Korean Tax Update

Samil Commentary

March 15, 2022

Government's Bill to Amend Enforcement Rules of Tax Laws for 2021

The Ministry of Economy and Finance (MOEF) announced a bill to amend enforcement rules to set out details as required in the recently amended tax laws and related presidential decrees. The proposed amendments to the enforcement rules will be proclaimed and effective in March 2022. Selected important changes contained in the bill would: 1) specify the scope of facilities to commercialize national strategic technologies in the three industrial sectors of semiconductor, secondary battery and vaccine, which are eligible for the highest rates of tax credits (6%~16%) (applicable for investment made on or after July 1, 2021); and 2) expand the scope of facilities to commercialize new growth or source technologies to include a new list of facilities used in the carbon-neutral technology areas and additional kinds of facilities used in the areas of bio and resource circulation, future cars and core materials (applicable from the fiscal year starting on or after January 1, 2022). For investment in facilities to commercialize new growth or source technologies, higher rates of tax credits (3%~12%) are applicable, compared with investment in general facilities (1%~10%). In addition, the government's bill would eliminate the duty-free shopping limit (USD5,000 per Korean national at departure) to support the duty-free retail industry with expectations that it would result in increased domestic spending and reduced travel spending abroad.

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Other proposed changes would: 1) provide details for the implementation of the periodic auditor designation regime for public interest corporations; 2) expand the scope of orphan drugs to which the exemption from valued added tax on imports applies; and 3) change in the base rate which is deemed as an arm's length interest rate applicable to loan transactions between a resident and its overseas related parties, specifically from the LIBOR for each major currency plus 1.5% to the index interest rate for each major currency prescribed in the Enforcement Rules (e.g., KOFR for KRW loans) plus 1.5%.

The NTS Investigation Targets Some Overseas Subsidiaries of Domestic Companies and Domestic PEs of Multinationals

The National Tax Service (NTS) announced on February 22, 2022 that it has undertaken tax audits on 44 offshore tax evasion suspects, including those which took advantage of overseas entities for tax evasion purposes and multinational companies concealing their permanent establishments (PEs) in Korea. Based on the systematic verifications of tax filings, the NTS investigation specifically targets: 1) tax avoidance associated with tunnelling that illegally directs company assets to an overseas subsidiary established to avoid taxation in the country; 2) concealment of the existence of a PE or disguise of a PE as a liaison office of multinational companies to avoid taxation in fast growing industries such as semiconductors, logistics, equipment, etc.; and 3) avoidance of tax liabilities by reducing domestic taxable income through unfair financial transactions between related parties such as the liquidation of an overseas subsidiary prior to recovering the invested amount in or loans to the subsidiary or share transactions at higher or lower prices than their arm's length price.

The KCS Enforces and Briefs on Measures to Improve the Amended Import VAT Invoice Issuance Regime to Strengthen Taxpayers' Rights

According to the import VAT invoice issuance regime, if an error contained in an import VAT invoice is found to be caused by a mistake or minor negligence on the part of the importer (taxpayer) and the importer proves that such an error is not attributable to itself, an amended import VAT invoice can be issued. Since the existing regime requires taxpayers to provide such evidence, there has been the possibility of disputes between taxpayers and the customs authorities over the interpretation of the ambiguous concept of a mistake or minor negligence. Considering these circumstances, the Korea Customs Service (KCS) has announced measures to improve the amended import VAT invoice issuance regime and strengthen the protection of taxpayer's rights in this regard. The improved measures are aimed at promoting the issuance of amended import VAT invoices in a broader range of instances. Specific improvements are as set out below:

- Specify and categorize the reasons corresponding to 'a mistake or minor negligence' which allow an amended import VAT invoice to be issued under the VAT Law.
- Provide the "Operation Guidelines for Issuing Amended Import VAT Invoices" setting forth the types of 'mistakes or minor negligence' and specific related instances to facilitate the issuance of amended tax invoices.
- Put in place the procedures whereby a taxpayer may seek an examination by the KCS

Taxpayer Advocate Committee as to whether the decision notified by the customs office not to issue the import VAT invoice is appropriate.

