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Korean Tax Brief

Update on Current Issues and Trends

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1. Initiation of deliberation on 2017 Tax Revision Bill that includes the proposed increase of income tax and corporate tax rates

The government called a meeting of the tax reform deliberation committee on August 2, 2017, held under the auspices of Dong-Yeon Kim, the current deputy prime minister for Economic Affairs and Minister of Strategy and Finance. The committee approved the 2017 Tax Revision Bill which focuses on tax hikes on the high-net-worth individuals, including the raise of the highest tax rates for individual income tax and corporate income tax.

The government determined to increase the highest individual income tax rate from 40% to 42%. Under the current tax law, 38% of tax rate is applied to the tax base exceeding KRW 150 million but not over KRW 500 million and 40% for the tax base exceeding KRW 500 million. The tax revision increases the highest individual income tax rate from 40% to 42% for the tax base exceeding KRW 500 million and also includes an additional tax bracket of 40% for the tax base exceeding KRW 300 million but not over KRW 500 million. The number of high-income earners who will now have to pay additional taxes due to the amendment is estimated at approximately 93,000.

The highest corporate income tax rate that was lowered from 25% to 22% by the previous government will be brought back to 25% by the revision. Under the current tax laws, the tax rate of 22% is applied to the tax base exceeding KRW 20 billion. Once the Revision Bill is passed into law, the rates will rise to 22% for the tax base exceeding KRW 20 billion but not over KRW 200 billion, and 25% for the tax base exceeding KRW 200 billion. The new top bracket of 25% might impact approximately over 130 large corporations.

Apart from the increase of income tax rates, the Tax Revision Bill will also include the increase of capital gains tax rate for major shareholders, expansion of the scope of 'major shareholders' of listed companies, reinforcement of Deemed gift taxation on profits earned from related party transactions, and gradual reduction of the tax credits for reporting inheritance and gift tax. These will also in effect increase taxes on the large corporations and high-income earners. In addition, the amendment includes plans to move up the date for the advance notice of tax investigation from current 10 days to 15 days. It is intended to relieve the burden to taxpayers by allowing them to prepare for a tax audit based on the earlier notice of information on the scope, period, and grounds of tax audit. Taxation of the clergy is expected to take effect from next year as arranged previously. For further information on taxation of the clergy, see the following section.

The tax subcommittee of the National Assembly deliberates on the first Tax Revision Bill of the current administration for two weeks, from November 13 to 29. However, it is expected to be difficult to achieve a consensus from the meeting because the meeting has been shortened by the delayed deliberation due to the long Chuseok holidays (Korean holidays) and there is currently a wide gap in opinions between the ruling and opposition parties.

2. Foreign fund is not considered to have a permanent establishment in Korea since the subject activities are preliminary, preparatory, or auxiliary in nature in light of the main purpose of establishment and the business of the Korean subsidiaries (Supreme Court 2017. 10. 12. Sentenced 2014du3044, 2014du3051)

The National Tax Service ("NTS") Seoul Regional Office conducted a tax audit from August 2007 to May 2008 on Korean entities, which were established to serve the purpose of Lone Star Funds to invest in Korea. Following the tax audit, the NTS charged Lone Star Funds and eight other investors with approximately KRW 173.3 billion (US$ 155 million) arguing that the beneficial owner of the dividend income and the capital gains from transfer of stocks is not the intermediary holding company incorporated in Belgium but Lone Star Funds and the eight others that carried out business activities through a place of business in Korea. However, Lone Star Funds and the others filed a suit against the tax assessment.

The lower courts ruled for the taxpayer thereby upholding the Lone Star Funds' appeal in the first and second trial. The Supreme Court recently upheld the lower court's rulings based on the following line of reasoning: In order for a contracting state to exercise its taxing authority on the income of a foreign company, the foreign company must have a permanent establishment in the contracting state. The permanent establishment exists only where the foreign company has essential and important part of its business carried out by its employees or agent through a fixed place such as a building located in the contracting state where the foreign company has the rights to dispose of or use. However, it is difficult to conclude that Lone Star Funds and the others have a permanent establishment in Korea in light of the fact that, (i) the major decisions in the income generating process including raising funds from investors, making investment decisions, and withdrawing investment by selling assets were all made within the U.S. and (ii) although certain individuals significantly involved in the process of taking over and intervening with the management of distressed companies thereby generating profits of Lone Star Funds, the individuals acted in the name of the executives of Lone Star Advisors Korea, etc., which are legally separate entities from Lone Star Funds.

