Korean Tax Update

Samil Commentary

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The Cabinet Approves Bills to Amend Local Tax Revenue-related Laws for 2022

The government has finalized bills to amend the Local Tax Act and other local tax revenue-related laws for 2022 which were approved in the Cabinet meeting. The finalized bills will come into force in January 2023 if they pass the National Assembly within this year. Major points of the government's finalized bills include: 1) extending the valid period of local tax reductions or exemptions for social welfare service corporations to improve social welfare support, and expanding the eligible scope to all social welfare facilities as prescribed in the Social Welfare Services Act; 2) extending by two years the acquisition tax exemption (up to KRW400,000) for purchases of hybrid vehicles, which is aimed at facilitating the supply and technology development of eco-friendly vehicles; 3) adding nonprofit organizations assisting the activities of disabled people to a list of entities eligible for resident surtax exemption or reduction; and 4) providing acquisition tax or property tax incentives for a company which: i) starts a business in, or establishes/relocates a place of business to an area of population decline as designated and posted by the Ministry of the Interior and Safety; or ii) executes a change of business as prescribed in the Special Act on Facilitating the Change of Business by Small and Midsize Enterprises.

The Presidential Decree of the CITL Amended to Exempt Income Tax on Interest or Capital Gains from Government Bonds, etc. Derived by Foreign Corporations or Non-residents

The amended Presidential Decrees of the Individual Income Tax Law and the Corporate Income Tax Law (CITL) were proclaimed on October 27, 2022 to provide income tax exemption (zero rate to be applied) for interest or capital gains from government bonds and monetary stabilization bonds ("government bonds, etc.") derived by non-residents or foreign corporations. The zero rate of tax will apply to interest paid on government bonds, etc. or the transfer of such bonds during the period from October 17, 2022 through December 31, 2022. It was initially proposed to exempt foreign corporations or non-residents from tax for interest or capital gains on such bonds, effective from 2023, as part of the government's tax reform package for 2022 announced in July 2022. The latest amendment would move forward the date for the exemption. The government expects the measure to help stabilize capital markets through facilitated foreign purchases of government bonds, etc. and lower interest rates on these bonds.

Currently, Korean source interest income and capital gains derived by foreign corporations or nonresidents is subject to tax on a withholding basis in Korea. Under the income tax treaties between Korea and foreign countries, residents of foreign countries are taxed at a reduced treaty rate of 5% to 12% generally on interest income from bonds. Residents of a foreign country with which Korea has not concluded a tax treaty are subject to withholding tax on such interest income at a rate of 14% (15.4% including local income tax) under domestic tax law. Gains from the transfer of bonds are generally exempt from income tax under tax treaties with Korea, with the exception of tax treaties between Korea and four countries (Hong Kong, Luxembourg, Australia and Brazil). For residents or corporations of these countries, gains from the transfer of bonds may be taxed in Korea, withheld at the lesser of 10% of sales proceeds or 20% of capital gains (exclusive of local income tax).

The Government Announces its Carbon Neutrality and Green Growth Strategy

The government announced on October 26, 2022 its carbon neutrality and green growth strategy including a plan to expand tax credits for research and development (R&D)/facility investments by designating technologies helping to reduce greenhouse gases generated by major emitting industries as new growth and source technologies. According to the strategy, the government will review in 2023 additional tax incentives for energy-saving facilities acquired by companies as part of tax incentives to promote energy-efficient investments, and the addition of efficiency-improving core technologies to the list of new growth/source technologies and commercialization facilities. Further, a review will also be made regarding an accelerated depreciation of energy-saving facilities and assets acquired during the period from January 1 through December 31, 2023. Meanwhile, the strategy was released in the first plenary meeting of the Presidential Commission on Carbon Neutrality and Green Growth, attended by government officials and the private sector after the Commission was officially launched pursuant to the Framework Act on

Low Carbon Green Growth (effective in March 2022) to spearhead the country's carbon neutral green growth policies.

The NTS Audit to Be Temporarily Suspended for Companies Contributing to Job Creations

In a bid to support companies contributing to job creation, the National Tax Service (NTS) announced that certain small and midsize enterprises (SMEs) would be excluded from selected targets for periodic tax audits of corporate or individual income tax returns filed for the fiscal year 2021. To qualify for the exclusion, the following requirements must be met: i) they shall be SMEs as specified under the Special Tax Treatment Control Law with the revenue of less than KRW150 billion for the fiscal year 2021 (corporations with the total assets of KRW200 billion or more, or professional personal service providers with the total assets of less than KRW50 billion); and ii) shall submit plans to increase the number of full-time employees in 2023. The minimum requirement for new full-time employment includes a 2% or a 3% increase (and at least one new full-time employee) compared to the level in 2022. The 2% increase requirement will apply to companies with less than KRW50 billion of revenue in 2021 and 3% to those with revenue ranging from KRW50 billion to less than KRW150 billion in 2021. The application for exclusion must be made on the NTS website (Hometax) no later than November 30, 2022. Unless the requirement for employment increase is met, the tax administrative support will be waived.

Rulings Update

Whether a tax credit for regular worker conversion would be available for regular workers hired under an intern-to-regular worker conversion internship program

According to Article 30-2 of the Special Tax Treatment Control Law (STTCL), where non-regular workers (such as fixed-term, part-time or dispatch workers) are converted into regular workers in a SME or a middle-scale company, a tax credit will be available at a fixed amount per employee (KRW10 million and KRW7 million per employee for SME and middle-scale company, respectively) (the 'tax credit for regular worker conversion').

