Part 1: Introduction

Chapter 1: Tax System in Korea

1. Taxes in Korea

Taxes in Korea comprise national and local taxes. National taxes are divided into internal taxes, customs duties, and three earmarked taxes; the local taxes include province taxes and city & county taxes as shown below.

National Taxes
   Internal Taxes
      Direct Taxes
         Income Tax
         Corporation Tax
         Inheritance Tax
         Gift Tax
         Comprehensive real estate holding tax
      Indirect Taxes
         Value-added Tax
         Special Excise Tax
         Liquor Tax
         Stamp Tax
         Securities Transaction Tax
   Customs Duties
   Earmarked Taxes
      Transportation Tax
      Education Tax
      Special Tax for Rural Development

Local Taxes
   Province Taxes
      Ordinary Taxes
         Acquisition Tax
         Registration Tax
         Leisure Tax
         License Tax
Earmarked Taxes
- Community Facility Tax
- Regional Development Tax
- Local Education Tax

City & County Taxes
Ordinary Taxes
- Inhabitant Tax
- Property Tax
- Automobile Tax
- Agricultural Income Tax
- Butchery Tax
- Tobacco Consumption Tax
- Motor Fuel Tax

Earmarked Taxes
- Urban Planning Tax
- Business Place Tax

The national internal taxes consist of direct and indirect taxes, and each consists of five internal taxes. Of these ten taxes, the Income Tax, Corporation Tax, and Value Added Tax make up the bulk of the Korean tax revenue. There also exist three national earmarked taxes, the Transportation Tax, Education Tax, and Special Tax for Rural Development; the revenues from these sources go directly to pre-designated government programs.

There are sixteen local taxes, and they are divided into province and city & county taxes. At the province level, there are four ordinary taxes and three earmarked taxes. At the city & county level, there are seven ordinary taxes and two earmarked taxes. In the six large specially designated cities that are run as autonomous local administrative units (independent of the provinces they appertain to), the tax composition is slightly different from that of the provinces and cities or counties, although the residents are required to pay the same taxes.

A person is either a resident or a non-resident of Korea depending on residence or domicile. A resident is liable to income tax on items of income derived from sources both within and outside Korea. On the other hand, a non-resident is liable to income tax only on items of income derived from sources within Korea.

Under the income tax law, income earned by both residents and non-residents is subject to global and schedular taxation. Under global taxation, real estate rental income, business income, earned income, temporary property income, and miscellaneous income attributed to a resident are aggregated and taxed progressively. Interest and dividends are subject to tax withholding. Non-residents are similarly taxed on income from Korean sources. The tax rates on individual income range from 9% to 36%.
When a company is incorporated in Korea, it is deemed a domestic corporation and is liable to tax from worldwide income whereas a foreign corporation is liable to tax on Korean source income. The corporate income tax rates are 15% and 27%. A foreign corporation without a permanent establishment in Korea is subject to withholding tax.

2. Tax Laws and Regulations

A Presidential Decree may be set in order to enforce the tax laws. The Minister of Finance and Economy also enacts Ministerial Decrees to enforce the Presidential Decree, to make rulings and authoritative interpretations of the laws, and to enforce the decrees. In addition to the Presidential and Ministerial Decrees, the Commissioner of the National Tax Service may issue administrative orders and rules to ensure the consistent application of the laws. The courts of justice have the final authority in interpreting the tax laws, and the rulings and interpretations by tax authorities do not bind. Laws of national taxes are shown in the table below.

The Constitution also provides for the principle of local autonomy. Under this principle, local governments are given the right to assess and collect local taxes. The Local Tax Law, the Presidential Enforcement Decree on Local Tax Law, and the Ministerial Enforcement Decree on Local Tax Law are enacted under the Constitution.

**Laws of National Taxes**

<table>
<thead>
<tr>
<th>Classification</th>
<th>Law</th>
<th>Presidential Decree</th>
<th>Ministerial Decree</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct Taxes</td>
<td></td>
<td></td>
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<tr>
<td>Income Tax</td>
<td>Income Tax Law</td>
<td>Enforcement Decree on Income Tax Law</td>
<td>Enforcement Decree on Income Tax Law</td>
</tr>
<tr>
<td>Corporation Tax</td>
<td>Corporation Tax Law</td>
<td>Enforcement Decree on Corporation Tax Law</td>
<td>Enforcement Decree on Corporation Tax Law</td>
</tr>
<tr>
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<td>Inheritance Tax Law</td>
<td>Enforcement Decree on Inheritance Tax Law</td>
<td>Enforcement Decree on Inheritance Tax Law</td>
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<td>Tax Type</td>
<td>Law Name</td>
<td>Enforcement Decree on</td>
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<td>Comprehensive Real Estate Holding Tax Law</td>
<td>Enforcement Decree on Comprehensive Real Estate Holding Tax Law</td>
<td>Enforcement Decree on Comprehensive Real Estate Holding Tax Law</td>
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<tr>
<td><strong>Indirect Taxes</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Value-Added Tax</td>
<td>Value-Added Tax Law</td>
<td>Enforcement Decree on Value-Added Tax Law</td>
<td>Enforcement Decree on Value-Added Tax Law</td>
</tr>
<tr>
<td>Special Excise Tax</td>
<td>Special Excise Tax Law</td>
<td>Enforcement Decree on Special Excise Tax Law</td>
<td>Enforcement Decree on Special Excise Tax Law</td>
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<tr>
<td>Liquor Tax</td>
<td>Liquor Tax Law</td>
<td>Enforcement Decree on Liquor Tax Law</td>
<td>Enforcement Decree on Liquor Tax Law</td>
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<td>Stamp Tax Law</td>
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<td>Enforcement Decree on Stamp Tax Law</td>
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<td>Enforcement Decree on Securities Transaction Tax Law</td>
<td>Enforcement Decree on Securities Transaction Tax Law</td>
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<td>Transportation Tax Law</td>
<td>Enforcement Decree on Transportation Tax Law</td>
<td>Enforcement Decree on Transportation Tax Law</td>
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<td><strong>Earmarked Tax</strong></td>
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<td></td>
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<tr>
<td>Education Tax</td>
<td>Education Tax Law</td>
<td>Enforcement Decree on Education Tax Law</td>
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<td>Special Tax for Rural Development</td>
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<td>Enforcement Decree on Special Tax Law for Rural Development</td>
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<td><strong>Others</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
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<td>Basic Rules and Tax Appeal</td>
<td>Basic Law for National Taxes</td>
<td>Enforcement Decree on Basic Law for National Taxes</td>
<td>Enforcement Decree on Basic Law for National Taxes</td>
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<td>Enforcement Decree on National Tax Collection Law</td>
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3. Tax Administration

