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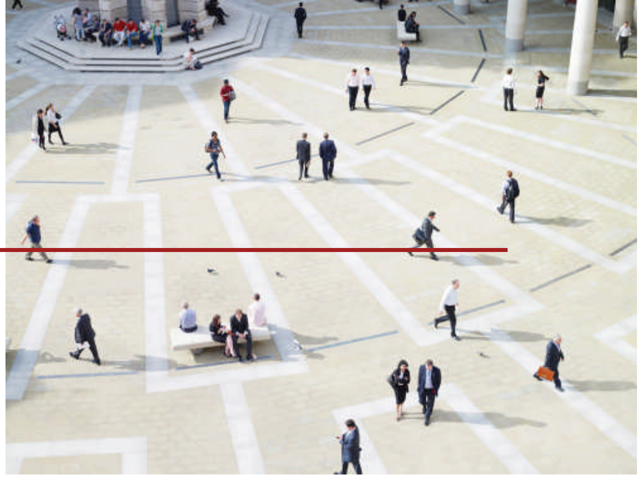

Tax News Flash

Korea's Tax Reform Proposals for 2017

August 3, 2017

In brief

The Ministry of Strategy and Finance announced the Korean government's tax reform proposals on August 2, 2017. The main focus of the tax reform proposals is to encourage job creation by reforming the existing tax credits for corporate investment to create jobs and additional incentives to stimulate youth employment. Another focus is placed on strengthening the collection of income tax on high-income earners by raising the top marginal individual income tax rate and expanding tax revenue sources by raising the corporate income tax rate for taxable income over KRW200 billion. In addition, the reform proposals include significant changes that would affect cross-border transactions of multinational companies. In the government's commitment to implement the OECD's recommendations under the BEPS project, the proposals contain new rules to restrict the deductions for hybrid financial instruments and interest expense deductions.

The proposed reforms may be subject to some modifications before finalization for submission to the National Assembly in September. If approved by the National Assembly, most of the proposed changes will take effect from January 2018 unless otherwise specified.

In detail

Corporate Income Tax Law

Increase in Marginal Tax Rate to 25% for Tax Base Exceeding KRW200 Billion

Under the proposal, the corporate income tax rate will increase to 25% for the tax base exceeding KRW200 billion, effective for the fiscal year beginning on or after January 1, 2018. However, the tax rates applicable to the taxable income of KRW200 billion or less will remain unchanged.

Currently, corporate income tax rates are 10% for the tax base not exceeding KRW200 million, 20% for the tax base exceeding KRW200 million but not more than KRW20 billion and 22% for the tax base exceeding KRW 20 billion.

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Limitation on Utilization of Tax Loss of Companies Other than SMEs

Currently, tax loss can be carried forward to the next ten years. The tax loss carried over from prior years that can be utilized by a domestic company in a year are limited to 80% of the company's taxable income in the year (100% for small and midsize enterprise, 'SME'). The 80% threshold for the companies other than SMEs will be gradually reduced to 60% for the fiscal year starting from January 1, 2018 and 50% for the fiscal year starting from January 1, 2019. However, the 100% threshold for SMEs will remain the same.

Special Tax Treatment Control Law

Tax Credit for Job Creating Investment Allowed in Absence of Corporate Investment

Currently, a basic tax credit ranging from 3% to 8% is permitted in respect of corporate investment to promote job creation depending on the number of increased employees with certain limits if a company is engaged in businesses except for those which fall under the category of consumption-oriented services as specified in the tax laws, for example entertainment and beverage service. Under the reform proposal, the tax credit for job creating investment will be permitted even if there is no corporate investment. In this case, however, the amount of the tax credit shall not exceed the proposed limits below.

Types	SME	Medium scale company	Large company
Full time employees	KRW7 million per employee a year	KRW5 million per employee a year	NA
Regular youth employees, handicapped employees	KRW10 million per employee a year	KRW7 million per employee a year	KRW3 million per employee a year

The proposed change will be temporarily available for two years (one year for large company) from the year beginning on or after January 1, 2018.

