



# Newsletter

October 2006

*This newsletter is prepared by Horwath Choongjung (Choongjung Accounting Corp.) and intended to provide foreign investors with an update on tax law changes in Korea and other related subjects of special interests to foreign investors. The information provided herein should not form the basis of any decision as to a particular course of action, nor should it be relied upon as a substitute for a detailed advice in individual cases.*

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*(You may find this newsletter and other items of interest at <http://www.horwath.co.kr>)*

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## News on International Taxation in Korea

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### **1. New Changes under the Revised Presidential Decree of the International Tax Coordination Law**

The Korean government enacted an amendment to the Presidential Decree of the International Tax Coordination Law (“ITCL-PD”). Such revisions generally became effective from August 24, 2006 unless otherwise indicated. The followings are the key aspects of the revisions.

- **Ease of report obligation for transfer pricing method chosen and the reason thereof**

According to the revised ITCL-PD, a company may omit submission of the “Report on Arm’s Length Price Determination Method” and “Summary Profit and Loss statement(s) of the Overseas Specially Related Parties” if the company meets the two conditions of: (i) transactions (including both sales and purchase transactions) with its overseas specially related parties (“OSRP”; defined) shall not exceed Won 5 billion and (ii) service transactions among the total transactions with its OSRP shall not exceed Won 500 million.

Previously, in accordance with the notice (No. 2005-1) from the National Tax Service (“NTS”), if the amounts in question are both less than Won 1 billion (for sales and purchase transaction) and Won 100 million (for service transactions), the company was exempt only from the obligation to submit the “Summary Profit and Loss statement(s) of the Overseas Specially Related Parties”.

- **New introduction of arm’s length standard for intra-group services**

The revised ITCL-PD sets forth a new arm’s length standard for intra-group services such as management advisory services, financial advisory services and training, legal and accounting services to reflect the OECD Transfer Pricing Guidelines. According to the ITCL-PD, all of the following conditions shall be met for expenses to be deductible for Korean tax purposes:

- (i) A service agreement shall be concluded in advance and intra-group services should be in fact provided in accordance with the service agreement;
- (ii) Expected benefits or cost savings should exist related to the intra-group services;
- (iii) The service charges shall be determined at arm’s length price acceptable to independent third parties in comparable circumstances; and
- (iv) Documentations supporting (i) through (iii) above should be prepared and maintained.

Formerly, the ITCL stipulated a similar standard in the Basic Rules (Article 4-0-2 of the Basic Rules of the ITCL).

## News on International Taxation in Korea, *Continued*

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- **Revision of the scope of specially related party**

The revised ITCL-PD limits the scope of the specially related party (defined). Formerly, in the case where there does not exist any common interests (defined) between trade parties, but one party can substantially determine the business policy of the other, the concerned parties were treated as specially related parties. However, according to the new ITCL-PD, the concerned parties without any common interests are no longer deemed as the specially related party. The revised provision is applicable to transactions commenced after May 24, 2006.

- **“Expected benefits” as standard for allocation of costs under cost sharing arrangement**

According to the revised ITCL-PD, the “expected benefits” which is a basis for allocation of costs incurred from co-development of an intangible asset between a domestic company and its OSRP shall be calculated considering potential reduction of costs and expenses, increase of sales, operating income, and the quantity used, produced or sold, which are expected to be realized after completion of the co-development of the intangible asset.

- **Berry Ratio accepted as allowable arm’s length transfer pricing method at second tier**

The ITCL sets a hierarchy in application of the arm’s length transfer pricing methodologies. The revised ITCL-PD added the Berry Ratio method in the second tier together with the profit split method and the transactional net margin method. Before the revision, the Berry Ratio method was in the third tier in its application. The first tier of the arm’s length transfer pricing methodologies are the comparable uncontrolled price method, the resale price method and the cost plus method.

## 2. **Third Meeting of the OECD Tax Administration Forum in Seoul**

The Third Forum on Tax Administration was held on September 14 and 15, 2006 in Seoul, under the auspices of the Organization for Economic Cooperation and Development (“OECD”) and hosted by the NTS. Twenty six (26) OECD members, the European Commission, nine (9) non-OECD members, and three (3) international organizations attended the forum. This year's meeting focused on the two topics of: (1) detecting, deterring and responding to international non-compliance; and (2) implementing administrative reform activities to meet modern day challenges in tax administration. At the end of the meeting, the participants adopted the “Seoul Declaration”.

The OECD Forum on Tax Administration is a commissioner level forum started in July 2002 under the Committee on Fiscal Affairs. The first meeting convened in Seville, Spain in January 2004 and the second conference was held in Dublin, Ireland in June 2005.

## **News on International Taxation in Korea,** *Continued*

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The Forum on Tax Administration was created with the aim of bringing together heads and senior officials of tax administrations to collaborate in developing solutions to common taxation issues surfacing in the rapidly changing global environment and chart future policy directions.

## Proposed Tax Law Changes for 2007

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The Ministry of Finance and Economy announced a series of tax reform proposals in August, which will mostly become effective on January 1, 2007. Provided below is a summary of important provisions of the proposals.

### 1. Withholding Rate on Interest Income of Non-resident Investors Lowered

The withholding tax rate on interest income of non-residents including foreign corporations from bonds will be lowered to 14 % from 25%, which is the same rate applied to Korean resident investors.

### 2. Documentation Requirement Tightened on Company Expenditure

Under the proposals, each expenditure over Won 10,000 will be required supporting documents such as VAT statements, credit card receipts, etc. The present documentation threshold is Won 50,000. A penalty tax on failure to comply with the documentation requirement will be imposed at 2% of the total amount of undocumented expenditures.

