Korean Tax Update

Samil Commentary

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130 Countries Agree on a Digital Tax Framework at the Plenary Meeting of the OECD Inclusive Framework on BEPS

The Ministry of Economy and Finance announced key takeaways regarding Pillars One and Two, which garnered the agreement from 130 members of the OECD Inclusive Framework(*) at the plenary meeting held on July 1, 2017, and its implications for the Korean economy and corporations.

Pillar One will apply to multinational enterprises (MNEs) with high revenue and profits exceeding certain thresholds of global turnover and profitability. Pillar One will make it possible to tax foreign corporations in a jurisdiction where the corporations do not have a physical presence, providing a fundamental change in the international corporate tax system maintained for the past ten decades. According to the Ministry, Pillar One will allow Korea to secure additional taxing rights for foreign digital MNEs that sell or deliver their services and products directly to consumers in domestic market without permanent establishments in Korea.

Pillar Two will apply a minimum effective tax rate (15%) at the jurisdiction level and is regarded as the most aggressive attempt ever to tackle tax avoidance and evasion. According to the Ministry, the implications of Pillar Two for the Korean economy would be limited, considering the level of Korean corporate income tax rates. The Ministry expects that it would have a positive impact on Korea attracting multinational companies, as Pillar

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Two, if enforced, would discourage competition among advanced and developed economies to lower their corporate tax rates to attract foreign investments. Rather, the Ministry added that it would further underscore the importance of the environment for doing business in a country.

* Inclusive Framework (IF) is the consultation body established to discuss the implementation of the OECD Base Erosion and Profit Shift (BEPS) action plans. Currently, 139 countries including Korea and G7 economies are members of the IF and facilitate discussions under Pillars One and Two.

Korean Economic Policy and Strategy for the Second Half of 2021

The government finalized the Korean economic policy and strategy for the second half of 2021 in late June 2021. The policy direction to be taken in the second half of 2021 is to achieve a full-scale economic recovery and a structural shift to a leading economy. It includes tax incentives to support the government's commitment to economic recovery and transformation that would:

- significantly expand tax incentives for investment in research and development (R&D) and facilities with a focus on three major sectors including semiconductors, batteries and vaccines which have been designated by the government as the country's strategic technologies;
- provide tax incentives for investment in eco-friendly vehicles and R&D tax credits for system semiconductors (non-memory semiconductors) and bio-health technologies to help the country to become a hub of global supply chains for future cars, system semiconductors, and bio-health technology and products;
- expand tax relief for incentive stock options offered by venture firms and overhaul the support system for venture firms to trigger and sustain another round of a venture capital boom; and
- establish a new support package including reinforced tax incentives to facilitate M&A of small and midsize enterprises and venture firms to encourage corporate restructurings to be undertaken preemptively.

Government's Second Supplementary Budget Proposal for 2021

The second supplementary budget proposal for 2021 (worth KRW 33 trillion) was passed in the cabinet meeting on July 1, 2021. The supplementary budget proposal is based on the additional tax revenues expected to be secured in the amount of approximately KRW 31.5 trillion, due to an economic recovery at a rate faster than expected, etc. The supplementary budget will be allotted broadly to four categories of spending requirements related to the COVID 19 pandemic: i) support for small and micro businesses affected by the pandemic; ii) quarantines and vaccination; iii) support for employment and livelihood stability; and iv) improved local, provincial and community economic vitality.

NTS Becomes an Associate Member of IOTA

The National Tax Service (NTS) participated in the 25th annual meeting of the Inter-European Organization of Tax Administration (IOTA) to share information and experiences particularly in Korea's electronic tax administration system. During the meeting, the NTS application for associate membership in the IOTA was accepted. By joining the IOTA, the NTS expects to expand exchanges of experiences and information as well as cooperation with European tax authorities. Furthermore, Korean companies operating in IOTA member countries would be treated more favourably than before in tax administration. The IOTA is an intergovernmental organization established to help resolve common issues and facilitate developments concerning practical aspects of tax administration.

Rulings Update

Whether raw material costs incurred during the performance testing on the new machinery acquired would be treated as capital expenditures to the machinery

In this case, a company purchased new machinery in January 2015 (the 'machinery in question') whose installation was supposed to be completed in March 2015. The company conducted the performance testing for mass production of certain products on the machinery in question. During the course of performance testing, the company found that the machinery in question failed to meet the company's internal quality control standard for mass production of products due to its quality issue and defect ratio. As such, the company extended the performance testing period from March 2015 until August 2015 and incurred costs of raw materials for the testing on the machinery in question during the extended period (the 'raw material costs' in question).