Proposed Change to Encourage Job Creation by Foreign-invested Companies

Currently, foreign invested companies that engage in certain qualified high-technology businesses or conduct business in a designated zone are entitled to 100% exemption from corporate income tax for five years (or three years) and 50% exemption for the next two years in proportion to the foreign investment ratio ('seven-year incentive type' vs 'five-year incentive type'). Additional tax exemptions are allowed of KRW 10 million ~ KRW 20 million depending on the number of certain employees (e.g., youth employment). However, the total tax exemption amount is limited to 90% of the foreign investment amount, including 40% for the additional exemption amount in case of the seven year incentive type, and 70% of the foreign investment amount including 40% for the additional exemption amount in case of the five-year type. The limit on the additional tax exemption based on employment will increase from 40% to 50% for the seven-year incentive type while increasing from 30% to 40% for the five-year incentive type.

The proposed changes will be effective for the foreign investment tax exemption applications filed from January 1, 2018.

Continuity of Employment Proposed for Tax Deferral in Qualified Merger or Spin-off

Currently, corporate income tax on the capital gains in a qualified merger or spin-off is deferred until the disposal of the shares acquired during the merger or spin-off if certain requirements are met. They include the requirements for business purpose reorganization, continuity of shareholding and continuity of the transferred business succeeded by the acquiring company. The proposal adds the continuity of employment requirement to the existing requirements for tax deferral in a qualified merger or spin-off. According to the new requirement, at least 80% of the employees engaged in the transferred business as of one month prior to the registration date of the merger or spin-off should continue to be employed until the end of the year with certain exceptions as specified in the tax laws (e.g., bankruptcy or insolvency reasons).

The deferred income tax in a qualified merger or spin-off are currently recaptured unless the requirements are retained. Designed to secure employment from the viewpoint of the government's job-creation policy, the recapture rule will also apply if less than 80% of the employees engaged in the transferred business as of one month prior to the registration date are retained within three years after the merger or spin-off.

The proposed change will apply to a merger or spin-off occurring on or after January 1, 2018.

Proposed Change to Existing Tax Credit for Increase in Corporate Payroll

The tax law provides for a temporary 10% tax credit (5% for large corporation) on the incremental amount in average corporate payroll over a certain base level calculated in a prescribed manner by taking into account the average corporate payroll over the previous three years. This is conditional on the requirement of maintaining the number of full-time employees from the previous year. However, the tax credit is not available relating to certain categories of employees such as high income earners in the income bracket of KRW 120 million or more in annual compensation.

Two changes are proposed with respect to this tax credit. One of the prosed changes will increase the credit ratio from 10 to 20% for SMEs while the tax credits for medium scale or large companies will remain unchanged. The other change will be made to the threshold of annual compensation of employees ineligible for the tax credit whereby the current threshold of KRW120 million of annual compensation will be lowered to KRW70 million.

The tax credit which was supposed to be terminated at the end of December 2017 will be extended for three additional years until the end of December 31, 2020. The proposed change will apply from the year beginning on or after January 1, 2018.

New Tax Scheme to Replace Existing Additional Tax on Excess Corporate Earning Reserve

As the additional tax to facilitate the use of corporate retained earnings in facility investment, payroll increase, dividend payment and qualifying investment for the purpose of mutual growth and cooperation of large companies and SMEs under relevant law is to be terminated as scheduled on December 31, 2017, a new tax scheme is proposed to replace the additional tax for the purpose of promoting the mutual growth of large companies and small-and medium-sized companies. In order to motivate corporations to utilize corporate retained earnings in qualifying expenditures such as facility investment, etc., in case of the company having shareholder's equity exceeding KRW 50 billion or belonging to a conglomerate group subject to the restriction on cross shareholdings, a 10% additional tax is currently levied on excess corporate earning reserve if qualifying expenditure falls short of a certain threshold (i.e., 80% or 30% of adjusted taxable income).

The proposed new tax scheme is outlined below while its details will be set forth by the Presidential Decree.

