TAX LAW CHANGES FOR 2013

On January 1, 2013, the Korean National Assembly passed, and the government promulgated, amendments to tax laws, most of which took effect as of the same date (with the exception of those provisions for which different effective dates are specified). The amendments to tax laws will be followed by amendments to the corresponding Presidential Decrees sometime in February 2013. Among the amendments to tax laws and proposed amendments to the Presidential Decrees for this year, we provide below some of the major items that may affect your business or may be of interest to you.

Please note that this is only a very brief outline of select items among the amendments to tax laws and proposed amendments to Presidential Decrees for this year. If you wish to discuss any of the below item in more detail or have concerns that other amendments not addressed herein may have a bearing on your business, please feel free to contact us.

I. Amendments Applicable to All Industries

1. Adjustment of Tax Credits for Investments Leading to Job Creation

In order to stimulate job creation, the amendment decreased the basic credit component rate (from 3~4% to 2~3%) while increasing the additional credit component rate for new job creation (from 2% to 3%); both component rates are applicable to non-small and medium sized companies. In addition, the amendment (i) decreased the basic credit component for small and medium sized companies by KRW 10 million for each reduction in the number of jobs relative to the previous year and (ii) will entirely eliminate the basic credit component for non-small and medium sized companies that experience job reduction relative to the previous year.

2. Adjustments and Improvements to Foreign Investment Tax Exemption

A. Expansion of Eligible Businesses for Tax Exemption under Individual-Type Foreign Investment Zone

Under the current Presidential Decree, business types (with minimum foreign investment amount) eligible for the ‘7-year’ tax exemption program by being designated individual-type foreign investment zone are: Manufacturing (USD 30 million); Travel and Tourism (USD 20 million); Distribution and SOC (USD 10 million); and R&D (USD 2 million).

According to the proposed amendment to the Presidential Decree, the scope of business types eligible for tax exemption by being designated individual-type foreign investment zone will be expanded to also cover computer programing, system integration and management, information processing/hosting and related services with foreign investment of USD 30 million or more as a means to induce investment in Korea by leading global IT companies.

B. Exclusion of Certain Loans from Qualifying as Foreign Investment for Tax Exemption

Until last year, the relevant tax law disqualified eligibility for foreign investment tax exemption if 10% or
more of the voting shares of the foreign investor is directly or indirectly held by a domestic person(s) so as to prevent granting tax exemption benefits to investments that are made in substance by Korean domestic persons. The amendment further narrowed the scope of tax exemption eligibility by disallowing tax exemption for foreign investment made with loans from the foreign invested enterprise or domestic person (with 10% or more voting shares in the foreign invested enterprise).

C. Supplement to Recapture of Tax Exemption Rules for Foreign Invested Enterprise

The proposed amendment to the relevant Presidential Decree of the Special Tax Treatment Control Law further clarifies and strengthens the tax exemption recapture rules for foreign invested enterprises as follows in order to enhance predictability:

<table>
<thead>
<tr>
<th>Current</th>
<th>Proposed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax exemption recapture from sale of shares by foreign investor:</td>
<td>Tax exemption recapture from sale of shares by foreign investor:</td>
</tr>
<tr>
<td></td>
<td>(Corporate income tax)</td>
</tr>
<tr>
<td></td>
<td>(Customs duty)</td>
</tr>
<tr>
<td>− If sold within 3 years from commencement of tax exemption</td>
<td>− If sold within tax exemption period (i.e., 5~7 years)</td>
</tr>
<tr>
<td>− Recapture amount: Taxes Exempt X (1 – elapsed months / 36) X ratio of shares sold</td>
<td>− Recapture amount: Taxes Exempt during the most recent 5 years from the sale of shares X ratio of shares sold</td>
</tr>
<tr>
<td></td>
<td>− Recapture amount: Customs duty exempt during the most recent 3 years from the sale of shares, which exceeds the amount of customs duty exemption available to the remaining foreign investment amount</td>
</tr>
<tr>
<td>Tax exemption recapture from cancellation of registration, business closing, non-fulfillment of tax exemption conditions, and non-compliance with corrective order:</td>
<td>Among others, non-fulfillment of tax exemption conditions will be further specified as non-satisfaction of:</td>
</tr>
<tr>
<td>− Recapture amount: Taxes (Customs duty) Exempt during the most recent 5 (3) years</td>
<td>• The investment amount;</td>
</tr>
<tr>
<td>No mention of the method of applying the recapture rule in case of tax recapture caused by two or more violations</td>
<td>• Type of business engaged;</td>
</tr>
<tr>
<td></td>
<td>• Building of facilities; or</td>
</tr>
<tr>
<td></td>
<td>• Number of employees hired</td>
</tr>
</tbody>
</table>

The proposed amendment, if adopted, will apply to violations occurring on or after the effective date of the proposed amendment.

