Tax News Flash

MOSF Announces Korea's 2015 Tax Reform Proposals

August 6, 2015

In brief

The Ministry of Strategy and Finance (MOSF) announced the Korean government's 2015 tax reform proposals on August 6, 2015. The reform proposals include changes intended to boost the sluggish economy and facilitate job creation. One of such proposals is a new tax credit for youth job creation. They also propose measures to promote exports as well as business investment and corporate restructuring. In addition, changes are proposed to increase the transparency regarding sources of tax revenue.

Provided below are a summary of selected significant changes contained in these tax reform proposals.

In detail

Corporate Income Tax

Narrowed scope of labor costs eligible for R&D tax credit

Companies are entitled to a tax credit for the expenses incurred by research activities including labor costs incurred by dedicated research staff and research supporting staff as well as R&D administration staff of in-house laboratories or R&D-dedicated departments. Under the tax reform proposal, the tax credit will be no longer available for the labor costs incurred by R&D administration staff who are not directly engaged in qualified research activities.

Tax credit to subsidize youth job creation

A company will be allowed to claim a tax credit worth KRW5 million (KRW2.5 million for a large corporation) for the net job creation of youth if the number of youth jobs exceeds the number of full-time youth jobs in the immediately preceding fiscal year. Youth for this purpose includes those aged between 15 and 29 as at the end of each fiscal year, except non-regular employees for part-time, outsourced or short-term employment. If approved, this proposed credit will be available for three years from the fiscal year including December 31, 2015 through to the fiscal year including December 31, 2017.

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Also it is proposed that, in calculating payroll increases for the purpose of the additional surtax to facilitate the use of corporate retained earnings (*), payroll increases for new youth jobs will be multiplied by 1.5, while payroll increases for other new jobs will be multiplied by 1.0.

(*) In order to motivate corporations to utilize corporate retained earnings to fund facility investment, wage increases and dividend payments, the Corporate Income Tax Law (CITL) was amended in January 2015 to introduce a 10% additional levy on corporate income if the use of such earnings falls short of a certain portion of corporate net income for the concerned year.

Companies may elect one of the following methods and cannot revoke its election for three consecutive years:
i) (taxable income for the year x 80% – the total amount of investment payroll increases and dividend payments) x 10%; or
ii) (taxable income for the year x 30% – the total amount of payroll increases and dividend payments) x 10%.

The additional levy shall apply to companies with net equity in excess of KRW 50 billion (excluding SMEs) and companies belonging to business groups subject to restrictions on cross-shareholdings under the Act on Monopoly Regulation and Fair Trade.

Employment-friendly criteria to determine small company status

The average annual revenue for three years (rather than the number of full-time employees under the previous Act) shall serve as a single criterion to determine the status of a small-sized company, effective January 1, 2016. When determined as a small-sized company, a variety of tax exemptions and reductions are available for a qualifying company under tax laws.

Increase in deductible expense limits for culture and arts

The existing limits in deductible expenses for culture and arts will be raised from 10% to 20% of deductible general business entertainment expenses. Also, the scope of deductible expenses for culture and arts will be expanded to: i) expenses incurred on culture and art events for a company's own employees or customers and ii) a company's subsidy to sponsor culture and sports events organized by the company's clients if they are sponsored by the Ministry of Culture, Sports and Tourism.

Carry forward of R&D tax credits

Companies may carry forward unused tax credits for expenditure incurred for research and manpower development for five years. The five-year period will be extended to 10 years for such expenditure incurred for five years from the incorporation date of start-up small and midsized enterprises (SMEs) in fiscal years starting from January 1, 2016.

Foreign Investment tax incentive associated with job creation

The limit of tax incentives for foreign direct investment (FDI) is based on the FDI amount and job creation. In terms of the FDI amount, the limit of incentives is 70% of the aggregated FDI amount for those eligible for a seven-year incentive period and 50% for those eligible for a five-year incentive period. In addition, if there is job creation, the following amount is added to the aforementioned limit based on the FDI amount:

- KRW10 million (KRW15 million or KRW20 mill ion for certain employees) multiplied by the nu mber of an eligible company's net job creation. However, it shall not exceed 20% of the FDI am ount.

