Korean Tax Update

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I. Tax News

MOTIE is Scheduled to Foster in Full Scale Opportunity Zones with Tax Incentives and Fiscal Support

The Ministry of Trade, Industry and Energy (MOTIE) announced it is scheduled to drive in full scale the government's initiatives to create special opportunity zones offering tax incentives, etc. This announcement came in the wake of the approval of the plans for opportunity zones on October 27, 2023 by the Council on Cooperation between Central and Local Governments, which consists of Korea's President, Prime Minister and representatives from central and local governments. These special opportunity zones are designed to attract significant corporate investments in relatively underdeveloped local regions by offering a comprehensive set of incentives, including regulatory reliefs, tax advantages and enhanced conditions for employee residential environments. Each local government has the autonomy to design and oversee the development of these special opportunity zones within specific area limits (metropolitan cities: 4.95 million square meters, provinces: 6.6 million square meters). In the future, each metropolitan city or province will invite companies, create a master plan and submit an application for designation as a special opportunity zone to the MOTIE. The designation as an opportunity zone will be assigned through deliberation and resolution by the Presidential Council on New Initiative for Regional Development.

NTS Audits to be Temporarily Suspended for Companies Contributing to Job Creation or Investment Expansion

The National Tax Service (NTS) announced a temporary tax audit suspension with respect to corporate income taxes and VAT for FY2022 available for eligible companies contributing to job creation and investment expansion. To qualify for a temporary tax audit suspension the applicant must be a small and midsize enterprise (SME), as prescribed under the Special Tax Treatment Control Law (STTCL), with revenue of less than KRW150 billion* for FY2022 (*revenue should be less than KRW 50 billion in the case of companies with total assets of at least KRW200 billion or professional personal service providers). Additionally, the applicant should meet any of the following conditions:

- Submit and implement plans to increase the number of full-time employees in 2024 with a minimum requirement of a 2% or 3% increase (including at least one new full-time employee) compared to 2023. The 2% requirement applies to SMEs with revenue of less than KRW50 billion in 2022, while the 3% condition applies to those with revenue ranging from KRW50 billion to less than KRW150 billion in 2022
- Submit and implement plans to expand investment (in machinery and specific facilities defined in Article 24 of the STTCL) by at least 10% or 20% when compared with the amount invested in 2023. The 10% requirement applies to SMEs with revenue of less than KRW 50 billion in 2022, while the 20% criterion is applicable to those with revenue ranging from KRW 50 billion to less than KRW 150 billion in 2022.

The determination regarding whether a company meets the SME criteria will be made based on the revenue and total assets in FY2022. The grace period for retaining SME status, which is applicable to SMEs which fail to meet the SME criteria, is not applied with respect to the benefit of a temporary NTS audit suspension. The tax administrative support will be disallowed if a company fails to satisfy the requirements for increased employment or investment. The deadline for the plan submission to the NTS is November 30, 2023.

OECD Releases the Multilateral Convention to Implement Amount A of Pillar One and the Explanatory Statement

The OECD and the G20 Inclusive Framework (IF) on October 11, 2023 released the text of the Multilateral Convention (MLC) and accompanying explanatory statement, according to the Ministry of Economy and Finance (MOEF). The latest release of the MLC includes the current consensus achieved among members of the IF in relation to the 'allocation of revenues of multinational groups to market jurisdictions where sales arise' (Amount A). However, there are different views by several jurisdictions on a few specific items (for example, details on how to calculate estimated taxes to apply the safe harbor rule, scope of tax certainty for issues related to Amount A, etc.), as noted in the MLC. The Task Force on the Digital Economy of the IF announced that the latest release of the MLC is intended to: ensure transparency of consultation on Pillar One; facilitate the ability of some members of the IF to engage in internal processes necessary to enable swift adoption; facilitate resolution of remaining differences; and prepare a finalized MLC for signature. The OECD and the G20 IF will continue consultations to reach agreement on the final version of the MLC provisions pertaining to Pillar One by the second half of 2023. The consultations will be conducted in line with the Outcome Statement approved by 138 IF members on July 11, 2023. (* Five out of the 143 IF members including the Russian Federation, Belarus, Sri Lanka, Canada and Pakistan refused to sign)

II. Changes in Tax Laws

Enforcement Rules of the VAT Law

To encourage private sector investments in venture firms, amendments have been made to the Presidential Decree of the Value Added Tax (VAT) Law. These changes will allow VAT exemptions for asset management and operation services rendered by operating partners ("OP") of a private fund for indirect venture investment to the private fund. These private funds for indirect venture investment encompass entities formed by companies seeking to invest indirectly in SME startps, new technology venture capital firms and asset management firms as specified by the Venture Investment Promotion Law. Following the amendments to the Presidential Decree of the VAT Law, changes in the Enforcement Rules of the VAT Law were made. The changes will allow a joint OP to be exempt from VAT on all its asset management and operating services rendered to such private funds in cases where the joint OP is a collective investment company. Additionally, where a joint OP of

such a private fund is an investment trader or an investment broker, the VAT exemption will only be applicable to the provision of asset management and operation services related to investments made in other venture investment funds. *(MOEF Ordinance No.1021, October 10, 2023)*