The Office of Tax and Customs at the Ministry of Finance and Economy is responsible for planning tax policies and drafting tax laws, while the National Tax Service carries out the administration enforcement, which includes tax assessment and collection.

a. Office of Tax and Customs, Ministry of Finance and Economy

The Office of Tax & Customs plans and coordinates overall national tax and customs policies. It is headed by the Deputy Minister for Tax and Customs, assisted by three Directors-General and eleven Division Directors (seven for internal taxes, three for customs and duties and task force for office of real estate policy). The Divisions include Tax Policy, Tax Expenditure, Income, Corporation, Property, Consumption, and International Tax. The functions of each division except three divisions for customs and duties are below.
(1) Tax Policy Division
- Plans tax policy in general
- Estimates tax revenue and analyzes actual tax revenue
- Drafts the Basic Law for National Taxes and National Tax Collection Law

(2) Tax Expenditure Division
- Plans, drafts, and interprets laws, including Special Tax Treatment Control Law, Education Tax Law, and Special Tax Law for Rural Development
- Estimates and analyzes tax exemptions and reductions
- Does research on the internal tax systems

(3) Income Tax Division
- Plans, drafts, and interprets laws concerning individual income tax and other related internal taxes excluding matters dealt by the International Tax Division

(4) Corporation Tax Division
- Plans, drafts, and interprets laws concerning corporation tax and other related internal taxes excluding matters dealt by the International Tax Division

(5) Property Tax Division
- Plans, drafts, and interprets laws and provisions of the Income Tax Law concerning capital gains tax and those of the corporation Tax Law concerning additional tax on capital gains
- Plans, drafts, and interprets laws concerning inheritance tax, gift tax and securities transaction tax

(6) Consumption Tax Division
- Plans, drafts, and interprets laws concerning the value added tax, special excise tax, liquor tax, telephone tax, stamp tax, and transportation tax
(7) International Tax Division
- Researches, plans, drafts, and interprets tax treaties with foreign countries
- Researches, plans, drafts, and interprets laws concerning taxation on income of non-residents and foreign corporations
- Promotes international cooperation in the tax area
- Researches foreign tax systems

(8) Office of Real Estate Policy
- Support real estate conference of National Economy Advisory Council, which coordinates, reconciles real estate policies produced by each division.

b. National Tax Tribunal
The National Tax Tribunal was established as an independent organization under the former Ministry of Finance on April 1, 1975. It is now composed of a General Affairs Division, a Supreme Judge, 3 Judges, and 10 Examiners. It is responsible for examining and judging tax appellate cases.

c. National Tax Service
The National Tax Service was established as an external organization for the Ministry of Finance on March 3, 1966, taking over the Taxation Bureau of the Ministry of Finance. It is mainly in charge of the assessment and collection of internal taxes. Headed by the Commissioner, it is responsible for establishing basic policies; and it supports tax administration by directing, supervising, and controlling the Regional, District, and Branch Tax Offices. The National Tax Service consists of a Planning and Management Controller, a Data Management Controller, an Inspector, eight bureaus, three affiliated organizations, six Regional Tax Offices, 104 District Tax Offices, and 17 Branch Offices.

(1) Internal Organization
i) The Planning and Management Controller is responsible for policy formulation, planning, budgeting, and the management of tax administration in general.
ii) The Electronic Data Management Controller is in charge of managing
and developing data using a computer system located in the main Electronic Data Processing System (EDPS) center in Seoul and three regional EDPS branches.

iii) The International Tax Controller is responsible for collecting and giving out international-tax related information, dealing with cross-border tax issues.

iv) The Taxpayer Service Bureau has four divisions: Tax Collection Division, Taxpayer Advocate Division, and Public Relations Division. The Tax Collection Division covers revenue forecasting, controlling the collection of national taxes, refunds of overpaid taxes, and the management of delinquent taxpayers. The Taxpayer Advocate Division covers tax appellate review and handles civil applications whereas the Public Relations Division covers publicity planning and coordination.

v) The Legal Affairs & Appeals Bureau consists of four divisions: Legal Affairs Division, Tax Appeals Divisions I, II, and III.

vi) The Individual Taxation Bureau is composed of Value Added Tax Division, Individual Income Tax Division, and Property Related Tax Division. The Corporation Taxation Bureau is made up of the following: Corporation Tax Division, Excise Tax Division, and International Operation Division.

vii) The Corporate Investigation Bureau includes the Investigation Divisions I, II and the Corporate Affairs Division. The First Investigation Division is in charge of policy-making, planning, analyzing, and the evaluation of tax intelligence and investigation programs. The Second Investigation Division covers the collection, analysis, and management of intelligence and information related to internal tax evasion. The Corporate Affairs Division is in charge of tax investigations of large corporations and their income sources.

(2) Affiliated Organizations

i) The National Tax Officials Training Institute, an independent organization, undertakes the training of national tax officials.

ii) The Technical Service Institute performs technical analysis of taxable articles such as liquor and chemical products.

iii) The National Tax Consulting Center handles various complaints and queries raised by taxpayers and offers advice and answers over the phone.
(3) Regional Tax Office, National Tax Service

Under the supervision of the National Tax Service, the Regional Tax Office is responsible for the direct guidance and control over the activities of the District Tax Offices. In addition, a Regional Tax Office directly handles the assessment of special-case taxes on certain taxpayers. There are six Regional Tax Offices nationwide, located in the cities of Seoul, Suwon, Daejeon, Gwangju, Daegu, and Busan.

A Regional Tax Office has five bureaus: Collection Support Bureau, Revenue Control Bureau, Investigation Bureaus I, II & III.

The Collection Support Division is in charge of tax collection, review of appellate applications and electronic management. The Revenue Control Division consists of Individual Tax Division, Corporation Tax Division. The Investigation Bureaus I, II & III consists of several divisions such as Investigation Management Division and Special Investigations Divisions.

(4) District Tax Office

A District Tax Office is the front-line organization responsible for the assessment, collection, audit, and investigation of all internal taxes. In general, a District Tax Office consists of the Collection Support Division, Revenue Control Division, Investigation Division I, II & III. However, organization of the individual District Tax Offices varies according to the respective scale of the districts they govern.

- The Collection Support Division is in charge of personnel administration, accounting, collection, review of appellate applications against unfair taxation, tax consultation, and general affairs.

- The Revenue Control Division consists of Individual Tax Division, Corporation Tax Division. The Investigation Bureaus I, II & III consists of several divisions such as Investigation Management Division and Special Investigations Divisions.

4. A Brief History of Taxation in Korea

A modern tax system was introduced after the formation of the Government of the Republic of Korea in 1948, after which the Tax Law Committee was established to supplement modern tax laws.