Korea's National Tax Revenue Increases in 2021

The MOEF announced that the government collected a total tax revenue of KRW 524.2 trillion and executed the budget totaling KRW496.9 trillion during 2021. The national total tax revenue for 2021 grew by KRW58.7 trillion from 2020 which is a KRW17.5 trillion increase from the tax revenue budget for 2021. The more national tax revenue was due to faster than expected economic recovery from the pandemic and significant additional tax revenue in the wake of soaring real estate prices (KRW29.8 trillion). On the contrary, the non-tax revenue recorded a KRW12.3 trillion decline as the government expanded financial support for micro businesses and underprivileged people. Further, as the government scaled down bond issuances to stabilize the government bond markets and support fiscal soundness, it resulted in reduced non-tax revenue including deposits received in the account of the public financial management fund. The total expenditure marked a KRW43.1 trillion increase to KRW496.9 trillion in 2021 which represented 97.6% of the total budget executed. More of the national budget was actively executed and spent to i) support micro business owners and underprivileged people; ii) finance the projects for the pandemic control system building including purchases of COVID-19 vaccines, and creation of jobs; iii) and expand investment in the government's New Deal projects.

Rulings Update

Timing for determining the existence of reasonable cause for penalty exemption under the BNTL

Under the old Basic National Tax Law (BNTL), if a taxpayer fails to file a tax return or under reports taxable income by a statutory due date, penalties shall be imposed for the non-filing or underreporting. In addition, for the failure to pay the full amount of tax owed by a statutory due date, penalties shall be imposed on the unpaid or underpaid amount of tax. (Articles 47-2(1), 47-3(1) and 47-4(1) of the old BNTL effective prior to the amendment on June 7, 2013)

It is noted, however, that the Supreme Court previously rendered decisions that, whereas penalties are administrative sanctions imposed on taxpayers failing to comply with statutory obligations of tax filings and payments without reasonable causes, such penalties would not be imposed if a reasonable cause exists to argue that a taxpayer could not be blamed for neglecting the compliance obligation, specifically if there were circumstances in which it would be unreasonable to expect the taxpayer to fulfill their obligation. *(Daebeop 2002 du 66, 2002. 8. 23. and Daebeop 2016 du 44711, 2016. 10. 27. etc.)*

In this case, the taxpayer found out a portion of income from sales ('income in question') unreported in filing tax returns after the due date for filing and paying consolidated personal income tax and VAT had already passed. The income in question was associated with embezzlement of employees which was found during a tax investigation of the taxpayer. A district tax office considered that the taxpayer omitted the income in question and imposed penalties for underreporting and underpaid tax on the income. The issue in this case was on the timing for determining whether there exists a reasonable cause for exemption of penalties. Regarding this, the Seoul High Court ruled that the penalty exemption would apply to the underpaid tax owed by the taxpayer only for the period until it realized the embezzlement of its employees, given that the taxpayer had a reasonable cause for failing to report the income in question until it became aware of the embezzlement. It however, continued that the penalty exemption would not apply for underreporting and underpaid tax for the period after the taxpayer realized the employee embezzlement, considering the taxpayer was able to report the income in question thereafter. (*Seoulgobeop 2016 nu 44874, 2017. 3. 23.*). Meanwhile, the Supreme Court further considered that the taxpayer had a reasonable cause for the penalty exemption at the time of the statutory due date for tax filing and payment in that the due dates for filing for consolidated income tax and VAT had already passed by the time the taxpayer became aware of the embezzlement. In this regard, the Supreme Court finally decided that the taxpayer should be exempt from not only the penalty for underpaid tax for the period before it realized the embezzlement, but also the penalties for underreporting and underpaid tax for the period after it realized the embezzlement. *(Daebeop 2017 du 41108, 2022. 1. 14.)*