Presidential Decree of the Traffic, Energy and Environment Tax Law

In order to ease the burden of soaring fuel costs due to oil price hikes, a temporary reduction in flexible rates of transportation, energy, and environmental taxes on gasoline, diesel and similar alternative fuels is available until the end of December 2023, a two-month extension from the end of October 2023. *(Presidential Decree No.33833, Oct 31, 2023)*

Presidential Decree of the Individual Consumption Tax Law

A temporary reduction in flexible rates of individual consumption tax on butane out of petroleum gases is extended by two months through the end of December 2023. *(Presidential Decree No.3383, Oct 31, 2023)*

III. Rulings Update

Whether the mandatory application period for overdraft interest rates should apply where the overdraft interest rate is re-selected as the fair market value

Under the Corporate Income Tax Law (CITL), in principle, the weighted average interest rate of borrowings should be used as the fair market value of the interest rate on loan transactions between local related parties. As an exception, however, where the interest rate on an overdraft is selected as a fair market value of interest rate in prescribed cases, the overdraft interest rate should be used in the fiscal year of selection and two subsequent years for a three-year period (or the 'mandatory application period') (Article 89(3) of the CITL). However, where a company had selected and constantly used the overdraft interest rate as the fair market value for a three-year period, and it re-selected the overdraft interest rate as the fair market value in the subsequent year following the end of the three-year period (i.e. the fourth year) in calculating the deemed interest income on local related party loans under the CITL, a question arises as to whether the company is required to use the overdraft interest rate as the fair market value for two subsequent years following this fourth year.

The Daejeon High Court (Appellate court) decided that where the company selected the overdraft interest rate as a fair market value in calculating deemed interest income on local related party loans, it is required to use the overdraft interest rate for a three-year period pursuant to the CITL, and as such, where the company re-selected the overdraft interest rate as the fair market value of interest rate after the mandatory application period ended,

the mandatory application period for the overdraft interest rate should restart from the year of re-selection. (*Daejeongobeop2022nu 13693,2023.5.16*)

The Supreme Court reaffirmed the decision of the Appellate court, ruling that even if the overdraft interest rate had been selected and constantly used as the fair market value of interest rate for the three-year period in the past years, it should be used for another three-year period from the year of re-selection if the company re-selected the overdraft interest rate as the fair market value. (*Daebeop2023du 44443, 2023. 10. 26.*)

Observation: In this ruling, the Supreme Court explicitly ruled that the overdraft interest rate should be used for a three-year period from the year in which the overdraft interest rate was re-selected as the fair market value. As such, it seems meaningful in that the Supreme Court's recent ruling has effectively resolved the controversy over whether the mandatory application period for the overdraft interest rate should apply only for the first selection of the overdraft interest rate or it should repeatedly apply in case of the re-selection of the rate.

Whether the difference from the exercise of employee stock option with new share issuance is deductible if the stock option was exercised before Feb 14, 2022

According to the CITL, the 'difference between stock price at exercise and the pre-determined exercise price' (the 'difference from the exercise of stock options') is deductible if certain requirements under the CITL are met. The Presidential Decree of the CITL was amended on February 15, 2022 to expand this deduction to stock options granted as part of the employee stock ownership program (Article 19 (19-2) and Supplementary Provision 3 of the amended Presidential Decree of the CITL). Notably, this amendment applies to employee stock options granted before February 14, 2022, but exercised on or after February 15, 2022. In relation to employee stock options with new share issuance, the issue in this case was whether the difference between the stock price of newly issued shares and the pre-determined exercise price should be considered deductible for the company granting stock options where the employee stock option was exercised before February 14, 2022.

The Daejeon High Court decided that it is reasonable to view that the difference from the exercise of stock options with new share issuance is treated as deductible expenses on the basis that the difference represents payroll costs paid to the company's employees from its profits, and thus, even if its net assets did not formally decrease, its net assets can be regarded as being decreased in substance. (*Daejeongobeop2022 nu12690, 2023. 6. 8.)*

However, the Supreme Court revoked the decision of the High Court. The Supreme Court ruled that amounts that did not decrease the company's net assets cannot be considered deductible unless otherwise explicitly listed in the provisions for deduction under the CITL. The Court continued that upon exercising employee stock options with new share issuance, the granting company's capital would be increased by receiving the payment of stock

subscription prices for new shares issued, without triggering any decrease in its net assets. The Court further ruled that the amended provision should be viewed as a founding provision effective from February 14, 2022, rather than a confirmatory provision, and as such, the difference from the exercise of employee stock options with new share issuance made before the amendment on February 14, 2022 should not be considered deductible for the granting company. (*Daebeop2023 du 45736, 2023. 10. 12.*)

Observation: In this case, the Supreme Court made clear the principle for deduction of expenses that should involve a decrease in net assets under the CITL. The Court also clarified that the amended provision should be treated as a founding provision in nature and should not apply retroactively for the stock options exercised before the amendment. Therefore, it should be noted that even if the employee stock options with new share issuance were granted on the same date, the deductibility of the difference from the exercise of stock options may differ depending on whether the stock option is exercised before or after the amendment of the tax provision.