3. R&D Expense Tax Credit

A. Incremental R&D Expense Calculation Method
Domestic taxpayer can apply, among others, the incremental R&D expense calculation method for R&D expense tax credit, but such method may not apply to previous years, if the taxpayer has not incurred R&D expense for the most recent four previous years. The relevant law as amended further prohibits the use of incremental R&D expense calculation method if the R&D expense incurred in the immediately preceding year is less than the average R&D expense for the most recent 4 years. The amendment further revised the formula for the incremental R&D expense calculation method as follows:

<table>
<thead>
<tr>
<th>Previous</th>
<th>Amended</th>
</tr>
</thead>
<tbody>
<tr>
<td>R&amp;D expense tax credit = [\frac{\text{current year R&amp;D expense} - \text{average R&amp;D expense for the most recent 4 previous years}}{\text{X 40% (50% for small and medium sized enterprise)}}]</td>
<td>R&amp;D expense tax credit = [\frac{\text{current year R&amp;D expense} - \text{R&amp;D expense incurred in the immediately preceding year}}{\text{X 40% (50% for small and medium sized enterprise)}}]</td>
</tr>
</tbody>
</table>

* For fiscal year starting during 2013 (2014): average R&D expense for the most recent 3 (2) previous years

B. Clarification of the Scope of R&D Expense for Outsourced R&D Activities

R&D expense tax credit is allowed for R&D activities outsourced to the R&D department of a third party R&D firm. However, the relevant Presidential Decree is not sufficiently clear in this respect, and thus, the proposed amendment to the Presidential Decree seeks to clarify that R&D expense tax credit will be allowed only for the portion of R&D activities performed directly by the R&D department of a third party R&D firm, and not for those performed by other non-R&D departments.

4. Changes to the Flat Rate and the Sunset Period for Employment Income Earned by Foreigners

The flat rate applicable on employment income (i.e., salary) earned by foreigners until last year has been 16.5% (including 10% local surtax) and it was due to expire as of the end of 2012. The amendment to the relevant law increased the flat rate to 18.7% (including 10% local surtax) and extended the sunset period out to the end of 2014. The rationale behind the amendment is to encourage foreign manpower and related foreign investments to remain in Korea, while further narrowing the equality gap between the relatively low flat rate for foreigners and the higher progressive personal income tax rates applicable to domestic taxpayers.

5. Introduction of Comprehensive Limit on Special Deduction for Personal Income Tax Calculation

To prevent excessive deduction (in particular for high income earners), the amendment newly introduced and set a comprehensive deduction ceiling of KRW 25 million when calculating personal income tax. According to the amendment, specific deduction items including certain designated donations, private insurance expense, medical expense, education expense, home financing related expense, and credit card expenditure amount are combined into one basket to which the comprehensive deduction ceiling of KRW 25 million is applicable, while other deduction items such as basic personal deduction, earned income deduction, social insurance expense, qualified pension savings deduction, statutory donation, and disabled-person related expense are not subject to the comprehensive deduction ceiling, but continue to be subject to each prescribed deduction limit as in the past.
6. **Rationalization of Severance Income Taxation**

   **A. Clarification of Severance Income Classification**

   The amended law further clarified the scope of severance income in order to properly treat the income received as severance income if it is received as result of actual retirement, irrespective of the labeling of the income.

   **B. Improvement in Tax Deferral for Severance Income**

   Previously, tax deferral can be achieved if 80% or more of the severance income is contributed to a tax deferred account within 60 days of retirement. However, this rule has been made moot by the amendment of the Employee Retirement Benefit Security Act, which requires all severance income to be deposited into the private pension account, such as individual retirement pension plan, and prohibits immediate cash out. Accordingly, the amended tax law prescribes that withholding of tax on severance income is deferred if (i) the severance income is contributed into a private pension plan as of the retirement date or (ii) the severance income received is contributed to the private pension plan within 60 days of receiving the severance income.