Eight fundamental tax acts such as the Income Tax Act, Corporation Tax Act, and Liquor Tax Act were enacted in 1948. Later the Inheritance Tax Act, Travel Tax Act, Commodity Tax Act, and six more were added. The new tax system reduced the tax burden imposed on landowners, whose asset value was decreased by the Land Reform.
The Korean War (1950-1953) necessitated a change in the tax system. The Land Tax Act and the Temporary Tax Revenue Expansion Act were immediately introduced, and several existing tax acts such as the Income Tax Act were revised in order to provide for the additional revenue required to finance the war. In 1951, the Special Measure for Taxation and Temporary Land Income Tax Act was enacted, resulting in higher success in collection, and the Act contributed to the strengthening of the tax system. Thus, the land income tax replaced the general income tax as the main source of tax revenue.

Upon signing of the armistice in 1953, the government began to modify the tax system to better accommodate the economic needs during the period of peace. Such efforts led to the Report and Recommendation for the Korean Tax System by H. P. Wald, published on August 25, 1953.

a. Postwar reconstruction (1954-1961)

The Special Measure for Taxation and the Temporary Tax Revenue Expansion Act were abolished with considerable influence from Wald's Report on subsequent reforms of the tax system. The Textile Tax was absorbed into the Commodity Tax and the License Tax was transferred to the local authorities from the central government. The Income Tax System was divided into schedular taxes with flat rates and global taxes with progressive rates.

As for direct taxes, the short-term payment system, which was based on only the actual business results, was converted into a long-term payment system based on both prior estimation and the actual results. The Liquor Tax was raised substantially to increase the tax revenue. However, due to the difficulties in enforcement, several taxes including the Income Tax and the Liquor Tax were modified before the changes took effect, and resulted in lower revenue than originally planned.

In 1956, the rates on direct taxes were reduced and indirect tax rates were raised in order to alleviate the disincentive effect of high direct taxes on capital accumulation. The Asset Revaluation Tax, Foreign Exchange Special Tax, and Education Tax were introduced in 1958; the first two were abolished later. The Liberal Party initiated a tax reform for the Three-Year Economic Development Plan in 1959 upon the recommendation of a tax consultant group headed by Dr. Hall. As a result, most tax rates were reduced and the tax administration was streamlined. In general, the direct tax rates were reduced but the indirect tax rates were increased due to the tax reform, which was initiated by the Democratic Party in 1960. In addition, tax exemptions and deductions designed to promote exports and capital accumulation were increased substantially.

In order to collect delinquent taxes that were accumulating, the Military Government enacted the Temporary Measure for Tax Collection and the Special
Measure for Tax Evasion Punishment. The government reformed the Income, Corporation, and Business Tax Acts, and a new tax accounting system was established.

b. The period of economic development (1962-1967)

At the end of 1961, the government implemented a general tax reform to emphasize the elimination of irregularities within the tax administration. The reform set the foundation for a lasting and modern tax system, and provided strong support for the First Five-Year Economic Development Plan. The basic guidelines of this reform were to simplify tax administration, to promote efficient revenue collection as well as private savings and investment, and to establish an equitable tax system.

In December 1961, improvements were made in the following: Income Tax Act, Corporation Tax Act, Business Tax Act, Registration Tax Act, Travel Tax Act, Liquor Tax Act, Petroleum Products Tax Act, Admission Tax Act, Stamp Tax Act, Commodity Tax Act, National Tax Collection Law, Tax Evasion Punishment Law, Tax Evasion Punishment Law, and Tax Evasion Punishment Procedure Law. In the following year, the Adjustment Law for National and Local Tax and the National Tax Appellate Application Law were introduced. This reform established many features of the present Korean tax system. It resulted in a large increase in revenue and enabled the government to provide more public goods and services.

c. The period of sustained economic growth (1968-1973)

(1) In 1967, another tax reform took place to reflect the progress made in the country's economic growth during the First Five-Year Economic Development Plan. Twelve of the nineteen existing tax laws were modified extensively and the Real Estate Speculation Control Tax Law was implemented. The guiding principles were the promotion of further economic development, tax equity, and rationalization of tax administration. The reform also focused on the need for a more systematic approach to tax laws.

For corporations with outstanding shares, the tax rate was reduced with an objective of mobilizing domestic capital. Tax exemption applied to dividends and interest income from bank deposits, but the rate on interest income from private lending was increased. To encourage development of strategic industries, an investment credit system was adopted and the scope of the special depreciation allowance system was enlarged. To restrict consumption levels, the Liquor Tax was modified to an ad valorem tax and the number of items subject to Commodity Tax was increased. A special Real Estate Speculation Control Tax was introduced to discourage unproductive use of private capital.
To reduce the tax burden of low-income earners, the limit on exemptions was eased and tax credits for businesses and wage or salary earners were also instituted. At the same time, the tax burden on high-income earners (those with an annual income of more than 5 million won) was increased with the adoption of a global tax system with progressive rates.

In 1968, as a step toward a self-assessment system, field auditing of corporations with outstanding shares was abolished, tax penalties were raised, and tax credits for voluntary returns and payments were increased. The prompt refund of overpaid national taxes, supplementation of the tax deferral system, and improvement in the tax appeal system strengthened the rights of the taxpayers. This was a modification for effective enforcement of the revisions made to the tax laws in 1967.

In 1969, six tax laws including the Corporation Tax Law were revised in order to strengthen the practice of voluntary submission of returns and payments, to incorporate the green return system into law, and to establish the principle of assessment based only on objective evidence.

(2) In 1972, the Emergency Decree on Economic Stabilization and Growth (the so-called “August 3 Special Measure”) was introduced, which required business enterprises to report all of their debts and to repay them over a five-year period after a grace period of three years. Some provisions on special tax exemptions and special depreciation of up to 80% were made for strategic industries. In addition, a special tax credit equivalent to 10% of the investment amount was provided for new investments until December 31, 1974.

d. A period of economic downturn and growth (1974-1979)

(1) Korea achieved rapid economic growth during the period of the First and Second Five-Year Economic Development Plans. However, with its heavy dependence on international trade and imports of energy and other raw materials, the economy was inevitably affected by the volatile external economic developments of the 1970s. The price increases in 1973 and 1974 of raw materials, particularly petroleum, and related effects on the economies of industrialized countries led to a significant economic downturn. Although this was rapidly overcome, the global inflation that prevailed during the 1970s had an adverse impact in Korea. Throughout this period, fiscal measures were often undertaken for the specific purpose of counterbalancing the difficulties created by the external developments. In particular, a number of temporary fiscal measures (to stay in effect for up to one year) were adopted in the "Presidential Emergency Measure for Stabilization of National Life” in January of 1974.

