The Second Early Release of Statistics on National Taxes for 2018

The National Tax Service (NTS) recently released a summary of 81 key items of national tax statistics ahead of the publication of its annual statistics book this December. This is the second of its kind after the first release of 79 items of national statistics last July. National tax statistics are disclosed at an early stage so that the public may use them more promptly even before the publication of the National Statistical Yearbook. Selected key points of the latest summary are provided below:

- The number of small and midsize enterprises (SMEs) which filed corporate income tax totaled 561,000 in 2017, an 8.4% increase from 2016. By industry, the manufacturing industry took the largest share of 25.4% of the total number of SMEs, followed by wholesale (22.7%) and services (18.1%). The number of SMEs in the services industry significantly increased in 2017, while it notably decreased in the construction and engineering industry.

- The number of companies which filed tax exemptions or reductions for start-up (or venture) small and midsize companies (SME) totaled 6,864 in 2017, a 6.6% increase from 2016. The total amount of tax exemptions or reductions filed increased by 15.7% to KRW151.6 billion in 2017 (with KRW22 million in the average amount of tax exemption or reduction per company).

- During 2017, the number of large corporations whose corporate income tax paid exceeded KRW100 billion totaled 3,668, a 4.7% increase from 3,502 in 2016. Among those, 2,439 companies or 66.5% of these companies were located in the metropolitan areas including Seoul, Inchon and Gyeonggi-do.
• The number of foreign-invested companies slightly increased to 8,517 in 2017. The number of Korean branches and representative offices of foreign corporations increased by 1.4% to 1,907 and by 2.6% to 1,736, respectively.

• By country, Japan (2,531 or 24.3%) and the US (1,938 or 18.6%) took 42.9% of the total number of foreign corporations and foreign-invested companies during 2017, followed by China (8.5%), Singapore (5.9%) and Hong Kong (5.7%). Among these top five countries, China (48.4%), Hong Kong (34.2%) and Singapore (26.4%) recorded a significant increase in 2017 in the number of foreign corporations and foreign-invested companies, compared with 2013, while Japan and the US showed declines during this period.

• By industry, the wholesale trade industry accounted for the largest share of 36.2% of the total number of foreign corporations and foreign-invested companies in 2017, followed by the services and the manufacturing industry. While the services industry showed a significant rise in the number the finance and insurance industries marked a notable downturn.

A Temporary Suspension of Tax Audit for Qualifying Companies to Encourage Job Creation

On November 6, 2018, the National Tax Service (NTS) announced that certain qualifying corporate and individual taxpayers would be excluded from selected targets for periodic tax audits of corporate or individual income taxes filed for 2017. This was announced as part of a series of the government’s measures to encourage job creation.

The eligible scope will include SMEs as prescribed in the Special Tax Treatment Control Law with taxable income of less than KRW100 billion in 2017 (KRW50 billion in case of companies affiliated with business conglomerates subject to restrictions on cross-shareholdings, companies with KRW200 billion or more in total assets, professional personal services companies and individuals). The determination of the SME status will be based on the fiscal year ending from January to December 2017. The existing rule for a three-year grace period applicable to those graduating from the SME status shall not apply for the purpose of exemption from periodic tax audits.

To be eligible for a temporary exclusion from selected targets for tax audits, companies must submit their plans to increase the number of full-time employees no later than November 30, 2018 and implement the plans in 2019 as suggested. The minimum requirement for new full-time employment includes a 2% or a 4% increase (and at least one new full-time employee) from 2018. The 2% requirement will apply to companies with less than KRW30 billion in taxable income in 2017 while 4% to those with taxable income ranging from KRW30 billion to less than KRW100 billion in 2017.
Cabinet Meeting Approves the Fully Revised Presidential Decree of the External Audit Act

A bill to revise all of the Presidential Decree of the Act on External Audit for Joint-stock Company, etc. ("External Audit Act") was approved in the cabinet meeting on October 23, 2018. The approval came one year after the proclamation of the revised External Audit Act on October 30, 2017. The revision to the Presidential Decree shall be effective immediately after the enforcement of the External Audit Act on November 1, 2018 unless otherwise specified. Provided below is a brief summary of the revised Presidential Decree of the Act.