### 3. Extended Advance Notice Period for Tax Audit

Under the proposals, the advance notice for a tax audit must be given ten (10) days before commencement of the planned audit. The present tax law requires tax authorities to notify a taxpayer of tax audit schedules seven (7) days before the actual tax audit starts. If the taxpayer requests for postponing the tax audit for the reasons prescribed in the relevant tax law, the tax authorities must notify the taxpayer of their decision on whether the request is accepted or not. Without the notification, the tax audit may not be commenced.

### 4. A Common Tax Registration Number for Head Office and its Branches to be used

The present Value-Added Tax (“VAT”) Law requires each independent business unit to be registered with the district tax office that has jurisdiction over the business unit and the VAT statements to be issued by each registered business unit. Under the proposals, however, a head office and its branches will be able to issue their VAT statements with one (identical) tax registration number if certain conditions prescribed in the VAT Law are met.

## Bilateral Tax Treaty Development

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### 1. New Tax Treaty entered into with Algeria

The Tax Convention signed by Algeria and Korea on November 24, 2001 came into force on August 31, 2006. However, the articles on taxes withheld at source such as interest, dividends, etc. will apply to payments made on or after January 1, 2007, and the articles on other taxes will apply from taxable years beginning on or after January 1, 2007.

Under the Convention, withholding taxes shall not exceed 5% of dividends in the case where the beneficial owner is a company which holds directly at least 25 percent of the capital of the company paying the dividends (15% for all other cases), 10% of interest and 2% of royalties paid for the use of, or the right to use, industrial, commercial, or scientific equipment (10% for all other cases), respectively.

## New Tax Rulings

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### 1. Disallowed Stock Option Related Expenses of a Foreign Branch Office in Korea

According to the ruling of the NTS (*Seomyon 2team-1327, 2006.7.12*), in the case where a foreign (non-Korean) corporation granted stock options to the employees of its Korean branch and then the expenses incurred at exercise of those stock options were charged back to its branch, those expenses shall not be deductible for the corporate tax purposes. Apart from the deductibility, gains earned from exercising the stock options shall be considered as a Class B earned income of the employees concerned.

### 2. Fiscal Year of a Foreign Branch Office in Korea at Comprehensive Business Transfer

Where a Korean branch of a foreign (non-Korean) company closes its branch office during the fiscal year, the period from the first day of the fiscal year until the date on which it does not have the office shall be deemed to be one fiscal year of the branch (*Article 8(4) of the Corporation Tax Law*).

On the other hand, in the case where a Korean branch of a foreign company transfers its business comprehensively, the completion date of substantial transfer such as assets, employees and business of a branch is considered as a date the foreign company does not have its office in Korea (“closing date”) when counting the final fiscal year. Accordingly, income derived from the disposal of assets, etc. by the closing date should be included as taxable income in the final tax return, meanwhile taxes on the income incurred after closing date such as an interest income from bank deposit, shall be withheld at source of payment and there will be no additional tax filing obligations on it (*Seomyon 2 team –1389, 2006.7.25*).

## Proposed Commercial Code Changes

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### 1. Proposed Changes to the Commercial Code to Improve the Corporate Governance, etc.

Recently, the Ministry of Justice proposed changes to the Commercial Code, aiming not only to improve the corporate governance, but also systemize management methods and simplify related procedures. The bills for the revision will be presented at the National Assembly session of this fall.

One of the most noticeable features of the draft revision is a clause allowing a double derivative lawsuit, under which stakeholders at parent companies may file a lawsuit against affiliate companies, listed or not listed, that are suspected of fraud, etc.

Companies may also choose the executives system, which would allow executives to have the legal rights and duties similar to those of board of directors by registration at court. Under this system, a company should establish a structure with the representative executive and the board of directors, instead of current structure with the representative director and the board of directors.

Other changes include allowing the start-up companies to begin business with capital under 50 million Won, which eliminates the minimum requirement of capital for establishment of a corporation (Chu-sik Hoe-sa) in Korea. Presently, a start-up company is required to inject Won 50 million as a minimum paid-in capital.

## Horwath Choongjung News

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### 1. Horwath Choongjung Financial Service Inc. Established

The partners of Horwath Choongjung have established Horwath Choongjung Financial Service Inc. (“HCFS”) together with other reputable financial professionals in order to provide corporate finance and M&A related consulting services.

After established in July 2006, HCFS had a warming up period for commencement of its business and finally opened its new office next to Horwath Choongjung Accounting Corp. and Horwath Choongjung Consulting Corp. in of the KCCI building in Namdaemun, Seoul on September 1, 2006.

By establishing the HCFS, Horwath Choongjung is ready to provide a total service for financial consulting in respect to corporate finance, M&A, IPO, foreign investment, real estate, capital operation, etc. based on the firm’s domestic and international networks.

### 2. Appointment of Horwath Choongjung Consulting Corp. as an Appraisal Institute for Customer Satisfaction Awards

Horwath Choongjung Consulting Corp. (“HCCC”) has been appointed as an appraisal institute for the “Customer Satisfaction Awards in 2007” sponsored by The Korea Economic Daily. For the project, HCCC has developed a standard model for appraisal called “H-CS+” and will select the candidates according to “H-CS+” model and recommend them for the awards to The Korea Economic Daily. This award program is expected to be a guideline for a company’s innovation in management, and is intended to circulate successful examples in customer satisfaction and eventually to build the foundations for competing with the world-class companies. The appraisals will be performed starting from October through December 2006 and the award ceremony will be held on January 10, 2007.

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