Income definitions and tax allowances were regularly revised to reduce the
tax burden on medium and low-income earners, which had increased as a result of inflation. At the same time, changes in corporation tax incentives reflected the government's support for heavy industries and chemical industries. Measures were adopted to promote investment by small and medium-sized businesses in overseas resource development and in the infant stock market.

(2) In December 1974, the government undertook comprehensive reform measures of the tax system primarily to improve income distribution. The major features of the reform were as follows.

A full-scale global income tax system replaced the earlier schedular and global income tax system. To reduce the tax burden on low-income earners, generous personal exemptions were also allowed. A new rate structure reduced the tax burden on low-income earners, but the burden increased for those in high-income brackets. A new capital gains tax was also introduced to replace the Real Estate Speculation Control Tax that had been in effect since 1968.

The upward adjustment of taxable income classes and a downward adjustment of the rates applied to non-profit corporations rationalized the tax structure. This was done in order to reduce the tax burden on small and medium-sized enterprises (SMEs), to enhance the consistency of the global income tax rate structure, and to reduce the tax burden on non-profit corporations.

The scope of the tax exemption scheme was restricted to support major and strategic industries such as shipbuilding and heavy machinery. Taxpayers were given a choice of only one of three kinds of tax incentives: direct exemption, investment credit, or special depreciation. As a preliminary step toward the possible introduction of a value added tax, business tax rates were raised by 0.5% to 1% and were combined into six flat rates. Also, withholding taxes were extended to all manufacturers and wholesalers, and the reporting system was reinforced.

The Basic Law for National Taxes was enacted to clarify the legal basis of taxing power and liability to national taxes, to promote fair tax administration, and to protect the taxpayers' rights. The law included provisions for the prohibition of retroactive taxation, the principles of trust and honesty, and assessment based on bookkeeping, and other objective evidence. Under this law, the National Tax Tribunal was established as a special independent agency.

The Excess Profit Tax, temporarily introduced by the Presidential Measures in January 1974, was extended beyond its original duration of one year. The tax base and rate were left unaltered.

(3) In July 1975, the Defense Tax Law was enacted to secure adequate
funding for national defense. Under this law, most taxpayers of internal direct and indirect taxes, customs duties, and local taxes, as well as advertising sponsors were subject to the defense tax ranging from 0.2% to 30% based on the relevant tax amounts, import prices, telephone charges, or advertisement rates.

The defense tax was a temporary national tax and was originally planned to stay in effect for 5 years until 1980. However, it has been extended twice until it was finally abolished in December 31, 1990.

(4) In December 1976, the government carried out a large-scale tax reform and introduced the Value Added Tax (VAT) and the Special Excise Tax. Eighteen new tax laws also were enacted or amended under the reform. This tax reform was mainly aimed at stabilizing national life, meeting fiscal requirements for the "Fourth Economic Development Plan," and further modernizing the tax system.

The 1976 amendments to the internal tax laws generally went into effect in January of 1977, except for the Value Added Tax Law and the Special Excise Tax Law, both of which went into effect on July 1, 1977.

The traditional indirect tax system, which included a cascade type business tax, was replaced by a system mainly consisting of a consumption-type VAT and a supplementary special excise tax. This was devised primarily to simplify tax administration and to promote exports and capital investment. A single, flexible rate of 13% was applied to all items subject to the VAT. Significant contributions to the development of the new excise tax law based on the self-compliance system were made by the proposals put forth by J. C. Duigman, Dr. C. S. Shoup, and Professor A. A. Tait.

Entertainment and food tax, previously a local tax item, was incorporated into the national tax system. The registration tax, formerly a national tax, was converted into a local tax starting January 1, 1977.

(5) The basic directions of the 1977 and 1978 tax reforms included: 1) reduction of tax burden for wage and salary earners and the middle income class, 2) support for small and medium-sized business enterprises, and 3) supplementary measures to make up for the deficiencies in the VAT and the special excise tax.

In the tax reform of 1979, the basic objectives were the improvement in the structure of income tax and inheritance tax rates, the expansion of revenue sources for national defense, and the provision of a number of incentives for investment in the local equity market.
e. The period of recession, recovery, stabilization and liberalization (1980-1989)

Dramatic decline in GNP and high inflation in Korea was caused by another round of major petroleum price increases and the recession in the industrialized economies, not to mention the sluggish domestic economy and a poor harvest in 1980. This was offset in 1981 and 1982, although the growth was moderately volatile. Despite the fact that the government was able to successfully stabilize prices, it was apparent that economic development of Korea had reached a stage where the need for direct state intervention in the economy was not crucial, but the need for gradual liberalization of the domestic market was urgent. The government strongly emphasized welfare development, as reflected in the changes made to the existing taxes and fiscal provisions, such as reductions in tax incentives for some essential industries.

The Education Tax was introduced as an earmarked tax on December 5, 1981 and went into effect on January 1, 1982 to secure sufficient funding for improvement of the public educational system. The education tax was a temporary national tax to be levied for five years until December 31, 1986, but was extended to December 31, 1991. Upon the revision of the Education Tax Law, the Education Tax became a permanent national tax on January 1, 1991.

In light of the global economic downturn in the early 1980s, another tax law revision was made in 1982. Beginning in 1980, the world economy suffered from low growth despite increasing world trade and decreasing unemployment. Korea had been experiencing such problems since 1979 with a sharp decline in industrial output, employment, export, and market competitiveness. The most imperative task for the economy was to recover from the recession and rekindle growth in the 1980s. Fortunately, stable prices and a favorable balance of payments position gave the government greater flexibility in economic and tax policy formulation.

The tax laws were revised in the following directions.

1. In order to protect the economy from a long-term depression, corporation tax and income tax were lowered and the taxation of presumptive dividends was eased as an incentive for business enterprises to improve their financial positions as well as their structures.

2. In order to implement the real-name financial transaction system and to prepare for the global taxation of income from financial assets, such income became separately subject to higher taxation. In addition, financial assets not previously taxed were to be taxed under a new law. A number of existing laws and regulations (e.g., the Secrecy Law for Deposits) were also modified to allow the tax authority to conduct thorough investigations of financial assets for tax purposes.

3. The categories of preferential tax exemption for specific industries were reduced once again despite the lower corporation and income tax rates. As a
result, tax neutrality was further improved by adopting the principle of low tax rates and limited exemptions.

4. Tax credits were enlarged in order to reduce the burden on the low-income group without reducing the number of income tax payers. The revisions of tax laws in 1984, 1985, 1986, and 1987 reflected the government's intention to emphasize the recovery of growth potential to fuel a new round of economic and social development by means of improving income distribution and implementing social welfare programs.

The main revisions are as follows.

1. **Tax regime inducive to technology development**
   - Investment credit, additional depreciation, and reserves for technological development were permitted for assets related to new technology.