   ✽ There are other supplements to the severance income and pension income taxation provision in the tax law amendments and the proposed amendments to the Presidential Decrees which are not mentioned here. For further details, please feel free to contact Kim & Chang.

7. **Improvements to International Taxation System**

   **A. Introduction of Specific Transfer Pricing Method for Payment Guarantee**

   Up until last year, the relevant Presidential Decree of the International Tax Coordination Law merely prescribed that the general arm’s length transfer pricing principle (most reasonable out of the six (6) methods) is applicable in determining the appropriate level of payment guarantee fee between a resident and a foreign related party. The amended law, however, introduced a more specific arm’s length determination standard and methodology for intercompany payment guarantee with further details to be prescribed in the Presidential Decree to be amended.

   **B. Further Clarification on Taxation of Intra-company (Head office – Branch) Transaction within a Foreign Corporation**

   Whereas no clearly stated transfer pricing guidelines previously existed for taxation of intra-company transaction within a foreign corporation (i.e., between head office and branch, or between Korean branch and other foreign branch of the same head office), proposed amendment to the relevant Presidential Decree will introduce further clarification on taxation of intra-company transaction within a foreign corporation. Also, to clarify taxation basis by following the international standards, the intent of Article 7 of the OECD Model Tax Convention amended as of July 2010 will be duly reflected in the proposed amendment to the Presidential Decree to be amended.

8. **Classification of Foreign (Joint Business) Entities**

   **A. Clarification of Foreign (Joint Business) Entities**
Previously, the Corporate Income Tax Law ("CITL") merely provided that a foreign corporation is subject to corporate income tax without providing details on what type of foreign entity qualify as a foreign corporation. To enhance predictability and legal stability for the concerned foreign parties, detailed criteria for determining a foreign entity as a foreign corporation will be further introduced and prescribed in the relevant Presidential Decree to be amended. According to the proposed amendment to the relevant Presidential Decree, a foreign entity will be treated as a foreign corporation if (i) it is bestowed with corporate entity status, (ii) all of its owners have only limited liability, and (iii) same or similar domestic business entity is treated as a corporation under domestic law. Further, the proposed amendment requires the National Tax Service to issue a notification on the classification of various types of foreign entities by applying the above three criteria.

B. Clarification of Taxation of Foreign Entities not Classified as Foreign Corporation

The current Presidential Decree of the Personal Income Tax Law ("PITL") taxes a foreign entity, which is not treated as a foreign corporation, in the following manner: (i) if profits are not distributed, the foreign entity is taxed by deeming the entity as one single non-resident taxpayer; and (ii) if profits are distributed, the foreign entity is treated as a flow-through entity and each recipient of income distributed from the foreign entity is taxed on its respective portion of the income. The proposed amendment seeks to further clarify item (ii) above as follows:

<table>
<thead>
<tr>
<th>Foreign entity with a domestic place of business</th>
<th>Foreign entity without a domestic place of business</th>
</tr>
</thead>
<tbody>
<tr>
<td>If information on income recipient and profit distribution ratio is submitted at the time of business registration</td>
<td>If no business registration or information on income recipient and profit distribution ratio is not submitted at the time of business registration</td>
</tr>
<tr>
<td>Taxation of each income recipient</td>
<td>Taxation of each income recipient</td>
</tr>
<tr>
<td>Taxation of foreign entity as a non-resident, i.e., item (i) above</td>
<td>Taxation of foreign entity as a non-resident, i.e., item (i) above</td>
</tr>
</tbody>
</table>

C. Application of Domestic Partnership Taxation Rules on Foreign (Joint Business) Entities

Until now, domestic partnership taxation provision applied only to domestic business entities such as an association. However, according to the amended domestic partnership taxation rules, if a certain foreign entity (i) qualifies as a foreign corporation under the amended CITL (or qualifies as a non-corporate entity under the amended PITL), but is similar in nature as a domestic business entity eligible for the application of the domestic partnership taxation rules, and (ii) meets the detailed criteria to be further introduced and prescribed in the relevant Presidential Decree, such foreign entity will be eligible for the application of the domestic partnership taxation rules, to the extent the income is effectively connected with or attributable to the domestic place of business of such foreign entity.
9. **Extension of Statue of Limitation for National Tax Collection**

The statute of limitation on the government’s right to collect national tax, until last year, was five (5) years from the time such collection right can be exercised regardless of the amount of national tax at issue. The amended law extended the statute of limitation to ten (10) years if the amount of national tax at issue is KRW 500 million or more.

