Korean Tax Update

Samil Commentary

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Cabinet Approves the Government's Tax Reform Bill for 2022

The Cabinet approved on August 30 the government's tax reform bill for 2022 which was released by the Ministry of Economy and Finance (MOEF) in July. The finalized tax reform bill includes some modifications. One of the modifications is to extend the grace period for the application of the amended dividend received deduction (DRD) rates for Korean holding companies for four years, a two-year extension from the originally proposed two years. Under the original reform bill announced in July, while the amended DRD rates would be applicable to dividends received on January 1, 2023 or thereafter, dividend-receiving companies would be allowed to choose the existing or the amended DRD rules with respect to dividends received in 2023 and 2024. The approved bill to amend 17 kinds of tax laws including the Corporate Income Tax Law, the Individual Income Tax Law and the Special Tax Treatment Control Law was submitted to the National Assembly on September 2, 2022. (*For details, please see our Tax Newsflash _Korean Tax Reform Proposals for 2022*)

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MOEF Forecasts the National Tax Revenue for 2022-2023 and Submits the National Tax Expenditure Plan for 2023

The MOEF announced that national tax revenue is estimated to be KRW397.1 trillion for 2022, which is at a similar level to that announced in the supplementary budget of KRW396.6 trillion for 2022, and a 15.4% increase from KRW 344.1 trillion in tax revenues collected in 2021. The expected growth in tax revenue is derived from an increase in collected corporate income taxes, assisted by improved business performance as well as more payroll income taxes and comprehensive income taxes in the wake of a recovery in employment and consumption. The national tax revenue is forecasted to be KRW400.5 trillion in 2023, a KRW3.4 trillion or 0.8% point increase from the revenue estimate for 2022. The slowdown in revenue growth is attributable to an expected reduction in taxes on assets influenced by interest rate hikes and the base effect of deferred tax payments in 2022 as part of the government's fiscal support in 2021.

The MOEF submitted the National Tax Expenditure Plan for 2023 to the National Assembly in September 2022 as an attachment to the 2023 Budget Bill. According to the expenditure plan, national tax reliefs (i.e. non-taxation, tax exemptions, tax credits and income deductions) are predicted to be KRW63.6 trillion, an increase of KRW6.6 trillion from KRW57 trillion in 2021. Although tax exemptions and reductions have grown primarily because of tax incentives for national strategic industry technology as well as new growth and source technologies, the total amount of tax exemptions, etc., as a proportion of the total national tax revenue ('exemption ratio'), is expected to reduce to 13.1% in 2022 from 13.6% in 2021. Also, tax exemptions for 2023 are estimated to be KRW69.3 trillion, which is KRW5.7 trillion higher than KRW63.6 trillion in 2022. Furthermore in 2023, the plan forecasts that the exemption ratio would increase to 13.9% from 13.6% in 2022 due to larger amounts of tax exemptions, which are the result of more incentives to be offered for the foregoing technologies and eased property criteria for earned income tax credits and child tax credits.

MOEF to Consider a Measure to Cope with the Introduction of Foreign Rules on Reverse Hybrid Entity

The MOEF announced it would consider an amendment of relevant regulations to prevent the possibility that overseas investments of Korean companies might be subject to foreign income tax that would arise as a result of the introduction of the reverse hybrid entity rules in foreign countries. Earlier in 2017, in accordance with the OECD recommendations, especially on the rule to neutralize the effects of hybrid mismatch arrangements,* the government enforced a new rule on the taxation of hybrid financial instruments. (*Interest paid on hybrid financial instruments (redeemable preferred stock, etc.) which are treated differently under the tax laws of the payee and payor jurisdictions would be deductible only where it is taxed in the jurisdiction where an overseas related party receiving the income is located.)

The OECD has recommended countries to develop or amend domestic laws and tax treaties to prevent tax avoidance involving reverse hybrid entities or arrangements. In

accordance with the OECD recommendation, the EU has enforced from this year the rule that a reverse hybrid entity shall not be taxable only in the case where the reverse hybrid entity is regarded as a transparent entity in an investor jurisdiction,* and in other cases, the reverse hybrid entity shall be regarded as a resident of the establishment jurisdiction and taxed on its income therein. (*i) Under the laws of the country where investors holding an interest in 50% or more of rights to a share of profit in a transparent entity reside, i) income distributed through a transparent entity should be recognized on a current basis; and ii) the character of the income recognized in the hands of the investors should not be changed). Under the US reverse hybrid mismatch rules, in respect of US-source income (e.g. dividend, interest and royalty income) that a non-US resident investor receives through a reverse hybrid entity, the US tax treaty is only applicable where income is recognized on a current basis by the non-resident investor and the character of income (as dividend, interest or royalty income) in the hands of the investor should remain the same.

In response to foreign legislative developments, there are recommendations* from the National Pension Service, etc. including an amendment of Presidential Decrees of tax laws. The MOEF is actively seeking public consultation to reflect them in tax legislation. (*i) income derived by a transparent entity should be recognized by a domestic investor in the entity on a current basis (matching the timing of income recognition) and ii) the character of the income recognized by a domestic investor in an investor jurisdiction should remain the same as that of the transparent entity's in the establishment jurisdiction (matching the character of income). According to the Ministry, where a partnership or a special purpose company (SPC), etc. which is treated as a transparent entity in a foreign country would be treated in the same way as a transparent entity under Korean tax laws, it would presumably not be subject to tax on its income in the foreign country. In this regard, the Ministry is considering recommendations to amend the relevant regulations of Korean tax laws.