2. **Assessment of the value added tax**
   - The Enforcement Decree and Regulation of the VAT Law were amended to widen the scope of zero-rated VAT and VAT exemptions, as well as to simplify the assessment procedures.

3. **Tax measures to improve corporate financial structure**
   - The presumptive dividend was phased out.
   - Deductions in income for capital increases were systemized in the Corporation Tax Law.
   - Excessive interests paid out were not considered as losses.

4. **Reinforcement of tax incentives for industrial restructuring**
   - The Tax Exemption and Reduction Control Law was revised to eliminate the obstacles caused by the tax system for structural adjustment of the national economy.

5. **Extension of temporary national taxes**

6. **Tax incentives for newly established small and medium-sized enterprises (SMEs)**
- For SMEs newly established in an agricultural or fishing district or those related to technology-intensive businesses, the income tax or the corporation tax on income is exempt from taxation for four years (including the year of organization) and is reduced by 50% for the subsequent two years.

- For a venture capital company that has invested in newly organized SMEs, the capital gains from transfer of shares or interest are exempt from corporation tax.

- The dividend income of an individual shareholder of an investing company is taxed separately from global income, and is subject to income withholding at the rate of 10%.

7. **Special treatment for foreign taxes paid**

- When a resident or a domestic corporation receives income from foreign sources, the taxpayer is allowed to treat the total amount of foreign taxes paid as losses when calculating the income amount for the respective business year, or to deduct the paid foreign taxes from income tax or corporation tax.

- The amount of taxes spared abroad is deemed to be foreign taxes paid, and is eligible for special treatment subject to the provisions of tax treaties.

8. **Establishment of the Excessive Land Holding Tax**

- The Excessive Land Holding Tax was enacted as a local tax on December 31, 1986, but did not go into force until January 1, 1988.

9. **Establishment of the Excessively Increased Value of Land Tax**

- The excessively increased value of land tax was newly established as of December 30, 1989. This tax was applied from January 1, 1990.

10. **Some property taxes replaced by or incorporated into new tax**

- The aggregate land tax had been newly enacted to replace the existing property tax on land and the excessive land holding tax.

**f. Tax reform during the period of 1990-1997**

Domestic economic circumstances began to change in the latter half of 1988, with an adverse impact on growth, exports, prices, employment, and balance of payments. There were several reasons for this change. First, the rate of economic
growth, which had relied mainly on technology transfers and low wages, had reached its extent. Simultaneously, efforts to enhance competitiveness by expanding the infrastructure and by investing in technology development were no longer sufficient, resulting in substantially weak productivity levels in all economic sectors. Second, the lower investment levels and declining willingness to participate in the labor force resulted from economic uncertainty and instability caused by a sudden change in socioeconomic circumstances. Third, investment in real estate became exceptionally popular.

Several different measures were taken in order to correct these problems. The government granted several tax incentives for investments in facilities and technology development, targeted to improve productivity and adjustment of the industrial structure. In addition, the government strongly subdued both inflation and real estate speculation that had been distorting income distribution. Short and long-term policy tools were also prepared to encourage a better work ethic and to establish a satisfactory relationship between employees and employers.

Although the financial crisis of 1997 forced the government to adopt new approaches to economic policies and taxation, the long-term goal of fiscal integrity and efficient tax administration remains intact.

(1) Tax reform in 1989-1992

The major contents of the tax reforms from 1989 to 1992 were as follows. First, the government reduced the burden of wage and salary earners by increasing deductions for wage and salary income, medical expenses, those who do not own homes, and those who lived with aged parents. The government also increased the limits on tax credits for wage and salary earners.

Second, tax equity was enhanced among income brackets and among different types of income by strengthening the taxation on property. Tax rates were raised on financial assets (16.75% → 17.75% → 21.5%), on inheritances and gifts by revising the appraisal method, and on the self-employed such as doctors, lawyers, and accountants.

Third, the government simplified the personal and corporate income tax structures and lowered the rates. An alternative minimum tax system was also introduced.

Fourth, reinforcing taxation on real estate holdings renewed the property tax system. This included the following: a progressive aggregate land tax consolidating the property tax on land, a tax on excessively increased value of land (even a tax on unrealized capital gains from excessive land holding was levied), a ceiling on ownership of residential land, a tax on profits from regional development projects, and regulations forcing conglomerates to sell excessive holdings of land. In addition, the
scope of tax preferences on capital gains from real estate transfers was sharply
narrowed. These measures attempted to suppress real estate speculation, promote
efficient land use, and stabilize land prices.

Fifth, while the defense tax was repealed as of January 1, 1991, the education
tax was permanently set. Additionally, a system was introduced to transfer national
tax revenue to local governments for the purpose of supporting the local autonomy,
which went into effect in early 1991. The revenue to be transferred consisted of 50% of
the excessively increased value of land tax, 15% of the liquor tax, and all of the
telephone and education taxes.

(2) Tax reform in 1993

The new administration launched a Five-Year Plan for the New Economy in
1993. It included Korea's economic policy directives targeted for 1997, and it was
expected to play a greater role than ever before.

The new Korean government enacted the measure for a real-name financial
transaction system on August 12, 1993. This system had the intention of enhancing
economic justice and facilitating the sound development of the national economy
through normalizing financial transactions by enforcing the conduct of all financial
transactions under real names.

It was expected that various tax data of current financial transactions veiled
under false names or pseudonyms would be exposed during the implementation of the
real-name financial transaction system. This resulted in the increase of the burden
faced by such taxpayers.

To alleviate the tax burden increase from the enforcement of the real-name
financial transaction system and to induce immediate consolidation of the new system,
thirteen tax laws were either amended or newly enacted under the reform, one of
which was the Tax Exemption and Reduction Control Law.

Other key points of the 1993 Tax Reform were to enhance tax equity, to
secure financial revenue by expanding areas of taxation, and to reduce tax exemptions
by the comprehensive review of the tax support system. The tax reform contributed
to the adjustment of tax rates and the tax credit system; various measures were also
taken to improve the management environment and the financial structure of
corporations.

The main contents of the 1993 Tax Reform are as follows:

- To adjust the difference between recognizing profits and losses in both
  business and tax accounting

- To lower the tax rates of the corporation tax, individual tax, and
  inheritance and gift tax
- To adjust methods of taxation on capital gains
- To introduce a taxation deferral system in the Tax Exemption and Reduction Control Law
- To introduce a marginal tax credit system on VAT
- To adjust the rates of the special excise tax and the liquor tax
- To introduce the transportation tax for social overhead capital investments

(3) Tax reform in 1994-1995

The 1994 tax reform was designed to establish an advanced tax system characterized by low tax rates and a broader tax base. By pursuing a lower-rate/broader-base policy mix, the Korean government planned to establish a fair tax system in terms of horizontal equity. It also hoped to improve the efficiency of the economy by mitigating the effects of distortions caused by government intervention and by encouraging market competition.