10. **Decrease in Tax Limit for Entertainment Expense Deduction**

For corporate income tax calculation purposes, deduction of entertainment expense is subject to certain tax limit, the main components of which is calculated by multiplying certain rates on different revenue brackets of the company for the concerned fiscal year, and the revenue-based limit calculated is further reduced by multiplying additional 20% to the extent that such revenue is generated from transactions with the related parties. The amendment decreased the rate applicable to related party revenue transactions from 20% to 10%.

11. **Clarification of Foreign Source Income for Foreign Tax Credit Limit Calculation**

For corporate income tax calculation purposes, a domestic corporation with foreign source income is eligible for foreign tax credit subject to certain limit. However, given the lack of sufficient guideline on the method of calculating the foreign source income in determining the foreign tax credit limitation, the amendment states that the relevant Presidential Decree to be amended will introduce a more specific method for calculating the foreign source income for foreign tax credit limitation purposes.

12. **Increase in Alternative Minimum Tax Rates**

While there are prescribed statutory tax rates that apply to certain taxable income base, effective tax rates may be lower to the extent the taxpayer is eligible for significant tax deduction and/or credits. In this regard, to achieve tax equality and sustain minimum level of tax revenue, tax law prescribes a system of alternative minimum tax, where the alternative minimum tax rates are applied to taxable income base without consideration of deductions and credits and the resulting tax is payable by the taxpayer if such resulting tax is higher than the normally calculated tax. The amended law increased the alternative minimum tax rates applicable to corporations as follows:

<table>
<thead>
<tr>
<th>Alternative Minimum Tax Bracket</th>
<th>Alternative minimum tax rates before amendment</th>
<th>Alternative minimum tax rates after amendment</th>
</tr>
</thead>
<tbody>
<tr>
<td>10 or less</td>
<td>10%</td>
<td>10%</td>
</tr>
<tr>
<td>More than 10 up to 100</td>
<td>11%</td>
<td>12%</td>
</tr>
<tr>
<td>More than 100</td>
<td>14%</td>
<td>16%</td>
</tr>
</tbody>
</table>
II. Amendments Applicable to Financial Industry

1. Reduction of Threshold Amount of Financial Income Subject to Individual Global Income Taxation

To improve the effectiveness of individual global income taxation system and to achieve fairness in taxation, the amendment reduced the threshold amount of financial income (such as interest and dividend) subject to individual global income taxation from KRW 40 million to KRW 20 million per calendar year.

2. Expansion of Taxation on Capital Gains from Listed Share Transfer by Resident Individual

Previously, only capital gains from transfer of (KRX and KOSDAQ) listed shares by a major individual shareholder was subject to capital gains tax; a major shareholder was defined as individual shareholder owning 3% (5% for KOSDAQ listed shares) or more of the total outstanding shares or owning shares with market value of KRW 10 billion (KRW 5 billion for KOSDAQ listed shares) or more.

To improve the effectiveness of capital gains taxation on the transfer of listed shares, the proposed amendment calls for reduction of the 3% (5% for KOSDAQ listed shares) ownership threshold to 2% (4% for KOSDAQ listed shares) and reduction of the KRW 10 billion (KRW 5 billion for KOSDAQ listed shares) market value of shares to KRW 5 billion (KRW 4 billion for KOSDAQ listed shares), effective on share transfers occurring on or after July 1, 2013. However, if a non-major individual shareholder becomes a major individual shareholder solely on the basis of the proposed amendment, such shareholder will not be regarded as a major individual shareholder until the end of this year.


Much-disputed on-the-market derivative transaction tax (“DTT”) was not introduced as the bill is still under review by the National Assembly. Currently, while the transfer of equity securities is subject to securities transaction tax, derivatives transactions are not. In order to achieve equity relative to other similar financial products, the government proposed to the National Assembly last year to impose the DTT with respect to KOSPI 200 futures and options (listed derivatives products, which are based on the stock price index) effective for transactions occurring on or after January 1, 2016, after a 3-year grace period. The proposed DTT rates are 0.001% of the notional amount for futures and 0.01% of transaction price for options.