- 20% additional tax will be levied on excess corporate earning reserve which will be computed under either option as elected by a taxpayer as follows:

  (Option A) (adjusted taxable income for a year x a prescribed rate – the total amount of qualifying expenditure including facility investment, payroll increase and certain expenditure incurred for mutual growth as designated under the presidential decree) x 20%; or

(Option B) (adjusted taxable income for a year x a prescribed rate – the total amount of payroll increases and certain expenditure incurred for mutual growth as designated under the presidential decree) x 20%

The prescribed rate will range from 60% to 80% in case of option A and it will range from 10% to 20% in case of option B. In either option, the adjusted taxable income will exclude the taxable income over KRW 200 billion. Also, of a particular note, dividend payments will be excluded from the scope of qualifying expenditures. In addition, an increased weighting will be given to the expenditure for mutual growth and cooperation of large companies and SMEs according to relevant law (from currently 1 to 3). Furthermore, on top of a 1.5 weighting for wage increases, an additional weighting will be granted to wage increases due to employment increases (from currently zero to 0.5) and wage increases for youth employment or employment converted from part-time to full-time workers (from currently 0.5 to 1).

The proposed change will apply to the year beginning on or after January 1, 2018 until December 31, 2020.

Change to Special Tax Exemption for SMEs

Currently, SMEs engaging in one of 46 businesses including manufacturing business are allowed to claim the special tax exemption at 5% ~ 30% of corporate income tax calculated depending on the type of industry, corporate scale and company location. The following changes are proposed to the special tax exemption:

- The tax exemption amount will be capped at KRW100 million and the ceiling will be reduced by KRW5 million per employee in case where the number of employees reduces. However, the tax exemption will be available for qualifying SMEs which also claim the tax credit for job creating investment and/or the tax credit for social security tax paid for an increase in regular employees. This revised tax exemption will apply for the year beginning on or after January 1, 2018 until December 31, 2020.

In addition, the existing R&D credit rate for SMEs having qualifying R&D expenditures in new growth engine industries or core technologies as prescribed under the tax law will increase from 30% up to 40% (*).

(*) 30% + a maximum of 10% x (qualifying R&D expenditure for new engine growth industries or core technology/total sales revenue x 3).

Reduction in R&D Tax Credit for Large Company

Large companies currently claim a tax credit for qualifying R&D expenditure during a year at a rate ranging from 1% up to 3% (*) or at 30% of the incremental portion of the current R&D expenditures during a year over the average of the previous four years. Under the proposal, from the year beginning on or after January 1, 2018, the R&D tax credit rate of 1% ~ 3% under a current year expense method will be lowered at 0~2%, while there will be no change to the tax credit rate under an incremental expense method. The existing R&D tax credit rates for medium-scale companies and SMEs will remain the same (8% and 25%, respectively for medium-scale companies and SMEs under a current year expense method or 40% and 50%, respectively for medium-scale companies and SMEs under an incremental expense method).

(*) 1% + 2% x [(qualifying R&D expenditures/sales revenue) x 50%].

Reduction in Tax Credit for Certain Facility Investment by non-SMEs

With respect to investment in certain facilities, companies are allowed to deduct 3% of the investment amount (5% for medium scale company and 7%/10% for SME) from corporate income tax. Three categories of facilities eligible for the tax credit include: (i) facilities to improve the productivity such as factory automation, knowledge management system, advanced technology facilities, etc.; (ii) safety control facilities such as fire-fighting, chemical safety control, prevention of technology information leak, etc.; (ii) facilities for environmental protection such as anti-pollution, waste water treatment, desulphurization, etc.

The tax credit rates will be lowered by two percentage points to 1% for large companies and 3% to medium scale companies, while the credit rates (7% for the investment in facilities for productivity enhancement and 10% for the investment in facilities for environmental protection) for SMEs will remain unchanged. The reduced tax credits for facilities for productivity improvement and safety control will be available for two additional years until the end of December 2019. However, the tax credit for investment in environmental protection facilities will be terminated as scheduled at December 31, 2018.

Individual Income Tax Law

Increase in Marginal Individual Income Tax Rate

The top marginal individual income tax rate will increase from 40% to 42%, while the individual income bracket of KRW300~500 million will be subject to the tax rate of 40%. The individual income tax rates for the year beginning on or after January 1, 2018 will be as follows:

Tax Base	Tax Rates (*)	
	Current	Proposed
KRW12 million or less	6%	Same
Exceeding KRW12 million but not more than KRW46 million	15%	Same
Exceeding KRW46 million but not more than KRW88 million	24%	Same
Exceeding KRW88 million but not more than KRW150 million	35%	Same
Exceeding KRW150 million but not more than KRW300 million	38%	Same
Exceeding KRW300 million but not more than KRW500 million	38%	40%
Exceeding KRW500 million	40%	42%