Scope of Companies subject to Statutory Audit Requirements
(From fiscal years starting on or after November 1, 2019)

<table>
<thead>
<tr>
<th>Chusik Hoesa (i.e., Joint-stock Company)</th>
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<tr>
<td><strong>Before revision</strong></td>
<td><strong>After revision</strong></td>
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<td>Companies that meet the following criteria:</td>
<td>An exception shall be given to companies that satisfy three of the four criteria:</td>
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<td>i) KRW12 billion or more in total assets; or</td>
<td>i) less than KRW12 billion in total assets</td>
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<tr>
<td>ii) KRW7 billion or more in total assets and any of the followings:</td>
<td>ii) less than KRW10 billion in sales</td>
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<tr>
<td>- KRW7 billion or more in total liabilities;</td>
<td>iii) less than KRW7 billion in liabilities</td>
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<tr>
<td>or</td>
<td>iv) less than 100 employees</td>
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<td>- at least 300 employees</td>
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<th>Yuhan Hoesa (i.e., Limited Company)</th>
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<td>• In principle, an external audit shall be mandatory for all Yuhan Hoesa. An exception shall be given to companies which meet three of the five criteria, including the four criteria applying to Chusik Hoesa and one additional criterion of less than 50 members.</td>
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<td>• In case of a change from Chusik Hoesa to Yuhan Hoesa after the enforcement date of the Act (January 1, 2019), the same criteria for Chusik Hoesa shall be applicable for five years.</td>
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Large corporation:
An external audit shall be mandatory for all large corporations with KRW50 billion or more in total assets or sales.

Exception to the Auditor Designation Program

The six-plus-three year mandatory auditor designation scheme, where a company selects its statutory auditor through a competitive process for the first six years, and the Securities and Futures Commission (SFC) appoints it for the subsequent three years, will be mandatory for all listed companies as well as non-listed companies where corporate management is not separated from ownership. An exception will be given to the cases where a qualifying company applies for a review by an oversight body (i.e. SFC Commission under the Financial Services Commission),
and the review result shows there is not any violation. The qualification includes: unqualified opinions on a company’s internal control system for three consecutive years as a result of auditor’s audit (or review) and the commitment to appoint a new auditor for the three subsequent years following its designation of an external auditor through a competitive process for six years. Such a qualifying company must apply for the oversight body review one year before the date of the appointment of the auditor (the date of the initial designation is scheduled on November 14, 2019).

**Strengthened Role of the Audit Committee**

The audit committee’s roles and responsibilities will be strengthened. The committee will be required to document and maintain certain criteria and procedures for appointing auditors.

The criteria must include specific guidelines to assess the adequacy of audit time, audit professionals, audit fees, audit planning as well as the auditor’s independence and technical competency.

The procedural requirements will make it compulsory to hold face-to-face meetings to assess auditor candidates, and document meeting minutes including the number of such meetings, attendees and discussion results of each meeting.

The audit committee shall have the responsibility for monitoring and assessing the factors in relation to the performance of external auditors following the completion of annual audits. In other words, it shall assess whether the matters agreed upon at the time of appointment was fulfilled as planned and whether the auditor solicited unnecessary external advisory services to the company, etc. The audit committee’s assessment results will be utilized for the appointment of a future auditor.

**Rulings Update**

The time for the determination as to whether the denial of unfair transaction rules should apply to long-term related party loans

In October 2018, the Korean Supreme Court issued a ruling on the time for the determination as to whether the denial of unfair transaction rules should apply to a long-term loan transaction between Korean related parties. Under the Corporate Income Tax Law, the denial of unfair transaction rules may apply if a Korean company is considered to unreasonably reduce its tax burden via a transaction with its Korean related party. Under the denial of unfair transaction rules, among others, where a company borrows a loan at an interest rate higher than a market rate, the difference between the interest rate on the loan and the market rate would be treated as non-deductible interest expense for the corporate income tax purpose. Regarding this, in general, the market rate should be determined at an overdraft interest rate or the weighted average of interest rates on borrowings.
In the recent case, a Korean company borrowed loans from its shareholder in December 1999 with the 18-year maturity, and paid interest expenses on the loans at a rate of 13.06% per annum. In 2011, the tax authorities challenged that the interest rate of 13.06% on the loans during the period from 2009 to 2012 was higher than the market rate for the respective years (i.e., overdraft interest rates of 8.5% per annum for 2009–2001 and 8.6% per annum in 2012). The company filed an appeal against the tax authorities’ challenge, arguing that whether to apply the denial of unfair transaction rules should be determined based on relevant market rates at the time when the underlying activity was conducted (i.e., when the loan contract was executed).

