

KOREA, REPUBLIC OF¹

Tax reforms conducted in 2007 are aimed at achieving two main goals of supporting sustainable and broad-based economic growth and enhancing competitiveness of the tax regime. Based on these goals, the government of the Republic of Korea has identified five areas which merit particular attention: supporting job creation through furthering economic vitality; supporting the mid-and low-income households; helping better identify hard-to-trace income; streamlining tax incentives to enhance tax neutrality; and rationalizing and advancing the tax system.

The gist of tax changes for the tax year 2007 is as follows:

1. Supporting job creation through furthering economic vitality

i) Several measures have been adopted to help keep momentum of economic recovery going. Firstly, the sunset date for the tax credits aimed at encouraging investment in facilities has been extended. To be more specific, both tax credit associated with investment in facilities for environment protection and safety (i.e. credit equivalent to 3% of value of investment made) and tax credit associated with investment in facilities for productivity improvement (i.e. credit equivalent to 3% (7% in the case of an SME) of investment value) have been extended for another three years through the end of 2009.

Secondly, special provisions to grant favorable holding tax treatment to land for business use by the service industry have been newly established. Under the new provisions, the value threshold for the Comprehensive Real Estate Holding Tax applicable to such land is 20 billion won and the excess over the 20 billion mark is subject to relatively low rate of 0.8%. Business eligible for this benefit includes amusement facility operation business, ski resort business, public golf course business, distribution center business, etc.

Thirdly, the scope of entertainment expense has been adjusted in favor of companies. Advertising expenses (e.g. expenses incurred for 45 manufacturing samples) to the extent of 30,000 won per annum per client and sales promotion fees paid to unrelated salespeople are not included in the scope of entertainment expense any more and, thus, are now fully deductible, which was not the case prior to the revision of the tax law.

Fourthly, the criteria used for determining applicability of the rule of denial of unfair transactions have been improved in a way that promotes business activities of companies. Previously, in case where the payment made between related parties differs from the market price, the rule applied no matter what. However, under the revised tax law, where the difference between the market price and the payment actually made is negligible (i.e., unless the difference is 5% or more of the market price or 300 million won or more), the rule does not apply, except for the case where the market price is obvious (e.g. listed shares).

Fifthly, the withholding tax rate applicable to interest income derived by non-resident individuals or foreign companies from bonds issued by the State, local authorities and domestic companies has

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been lowered from 25% to 14%, the same level applicable to resident individuals and Korean companies, with a particular aim of encouraging investment in bond markets by foreign investors.

ii) There have been some tax revisions to help expand growth potential. For starters, tax credits for encouraging investment in R&D have been increased or extended. For example, the expiration date of tax credit for investment in research and test facilities, job training facilities and facilities for commercializing new technology (i.e. the amount equivalent to 7% of investment is deductible against the individual income tax and the corporate tax) has been pushed back to December 31st, 2009 from December 31st, 2006.

Tax credit for research & human resources (HR) development has also been increased, and extended for another three years. Previously, the credit amounted to 40% of the excess of the research & HR development expense incurred by a large company for the tax year concerned over the average of such expense over the four years immediately preceding that year. From 2007, in the case of a large company, the tax credit equals the sum of 40% of the excess of expenses incurred for research & HR development conducted by the large company itself for the taxable year concerned over the average expense incurred for research & HR development conducted by the company itself over the four years immediately preceding that year and 50% of the excess of expenses incurred for commissioning SMEs or universities to conduct research & HR development on behalf of the large company for that taxable year over the four-year average expense incurred for commissioning 46 SMEs or universities to conduct research & HR development.

Moreover, the scope of deductible expenses incurred in association with education of preschoolers has been expanded to include the expense paid to sports facilities for preschooler's lesson purpose in order to reduce tax burdens of wage earners and support education of preschoolers.

In the meantime, with a view to encouraging childbirth and providing childcare support, eligibility and amount of extra allowance for income tax purposes have been changed. Prior to the revision of tax law, extra allowance was granted to an income earner who is not claiming any other dependents and to a single income earner with a single dependent eligible for basic allowance, and the amount of allowance was 1 million won and 500,000 won, respectively. Under the revised tax law, however, a resident with earned income or business income who has two or more dependent children eligible for basic allowance are eligible for extra allowance equivalent to 500,000 won plus additional 1 million won per child added to the first two children (e.g.. 2 children-500,000 won, 3 children-1.5 million won, 4 children-2.5 million won...).

iii) Measures for providing support for SMEs and venture companies have been developed. To begin with, in case of switch of a line of business by an SME which has been operating for 5 or more years, 50% of the income tax and the corporate tax are exempted in the year in which the new business generates income for the first time and in the subsequent 3 years. In addition, the expiration date for 50% exemption of the income tax and the corporate tax granted to start-up SMEs in the year during which the company generate income for the first time and in the following 3 years has been extended by another three years to December 31st, 2009.