( ) Rates are exclusive of local income tax*

Taxation of Capital Gains for Large Shareholder to Be Strengthened

While capital gains from the disposal of listed shares is exempt from tax, such capital gains are exceptionally taxed when the total shareholding of a shareholder together with its related parties in any listed company exceeds certain thresholds (so-called "large shareholder"). Based on the current tax laws, the scope of large shareholder includes:

- In the case of a company listed on the Korea Stock Exchange (KSE), shareholding of 1% or more or market capitalization of KRW2.5 billion or more
- In the case of a company listed on the KOSDAQ, shareholding of 2% or more or market capitalization of KRW2 billion or more
- In the case of a KONEX-listed company, shareholding of 4% or more or market capitalization of KRW1 billion or more
- In case of an unlisted company, shareholding of 4% or more or market capitalization KRW2.5 billion or more

Large shareholders are currently subject to 20% capital gains tax (30% if the shares disposed are held for less than one year and they are not SME shares). Under the proposal, they will subject to 25% capital gains tax on the tax base in excess of KRW300 million, effective for the share transfer from January 1, 2018.

In addition, under the proposal, the scope of large shareholders in companies listed for trading on the KSE, the KOSDAQ and the KONEX will be expanded as follows:

	Current		Proposed
	For share transfer from April 1, 2018 until March 31, 2020	For share transfer From April 1, 2020	For share transfer from April 1, 2021
Listed company in KSE	shareholding of 1% or more or market capitalization of KRW1.5 billion or more per company	shareholding of 1% or more or market capitalization of KRW1 billion or more	**shareholding of 1% or more or market capitalization of KRW300 million**
Listed company in KOSDAQ	shareholding of 2% or more or market capitalization of KRW1.5 billion or more per company	Shareholding of 2% or more or market capitalization of KRW1 billion or more	**Shareholding of 2% or more or market capitalization of KRW300 million**
Listed company in KONEX	shareholding of 4% or more or market capitalization of KRW1 billion or more per company	Same as left	**shareholding of 4% or more or market capitalization of KRW300 million**

Law for Coordination of International Tax Affairs

Proposed New Rule to Reduce Deductions for Hybrid Financial Instruments

In a commitment to implement the hybrid mismatch rules recommended by the OECD (BEPS Action 2), a new rule is proposed to limit expense deductions for hybrid mismatch arrangements. Significant points of the proposed new rule include:

- The proposed rule will apply to cross-border transactions of hybrid financial instruments between a domestic company (including a Korean permanent establishment of a foreign corporation) and its foreign related party.
- Hybrid financial instruments will include financial instruments which have debt or equity positions at the same time but are treated as a debt in one country but treated as an equity in the other country (e.g., participating bonds) with exceptions for those which are issued by financial institutions for the purpose of capital increase according to related regulations.
- The proposed rules will apply where deductible payment is partially or entirely not taxed in a counterpart jurisdiction for a certain period (i.e. until the end of the recipient's fiscal year commencing within 12 months after the end of the payer's fiscal year).
- Expense deduction will be denied only for the amount of payment which is not taxed in a counterpart jurisdiction.

The proposed will apply for the fiscal year beginning on or after January 1, 2018.

Proposed New Rule to Reduce Interest Expense Deductions

The Korean thin capitalization rules disallow the deduction of interest relating to the debt from an overseas controlling shareholder (and debt from a third party as guaranteed by an overseas controlling shareholder) if the debt to equity ratio exceeds 2:1 (6:1 in case of a financial institution). The disallowed interest expense on the debt from a foreign controlling shareholder is further treated as dividends to the shareholder.

