July 28, 2023

MOEF Announces Korea's tax reform proposals for 2023

In Brief

The Ministry of Economy and Finance (MOEF) released the government's tax reform proposals on July 27, 2023. The proposals include measures to supplement the domestic global minimum tax rules which were introduced to be implemented from the fiscal year starting on or after January 1, 2024. While the proposed measures largely reflect the OECD Pillar Two Model Rules and related Commentary it is notable that the application of the UTPR is proposed to be delayed for one year. The tax reform proposals also introduce new reporting requirements relating to offshore trusts and employee stock-based compensations in order to strengthen rules against tax avoidance. This newsflash highlights selected key tax reform proposals related to the domestic global minimum tax rules and other proposed changes affecting multinational enterprises doing business in Korea as well as domestic corporations.

The government's reform proposals will be finalized with modifications before being submitted to the National Assembly on September 1, 2023. If approved by the National Assembly, most of the proposed changes will be implemented in January 2024 unless otherwise be specified.

In Detail

Proposals to supplement the domestic global minimum tax rules

Postponed implementation of the UTPR. Korea introduced into domestic legislation the global minimum tax rules that include Income Inclusion Rule ("IIR") and UTPR. Under the current tax law, both rules are to be enforced for the fiscal year beginning on or after January 1, 2024. Under the current tax reform proposals, however, the implementation of the UTPR will be deferred for one year with a revised effective date from January 1, 2025, considering the progress in other countries' implementation of the UTPR, while the IIR will be implemented as scheduled from 2024.

Exception to the general statute of limitations for tax assessment. Even after the statute of limitations for national tax assessment expires, the tax authorities may assess taxes in exceptional cases prescribed in Article 26-2(6) of the Basic National Tax Law ("BNTL"). Under the current proposal, the exception to the general statute of limitations for tax assessment will apply in case there is a change in effective tax rates for global minimum tax purposes. In this case, the tax authorities may impose tax within one year from the date they become aware of the change in effective tax rates. The proposed change is aimed at securing the taxing rights in line with the

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introduction of the domestic global minimum tax rules.

Clarification of definition of permanent establishment. The proposals clarify the definition of permanent establishment (PE) in accordance with details in the OECD Pillar 2 Model Rules and the Commentary to the Model Rules. Under the proposals, a PE is defined as: (1) a place of business treated as a PE in accordance with an applicable tax treaty in force; (2) if there is no applicable tax treaty in force, a place of business in respect of which a jurisdiction taxes under its domestic law the income attributable to such place of business on a net basis similar to the manner in which it taxes its own tax residents; (3) if a jurisdiction has no corporate income tax system, a place of business situated in that jurisdiction that would have been treated as a PE in accordance with the OECD Model Tax Convention on Income and on Capital provided that such jurisdiction would have had the right to tax the income attributable to it; or 4) a place of business that is not already described in paragraphs (1) to (3) through which operations are conducted outside the jurisdiction where the Entity is located provided that such jurisdiction exempts the income attributable to such operations.

Clarification of definition of ultimate parent entity. Ultimate Parent Entity ("UPE") is defined as an entity that owns directly or indirectly a controlling interest in any other entities and whose controlling interest is not owned directly or indirectly by another entity. Under the proposals, the Main Entity of a group would be included in UPE whereas a sovereign wealth fund would be excluded from UPE. Computation of non-Euro sales revenue: The Korean global minimum tax rules shall apply with regard to the Constituent Entities of a group if the sales revenue per the consolidated financial statements of the UPE of the group is EUR 750 million or more in at least two of the four fiscal years immediately preceding the tested fiscal year. As for the computation of the revenue threshold in a non-Euro currency, it is proposed that non-Euro currency sales revenue would be converted into Euro based on the average foreign exchange rate for December of the year immediately preceding the tested fiscal year in accordance with the OECD Administrative Guidance on the Pillar Two Model Rules.

Adjustment to GloBE income or loss relating to change in Adjusted Covered Taxes. It is proposed that if there is an increase in Covered Taxes or there is insignificant decrease in Covered Taxes after the GloBE tax return filing, the related amount would be considered in the computation of the GloBE income or loss for the year when the change in Adjusted Covered Taxes happens. On the other hand, it is proposed that if there is a significant increase in Covered Taxes, the related amount would be considered in the computation of the GlobE income or loss for the year which is associated with the change in Adjusted Covered Taxes. This proposal is in line with the OECD Administrative Guidance on the Pillar Two Model Rules.