This case addresses an issue of whether, in the case of long-term loans, whether to apply the denial of unfair transaction rules should be determined at the time when the loan contract was initially executed or but also at time when interest expenses on the loans were paid thereafter.

The earlier decision of the district court in favour of the taxpayer was overturned by the Seoul High Court in 2016, and further upheld by the Supreme Court in October 2018. The Supreme Court rendered a decision in favour of the tax authorities, ruling that in case of long-term loans, unless there were justifiable circumstances, whether to apply the denial of unfair transaction rules can be determined based not only on the time of the initial loan execution but also at the time when interest expenses were paid thereafter. The Supreme Court also decided that the company’s interest rate on the loans for the period from 2009 to 2012 was higher than the market interest rate such as overdraft rates, therefore, the rate could be regarded as unreasonable due to the lack of economic reasonableness in respect of normal social notion and commercial practices, and the denial of unfair transaction rules should apply in this case accordingly. (Daebop 2016du 39573, 2018. 10. 25.)

The Supreme Court’s decision provides implications that if an interest rate was agreed reasonably at a market rate at the time of initial loan execution, but the market rate such as overdraft rates changed thereafter, it might trigger an issue of the denial of unfair transaction rules unless there are justifiable circumstances. As such, it may be necessary to make reference to this decision in case long-term loan transactions are implemented between Korean related parties.

Whether the deemed acquisition tax liability would exist in case of the shareholder’s waiver of its voting rights on the shares acquired as part of the workout proceedings

Under the Local Tax Law, where an individual or a company becomes a controlling shareholder (i.e. a shareholder owning more than 50% of shares) by acquiring additional shares in a Korean company, in general, the controlling shareholder would be subject to a deemed acquisition tax on certain properties owned by the Korean company. In the recent case, there was a dispute over whether a deemed acquisition tax liability should exist in hands of a controlling shareholder who acquired additional shares from other shareholders who opposed to the company’s workout proceedings (‘additional shares in question’). In this case, subsequent to the acquisition of the additional shares, the controlling shareholder delegated the disposal rights of all of its shares to the company’s main creditor bank, and agreed on the waiver of its voting rights and the management right over the company.
In April 2018, the Seoul High Court ruled that the controlling shareholder in question should be subject to the deemed acquisition tax for the additional shares acquired since whether the deemed acquisition tax liability exists should be determined at the time of the acquisition of the additional shares, and it should not be affected by the fact that the shareholder gave up its voting rights after its acquisition of such additional shares.

However, in October 2018, the Supreme Court overturned the previous decision of the Seoul High Court, and ultimately ruled that, taking into account the facts that the controlling shareholder delegated the disposal rights of its shares to the creditor banks and waived its voting rights and management right over the company, and the company underwent the joint management of the creditor banks thereafter under the workout proceedings, it should be difficult to view that the controlling shareholder has increased substantially its management control over the company by the acquisition of the additional shares in question. In addition, the Supreme Court further decided that in light of the deemed acquisition taxation rules and substance over the form rules, it should be reasonable to determine whether there was, in substance, an increase in management control over the company based on all of the facts and circumstances before and after the share acquisition comprehensively (rather than solely based on the time of the additional share acquisition), and as such, the controlling shareholder in question should not be subject to the deemed acquisition tax for the additional shares acquired in this case. (Daebeop 2018du 44753, 2018. 10. 4.)

The Supreme Court decision indicates that in determining whether or not a shareholder would be liable for a deemed acquisition tax, it must consider the facts and circumstances not only at the point of acquiring shares but also all of the facts and circumstances before and after the acquisition of shares comprehensively. In this regard, it is advisable to consider this court decision in the event where there is a significant change in management controls over a company before and after the acquisition of shares by a controlling shareholder of the company.
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