Under the proposal, the 20% threshold will increase to 40% for those eligible for a seven-year incentive period and 30% for those eligible for a five-year incentive period, while the threshold of the aggregated FDI amount will decrease from 70% to 50% and from 50% to 40%, respectively.

Change to facilitate FDI business start-up

Under the current FDI incentive system, a FDI tax incentive shall become invalid unless an initial contribution of FDI is made in three years from the date the FDI incentive is approved and notified to an

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applicant for the FDI incentive. In order to facilitate initial business start-up of FDI, a proposed change will require that a foreign-invested company is deemed to start a business unless it is initiated in five years from the date of notifying the authorized FDI incentive, even if initial contribution is made within three years. This proposed change will be effective for tax incentive applications made on or after January 1, 2016.

Changes in deductible work-related car expenses

A new deduction rule for work-related car expenses will apply to company-owned and leased passenger cars which are subject to non-deductible input VAT under the VAT law. However, light vehicles, sports utility cars and commercial vehicles including taxis shall not be subject to this new rule. Deductible expenses will include amortization costs, lease fees, fuel cost, insurance premium, repairing cost, auto-related taxes, toll fees, etc. To qualify for a deduction for corporation tax purpose, it is proposed that:

- A company must purchase (or renew) an auto insurance policy which should limit the scope of covered drivers to a company's employees and register a covered vehicle as a work-related car with a tax office.
- Only a certain percentage (e.g. 50%) of eligible auto-related expenses can be allowed. If an additional use of a car is documented, including mileage notes, the additional percentage of expenses will be allowed as a deduction.
- If a corporate or business logo is installed on a car in a prescribed manner, 100% of work-related car expenses will be allowed a deduction.

Unless the foregoing requirements are met, an entire amount of work-related car expenses will be disallowed for corporate taxpayers. For individual entrepreneurs, a portion of such expenses will be allowed if the car use for business purposes is documented. The proposed changes will apply to corporate taxpayers from the fiscal year starting January 1, 2016 (January 1, 2017 for individual entrepreneurs subject to double-entry booking).

Proposed criteria for Korean residents subject to offshore financial reporting requirements

Korean residents or domestic companies are currently required to report their offshore financial accounts if the aggregate balance of these accounts exceed KRW1 billion at the end of each month during the concerned year. In accordance with the amended residency test rule in February 2015, Korean residents subject to the reporting requirements will include those who are present in Korea for at least 183 days (rather than one year) during the current year or during two consecutive tax years. The proposed change will apply when residents file in 2017 their information of offshore financial account holdings for 2016.

New reporting requirement to examine cross-border transactions of multinationals

The latest proposals contain a new requirement for multinationals in Korea to submit information on their cross-border transactions. The applicable scope will be domestic companies as well as foreign companies having PE's in Korea if their total assets or transactions exceed a given threshold. Under the requirement, companies will have to submit their master and local files of cross-border transactions together with the documentation on their international transactions currently required under the Law for Coordination of International Taxation Affairs. The failure to comply with the reporting requirement will be subject to a penalty up to KRW10 million. The threshold and other details of the proposed requirement will be set out by the Presidential Decree. The proposed change will apply to fiscal years starting from January 1, 2016.

Ceiling on tax loss to be utilized

For fiscal years starting from January 1, 2009, the tax law allows tax losses to be carried forward for the next ten years (five years for fiscal years starting on or before December 31, 2008). Under the 2015 tax reform proposal, it is proposed that the tax loss that can be utilized by a domestic company in a year will be limited to 80% of the company's taxable income in that year. The exceptions to the proposed ceiling will

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include small- and mid-sized enterprises (SMEs), corporations in workout procedures by a court decision, implementation of plans for management normalization under the Corporate Restructuring Promotion Act or business normalization plans with creditor banks. The proposed ceiling will apply for the fiscal year starting on or after January 1, 2016.

Extended due date for request of extension return filing

Under the current tax law, if a company subject to external audit expects that the external audit will not be completed in time and so there will be a delay in book closing, it can request for an extension to the corporate income tax return filing deadline by one month with the payment of interest at 2.5% per annum. The request must be filed no later than two weeks before the return filing due date. Based on the tax reform proposal, the due date of submitting the request can be filed three days prior to the return filing due, increasing the convenience for taxpayers.