Penalty exemption or reduction for a transitional period. Under the current Law for Coordination of International Tax Affairs ("LCITA"), the reporting and payment of top-up tax liability under the IIR or UTPR should be made within 15 months (18 months in the first year of the application) from the end of a concerned fiscal year. If the reporting and payment of top-up tax liability are not properly made by the due date, there would be penalties for the non-compliance (e.g., penalty for non-reporting, penalty for underreported tax, interest penalty for unpaid tax) under the BNTL. Under the proposal, penalties for the non-compliance (excluding interest penalty for unpaid tax) under the BNTL would be exempt for a transitional period while the interest penalty will reduce by 50% for the transitional period. The transitional period is defined as all fiscal years that begin on or before December 31, 2026, and end on or before June 30, 2028.

Exemption from fine for incorrect submission of global minimum tax information report. The LCITA imposes fine for the noncompliance with the obligation to submit global minimum tax information report. It is proposed to exempt such fine for the foregoing transitional period if a set of appropriate actions are taken for the application of the global

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minimum tax in cases where: 1) all computation details are fully disclosed to the tax authorities; 2) there is a reasonable ground for misconception; 3) there are reasonable circumstances causing error; 4) it is based on reasonable interpretations; or 5) a tax liability is not reduced in the current or subsequent fiscal year.

New proposed rules to strengthen rules against tax avoidance

New obligation to report offshore trusts. Under the new proposed rules, residents and domestic corporations would be required to submit the required information concerning offshore trusts. An offshore trust is a trust formed under the laws of a foreign jurisdiction and is in nature similar to trusts under Article 2 (i.e. Definition of trust) of the Korean Trust Act. The new proposed rules are outlined as follows:

- When a resident or a domestic corporation creates an offshore trust or transfers property to an offshore trust, the trustor must submit the required information once per case. The submission must be made within six months from the end of the month when a fiscal year-end falls.
- Where an offshore trust has been created, the trustor must submit the required information every year in case it actually governs and controls (*) the trust assets (*the trustor holds the rights to terminate a trust, make an appointment or a change of beneficiaries from a trust and distribute the assets remaining in a trust after termination, etc.).
- The required information would include information on a trustor, a trustee and beneficiaries and other basic information related to trust contacts and the value* of trust property, etc. (*market value or acquisition value if it is difficult to calculate the market value).
- Noncompliance with the submission requirement would be subject to a penalty of 10% or less of the trust property value with a cap of KRW 100 million.
- The proposed rules would apply to trusts with an obligation to submit required information for the fiscal year starting on or after January 1, 2025 (with the submission occurring after January 1, 2026). However, as for the trusts created before December 31, 2024 and maintained in the years beginning on or after January 1, 2025, the new reporting requirement would apply.

Requirement to report employee stock-based compensation details. A Korean company or PE of a foreign company would be subject to the proposed new requirement for submitting detailed information concerning overseas stock-based compensations of its executives and employees (including former executives and employees), which were granted by an overseas controlling shareholder. The proposed new requirement is outlined as follows:

- In case of executives and employees of a Korean company, overseas controlling shareholder company refers to the foreign company directly or indirectly owning 50% or more interest in the Korean company. In case of executives and employees of the Korean PE of a foreign company, the head-office or another PE of the foreign company, or another foreign company directly or indirectly owning 50% or more interest in the former foreign company.
- Overseas stock-based compensation refers to: 1) stock options or similar rights to acquire or purchase stocks of an overseas controlling shareholder at pre-determined prices; and ii) rewards given by an overseas controlling shareholder in shares or money equivalent to the share value according to the pre-determined operating guidelines of stock-based compensation.
- The information to be submitted would include transaction details related to stock-based compensation such as details of the grant/exercise/payment of stock-based compensation, income from exercise of stock options, personal information of executives and employees, etc.
- The submission would be made not later than March 10th of the year following the year when the stock based compensations are exercised

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or paid. The new reporting requirement will apply to the exercise or payment of such compensation on or after January 1, 2024.