The main contents of the 1994 tax reform are as follows.

i) The income tax system was strengthened by incorporating interest and dividend income into the global income tax system (this has been applied since the beginning of 1996). Until 1995, interest income and dividend income were assessed separately from global income and were withheld at the rate of 20%. The improvement in the income tax system was expected to enhance tax equity for taxpayers with income from different sources.

ii) The self-assessment system for individual income taxes was introduced and went into effect on income reported in 1996. This further simplified the process of tax administration.

iii) Corporation tax rates were reduced to improve the international competitiveness of domestic industries.

<table>
<thead>
<tr>
<th>Taxable year</th>
<th>Tax rate (private corporations)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994</td>
<td>Income ≤ 100 million won: 18% (19.35%)</td>
</tr>
<tr>
<td></td>
<td>Income &gt; 100 million won: 32% (34.40%)</td>
</tr>
<tr>
<td>1995</td>
<td>Income ≤ 100 million won: 18% (19.35%)</td>
</tr>
<tr>
<td></td>
<td>Income &gt; 100 million won: 30% (31.50%)</td>
</tr>
</tbody>
</table>
*Figures in parentheses include the inhabitant tax.

*An additional tax of 15% is imposed on the accumulated excess earnings of unlisted large-scale corporations.

In order to induce investment, the accumulated earnings tax was improved to exclude the calculation of accumulated earnings as part of the tax amount by establishing a reserve for corporation development.

Under the new corporation tax system, carry-overs of foreign tax credits were allowed for up to 5 years. This change enhanced the competitiveness of Korean companies investing overseas. The scope of Permanent Establishment was also adjusted. The revised version established the duration and characteristics of a PE in a clear manner.

iv) The Special Excise Tax Law (SETL) was redefined. Its categories were simplified and revised in order to improve the equity of different goods. Accordingly, tax rates were simplified from six different rates ranging from 10-60% to three different rates of 10%, 15%, and 25%.

The Korean government designed its 1995 tax reform to ensure the firm establishment of a system based on the "Incorporation of financial income into a global income base." To broaden the base for the global income tax, the Korean government carefully monitored the rapid behavioral changes of individuals and corporations in response to tax reforms; and to reduce the short-term effects of behavioral changes on the economy, the Korean government proposed supplementary measures. For example, certain kinds of interest income were not to be subject to the global income tax. In fact, adjustments of tax brackets resulted in decreased income tax burdens.

At the same time, as a part of the WTO system and the movement toward the globalization of business activities, Korean firms were expected to face severe competition with foreign companies. With these changes already embedded in the economic environment, the Korean government tried to search for some measures to strengthen the competitiveness of Korean firms (e.g., tax incentives for research and development). In 1995, the government improved its international tax system through the application of internationally recognized standards. It also continued to improve Korea's economic efficiency by simplifying the tax system and tax compliance processes that reduce the cost of tax compliance and tax collection.

The main contents of the 1995 tax reform are as follows:

i) In order to alleviate the income tax burden, the interest on time
deposits with a maturity of five years or more was not included in the global income tax base. In addition, interest on one of the checking accounts of a family was not to be included in the global income tax base if the account does not exceed the sum of 12 million won.

ii) Individual income tax brackets were adjusted.

<table>
<thead>
<tr>
<th>Tax rate</th>
<th>Brackets</th>
<th>Before</th>
<th>Revised</th>
</tr>
</thead>
<tbody>
<tr>
<td>10%</td>
<td>~ 10 million won</td>
<td>~ 10 million won</td>
<td></td>
</tr>
<tr>
<td>20%</td>
<td>10 ~ 30</td>
<td>10 ~ 40</td>
<td></td>
</tr>
<tr>
<td>30%</td>
<td>30 ~ 60</td>
<td>40 ~ 80</td>
<td></td>
</tr>
<tr>
<td>40%</td>
<td>60 ~</td>
<td>80 ~</td>
<td></td>
</tr>
</tbody>
</table>

iii) The corporation tax rate was decreased by 2%.

<table>
<thead>
<tr>
<th>Tax Year</th>
<th>Tax Rate (private corporation)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
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</tr>
<tr>
<td>1996</td>
<td>income ≤ 100 million won: 16% (17.20%)</td>
</tr>
<tr>
<td></td>
<td>income &gt; 100 million won: 28% (30.10%)</td>
</tr>
</tbody>
</table>

- Tax incentives were strengthened for industries such as research and development and intellectual services.

- On the condition that the tax treaty for the contracting states allowed for indirect tax credits, foreign tax credits were permitted on dividends from foreign subsidiaries (indirect tax credits).

iv) The VAT burden was mitigated, and tax compliance costs for small businesses were reduced.

- The tax exemption limit was raised from 12 million won to 24 million won, and the limit for special cases of the VAT (tax rate: 2% of total sales) was also raised from 36 million won to 48 million won.

- The proposal introduced a new special case for those with total sales less than 150 million won.
Tax Liability = Total Sales Value Added Rate (announced by the government) 10%

v) The education tax rate was raised, and the tax base was broadened through the inclusion of tobacco sales.

vi) The proposal simplified the customs clearance process.

vii) The proposal for the legislation of the Law for the Coordination of International Tax Affairs was also submitted to the National Assembly. The purpose of this law was to streamline Korea's international tax system in accordance with international standards.

The law covered the following:

Transfer Pricing
Thin Capitalization
Anti-Tax Havens
Mutual Agreement Procedure
Mutual Assistance in Tax Matters

(4) Tax reform in 1996-1997

In 1996, the government launched tax reforms, resulting in the revision of nine tax acts and fourteen Presidential Decrees. The major tax law changes in 1996 are as follows. In order to bolster corporation competitiveness, the tax law was changed to give tax relief to technology and human resource development of corporations of small and medium-sized companies, in particular.

The Collection System of customs duties was converted from pre-payment & post-compensation to post-payment, based upon exact calculation. To enhance equitable tax burden between different socio-economic classes, tax rates imposed on employees were lowered and inheritance and gift tax rates levied on the middle class were reduced as well. On the other hand, tax rates on transfer of high valued property were increased.

Another major revision of the tax law in 1996 was the creation of "long-term household savings" and "employee savings through stock," to promote savings and reduce the limit of entertainment expenses in order to curb conspicuous consumption. The procedure of paying taxes was simplified and the method of granting tax relief was streamlined.