Management after cancellation of consolidated tax return filing

Currently, companies may voluntarily elect for consolidated tax return filing and the elected consolidated filing cannot be cancelled for five years unless there are qualifying reasons for the cancellation as prescribed in the Corporate Income Tax Law. One of the proposed changes to the consolidated tax return filing addresses the treatment of tax losses taken as a deduction if the consolidated tax return filing is cancelled earlier than the mandatory five-year period. In this case, it is proposed that the amount of a consolidated subsidiary's tax losses taken as a deduction in previous consolidated tax returns will be included in the taxable income of the consolidated subsidiary enjoying the deduction of the tax loss and the consolidated subsidiary incurring the tax losses will be allowed to claim its tax losses as a deduction in the year when the other subsidiary includes the tax loss in its taxable income. The proposed treatment will also be applicable in cases where a consolidated subsidiary is excluded before the end of the mandatory five-year period.

Change to test for real property shares

Based on the existing tax law, in case of the transfer of shares in a domestic company by a Korean nonresident or foreign company, whether the domestic company is real property shares for which capital gains would be subject to Korean withholding tax is determined based on whether 50% or more of the total assets owned by the domestic company constitutes real property. Under the tax reform proposal, it is suggested that the value of shares in a real property-rich company owned by the domestic company will be taken into account in conducting the real property share test for the domestic company The change will be applicable for the transfer of shares in a domestic company from January 1, 2016.

Individual Income Tax

New withholding obligation on domestic company having foreign secondee earning high income

Currently, the foreign secondee working in Korea who receives employment income from a foreign corporation outside Korea is not subject to payroll withholding tax on such Korean sourced employment income, but can voluntarily join a taxpayers association to pay payroll withholding tax via the association and enjoy a 10% tax credit. A proposed change will require a domestic company using foreign secondees to withhold payroll income tax at 17% when the domestic company pays service fees to the foreign corporation which dispatched the foreign secondees. The new withholding obligation will arise for the amount of the service fee which is confirmed as employment income. Also, it will be applicable to a limited scope of foreign secondees if their income bracket exceeds a given threshold. Detailed scope and procedures will be later announced in the proposal to revise the Presidential Decree of Individual Income Tax Law. For the withholding tax withheld and paid by the domestic company, the foreign companies dispatching foreign secondees will be allowed to claim the refund of any overpaid withholding tax through a year-end settlement of the payroll withholding tax. The proposed change will

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apply from the fiscal year starting on or after January 1, 2016.

Expanded scope of large shareholders subject to capital gains tax

While gains from the sale of listed stock is exempt from tax, such capital gains are exceptionally taxed when the total stake of a shareholder together with any related parties ("large shareholder") in a listed company exceeds either 2% (4% for a KOSDAQ or a KONEX -listed company) or the total market value of the sock held by a shareholder amounts to KRW5 billion (KRW4 billion for a KOSDAQ-listed company or KRW1 billion for a KONEX -listed company).

The thresholds will change to: i) 1% and KRW2.5 billion in the Korea Stock Exchange; ii) 2% and KRW2 billion in the KOSDAQ. However, the thresholds in the KONEX will remain unchanged. The proposed changes will apply to share transfers made on or after April 1, 2016.

The capital gains earned by a large shareholder are taxed at the rate of 20% (30% if the holding period is less than one year). If the stake is in a SME, a large shareholder is currently subject to a 10% capital gains tax. Under the proposal, the capital gains tax rate for a large shareholder in a SME will increase from 10% to 20% (excluding local income tax), while a 10% rate continues to apply to other shareholders in a SME. This change will apply to share transfers made on or after January 1, 2016.