Rulings Update

Whether birthday gifts provided to premier customers would be treated as entertainment expenses

This case involves a taxpayer which sold health and wellness products through multiple channels including department stores, direct stores and online shopping malls while offering a membership program to customers. The taxpayer provided free birthday gifts to members of a certain grade or above based on their annual purchase records ('premier customers'). The taxpayer treated the expenditure incurred to provide these gifts (expenses at issue) as entertainment expenses in filing its corporate income tax return for the concerned year and disallowed an amount of the expenses exceeding the deduction limit of entertainment expenses.

Later the taxpayer filed an amended corporate income tax return for a refund request, claiming that the expenses at issue should be considered sales-related expenses or advertising expenses (which are fully deductible as business expenses) on the following

grounds: i) the taxpayer disclosed the conditions for provision of birthday gifts in advance to an unspecified number of people through its website and handouts at stores, and provided birthday gifts to all customers who met the pre-disclosed conditions; and ii) birthday gifts were not provided for the purposes of facilitating its business relationship with customers but were provided based on the result of customer sales by the taxpayer on a yearly basis. The concerned district tax office rejected the taxpayer's refund claim, arguing that the expenses at issue constitute entertainment expenses because: i) it cannot be viewed that an advance notice was sufficiently given by the taxpayer to an unspecified number of people since it had failed to disclose such notice in newspapers, broadcasts, etc. to all unspecified customers and ii) the provision of birthday gifts was intended to maintain an existing business (transaction) relationship with specific customers or show such customers appreciation for their transactions with the taxpayer.

In this regard, the Tax Tribunal found that: i) the taxpayer disclosed the conditions for the provision of birthday gifts to an unspecified number of people on its website and handouts at stores in advance; ii) birthday gifts were provided to all customers of a certain grade or above who met pre-determined purchase thresholds and therefore it is difficult to view that the provision of birthday gifts was limited to specific selected customers; iii) whereas the purpose of the expense at issue was to raise customers' purchasing desires, lead to customers' additional purchases, induce an unspecified number of customers to join the membership, and consequently to increase the taxpayer's sales revenue, it is difficult to consider the purpose as being intended to facilitate an existing business relationship with customers; and iv) it cannot be deemed that the expenses at issue were excessively incurred in light of purchases by premier customers. On this basis, the Tribunal decided in favor of the taxpayer that the expenses at issue should not be considered as entertainment expenses and that the rejection of the taxpayer's refund claim made by the district tax office should be revoked. (*Joshim Jeon6986, 2022. 7. 12.*)

The Tribunal decision indicates that it is not reasonable to regard the expenses at issue as entertainment expenses solely based on the grounds that the scope of the customers who actually received the gifts was limited to certain specific premier customers, despite the fact that the pre-disclosed conditions for the selection of customers receiving gifts were given to an unspecified number of customers. In a previous case, the Supreme Court made a similar decision that expenditure incurred by a taxpayer operating a department store to provide free gifts to premier customers as published in a prior notice should constitute advertising expenses rather than entertainment expenses and thus the entire amount of such expenditure can be included in the taxpayer's deductible expenses. (*Daebeop2000du 2990, 2002. 4. 12.*) It may be necessary to consider the Tribunal's decision when examining whether spending in the nature of free gifts to customers based on sales records or any pre-determined arrangement would constitute either entertainment expenses or sales related- and advertising expenses.

Whether a foreign government would be included in the scope of parent company in determining the independence criterion for a middle-scale company

There are several criteria including independence (between ownership and management) that determine whether a company qualifies as a middle-scale company to be eligible for research and development tax credits. Under Article 9(4) of the Special Tax Treatment Control Law (STTCL), to qualify as a middle-scale company, a substantial independence condition should be met under Article 2(2)(1)(b) of the former Presidential Decree of the Special Act on the Promotion of Growth and Strengthening of Competitiveness of Middle-Scale Companies (called the 'independence criterion for parent company of a middle-scale company'). The independence criterion for parent company prescribes that it shall not belong to a large corporation (including a foreign corporation) with total assets worth KRW 10 trillion or more, being the largest investor holding directly or indirectly at least 30% interest in the company. Unless the independence criterion for parent company is met, it shall not be considered as having a substantial independence between ownership and management and a company shall be excluded from the scope of middle-scale company.

A recent authoritative interpretation by the National Tax Service (NTS) addresses the issue of whether a foreign government should be included in the scope of foreign corporation in respect of the independence requirement for middle-scale companies and if this is the case, whether the independence criterion for parent company is applicable to determine if a domestic company whose parent company is a foreign government would meet the qualifications for a middle-scale company

The interpretation provides that a foreign government should be included in the scope of a foreign corporation in applying the independence criterion for parent company of a middle-scale company. Currently, according to Article 2(4) (Definitions) of the Corporate Income Tax Law (CITL), a foreign government shall be classified as a non-profit foreign corporation among foreign corporations. As such, by referring to this article of the CITL, it is considered to have been interpreted to include a foreign government in the scope of foreign corporation even under the STTCL which does not have a separate provision for defining a foreign corporation. (*Seomyeon-2021-Beobgyubeobin-4819, 2022. 5. 26*)

In short, this interpretation implies that the scope of parent company includes foreign governments and foreign local governments as well as the Korean central government or local governments in applying the independence criterion for parent company of a middle-scale company (*Seomyeon-2020-Beobin-1809, 2021. 11. 10, Seomyeon-2021-Beobgyubeobin-4819, 2022. 5. 26*.). Accordingly, in determining whether a company would qualify as a middle-scale company, special care should be taken not to determine whether the independence criterion for parent company would be met, given the situation where the largest shareholder in the company is not an ordinary profit-making company but a domestic or a foreign central government or local government.

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