Insurance Tax Highlights – Asia Pacific

Korea

Education Tax on Variable Insurance in Korea

January 2015

Controversy on education tax on variable insurance

Variable insurance is a type of insurance in which insurers invest a portion of the premium into a separate account comprised of various instruments and investment funds within the insurers' portfolio, such as stocks, bonds, equity funds, and money market funds (MMFs). Profits are then distributed based on the performance of the portfolio. The policy holder of the variable insurance (i.e. the insured) is responsible for all of the risks, and receives all of the returns of investment since the operating revenues of the variable insurance separate account belongs to the insured.

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In Korea, there is increasing concern over variable insurance and how it can be used for the purposes of evading tax. In 2008, the National Tax Service (NTS) challenged an insurance company, which took the position that gains on the valuation of securities in variable insurance separate accounts, even if unrealised, should not be excluded from the taxable income since such gains belonged to the insured and not the company. The NTS ultimately ended up losing the case since Article 5(2) of Corporate Income Tax Act (CITA) states that revenues from variable insurance separate accounts shall be deemed as the revenues of an insurer[1].

Recently, the special characteristics of variable insurance have triggered controversy from an education tax perspective, which remains unresolved. This article provides a snapshot of issues that insurers in Korea may face.

An overview of education tax in Korea

Education tax is levied on the revenues of financial institutions (including insurers) to secure resources necessary for expanding education spending and improve the quality of education. The education tax base and attributable period of the revenues is as follows:

1. Following the NTS challenge, the Presidential Decree of the Corporate Income Tax Act was revised to allow insurers to either value securities on variable insurance separate accounts using a mark-to-market method or to apply acquisition cost basis in calculating corporate income tax base.

a. Education tax base

For insurers, the tax base is the amount of revenues of insurers.

b. Revenues of insurers

Revenues of insurers consist of the following:

- Interest income
- Dividend income
- Commission income
- Guarantee fee income
- Gains from disposal of securities
- Gains from disposal of fixed assets
- Discount income
- Premiums
- Consigner fee and dividend income
- Trust fee income
- Rental income
- Net income computed by adding the below items
  - Gains from foreign exchange transactions
  - Gains and losses from derivative transactions
- Other operating income and non-operating income

c. Attributable period of revenues of insurers

The attributable period of revenues of insurers shall follow Article 40 (attributable period of gross income and deductible expenses) and 43 (application of corporate accounting standards and practices) of the CITA.

Should we include or not?

In July 2009, an insurer appealed that the premium and operating revenues of variable insurance separate account should not be included in the education tax base. Although the insurer won the first trial against the NTS, the High Court reversed the verdict in October 2014.

At the High Court, the insurer asserted that the beneficial owner of the revenue was not the insurer, but the insured since the insured of the variable insurance is responsible for the risks and returns of investment and the Insurance Business Act provides that operating revenues of variable insurance separate account belong to the insured. Therefore, the premium and operating revenues should not be subject to education tax (i.e. substance over form).

However, the High Court determined that as long as the insurance is not paid out to the insured pursuant to the policy, the revenues of the variable insurance separate account belong to the insurer. In other words, since the insurer is a beneficial owner of the revenues before they are paid out to the insured, the premium and operating revenues of variable insurance separate account should be included in the education tax base.

The insurer also asserted that since the variable insurance separate account is regarded as an investment trust operated by collective investment vehicle, if the insurer is permitted to run a collective investment business pursuant to the Financial Investment Services and Capital Markets Act (FISCMA), the revenues of the variable insurance separate account should be excluded from the education tax base as is the case with the customers' deposits of other collective investment vehicles.

The High Court, however, insisted that since the provision to regard the variable insurance separate account as the investment trust is based on the assumption that insurer and collective investment vehicle are originally different in their characters, even if the insurer is permitted to run a collective investment business, the revenues of the insurer shall be subject to the education tax.

Lastly, since the Education Tax Act (ETA) does not have the provision similar to Article 5(2) of CITA, which states that no revenues and expenses from trust properties of a corporation regulated by FISCMA (excluding special accounts of insurers) shall be deemed as the revenues and expenses of the corporation, the insurer believed that the revenues of the insurer should be excluded from the education tax base.

The insurer is now waiting for the decision of Supreme Court. Given the complexities and uncertainties associated with variable insurance, it is difficult to predict the outcome.