VAT

Application of zero-rated VAT for professional service and business support services on a reciprocal basis

According to the existing VAT Law, zero-rated VAT is available on the supply of certain services by a taxpayer if they are provided to a Korean nonresident or foreign enterprise having no permanent establishment in Korea and the taxpayer earns foreign currency consideration for such supply. However, under the 2015 tax reform proposal, it is suggested that in case of professional services and business support services supplied to the Korean nonresident or foreign enterprise without having PE in Korea, zero-rated VAT will apply only if a foreign country where the nonresident or foreign enterprise is established gives similar VAT treatment (including VAT exemption) on the supply of those services by a Korean resident (ie zero-rated VAT on a reciprocal basis). The VAT Law change is proposed to give equal VAT treatment between the domestic resident or company receiving professional services and business support services and a nonresident or foreign company receiving those services in light of the fact that those services in nature are actually consumed in Korea. Professional services include legal services (those rendered by lawyers, patent attorney, and judicial scrivener), accounting & tax services, advertising, market survey and management consulting services. Business support services include human resources outsourcing and activities of employment placement agencies, office support services, etc. The proposed change will apply to the professional services and business support services supplied on or after July 1, 2016.

Change to the scope of the supply of electronic services subject to VAT compliance

Based on the new VAT rule which is effective from July 1, 2015, a non-resident or a foreign corporation that supplies electronic services into Korea is subject to simplified VAT registration in Korea and must pay VAT on the supply of electronic services (in case of supply via an open market operator or an intermediary, the open market or intermediary is subject to such VAT obligations). Regarding this, there has been controversy over whether the rule applies to B2B transactions. Under the 2015 tax reform proposal, it will be clarified by inserting a provision that if electronic services are supplied with respect to the business of a Korean business entity, they would not be subject to the new VAT rule. Such clarification is intended to solve the problem that a Korean business entity could not claim the deduction of input VAT paid on the supply of electronic services

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by a nonresident or foreign enterprise which is exempt from VAT invoicing if such B2B transaction is subject to the new VAT rule. The proposed change will apply to the supply of B2B electronic services made in the VAT taxation period in which the new VAT Law based on 2015 tax reform proposal is formally announced. Assuming that the new VAT Law is formally announced in the 2nd half of 2015, the supply of B2B electronic services made in the 2nd half of 2015 and thereafter will be excluded from the new VAT rule.

Extended due date for receipt of VAT invoices for eligibility of input VAT deduction

In order to be entitled to the deduction of input VAT, a recipient of goods or services supplied must receive a proper VAT invoice from the supplier of goods or services at the time of supply or at least by the end of the VAT taxation period (e.g. June 30 and December 31) in which the supply belongs to. Under the 2015 tax reform proposal, it will be allowed to receive VAT invoices by the due date for filing a final VAT return for a taxation period, that is, July 25 for the first taxation period from January 1 to June 30 and next January 25 for the second taxation period from July 1 to December 31.

Import VAT deferment

The current law requires importers to pay import valued added tax (VAT) to a customs office when importing goods into Korea and allows them to deduct the import VAT on their VAT return. A change is proposed to allow qualifying importers mainly engaging in export transactions to defer the payment of import VAT due on imported goods until they file VAT returns with a tax office, effective for imports made on or after January 1, 2016. The eligible importers will be small and medium-sized enterprises which mainly conduct export transactions and will be specified in the Presidential Decree.

Others

Proposed changes for taxpayer-friendly tax administration

Under the 2015 tax reform proposal, measures are proposed to reduce the administrative and compliance burden of taxpayers. One such proposed measures is to allow a local government to assess local income tax based on the tax base for corporate income tax and individual income tax as determined by the National Tax Service (NTS). In other words, a proposed change addresses that the local income tax base must be determined or corrected in accordance with the corporate income tax or individual income tax base as determined by the NTS. In addition, the NTS will be the single unitary authority to conduct audits on taxpayers associated with the calculation of the tax base for national taxes and local income tax thereon.

Tightened criteria for expansion of tax audit scope

The tax authority is currently allowed to expand the scope of a tax audit by notifying in advance to an audited taxpayer of reasons for and scope of the expansion to other fiscal years in writing. A change is proposed to clarify reasons for the expansion of a tax audit scope. Specifically, the law currently provides that an extension of tax audit can be allowed when a suspected tax evasion case is deemed to exist and certain issues relating to a clearly suspected tax evasion case found during the audit are considered to be related with other fiscal years. A proposed change will clarify the reasons for expansion of the audit scope by providing that (i) specific evidence supporting suspected tax evasion is found and (ii) certain issues relating to clearly suspected tax evasion cases found during the audit also exist in other fiscal years and it is reasonably suspected that such issues would result in the same or similar tax evasion as that found during the course of the audit.

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