Under the latest proposal, in line with the OECD's recommendation on the limitation of interest expense deductions (BEPS Action 4), the following new rule to restrict interest deduction on top of the existing thin capitalization rule would be introduced:

- The proposed rules will apply to the domestic company (including a Korean PE of a foreign corporation) having intercompany transactions with overseas related parties with the exceptions for banks and insurance companies.
- Net interest deduction claimed by a domestic company for the international transactions will be limited to 30% of the adjusted taxable income of the domestic company, meaning the interest expenses in excess of the 30% threshold will not be deductible.
  - The adjusted taxable income will be calculated by adding depreciation expense on fixed assets and net interest expense to the domestic company's taxable income.
  - The limitations will apply to the net interest expenses payable to overseas related parties (i.e. the amount of interest expense to be paid to overseas related parties minus the amount of interest income to be received from overseas related parties).
- In applying the existing thin capitalization rule and the new interest deduction rule, a domestic company should apply the rule which would result in more denial of interest expense.

If approved by the National Assembly, the proposed rules will be implemented from the fiscal year beginning on or after January 1, 2019.

Reporting Threshold to Be Lowered for Overseas Financial Accounts

A Korean resident or domestic company holding overseas financial accounts must report the information on the overseas financial accounts to the Korean tax authorities, such as the name of the account holder, account number, name of the financial institution, the highest balance throughout the year, etc., if the balance at a month end during a year exceeds KRW 1 billion. This reporting threshold will be lowered to KRW 500 million as the government intends to reinforce its administration of offshore tax revenue source.

Working-Level Committee to Be Created to Facilitate and Coordinate the Harmonization of Transfer Pricing and Customs

Currently, taxpayers subject to transfer pricing adjustments for corporate income tax purpose or customs base adjustment for customs duty purpose may request reviews by Korean tax authorities to obtain "advance corresponding adjustments."

Under the existing laws, the review request is available when the methods employed for transfer pricing purpose and customs valuation purpose are similar. In other words, it is available when comparable uncontrolled price or CUP method, resale-price method or cost plus method is used for corporate income tax purposes under the LCITA, transaction price method for the same or similar goods (similar to CUP method), deductive method based domestic sale price (similar to resale price method) and calculated price method (similar to cost plus) used for customs duty purpose under the Customs Act.

In order to operate this harmonization system more effectively and efficiently, it is proposed to form and operate a committee to facilitate and coordinate advance adjustments between the National Tax Service and the Customs Service which should consist of 10 or less working-level officials from both authorities. Details will be set forth in the enforcement rules of the law.

The proposed change will apply to advance adjustment requests filed from July 1, 2018 or thereafter.

In addition, the period while a taxpayer may file a request for the re-examination of income tax base or customs base as a result of the advance adjustments will be extended from two months to three months from the date the taxpayer is notified of the acceptance of an application for advance corresponding adjustment or review results. The expanded period will apply to the request filed from July 1, 2018 or thereafter.

Other Proposed Changes

Increasing Penalty on Fictitious VAT Invoices

When a tax invoice is wrongfully issued without the supply of goods or services, which is called a fictitious VAT invoice, currently, a penalty for issuing a fictitious VAT invoice is imposed at 2% of the supply price per the fictitious invoice. Under the tax reform proposal, this penalty will increase to 3% of the supply price per fictitious VAT invoice. Also, if the supply price per VAT invoice is overstated, the penalty at currently 1% of the overstated supply price will increase to 2% if a taxpayer intentionally overstated the supply price. However, if a VAT invoice is not issued in the name of the recipient or supplier of goods or services provided, the current penalty at 2% of the supply price will remain unchanged.

Proposed VAT Payment by Proxy for Certain Goods or Services Paid by Credit Cards

VAT payment by proxy will be adopted for the supply of certain services or goods purchased using credit cards (including debit card and prepaid card). These certain services or goods including those provided by bars or public amusement establishments will be specified by the presidential decree. Under the proposed change, the concerned credit card companies will be obliged to comply with VAT payment by proxy by collecting 4/110 of credit card payment (equivalent to 4% of supply price excluding service charges).

The proposed change will apply to goods and services supplied from January 1, 2019. The proposed rule will temporarily operate until the end of December 2021.

Proposed Change to Korean Residency Test

A Korean resident is an individual who has an address in Korea or who is present in Korea for at least 183 days during a year or the two consecutive years. In order to promote inbound investment by Koreans living abroad, this residency criteria will be amended. Under the tax reform proposal, a Korean resident shall be an individual who has an address in Korea or who is present in Korea for at least 183 days during a year.