3. If the salary paid to a representative director is in substance the same as the disposition of the company's income, it is non-deductible for corporate income tax purposes (Supreme Court 2017. 9. 21. Sentenced 2015du60884)

In general, the salaries of executives paid as a consideration for the services performed for the company's business are deductible for corporate income tax purposes. However, the Supreme Court concluded that in light of the operative words and legislative intent of the tax law, if the payment to a major shareholder and executive of a company is not a normal consideration for his services to the company but in substance the disposition of the company's income merely taking the form of salary, such payment should be in substance same as the bonus paid by income disposition which is non-deductible for corporate income tax purposes and hence be non-deductible according to Article 43 of the Enforcement Decree of the Corporate Income Tax Act.

The Supreme Court, for its specific reasons, stated that (i) the representative director as a sole shareholder of the company has the authority to freely decide his own remuneration without restriction; (ii) he does not have a written salary contract unlike other executives; (iii) his remuneration is disproportionately high compared to the operating profits of the company and is also significantly

higher than the average remuneration of representative directors of similar sized companies in the same industry; (iv) his remuneration suddenly increased from the first business year that the company had operating profits; (v) despite the continued increase of operating profits, the company never paid out dividends; and (vi) the increase of salary is described on an internal document prepared by the company's employee as a strategy to reduce corporate taxes and therefore, it is obvious that the company intended to reduce corporate income tax by deducting the representative director's remuneration, etc

4. Expense incurred from a collusion with other companies should be treated as non-deductible according to the Corporate Income Tax Act (Supreme Court 2017.10.26. Sentenced 2017du51310)

According to Article 19 (2) of the Corporate Income Tax Act, the scope of deductible expense is limited to cost or expense incurred in connection with the business of the company that is generally accepted or is directly related to its profits. The term 'generally accepted expense' herein means the expense that would usually incur under the same circumstances by other companies engaged in the same type of business. It should be reasonably determined whether an expense may be classified as 'generally accepted expense', based on the reason, purpose, form, amount and effect, etc. of the expense incurred. With the same reasoning, the expenses incurred in violation of the social order should not be treated deductible nor be considered as related directly to the profits unless there are any special reasons to think otherwise.

The expense incurred from colluding with other companies, thereby obstructing or restraining the free competition in the bidding (in violation of the Monopoly Regulation and Fair Trade Act), is itself subversive of the social order and it cannot be regarded as 'generally accepted expense or expense directly related to profits' under Article 19 (2) of the Corporate Income Tax Act. In this regard, the Supreme Court has ruled such expense should be treated as non-deductible for corporate income tax purposes.

5. Taxation of the clergy

Taxation of the clergy has been drawing attention for many years and it is expected to take effect from next year (2018). There have been many oppositions from religious organizations and clergy members as the issue of imposing tax on clergy members came to the fore. However, the possibility of implementation of taxation of the clergy has risen, due to the favorable public consensus that has been formed for a long time. Income of the clergy refers to the income earned from a religious organization in relation to activities as a religious worker, such as conducting religious rituals. The term 'religious worker' is defined as religious practitioners in accordance with Korean Standard Classification of Occupation, including pastors, monks, and priests. On the other hand, the term 'religious organization' is defined as non-profit corporations with the religious purposes, established under Article 32 of the Civil Code, and their affiliates.

Income of the clergy from religious organizations includes honorarium, alms, pastoral activity fee, basic money, and benefits paid monthly or regularly. On the other hand, education expenses of the clergy permitted by law, meal expenses not exceeding KRW 100,000 per month, and compensation for actual expenses such as duty charge, travel expenses, vehicle subsidies and clothing costs are classified as non-taxable income. In principle, income of the clergy should be reported as miscellaneous income. However, one can opt to report it as wage and salary income by monthly withholding tax, or declare it on the final annual comprehensive income tax return. In case of reporting the income as miscellaneous income, 20% to 80% of the income received can be deducted as necessary expenses. Whereas reported as wage and salary income, one can benefit from income support such as employment subsidy if certain requirements are met. One can report the income of the clergy either as miscellaneous income or employment income, meaning that one can choose the most favorable method. In addition, religious organizations can choose whether or not to withhold taxes on the income of the clergy. If choose to withhold tax, religious organizations should withhold income tax monthly and conduct the year-end settlement in February of the following year. Otherwise, the cleric has to declare his/her income of the clergy and other income on the final annual comprehensive income tax return in May of the following year.

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