The economic crisis of Korea in late 1997 has forced the government to initiate a series of comprehensive economic reform measures to overhaul the economy. Aside from the adverse external volatility of the Asian economic crisis, there were a number of internal factors that are believed to have significantly contributed to Korea's economic crisis. They range from exposure to short-term external borrowing, a debt-laden corporate sector, inefficient financial institutions, rigid labor market, and persistent trade deficit, to excessive government intervention in the economy, which tended to distort market incentives and signals.

Although a series of unprecedented bankruptcies, a credit crunch, and the depletion of foreign currency reserves hastened the Korean economic crisis, internal factors pointed to more fundamental structural weaknesses in the Korean economy, especially in the corporate and financial sectors. The government acknowledged and responded to the crisis by initiating bold measures to restructure the corporate and financial sectors.

One of the most urgent tasks that confronted the government was the liquidation of bad loans held by domestic financial institutions. Support for the unemployed in the form of unemployment insurance payments and other social safety net expenditures was another urgent task that confronted the government as unemployment rose. Not surprisingly, as government spending rapidly grew to meet the expenditure demands necessitated by restructuring and unemployment, the budget deficit level increased at a similar pace.

Despite the expected large budget deficit, the prospect for rising tax revenue is not expected to improve in the short run, given the likelihood of continued recession and shrinking tax revenue. Increasing revenue is not anticipated because of expanded tax exemptions and rate reductions the government has granted to attract foreign capital and stimulate domestic investment and consumption. To prevent the likely result of excessive revenue deficit, the government raised tax rates on items that were believed to have been minimally affected by the economic crisis. Thus, among others, taxes on petroleum and diesel were raised, and the progressive taxation of interest income was switched to a proportional withholding tax.

Soon after Korea reached an agreement with the IMF on macroeconomic and fiscal policy objectives, the government made a number of changes in tax laws in order to facilitate the restructuring process, to stimulate investment and consumption, and to broaden the tax base and tax revenue.

(1) Tax measures for restructuring

From early on, it was decided that tax liability should neither discourage nor prevent companies and financial institutions from undergoing necessary
restructuring. Therefore, the government has exempted or reduced taxes on asset transactions for the purpose of corporate and financial restructuring.

Tax incentives to encourage and accelerate restructuring were mostly granted to transaction-related taxes such as Capital Gains Tax, Acquisition Tax, and Registration Tax. They include:

i) Corporate mergers and acquisitions: Profits resulting from revaluation of corporate assets after mergers and acquisitions are eligible for deferral from corporate income tax until the alienation of the revalued assets. Corporate mergers and acquisitions are also exempt from the Registration Tax.

ii) Business divisions: Capital gains resulting from revaluation of corporate assets after business divisions are eligible for deferral from capital gains tax until the alienation of the revalued assets. Business divisions are also exempt from the Acquisition Tax and the Registration Tax.

iii) Business asset swaps: Companies that swap business assets with other companies as a part of their restructuring plan are eligible for deferral on capital gains tax on any gains resulting from business swaps. Such companies are also exempt from the Acquisition Tax and Registration Tax.

iv) Alienation of business assets: Companies that use proceeds from the sale of real estate assets for debt payment to their creditor banks are eligible for exemption from capital gains tax. Where alienation or purchase of real estate assets are initiated for restructuring purposes, the companies making such transactions are eligible for a 50% reduction in capital gains tax.

v) Contribution by company owners: Where company owners donate personal assets or make capital contributions to their own companies, the recipient companies are eligible for exemption from corporate income tax on such contributions and a 50% reduction in capital gains tax, as well as exemptions from the Acquisition Tax and Registration Tax.

(2) Stimulating investment and consumption

The withdrawal of foreign capital was one of the principal factors that precipitated Korea's economic crisis. Therefore, restoring the confidence of foreign investors and attracting foreign investment were the overriding priority and concern of the government. The measures that ensued after the agreement with the IMF included accelerated liberalization of domestic markets and removal of restrictions on foreign ownership of shares in domestic companies and real estate properties.

With respect to foreign direct investment (FDI), the enactment of the
Foreign Investment Promotion Act (FIPA) in 1998 is noteworthy. In May 1999, provisions dealing with tax incentives for foreign direct investment (FDI) were subsumed into the Special Tax Treatment Control Law (STTCL).

The principal objective of the FIPA is to attract FDI by creating a more liberalized and favorable business environment for foreign businesses and by providing tax incentives to certain types of FDIs. Under the FIPA, foreign businesses and investors who make advanced technology FDI in Korea are eligible for exemption from individual and corporate income taxes for the first seven years, and a 50% reduction for each of the next three years. In addition, foreign businesses and investors are granted exemption from a number of local taxes such as Acquisition Tax, Property Tax, Aggregate Land Tax, and Registration Tax for a minimum of five years, and 50% reduction in the next three years. Imported capital goods are eligible for full or partial exemption from customs duty, special excise tax, and value added tax (VAT).

The opening of Korea's long-protected real estate market to FDI is also noteworthy. With numerous revisions to the Foreign Land Acquisition Act in June 1998, the government completely removed restrictions on real estate acquisition by foreign businesses. In an effort to attract large-scale foreign investment, a Foreign Investment Zone (FIZ) system was introduced. The national government formerly granted tax incentives to FDI in pre-designated areas; but currently the FIPA grants local governments the autonomy to designated FIZ for FDI upon the request of foreign investors. This request is based on the amount of investment and the number of expected jobs to be created from their FDI. Foreign companies that receive the FIZ designation are eligible for government support and tax benefits.

In response to the sharp drop in investment and consumption levels, the government has also revised a number of tax laws to provide tax incentives to small and medium-sized companies in order to stimulate employment and technology investment. They include:

i) Tax exemption on stock options: For employees of venture capital companies who elect stock options, the individual income tax on income from stock options is exempt from tax.

ii) Tax credit and exemptions on R&D: High value-added service industries have been made eligible for tax credits and exemptions, which are normally given to manufacturing companies. Expenditures on research for the millennium bug have also been made eligible for tax credits and exemptions.

iii) Reduced special excise tax: The special excise tax on consumer electronic goods and automobiles has been cut by 30%.
iv) Reduced automobile tax: The tax on automobiles has been reduced to 220 won per cc from 370 won per cc for those with engine displacement greater than 3,000 cc. Likewise, the tax on automobiles with engine displacement less than 3,000 cc has been reduced to between 20 won per cc and 60 won per cc.

v) Reduced capital gains tax: In an effort to stimulate the depressed real estate market and to accelerate the restructuring process, the government reduced each of the three brackets of capital gains tax rates from 30%, 40%, and 50% to 20%, 30%, and 40%, respectively.

(3) Broadening tax bases and increasing tax revenue

Tax revenues have been declining significantly since the beginning of 1998. Among the decrease in tax revenue, that from income-elastic tax bases has been particularly pronounced. Therefore, the government has chosen to increase taxes on such income-inelastic goods as cigarettes and gasoline to meet the cost of restructuring and unemployment benefits.