Proposed Changes to Shareholding Restrictions on Qualifying Public Interest Corporations

According to the Inheritance and Gift Tax Law (IGTL), where a public interest corporation (such as schools which engages in activities for the public good as designated under the Presidential Decree of the IGTL) receives the contribution of voting shares in a domestic company, if the sum of the contributed shares together with any of the prescribed shares in the IGTL exceeds 5% of the total number of voting shares in the domestic company (the "5% threshold"), in general, the value of the shares contributed to the public interest corporation in excess of the 5% threshold should be included in gift tax base. As an exception, where a public interest corporation meets transparency requirements such as an external audit, public disclosure of financial statements, etc. ("qualifying public interest corporation"), such qualifying public interest corporation has been eligible to apply a 10% threshold. However, exceptionally, for qualifying public interest corporations having a special relationship with business conglomerates subject to cross-shareholding restrictions under the Anti-Monopoly and the Fair Trade Act, they are subject to the 5% threshold.

Under the proposal, the threshold will increase to 20% for a qualifying public interest company satisfying all of the following requirements:

- The company does not have a special relationship with any business conglomerate subject to the above mentioned restrictions on cross shareholdings
- The articles of incorporation must state that it does not exercise voting rights for the shares contributed.
- It must be incorporated for purposes of promoting charities, scholarship and social welfare.

Currently, gift tax and penalty shall be assessed on the value of contributed assets in excess of the prescribed threshold unless the contributed assets has been used for public interest projects within three years from the date of contribution. The tax reform proposal introduces the assessment of gift tax and penalty in case where a public interest corporation holding 10%~20% of voting shares exercises the voting right.

The proposed change will apply to the shares contributed or acquired on or after January 1, 2018.

Proposed Changes for Tax Audit

To protect taxpayers' rights in relation to tax investigations, the tax authorities must give taxpayers an advance notification of a periodic tax audit in ten days before the audit starts. In relation to the advance notification, the proposal includes the following changes:

- The advance notification must be given 15 days before the audit starts.

- In case of a partial tax audit, the scope of partial audit should be specified in the advance notification in addition to a reason for audit, investigation period, tax items to be audited, etc.

- If the advance notification is omitted in an exceptional case where the audit purpose cannot be achieved due to some reasons such as destruction of evidence, etc., a notification must be given to a taxpayer at the time of undertaking the audit. In this case, the notification should include the information to be specified in an advance notification and the reason for omitting the advance notification.

- The tax authorities will not be allowed to request a taxpayer to submit the information which is not directly related to an audit. That said, the tax authorities will not be allowed to request other records from a taxpayer as long as they are not related with the types of taxes subject to an audit, or the computation of tax base or tax amount for the years subject to an audit.

The proposed changes will take into effect from January 1, 2018.

Proposed Changes regarding Tax Appeal Procedures

When a taxpayer files an appeal with the National Tax Service, the Tax Tribunal, etc., it is allowed to participate in a hearing to present its opinion. In this regard, a taxpayer must be given an advance notification of the hearing date and venue three days before the scheduled hearing date. The following changes are proposed to tax appeal procedures.

- In case of the first appeal hearing, the advance notification must be given seven days before it is held.

- Currently, both taxpayers and the tax authorities are entitled to present their arguments or opinion as part of tax appeal procedures. However, the presentation of arguments is not allowed if i) reasons of an appeal filing are of trivial nature or the deadline for an appeal filing is past due, ii) the purpose of an appeal filing is related with the interpretation of tax laws and the taxpayer's presentation is considered unnecessary and iii) only the tax authorities apply for their argument presentation but such presentation is considered unnecessary in light of the matters subject to an appeal, etc. Under the proposal, the existing ban on the presentation of argument will be abandoned in the first two cases, suggesting taxpayers could present their arguments even in the two cases in i) and ii).

- In case of an appeal with the Tax Tribunal, taxpayers may submit documentary evidence to make rebuttal arguments. The submission of such evidences will also be allowed in case of the appeal with the regional office of the National Tax Service or the appeal with the Board of Audit or Inspection.

The proposed changes will be effective for the appeal filed from January 1, 2018.

Easing Requirements for Preferential Tax Treatment to Facilitate Corporate Restructuring

The latest reform proposal includes two significant changes to facilitate corporate restructuring by easing requirements for preferential tax treatment for certain activities such as in-kind contributions and spin-off.