Whether the deemed acquisition tax would arise where the controlling shareholder acquires additional shares through the company's capital increase without consideration

In this case, a shareholder's ownership in a company increased from 50% to 100% due to the company's acquisition of treasury stock. Subsequently, the shareholder acquired additional shares through the company's capital increase without consideration. The main issue in this case pertains to whether the acquisition of additional shares by the shareholder, who has become a controlling shareholder through the company's purchase of treasury stock, would trigger the deemed acquisition tax. (*Note*: *Deemed acquisition tax is applicable when a person, together with its related parties, becomes a controlling shareholder of an unlisted company, owning more than 50% of the shares, as the person is deemed as having acquired certain assets held by the company*.)

Regarding this issue, the local tax authorities asserted that if a shareholder became a controlling shareholder in a company due to the company's purchase of treasury stock, without acquiring additional shares directly, the deemed acquisition tax liability would not arise. However, if the controlling shareholder later acquired additional shares and increased its shareholding ratio in the company, it should become liable for deemed acquisition tax on the increased percentage of ownership. (*Local Tax Policy Division of the Ministry of Interior & Safety (MOIS)-3860, 2015. 12. 11.*)

Contrary to the above, the Tax Tribunal decided that even if a person, who has already become a controlling shareholder due to the company's purchase of treasury stock, subsequently acquires additional shares, the acquisition of additional shares by the person would not trigger a deemed acquisition tax unless its shareholding ratio increases due to the acquisition of additional shares. (*Joshim2022ji 0780, 2023. 8. 31.*).

Observation: In previous authoritative interpretations and tax tribunal cases, both the tax authorities and the Tax Tribunal ruled that if the controlling shareholders' ownership ratio increased due to the company's purchase of treasury stock and its acquisition of additional shares, they were liable for deemed acquisition tax on the increased ownership percentage. For instance, if the controlling shareholder's ownership ratio increased from 70% to 92%, and later to 100%, it would be subject to deemed acquisition tax on the 8% increase. (*Local Property Tax Division of the MOIS, Joshim 2019ji 1694, 2019.11.28*). The recent Tax Tribunal decision appears to align with these earlier rulings, stipulating that deemed acquisition tax liability only arises if there is an increase in the controlling shareholder's ownership ratio where the shareholder has become the controlling shareholder through the company's purchase of treasury stock and later acquires additional shares in the company.

Withholding tax rate for income from the rental of aircraft received by a US corporation engaged in the financial services business

This case concerns a US corporation which is not engaged in the operation of aircraft in international traffic and has no permanent establishment (PE) in Korea. The US corporation received payment as consideration for the rental of aircraft from a domestic airline company. The issue in this case involves the income classification for such payment and the applicable withholding tax rate for corporate income tax on the payment.

In this context, an advanced tax ruling issued by the National Tax Service (NTS) provides that the said payment constitutes the US corporation's Korean-source rental income of ship, etc. subject to 2% withholding tax rate (Article 93(4) and Article 98(1) of the Corporate Income Tax Law, 'CITL') and shall not be subject to a withholding tax rate exceeding the reduced treaty rate of 15% on royalties under the Korea-US tax treaty. Consequently, the domestic airline company shall withhold 2% of the payment amount as corporate income tax at the time of payment to the US corporation in accordance with Article 98(1)(3) of the CITL. (*Advance Ruling-2023-Beobgyugukjo-0349, 2023.8.30*)

Observation: Under the CITL (Article 93(4)), income derived from the rental of aircraft is classified as income from the rental of ships, along with income from the rental of industrial, commercial or scientific machinery, facilities and equipment, etc. (collectively referred to as 'Equipment'). Additionally, according to Article 93(8) of the CITL, if income from the rental of Equipment is classified as royalties under a tax treaty, it should be treated as royalties. Under the Korea-US tax treaty, payment received by a US corporation as consideration for the use of ships or aircraft (but only if the corporation is not engaged in the operation of aircraft in international traffic) is treated as royalties. On the other hand, a recent advanced tax ruling issued by the NTS clarified that such payment from the rental of aircraft should not be treated as royalties but as income derived from the rental of ships, etc. under the CITL. This clarification addresses that aircraft should be distinguished from Equipment when interpreting provisions related to rental income and royalties under the CITL. It is worth noting that the said provisions of the CITL amended on December 22, 2020 were originally part of the special provision for application of withholding tax rates for foreign

corporation's interest, dividend and royalty income under Article 29(1) of the old Law for Coordination of International Tax Affairs (LCITA). As per the old LCITA, the Ministry of Strategy and Finance (currently MOEF) interpreted that income derived from the rental of ships and aircraft which were classified as royalties under a tax treaty should not fall under Equipment rental income and therefore should be subject to a 2% withholding tax, consistent with the rate applied to the rental income of ships, etc. under the CITL. (*International Tax Policy Division of the MOSF-528, 2017.11.13*)

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