Proposals to promote corporate investment and employment

Expanded tax credits for video contents industry. Tax incentives will be expanded for the expenditures or costs incurred to produce video contents (TV series of drama, animation as well as documentary, films and over-the-top (OTT) contents). The expanded incentives would increase the existing basic credit rates basically from 3%, 7% and 10% to 5%, 10% and 15% depending on a corporate type (i.e., large company, enterprise of middle standing and small- and medium-sized enterprise (SME)). They also include the introduction of additional tax credit on top of the basic credit. The additional credit rates would be 10%, 10% and 15% for large company, enterprise of middle standing and SME, respectively. To qualify for the additional tax credits, it would be required to meet certain criteria including a threshold of domestic production costs to be set forth in the Presidential Decree of the Special Tax Treatment Control Law (STTCL). It is proposed that the increased tax credit rates would apply to the production costs to be incurred from January 1, 2024.

New tax credit for investment in cultural content business. New tax credit would be allowed for investment in film, TV series and OTT contents making by SMEs and enterprise of middle standing via a company specializing in the cultural content industry. Qualifying expenditures would be limited to the amounts contributed to finance film or video contents making out of their total investment in such company. The tax credit rate would apply at the rate of 3% to qualifying expenditures made from January 1, 2024, and not later than December 31, 2025. However, it would not apply to entertainment expenses, advertising and public relations costs and certain labor costs (e.g., severance pay allowance).

Expanded scope of national strategic technology sectors. Currently, under the STTCL, a higher R&D tax credit (i.e., qualifying expenditures x [40% for SME or 30% for non-SME plus an additional rate capped at 10%]) applies to qualifying expenditures to acquire 54 categories of technology in the 6 sectors including semiconductor, secondary battery, vaccines, display, hydrogen, and future transport means which are called as national strategic technology sectors as listed under the STTCL. Further, a higher investment tax credit applies to the investment in 46 facilities to commercialize the technologies in the 6 sectors. It is proposed that biopharmaceuticals would be added to the national strategic industrial technology sectors and related eight categories in the sector would be newly eligible for a higher R&D tax credit while related four categories of facilities in the sector would be newly subject to a higher investment tax credit. The eight categories of technology include biosimilar manufacturing and improvement technology, technology for Phase 1~3 clinical trials, technology to manufacture raw materials for biopharmaceuticals, etc. The four categories of facilities include new biopharmaceutical candidate discovering and manufacturing facilities, facilities for biosimilar manufacturing, facilities to manufacture raw materials for biopharmaceuticals, etc. The proposed change will apply to the R&D expenditures to be incurred or facility investment to be made on or after July 1, 2023.

Expansion of new growth and core technology sectors. The STTCL applies a higher tax credit (i.e., qualifying expenditures x [30% for SME, 25% for enterprise of middle standing traded at KOSDAQ, or 20% for all other companies plus an additional rate capped at 10% or 15%]) to qualifying R&D expenditures incurred to develop and invest in 262 different kinds of technologies in 13 new growth and core technology sectors including future cars, artificial intelligence, next-generation software, etc. The proposal expands the scope of new growth and core technology sectors to include core technology for energy efficiency improvement and essential technologies related to core mineral refining, smelting and supply chain. Under the proposals, the R&D tax credit in the newly added technology

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sectors would be eligible for the qualifying expenditures to be incurred on or after January 1, 2024.

Expanded scope and eased requirement for reshoring incentives. The STTCL provides for tax incentives for Korean nationals or companies bringing into Korea their production and manufacturing facilities from overseas which have been operated for at least two years. They include a 100% exemption from individual or corporate income tax for the first five years and a 50% reduction for the next two years relating to income arising from the business place which has been relocated into Korea. The tax reform proposals expand the incentives to a 100% income tax exemption for the first seven years and a 50% reduction for the next three years. However, there will be no change in the current reshoring incentives for the partial relocation of production facilities in a metropolitan area where lower rates of income tax reduction apply (i.e. 100% for the first three years and 50% for the next two years). To qualify for the reshoring tax incentives, it would be ensured that overseas business places and post-reshoring business places in Korea engage in the same line of business according to the Korean Standard Industrial Code. This requirement would be eased to allow the incentives in other cases where the similarity between the business lines operated in overseas and post-reshoring business places of a reshoring company should be confirmed by the Support Committee for Reshoring Companies under the Act on Assistance for Korean Reshoring Enterprises. While the existing income tax exemption or reduction will continue to be available until the end of December 2024, the proposed change will apply to the new or additional establishment of domestic business places on or after January 1, 2024.