2. Providing support for the mid- & low-income households

i) Most noticeable change is the introduction of the earned income tax credit (EITC) aimed at financially supporting the working poor and encouraging people to work. To be eligible for the new benefit, households with earned income from employment must have total annual income of less than 17 million won, two or more dependent children under age 18, own no house and value of total property held must be less than 100 million won. The EITC is expected to benefit around 310,000

households and to cost nearly 150 billion won. The credit will start to be paid from 2009 based on income earned in 2008.

ii) Other measures designed to reduce tax burdens of wage earners, the self employed, farmers/fishermen and the elderly have also been adopted. Conditions to be met to benefit from marriage and funeral expenses related deduction have been eased. Previously, only those wage earners who are aged 20 or younger or 60 or older were eligible for the deduction. But from 2007, the age requirement does not apply so that the benefit can reach more people than before.

Also, the amount of standard deduction granted to business owners who meet certain requirements such as registering as merchant of credit cards and issuer of cash-receipt and using a business account has been raised from 600,000 won to 1 million won, the same level applicable to wage earners. As for farmers and fishermen, the scope of machinery for agricultural and fishery purposes eligible for VAT refund has been expanded to include three more items for the former category and two more items for the latter category.

Besides, the scope of small size savings account of 30 million won or less, interest or dividend income from which is non-taxable, has been expanded as the age requirement applicable to women has been eased from 60 years or older to 55 years or older.

Meanwhile, in response to rapid population aging, new provisions have been established to make interest income from loan on reverse mortgage extended to the elderly aged 65 or older deductible against pension income to the extent of 2 million won per annum.

iii) With a view to stabilizing the real estate market, taxation on capital gains has been toughened. For example, non-taxation benefit for capital gains involving a newly-built housing has been scaled back. Previously, in case where an owner of two houses one of which is a newly built house transfers the other house, capital gains were non-taxable as the new house was deemed not to be held by the owner and there was no sunset clause for this benefit. After the revision of the tax law, however, this benefit is applicable only when such transfer takes place by the end of 2007.

3. Helping better identify hard-to-trace income

i) First of all, various measures have been adopted to enhance identification of income derived by professionals and self-employed businesses. For example, business owners doing transactions directly with consumers and having annual income of 24 million won or more (the income threshold does not apply to those who provide professional services) are now required to register as issuer of cash receipt. If the obligation is not fulfilled, the penalty is charged.

Moreover, from 2007, business owners providing professional services (e.g. lawyer, certified public accountant, doctor, dentist, etc.) are required to adopt the double-entry system of recording 48 transactions, regardless of the size of their income. Prior to the tax law revision, the income threshold of 75 million won applied.

Not only that, the tax law has been revised to prescribe that sole proprietors who are required to adopt the double-entry system and whose annual income reaches a certain level (i.e. 300 million won for retail/ wholesale business, 150 million won for manufacturing, restaurant, lodging business, and 75 million won for real estate rental, service business) should open a business account with bank and use the account for payment or receipt of personnel expense or rents or for transactions payment for which is made through financial institutions.

At the same time, the scope of deductible medical expense has been expanded to include medical expense paid for dependents for treatment at any medical institutions or for purchase of any medicine on or after December 1st of 2006 so that income derived by medical institutions can be better identified by the tax authorities and tax burden of wage earners can be alleviated. One thing to note is that this expanded scope will apply just for two years on a temporary basis.

Meanwhile, to be eligible for bounty for reporting tax evasion, the value concerned should now be at least 100 million won per case compared to 500 million won or more per case prior to the revision of the tax law.

ii) Efforts have been made to ensure that the small size self-employed do not suffer from increased tax burden as a result of the measures to better identify hard-to-trace income. For example, in case where the income of business owners who meet certain requirements such as using a business account and maintaining adequate books and records for the tax year concerned has increased by more than 120% year-on-year, any tax amount attributable to the excess of that year's income over 120% of the income of the previous year is now deductible against income tax, corporate tax and VAT. Previously, the way to calculate the amount deductible against such taxes was much more complicated and the tax credit was granted over the period of two years.

Similarly, the tax credit equivalent to the amount calculated by multiplying the tax amount estimated by the ratio of 50% of income 49 additionally identified as a result of the acceptance of credit cards, the issuance of cash-receipts and use of other means of similar nature for the taxable year concerned to the total income for that year has been extended for another two years through the end of 2008.

4. Streamlining non-taxation and tax reliefs so that tax neutrality can be ensured

Out of fifty five non-taxation and tax reduction/exemption benefits which were due to expire in 2006, thirty two benefits have been extended while the remainder were abolished or scaled back. Besides, six tax incentives with no expiration date have been scaled back or repealed. Most of the benefits which were extended are the ones aimed at encouraging R&D and facility investment associated with expansion of growth potential and reducing tax burden of wage earners, farmers, fishermen and SMEs. In determining whether to repeal or scale back a certain tax incentive, such factors as whether the objective of the benefit concerned has been fully achieved and whether the benefit is in line with international standards were taken into account.

5. Rationalizing and advancing the tax system

The proportion of deductible dividend income received by a holding company from its subsidiary will be increased in a phased manner from 2007 so that corporate transparency can be further enhanced and companies can be encouraged to change their corporate structure to a holding company. In other words, dividend income derived by a holding company from holding of more than 40% shares in a listed company will be deductible in full from 2009 (until the end of 2008, the proportion of 90% will be deductible), while in case where the holding company holds 30-40% shares in a listed company, 70% and 80% of dividend income derived there from will be deductible in 2007 and in 2008 and beyond, respectively.