Gains on valuation of securities in variable insurance separate accounts

As stated in the introduction, after NTS challenged an insurance company in 2008 on the gains on the valuation of securities in a variable insurance separate account, the Presidential Decree of the CITA was revised to allow insurers to value securities in variable insurance separate accounts using either the mark-to-market (MTM) method or to the apply acquisition cost basis in calculating the corporate income tax base.

Article 75 of the current Presidential Decree of the CITA prescribes that insurers shall evaluate securities of variable insurance separate account using the rate as of the transaction date or the rate as of the end of the relevant business year and to continue using the rate once it is chosen.

According to the Presidential Decree of the CITA, insurance companies electing to apply the MTM method have included gains on the valuation of securities in variable insurance separate accounts in their corporate tax base. However, they did not include them in the education tax base.

As mentioned above, the ETA indicates that gains on the disposal of securities are revenues of insurers, which constitute the education tax base. Since it is evident from the ETA that only gains on the disposal of securities are included in the education tax base, they believe that the unrealised gains on the valuation of securities are excluded from the education tax base.

The tax authorities, however, challenged an insurer in a tax audit in 2014 by asserting that since the attributable period of revenues of insurance companies under the ETA shall follow the CITA and the gains from the valuation of securities in a variable insurance separate account is attributable to the period in which the securities are appraised for CITA purposes, they should also be included in the education tax base.

Therefore, the insurer requested the NTS to determine the appropriateness of taxation of the gains on the valuation of securities given the literal interpretation of ETA which states only realised gains on the disposal of securities are included in the education tax base. The final decision of NTS is still pending.

Gains / losses on the valuation of derivatives[2]

ETA indicates that the net income portion of gains and losses from derivative transactions is included in the education tax base. However, financial companies have not included gains and losses on the valuation of derivatives in the education tax base when they compute gains and losses from derivative transactions taking the position that gains and losses from derivative transactions under the ETA should be interpreted as 'realised', 'unrealised' gains and losses on the valuation of derivatives should be excluded.

In early 2013, however, the tax authorities challenged financial companies taking the view that gains on valuation of derivatives should be treated as other operating income, thereby including them in the education tax base.

2. The issue is not limited to the derivatives of the variable insurance separate account. It is also related to those in the general account.

Under the CITA, derivatives such as currency forwards, currency swaps, etc. shall be evaluated using either the rate as of the transaction date or the rate as of the end of the relevant business year. So the tax authorities challenged the financial companies that the gains on the valuation of currency forwards, currency swaps, etc. should be included in the corporate tax base by insisting that since the attributable period of revenues of financial companies pursuant to the ETA shall follow the CITA, there is no reason to exclude the gains on the valuation of the derivatives from the education tax base.

The financial companies further asserted that if the tax authorities are to include the gains on the valuation of derivatives in the education tax base, they should be viewed as gains and losses from derivative transactions, not as other operating income. If gains on the valuation of derivatives are regarded as other operating income, only gains are included in the education tax base. However, if gains are treated as the gains and losses from derivative transactions, both gains and losses are included in the education tax base, thus offsetting each other to some extent.

The Tax Tribunal has yet to render a decision on the appeal that a financial company made in 2014, however, according to recently proposed Presidential Decree of the ETA, gains and losses on the valuation of derivatives will be regarded as the gains and losses from derivative transactions which allow offsetting. The revised provision is now in effect (starting 2015).

The way forward

As the ETA does not provide clear guidelines, there have been a number of associated issues. In an effort to remove any ambiguity, the Presidential Decree of the ETA regarding taxation of gains and losses on the valuation of derivatives was recently revised and is now in effect (starting 2015). However, the gains and losses on the valuation of derivatives for the period up to 2014 still remains controversial. If the tax effect pursuant to the revised provision is favourable, it may be worthwhile for taxpayers to consider applying for refunds for periods up to 2014.

In addition to the revision of taxation of gains and losses on evaluation of derivatives, the ETA still has room for improvement as the CITA tries to close the uncertainties on the tax treatment of gains and losses on the valuation of derivatives and securities in variable insurance separate accounts by providing clear guidelines over the past few years. Moreover, as the education tax is imposed every quarter and is due two months after the last day of each quarter, financial companies have expressed the practical inconvenience of the quarterly tax filings. As such, a movement towards changing the quarterly taxable period into the yearly taxable period is recently gaining momentum.

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