Extension of the applicable timeline for employment income tax reduction to foreign engineers. Currently, qualified foreign engineers who meet prescribed criteria are entitled to a 50% reduction in income tax on their employment income for 10 years from the first service year in Korea if they start to work no later than December 31, 2023. Under the tax reform proposal, the applicable timeline will be extended by five additional years until December 31, 2028. Also, the special tax treatment will be additionally available for qualified engineers who are employed as professors at schools in R&D special zones and high-tech medical complexes if they satisfy all other existing criteria such as the thresholds for R&D experience, academic qualification, etc.

Extension of the special tax concession timeline for foreign workers. Foreign expatriates and employees are eligible for a flat tax rate of 19% (20.9% including local income tax) on income earned in Korea for a period of 20 years starting from the first day of their work if they start work no later than December 31, 2023. Under the tax reform proposal, the applicable timeline will be extended by five additional years until December 31, 2028. In this case, any other income deductions, tax exemption, and tax credit are disallowed. However, under the proposal, employer-provided housing benefits will be permanently excluded from the earned income of foreign expatriates and employees eligible for the special tax concession. Currently, the income exclusion applies to such housing benefits provided until December 31, 2023.

Proposals to facilitate M&A aimed at technology innovation

Extension of the applicable period for a tax credit for the acquisition of a technology innovative SME. Where a domestic company acquires shares or interest (the “shares”) in a qualified technology innovative SME (the “acquired company”), the domestic company shall be eligible for a tax credit at 10% of the share acquisition costs of up to the value of technologies prescribed in the Presidential Decree of the STTCL if it meets all of the requirements. These requirements include the ownership requirement that the domestic company should acquire more than 50% of the shares in the acquired company (or 30% of the shares if the domestic company is the largest shareholder and substantially controls over the management rights of the acquired company) and it should continue to own the shares as of the end of a fiscal year in which the share acquisition date falls. The tax

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credit currently applies to the share acquisition made from the date of initial acquisition through the end of the concerned fiscal year. The proposal would extend the applicable period from the date of initial acquisition through the end of the fiscal year following the concerned fiscal year. Meanwhile, where the ownership requirement is met in the fiscal year in which the date of initial share acquisition falls, the current applicable period for a tax credit will apply (i.e., from the date of initial acquisition through the end of the concerned fiscal year).

Increase in the value of technologies eligible for a tax credit for technology innovative M&A. Where a domestic company (surviving company) merges with a qualifying technology innovative SME (dissolving company), the domestic company shall be eligible for a tax credit at 10% of the share acquisition costs of up to the value of technologies prescribed in the Presidential Decree of the STTCL if all of the requirements are met. The value of technologies prescribed in the Presidential Decree refers to either of the following amounts selected by the surviving company: i) the total amount of patent rights, utility model rights, and certain technical knowhow or technology, etc. held by the dissolving company within three months before and after the court registration date of the merger (in such case, the value of technologies shall not exceed an amount calculated by subtracting the fair market value of net assets of the dissolving company as of the court registration date of the merger, from the transfer price paid by the surviving company to the dissolving company); or ii) the amount calculated by subtracting **130%** of the fair market value of net assets of the dissolving company as at the court registration date of the merger, from the transfer price paid by the surviving company to the dissolving company. Under the proposal, in calculating the amount based on the fair market value of net assets of the dissolving company in ii), the subtraction percentage will be lowered from 130% to **120%.**

Measures to streamline the taxation of capital transactions and promote equitable tax treatment

Expansion of deemed dividend subject to taxation upon capitalization. Under the Corporate Income Tax Law (CITL), in general, the value of shares received by a domestic shareholder company from another company through the conversion of capital surplus or earnings into capital shall be excluded from taxable income of the domestic shareholder company. As an exception, where capital is converted from any of prescribed capital surplus under the CITL such as gains from waiver of debts in case of conversion of debts into capital, certain gains on the retirement of treasury stock, certain gains from a tax qualified merger and certain gains from a tax qualified spin-off, any gains from the conversion of such capital surplus into capital shall be treated as deemed dividend and be included in taxable income of the domestic shareholder company. The tax reform proposal seeks to expand the range of deemed dividends subject to taxation upon capitalization, aimed at ensuring an equitable tax treatment and the prevention of tax avoidance. Under the proposal, the expansion will specifically include the additionally paid-in capital (i.e. issue price minus par value) of redeemable shares that are to be retired out of the company's earnings under the Korean Commercial Code.