This case concerns a middle-scale company adopting an internship program which allows the conversion of interns into regular workers after a probation period of three months ('intern-to-regular worker conversion internship' program). While the company hired 20 regular workers being converted from interns in 2019, it did not claim a tax credit for regular worker conversion in filing its corporation tax return for 2019. Later in June 2021, the company submitted an amended tax return for a refund request to the tax office by claiming a tax credit for regular worker conversion. The tax office denied the company's refund request, stating that the company's internship program appeared to be in the form of an employment contract with nonregular workers for fixed terms but in fact it was only the company's hiring process based on the premise of hiring regular workers.

Regarding this, the Tax Tribunal upheld the tax office's denial of tax refund request based on the following grounds: i) given that all the interns were converted into regular workers after their probation period, it seems reasonable to view that from the beginning the interns were hired on the condition of conversion to regular workers; ii) it is confirmed that the company separately hired fixed-term nonregular workers, distinct from the hiring of interns under the internship program; and iii) those interns were subject to the employment rules for regular workers rather than the rules applied to fixed-term workers such as temporary and daily workers. (*Joshim2021Joong6074, 2022. 9. 29*.)

The Tribunal's decision provides implications for SMEs and middle-scale companies adopting 'intern-to-regular worker conversion internship' programs. The Tribunal's view is that a tax credit cannot be granted in respect of regular workers being converted from interns, who fall within fixed-term nonregular workers, under an internship program in case the program is determined as a prerequisite process to hire regular workers although it meets the requirement for the tax credit for regular worker conversion.

Of particular interest is that the Tribunal took into account that the purpose of the legislation is to incentivize companies converting nonregular workers into regular workers by granting a tax credit benefit in order to reduce the wage gap between regular and nonregular workers and increase job security. In this context, it should be noted that it may not be accepted given the purpose of the legislative to apply a tax credit for regular worker conversion solely based on a change in employment status from nonregular workers to regular workers where interns are anticipated to be converted into regular workers as those in this case.

Whether the retirement of shares gifted to the donor's spouse would be subject to the deemed dividend taxation as if it were the retirement of the donor's shares

Article 14(3) of the Basic National Tax Act (i.e. Taxation based on the Substance) addresses the taxation based on the substance over form principle, providing that, where it is recognized that a transaction is made indirectly through a transaction with a third party, or it involves two or more activities or transactions for the purpose of unduly obtaining benefits of domestic tax laws, the domestic tax law would apply based on the economic substance of the transactions as if the transactions are made between the actual transaction parties or as if a series of transactions are a single transaction.

In this case, an applicant, who was a shareholder of a domestic company (Company A), gifted a portion of his shares in Company A ('shares in question') to his spouse (on November 1, 2018). In an extraordinary general meeting of shareholders of Company A, a resolution was made on the purchase of treasury shares for share retirement purpose (on November 19, 2018), and Company A retired the treasury shares purchased from the applicant's spouse (on December 26, 2018). The concerned tax office took the position that the series of transactions involving the applicant, his spouse and Company A ('transactions at issue') would constitute a multi-step transaction which would be devised to avoid the applicant's individual income tax liability on the deemed dividends triggered by the retirement of the shares in question. Based on this position, the tax office applied the substance over form principle to the transactions at issue and notified the applicant of an additional assessment of individual income tax on the deemed dividends.

An issue in this case is whether it is reasonable to assess individual income tax on deemed dividends in the hands of the applicant as if the applicant (rather than the spouse) had transferred the shares in question directly to Company A in the case where the applicant gifted the shares in question to his spouse, which were subsequently transferred to Company A for share retirement. In this regard, the Tax Tribunal found that: i) it took less than two months to complete the transactions at issue from the gifting of shares to the applicant's spouse and the purchase of the spouse's shares through the retirement of the shares in question; ii) at the shareholder meeting of Company A, the number of treasury shares purchasable was approved as the same number of the shares being gifted to the applicant's spouse, all of which were actually purchased by Company A for share retirement. It appears that the series of share transactions above were not based on independent decisions of each transaction party, but took place sequentially in line with the decision making of the applicant who was a shareholder and a director of Company A having control over the transactions at issue; and iii) contrary to the spouse's assertion about the need for cash assets, more than half of the payment received from Company A was lent to the representative director of Company A to settle temporary accounts receivable. Given these facts, the Tribunal concluded that there is no justifiable reason other than an intent to avoid an individual income tax liability that could be triggered by deemed dividends. Accordingly, the Tribunal considered it reasonable for the tax office to assess individual income tax on the applicant by treating the transactions at issue as disguised ones. (*Joshim 2022joong5344, 2022. 10. 13*.)

Besides this case, the Tax Tribunal and the NTS have consistently made similar decisions in precedent cases, upholding that it would be reasonable to assess income tax on deemed dividends by reconstructing a series of share transactions as the retirement of shares transferred by a taxpayer based on the economic substance in case the taxpayer chose to structure the transaction by way of the gifting of shares to the spouse, followed by the retirement of the shares, without any reasonable basis. (*Joshim 2022in6438, 2022. 9. 15, Joshim 2022seo5968, 2022. 8. 24, Simsasodeuk 2022-0013, 2022. 5. 18, Simsasodeuk 2022-0003, 2022. 4. 20, etc*.). As such, it is necessary to note that under the substance over form principle, a taxpayer's attempt to avoid the taxation of deemed dividends may not be accepted where they have structured share transactions involving a gift of shares to a spouse, followed by the purchase and retirement of the shares, while the spouse bears no gift tax liability on the gift shares by taking a spouse gift tax deduction (KRW600 million).

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