The issue in this case was whether the raw material costs in question would be regarded as capital expenditures which constitutes the acquisition cost of the machinery in question.

The tax authority took a position that the raw material costs in question should be treated as capital expenditures to the machinery in question and added back the costs to the company's taxable income. Thus, the tax authority assessed corporate income tax on the raw material costs in question after deducting a certain amount of depreciation expenses therefrom. The tax authority's position above was mainly based on the Basic Ruling of the Corporate Income Tax Law (CITL) that expenses incurred during a 'test operation' of a newly acquired machinery that is 'under installation', net of a revenue earned from the disposal of prototype products produced in the test operation, should be treated as capital expenditures to the machinery.

Regarding this, the Tax Tribunal ruled that in consideration of the nature of the machinery, it was difficult to view that it would take such a long period of time to complete the installation of the machinery in question and as such, it was difficult to view that all the raw material costs in question were incurred during the test operation 'under' the installation. Rather, these costs appeared to be incurred for the product development and testing for mass production 'after' the installation of the machinery, taking into account the company's internal approval documents comprehensively. Accordingly, the Tribunal decided in favour of the taxpayer that the tax authority's assessment should be revoked (*Joshim2020jeon8532, 2021. 6. 7.*)

This case indicates that it cannot be considered that all expenses incurred for the period from the purchase of a new machinery till it begins mass production of products using the new machinery fall under capital expenditures to the machinery. It also highlights that whether certain costs constitute capital expenditure should be determined on a case-by-case basis in light of the specific nature of the machinery and the surrounding fact pattern.

Whether underreporting and underpayment penalties would apply where the increased tax amount per the tax audit result is less than the tax amount per the tax return originally filed

According to the old Basic National Tax Law (BNTL), where a taxpayer has filed a national tax return by the statutory due date of return, but the taxpayer has reported the tax amount less than the amount it should report, or it has reported the tax amount to be refunded more than the amount it should report, the taxpayer shall be subject to an underreporting penalty for the total amount of the underreported tax amount to be paid and the overreported tax amount to be refunded as calculated pursuant to the old BNTL. In addition, where a taxpayer fails to make tax payment by the statutory due date, or has paid the tax less than the tax to be paid or is refunded more than the amount to be refunded, the taxpayer shall be subject to an underpayment penalty (i.e., penalty for late payment under the current law).

In this case, a taxpayer filed a tax return and paid corporate income tax for 2017 by the due date (the 'original tax return filing and payment'). The taxpayer further submitted an amended tax return for a tax refund claim on a specific item for 2017 and received a tax refund on such item in 2018. Later in 2019, the tax authority conducted a tax audit on the taxpayer, and as a result of the audit, the tax authority made an additional assessment of corporate income taxes for certain audit items, which were different from the item for which the taxpayer reduced its taxable income and received the tax refund for 2017 in 2018. The tax authority also imposed underreporting and underpayment penalties for those audit assessment items.

The taxpayer pursued a tax appeal against the tax authority's imposition of the penalties, arguing that it should not be subject to underreporting and underpayment penalties on the basis that the total tax amount reported and paid per the original tax return filed for 2017 is greater than the revised total tax amount per the tax audit result and there was no underreporting or underpayment of taxes from the original tax return filed.

Regarding this, the Tax Tribunal decided against the taxpayer that the tax audit assessment was made for certain items which were not reported nor paid though the taxpayer should have reported and paid them on the original tax return, and as such, it is reasonable to impose underreporting and underpayment penalties on the audit assessment items irrespective of the tax amount per the original tax return filed by the taxpayer. (*Joshim2020bu1856, 2021. 4. 21.*)

This case is considered meaningful in that the Tax Tribunal rendered a decision on the scope of underpayment or underreporting penalties in case where the taxpayer reduced its taxable income through the amended tax return for tax refund claim from the original tax return filed, and later the tax authority increased its taxable income on the tax audit which is still less than the tax amount per the original tax return. For the underreporting penalties, it may be necessary to refer to the NTS interpretations on similar issues to the Tribunal's decision (*Tax Collection Division-1039,2012.9.27, Seomyeon2019-jingse-2638, 2019.10.31*).

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