Adjusted scope of income exclusion for dividends received through capital surplus reduction. Under the current CITL, dividends received by a domestic shareholder company through the capital surplus reduction by the share issuing company shall be excluded from the taxable income of the domestic company to the extent of the book value of the shares held by the domestic company with certain exceptions. The exceptions currently apply where dividends are received through the reduction of any prescribed capital surplus under the CITL such as gains from waiver of debts in case of conversion of debts into equity, certain gains on the retirement of treasury stock, certain gains from a tax-qualified merger and a tax-qualified spin-off, and such dividends are included in taxable income. The tax reform proposal also suggests adding the 3% revaluation reserve and

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the additionally paid-in capital of redeemable shares in the scope of prescribed capital surplus subject to the exceptions, from which dividends received are included from taxable income.

Clarification of book value calculation for dividends received through capital surplus reduction. The tax reform proposal includes a new provision aimed at providing clarity for calculating the book value of shares held by a domestic company where dividends are received through capital surplus reduction. Under the proposed new provision, the book value of shares held by the domestic company upon capital surplus reduction would be determined at the book value of shares held by the company prior to capital surplus reduction minus the amount of dividends received by the company through capital surplus reduction.

Proposal to streamline the existing dividend received deduction rules. Under the CITL, in general, dividends eligible for a dividend received deduction (DRD) include profit or earning distributions or deemed dividends which are deemed as dividends for tax purposes. Currently, however, the DRD rules shall not apply to three categories of prescribed dividends that include: i) dividend income from stocks, etc. acquired within three months prior to the dividend record date; ii) dividends received from a special purpose company of asset-backed securitization which is entitled to income deductions on the dividend payments or dividends received from trust assets; and iii) dividends received from a company which is entitled to the non-taxation, exemption, or reduction of corporate income tax. Under the proposal, the DRD rules will not apply to the following additional categories of dividends: i) an excess amount of the distributed value over the acquisition cost of the shares through capital reduction with payout, gains from the transfer of capital surplus to retained earnings in situations where treasury stock is held; and ii) dividends received by reducing the 3% revaluation reserve (including a certain amount of gains transferred from gains on a merger or spin-off). The proposed change aims to improve the DRD regime to relieve double taxation and tax avoidance.

Changes in penalties against noncompliance, etc.

Sanctions against the noncompliance with the simplified VAT registration requirement for a foreign supplier of B2C electronic services. The Value Added Tax Law (VATL) requires any entrepreneur starting a business in Korea to register its business place with the tax authority within 20 days from the commencement date of the business. Currently, a penalty of 1% of the supply value of goods or services in Korea shall be imposed on the failure to meet the registration requirement or the registration shall be conducted by the head of the competent tax office in its power of authority. Under the proposal, a foreign supplier (a foreign company or a nonresident) supplying B2C electronic services in Korea would be subject to these sanctions against the noncompliance with the registration requirement if the foreign supplier fails to comply with the simplified VAT registration under the VATL.

Increase in penalty reduction rates for filing an amended declaration. Where an amended declaration is filed in a prescribed manner in the Customs Act after the revision period expires, penalties on the amount of unpaid duties shall be reduced by: 1) 20% of deficiencies in the declared duty amount if an amended declaration is filed within six months from the end of the correction period; and 2) 10% of such amount if an amended declaration is filed over six months from the end of this period, but within one and half years. Under the proposal, the penalty reduction rates will be adjusted higher to: 1) 30% in case of filing an amended declaration within six months from the end of the correction period; 2) 20% for the filing over six months but within one year; and 3) 10% for the filing over one year, but within one and half years.