4. Change of Income Classification for Non-Resident Limited Partners of Korean PEF

Previously, income allocated to limited partners of a Korean private equity fund (“PEF”) which elected to be treated as a partnership was classified as dividend regardless of the underlying income character. However, the amended law provides that in case of pensions, funds, etc. which are non-resident limited partners of PEF and established in a country with an effective tax treaty with Korea (to be further specified in the Presidential Decree), income allocated to such limited partners (such as pensions, funds, etc.), if it is not taxed in the country of establishment, will be taxed on the basis of the underlying income character (such as interest, dividend, and capital gains from share transfer).
5. **Expansion of Tax Exemption on Capital Gains from Share Transfer by Non-Resident**

Currently, if a non-resident or a foreign corporation transfers shares of a Korean company listed on a foreign stock exchange through the foreign stock exchange, such transfer is not subject to Korean capital gains tax under the current provisions of the Enforcement Decree of the Special Tax Treatment Control Law. However, if such shares were not acquired through the foreign stock exchange, the transfer of such shares will not be exempt from Korean capital gains tax.

The proposed amendment states that if shares were acquired in order to satisfy the share distribution requirement under relevant foreign regulations for initial public offering on the foreign stock exchange, the transfer of such shares will not be subject to Korean capital gains tax (even if they were not acquired on the foreign stock exchange) in order to facilitate Korean company’s ability to obtain financing through a foreign stock exchange.

6. **Introduction of Tax Exemption on Interest on Foreign Currency Deposits by Non-Residents**

To stabilize foreign currency funding structure and to reduce funding cost, the amendment exempts interest income earned by a non-resident or a foreign corporation (other than by a permanent establishment of the foreign corporation in Korea) from foreign currency deposit with maturity of 1 year or longer, from Korean tax, effective on deposits made on or after January 1, 2013. The exemption will apply to deposits made within December 31, 2015.

7. **Extension of Loss Utilization against Gains from Foreign Investment Fund**

Previously, losses realized from foreign investment fund can only be offset against gains from foreign investment fund realized from January 1, 2010 to December 31, 2012. The amendment extends the loss utilization by one year to the gains realized until December 31, 2013.

8. **Extension of Securities Transaction Tax Exemption on Establishment of Financial Holding Company**

When establishing a financial holding company, share transfers by both the shareholders of the financial institution and the financial holding company was exempt from securities transaction tax (“STT”) until December 31, 2012. The amendment extends the STT exemption until December 31, 2015.

9. **Reduction of Tax Limit on Bad Debt Allowance**

In case of banks, insurance companies and securities companies, tax limit on applicable bad debt allowance is the greater of (i) 2%, (ii) the rate of actual bad debt write off or (iii) the accumulated rate of bad debt allowance under the Financial Supervisory Regulation. The proposed amendment seeks to reduce the 2% rate above to 1%, for sake of fairness with non-financial companies, effective from fiscal years commencing on or after January 1, 2013. However, the rate of actual bad debt write off and the accumulated rate of bad debt allowance under the Financial Supervisory Regulation will remain the same.
10. Supplement to Exchange of Financial Information with Foreign Government

According to the amendment, the competent Korean tax authorities can request financial information of a non-resident or a foreign company from a financial institution if automatic exchange of financial information is required under the applicable tax treaty, effective on requests made from January 1, 2013. The request can be made comprehensively to the financial institution as a whole without the need to specify a particular branch office of the financial institution.

This is quite a significant change from the previous tax law, which provided that the competent Korean tax authorities can request financial information only from a specific branch office of a financial institution only if there is an official request for financial information from the competent authorities of the other contracting state.

11. Clarification of Withholding Agent on Bonds Issued by Foreign Company

The amendment clarified that the Korean agent paying income arising from bonds issued by a foreign company to a Korean corporation on behalf of the foreign company is liable to withhold corporate income tax upon payment of such income to the Korean corporation.

12. Expanded Taxation of CPI (Consumer Price Index) Linked Korean Treasury Bonds

Whereas under the current tax law, increase in the principal amount of CPI linked Korean Treasury Bonds (“KTBs”) is not subject to income tax, the proposed amendment provides that such increase will be subject to income tax in order to achieve equity with other bonds. If adopted, the proposed amendment will be effective starting with CPI linked KTBs issued on or after January 1, 2015, after a 2-year grace period.