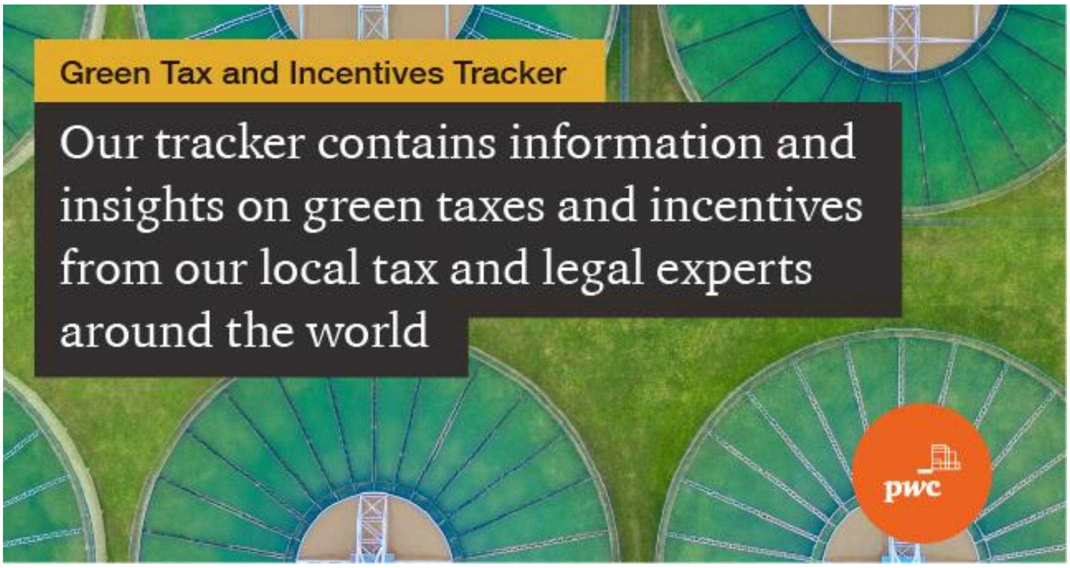
The Supreme Court's decision seems to address that whether to exempt penalties for underreporting and underpayment for reasonable cause must be determined as of the statutory due dates for tax filing or payment under the tax law. As in this case, where the full amount of taxes has failed to be reported or paid because taxpayers realized the employee embezzlement after the statutory due dates for tax filing and payment passed, it may be necessary to refer to the legal interpretation on the exemption from the penalty for 'reasonable cause' addressed in this Supreme Court's recent decision.

How to calculate the income ratio of a foreign holding company for purpose of applying the CFC exemption rule

Under the Law for Coordination of International Tax Affairs (LCITA), where a Korean resident (together with related parties) owns, directly or indirectly, at least 10% of a foreign corporation resident in a low-tax jurisdiction, which is a related party under Korean tax law, the undistributed retained earnings of the foreign corporation are deemed to be paid to a Korean resident, subject to corporate income tax in Korea ('CFC rule'). However, according to Article 28(3) of the LCITA, the CFC rule shall not apply to a foreign holding company owning shares in certain qualified subsidiaries as at the end of each fiscal year if all of the conditions under the LCITA are met ('CFC exemption rule'). One of the conditions provides that the foreign holding company must maintain the income ratio at 90% or more, as calculated by the ratio of [A] (the total amount of interest income, dividend income, etc. received by the foreign holding company from its subsidiaries in the same region (specified in the LCITA) to [B] (the adjusted income amount of the foreign holding company after subtracting a certain amount of income as specified in the LCITA). In addition, one of the criteria for a qualified subsidiary is that the foreign holding company must have at least 40% of shares in such subsidiary as stipulated in the LCITA.

Where a foreign holding company has disposed of a subsidiary after having received the dividend income from the subsidiary, a question has been raised of whether the dividend income received from the disposed subsidiary could be included in the foreign holding company's income [A] in calculating the foreign holding company's income ratio for the purposes of applying the CFC exemption rule. Concerning this question, the MOEF replied that, if the foreign holding company does not own 40% or more of the shares in the subsidiary as at the end of a fiscal year due to the disposal of shares in the subsidiary, the dividend income received from the concerned subsidiary prior to the disposal of shares should not be included in its income [A] in calculating the above-mentioned income ratio. (*International Tax Division of the MOEF-45, 2022.1.26*)

The MOEF's ruling addresses that only the dividend income received from subsidiaries that are qualifying as at the end of each fiscal year can be included in the income [A] in calculating the income ratio for the CFC exemption rule. As the NTS has issued a similar interpretation regarding this issue, it may be considered along with the MOEF's recent ruling. *(Seomyeon-2021-Beopryeonghaeseokgukjo-5478, 2021. 11. 18.)*



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