Additional exception to the underreporting penalty. Where a taxpayer underreports taxes payable to the tax authority by the statutory due date, underreporting penalties shall apply. As an exception, however, the underreporting penalty may be exempt for certain cases as provided in Article 47-3 of the BNTL. Under the proposal, the underreporting penalty would also be exempt

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where the tax credit amount is changed after a taxpayer's facilities, for which a tax credit has been claimed on tax return filed, are subsequently accepted as qualifying facilities for an integrated investment tax credit, as stipulated in Article 21(13) of the Presidential Decree of the STTCL (excluding cases of underreporting resulting from fraudulent activities).

Expanded scope of limits on penalty for late tax invoicing. Penalties of up to KRW100 million (KRW50 million for SME) shall apply per the type of violation of the obligations as prescribed in Article 49(1) of the BNTL. The current limits shall be applicable to the penalty for late tax invoicing under the Individual Income Tax Law and the VATL. Under the proposal, the penalty for late tax invoicing under the CITL would also be subject to the penalty limits.

Other proposed measures

Shortened deadline for submitting local files and master files. Large taxpayers meeting the thresholds for annual turnover and international transactions are currently required to submit local files, master files and country-by-country reports within 12 months from their fiscal year-end. Under the proposal, the submission deadline for local and master files would be shortened to six months, while the submission deadline for country-by-country reports remains unchanged.

Revised due date for filing amended tax return for treaty benefits. Under the CITL, where a nonresident or a foreign corporation, which is the beneficial and substantive owner of Korean source income and eligible for treaty benefits (such as non-taxation, tax exemption or reduced withholding tax rates), did not apply or incorrectly applied such treaty benefits when the income was paid, the nonresident or the foreign corporation, or a withholding agent (i.e. a payor of income) may file an amended tax return for tax refund claim with the local tax office within five years from the end date of the month in which the tax was withheld. Under the proposal, the due date of amended tax return filing is revised to five years from the 10th day of the month following the month in which the tax was withheld.

Special provision for deduction of bad debt allowance for loans to overseas construction subsidiaries. A new special provision is proposed to allow a deduction of bad debt allowance for certain loans to overseas construction subsidiaries. Specifically, under the proposal, a deduction of the bad debt allowance will be available for domestic construction companies that are parent companies owning overseas construction subsidiaries, provided that all the following conditions are met: 1) the domestic parent company has provided loans (including interest) to an overseas construction subsidiary in which the parent company has at least 90% of shares; 2) five years or more have passed since the due date for collection; 3) the loans were used to operate the business of the overseas construction subsidiary; and 4) it is considered extremely difficult to collect the loans such as the negative shareholders' equity (i.e. the negative balance of net assets) of the overseas construction subsidiary. The deduction of bad debt allowance would be limited to the year-end balance of qualifying loans of the parent company minus the book value of net assets, other than the said loans borrowed, of the overseas construction subsidiary, multiplied by a deduction ratio. The deduction ratio would increase by 10% points each year from 10% in 2024, 20% in 2025, 30% in 2026 to 100% in 2033 and thereafter.

New guidelines for the deduction of tax losses among consolidated affiliates. The proposal introduces a new provision aimed at rationalizing the deduction process for tax losses among affiliates within a consolidated group. Under the proposal, where a consolidate group occurs tax losses for a consolidated fiscal year, the corporate income taxes calculated for the consolidate group will be allocated to each affiliate proportionately based on the amount of taxable income and tax losses among all consolidated affiliates. The allocation amount will be computed at (1) the income amount or deducted tax loss amount of each affiliate times (2) the consolidated tax rate (A) for the consolidated fiscal year. (A = (tax losses for a consolidated fiscal year x corporate income tax rate)/ sum of individual income amount and

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individual tax loss amount after consolidation adjustments in all affiliates within a consolidated group).

Expansion of reasons for customs duty reinvestigation. In a bid to prevent the abuse of rights to investigate customs duties, the Customs Act permits the reinvestigation of customs duties in a limited scope of reasons where: 1) there is clear evidence supporting the alleged evasion of customs duties; 2) it is necessary to investigate trading partners of those already subject to an investigation; 3) there is evidence of offering bribes or soliciting customs officials in their official duties; and 4) general investigations are conducted against those who are suspicious of customs duty evasion. As for the reason in 1), it is proposed to expand the scope of reasons for conducting customs reinvestigation to include customs fraud and duty evasion. This would enhance the customs enforcement measures to tackle both fraud and duty evasion.

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