Currently, corporate income tax on capital gains arising from qualified in-kind contribution is deferred if all of the following conditions are met: (i) the investing company is engaged with the business for five years or more, (ii) the investing company owns 80% or more of the shares in the invested company, and continues to hold them until the end of the year when the in-kind contribution occurs, (iii) the invested company carries on the business transferred until the year end, and (iv) a separate and independent business division is transferred to the invested company. It is proposed to abolish the fourth requirement with a view to help facilitate corporate restructuring in a smooth manner.

In a qualified horizontal spin-off where a new company set up via the spin-off becomes a subsidiary of the spun-off company's shareholder, the tax exemptions or credits of the spun-off company that are related to a specific business or assets transferred to the new company or those which are allocated to the new company based on the ratio of the value of business assets transferred to the new company are carried over to the new company if certain requirements are met. Currently, there is no such rule to allow the carry-over of the tax exemptions or credits in case of a qualified vertical spin-off where a new company set up via the spin-off becomes the subsidiary of the spun-off company. Under the proposal, the rule to permit the carry-over will be introduced for a qualified vertical spin-off.

The proposed change will apply to the spin-off transaction from January 1, 2018.

International Tax Services
Alex Joong-Hyun Lee
709-0598
alexlee@samil.com

Sang-Do Lee
709-0288
sdlee@samil.com

Sang-Woon Kim
709-0789
swkim@samil.com

Michael Kim
709-0707
michaelkim@samil.com

Dong-bok Lee
707-4768
dongblee@samil.com

Chong-Man Chung
709-4767
cmchung@samil.com

Hyun-Chang Shin
709-7904
hcshin@samil.com

Chang-ho Jo
3781-3264
changhojo@samil.com

Il-Kyu Cha
3781-3173
igcha@samil.com

Nam-Gyo Oh
709-4754
ngoh@samil,com

Young-Ok Kim
709-7902
yokim3@samil.com

Domestic Tax Services
Jung-Il Joo
709-0722
jijoo@samil.com

Yeon-Gwan Oh
709-0342
ygoh@samil.com

Young-Sin Lee
709-4756
yslee@samil.com

Chul-Jin Hwang
709-0759
hcj@samil.com

Jin-Ho Kim
709-0661
jhokim@samil.com

Min-Soo Jung
709-0638
minsjung@samil.com

Chan-Woo Chung
709-0692
cwchung@samil.com

Bok-Suk Jung
709-0914
bsjung@samil.com

Hyungsuk Nam
709-0382
hyungnam@samil.com

Dong-Jin Nam
709-0656
djnam@samil.com

Seungdo Na
709-4068
sdna@samil.com

Sung-Wook Cho
709-8184
sungwcho@samil.com

Sun-Heung Jung
709-0937
shejung@samil.com

Youngsuk Noh
709-0877
ysnoh@samil.com

Transfer Pricing & International Trade
Heui-Tae Lee
3781-9083
htlee@samil.com

Henry An
3781-2594
henryan@samil.com

Won-Yeob Chon
3781-2599
wychon@samil.com

Junghwan Cho
709-8895
jhwancho@samil.com

Financial Tax Services
In-Hee Yoon
709-0542
ihyun@samil.com

Taejin Park
709-8833
tjpark@samil.com

Global Mobility Services (GMS)
Younsung Chung
709-0538
yschung@samil.com

Corporate Administrative Services (CAS)
Jina Park
709-0797
japark@samil.com

Inheritance & Gift Tax
Hyun-Jong Lee
709-6459
hyunjonglee@samil.com

Nonprofit Corporation Service Center
YoungSun Pyun
3781-9684
youngspyun@samil.com

Small and Midsize Enterprice and Startups Service Center
Bong-Kyoon Kim
3781-9975
bkyoonkim@samil.com

Knowledge & Innovation Center
Han-Chul Cho
3781-2577
hccho@samil.com

Samil Infomine/ Samil Academy
Sang-Keun Song
709-0559
sksong@samil.com

Samil Tax Corp.
Nam-bok Jo
709-0591
nbjo@samiltax.com

PwC Customs Services
Sang-Tae Moon
3781-2375
Sang-tae.moon@kr.pwc.com

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