayer with more comfort on customs issues, the KCS will be rolling out a new customs program in Korea that is similar to APAs for transfer prices. The Advance Customs Valuation Arrangement (ACVA) will allow companies importing goods into Korea to reach an arrangement with KCS officials in advance on the appropriate value of the imported goods. Thus, by following the terms and conditions of the ACVA, importers significantly reduce customs-related risks by exempting the importer from customs audit during the period covered under the ACVA.

Anti–Treaty Shopping Rule

During the 1997 Asian financial crisis, Korean companies overburdened by debt went bankrupt, leaving the Korean banking sector with a significant amount of nonperforming loans (NPLs). Foreign investors (including private equity funds) ended up purchasing many of these distressed companies as well as NPL portfolios. With Korea's relatively quick recovery and robust economic growth during the years following the crisis, many private equity firms began exiting these investments, some realizing substantial returns on investment but paying little or no tax. Many of these prominent private equity firms were subsequently subject to tax investigations.

The most highly publicized tax investigation in Korea relates to Lone Star's sale of its investment in the Star Tower building. Lone Star structured its investment through Star Holdings, a Belgian affiliate. In the course of selling the interest in a Korean real estate holding company, Lone Star realized capital gains of approximately \$1.5 billion. As a result of its tax investigation, the Korean tax office determined that Lone Star's Belgian subsidiary did not have substance and therefore could not rely on the Korea-Belgium tax treaty to exempt the capital gains. Lone Star was subsequently issued a tax assessment of approximately 140 billion *won* (approximately \$150 million). Although Lone Star appealed the tax assessment to the National Tax Tribunal (NTT), the NTT upheld the tax office view by stating that the Belgian affiliate was a conduit company with no operational activity and did not exercise genuine ownership and management rights. Lone Star is currently pursuing an appeal to the Korean courts, which will make a final determination on the issue.

In addition to Lone Star, other prominent investment firms have been subject to tax investigations in Korea; these include Warburg Pincus, Newbridge Capital, and the Carlyle Group. Most of these investigations have focused on treaty shopping and beneficial ownership, but they also include a review of other tax issues, including PE.

To discourage treaty shopping, MOFE introduced a new withholding tax regime in 2006. According to the new withholding rules, any Korea-sourced income paid to a resident of a designated tax haven is subject to domestic withholding tax rates regardless of an applicable tax treaty. Foreign investors in a tax haven may avoid domestic withholding tax rates by demonstrating actual substance and beneficial ownership of Korea-sourced income through an advance preconfirmation procedure or retroactive refund claim. Currently, the only tax jurisdiction designated as a tax haven is Labuan.

Anti-Avoidance Rules

Under the current Korean tax regime, anti-avoidance rules exist in the form of the general substance-over-form rules and the more specific anti-avoidance provisions. The specific anti-avoidance provisions consist of the denial of unfair transaction rule, restrictions relating to reverse mergers, and deemed-gift rules relating to certain trust arrangements as well as transfer pricing, anti–tax haven, and thin capitalization rules.

The general substance-over-form rules that do not require a tax avoidance motive for their application require the examination of the substance rather than the mere form in determining who should be assessed and to what extent. Currently no detailed guidelines exist on how and the extent to which the concept of substance over form needs to be applied in determining the correct tax treatment of a transaction. In recent years, the Korean tax authorities have applied the concept of substance over form to challenge alleged treaty-shopping practices; this has caused much debate over concerns of treaty override and general uncertainty on the tax outcome of investments by foreign investors.

Concluding Remarks

Korea has a vibrant, growing economy that continues to provide excellent opportunities for foreign-invested companies and foreign investors. At the same time, foreign-invested companies and foreign investors should be well advised that the Korean tax authorities are fully committed to enforcing tax compliance. For foreign-invested companies doing business in Korea, dealing with tax audits, transfer pricing, and customs issues can be a challenge, but potential risks can be mitigated through advance preparation and the pursuit of ruling requests where possible. Foreign investors also face unique challenges when investing in Korea. The Korean tax authorities have sent a clear message that treaty shopping will not be tolerated. The foreign investors must have economic substance in the country where they are claiming treaty benefits. These issues also continue to be the subject of an ongoing OECD discussion; hence it is critical to undertake a careful review of the tax issues in structuring investments into Korea.

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