In an effort to broaden tax bases, the government also curtailed tax exemptions and reductions. One notable example is the abolition of the VAT exemption on services supplied by professional service providers such as lawyers and accountants. In addition to enlarging the tax base of the VAT, the new measure is expected to significantly improve the transparency of the income base of the professional service providers. Other changes made by the government to broaden tax bases include:

i) Changes in the VAT: Cigarettes became subject to VAT on top of the existing local tax.

ii) Transportation tax increase: The excise tax on petroleum increased three times in 1998. The first increase took place on January 8 from 414 won per liter to 455 won per liter and the second on May 2 to 591 won per liter. The current rate is 691 won per liter.

iii) Withholding tax on interest: The National Assembly suspended the inclusion of interest income in the comprehensive income tax base but started to levy a 20% withholding tax on interest income as of January 1, 1998. The withholding rate has been increased to 22% beginning October 1, 1998.

iv) Streamlining tax exemption laws: In order to broaden the tax base, the Special Tax Treatment Control Law was enacted to control the widely scattered laws that are related to exemption. Tax laws that allow exemptions and reductions are subject to sunset rules—which limit the duration of the exemptions and reductions.
h. Tax reform in 2000~2005

The following contents include a summary of the tax reforms undertaken during 2000-2004.

(1) 2000

The 2000 tax reform focused on strengthening support for the middle and working class and enhancing tax equity within the framework of overall economic policy of restructuring and building up a system based on market principles. Also tax rules, which proved to be ineffective, were revised to improve efficiency of tax system.

First, in order to lessen the tax burden of the middle and working class and improve income inequality, pension contribution was allowed to be deductible from the taxable income and the scope of credits for medical expense and earned income were expanded. Non-taxable savings for the old and the disabled were established. Meanwhile, with the aging population, those who receive pension income is going to increase. Thus the proportion of pension incomes in the total incomes is expected to augment. Pension proceeds, which are currently non-taxable, will become taxable on a gradual basis, enhancing tax equity among various incomes.

Second, the current energy-related taxation system has been based on low energy prices for the sake of price stability and industry support. As a result, during 1991 to 1997, energy consumption in Korea soared 11.4%, eight times of OECD member nations while the consumption for OECD nations was increased by 1.5%. Despite the fact that main contributors to pollutions are factory exhausts and car exhausts, heavy oil used in factories was non-taxable and tax on diesel for automobiles was lower than that of advanced nations. The number of butane gas-powered car sharply increased, as the price of butane gas was only one forth of gasoline price. The large difference among fuels of vehicles contributes to distortion in energy consumption. To address energy waste, pollution and international payment problem arising from these distorted energy prices, taxation system for energy was modified to be in line with the level of international standard. The price rates among gasoline, diesel oil and butane gas will be revised upward to 100: 75: 60 on a gradual basis by July of 2006.

Third, tax incentives were provided to boost local economies and regain Korean economic rigor by narrowing economic gaps among regions. Previously income tax and corporation tax had been reduced by 20% for seven industries such as manufacturing and logistics industry etc. In 2000, a total of 16 types of local small and medium-sized enterprises (SMEs) including construction, retail and wholesale industries were given income tax and corporate tax cuts by 30%.

(2) 2001

The tax reform in 2001 focused on broadening tax base via the
reduction of tax exemption and deduction in order to enhance tax equity. At the same
time, the tax reform was focusing on building a competitive tax system through tax
cuts and business-friendly tax measures. These changes intend to recover economic
vigor and secure tax revenue for medium and long term.

First, to encourage entrepreneurship of the self-employed, who had had
a hard time in the process of restructuring and to relieve increased tax burdens of the
self-employed as a result of expanded usage of credit card, global income tax rates
were cut by 10% (10%~40 → 9%~36%) and deduction for taxable income was
increased.

Second, to create business-friendly environment, various tax reforms
were executed such as relieving tax burdens of corporations. Corporation tax rates of
16% and 28% were lowered by one percentage point each to 15% and 27%,
respectively, and the higher corporate income tax levied on profits accumulated by
certain corporations in excess of a level set by a tax law was abolished. Also,
requirements for incentives relating to investment in Foreign Investment Zones were
eased.

Third, tax regimes found to be stumbling blocks to corporate
restructuring such as merger and investment in-kind were lifted. Under the amended
tax law, environments have been created where restructuring can be done regularly by
companies spurred by their self-regulation and accountability. For example, tax
reconciliation items to be carried-over in a merger were expanded. Along with this,
various restrictions to doing business, which were embedded in the Korean tax system,
were eased. The gap between tax accounting and corporate accounting was narrowed
in order to lessen burdens of corporation in reconciling these two accountings.

Forth, tax exemption or reduction was curtailed in an attempt to
increase tax revenues and improve tax equity. Especially, excessive reduction or
ineffective exemption were reduced or abolished. For instance, foreign investment in
specified advanced technology and industry supporting service used to be granted a
100% exemption on corporate income tax and dividend. However, under the revised
tax law, exemptions for foreign investment by means of business transfer was reduced
since such investment was not effective in creating new employment and facility
investment. Meanwhile, exemptions needed for supporting creation of wealth of
middle and working classes remained as before.

Fifth, previously in order to crack down on speculation in the real estate
market, higher capital gain tax rates were provided. As the environment surrounding
real estate market changed, capital gain tax regime was normalized, granting lower tax
rates and smaller tax exemptions. By bringing capital gain tax rates on property to
the level of global income tax rates (20%~40%→9%~36%), tax burden arising from
real estate transaction was alleviated. Also the scope of tax exemption was
dramatically reduced to regain the function of capital gain tax as an income tax. While
the tax rate for capital gain from the sale of stocks remained the same as before,
transfer of stock held for a short term by a large shareholder was subject to a flat tax rate of 30%.

(3) 2002

The 2002 tax reform centered around supporting middle and working classes, stimulating economies of local provinces and boosting competitiveness of corporation sector. Also, taxes that caused tax inequity and tax exemptions or reductions that were not effective in terms of usage of resource have been phased out to secure funds to meet increasing demands for social welfare, social overhead cost, and a better education system. Through these efforts, tax equity has been enhanced and tax base has been broadened. Main contents of the 2002 tax reforms are as follows.

First, to lessen tax burden of working classes, personnel exemption and income deduction for medical expenses were expanded. The period of income deduction for credit card usage has been extended to November 30, 2005. Additionally with regard to interests arising from long-term loans for house, deductible interest expenses were increased.

Second, to support small and medium-sized enterprise (SMEs) and beef up competitiveness of corporation, type of industries entitled to SMEs special tax exemptions were expanded by nine to 27 and type of facilities subject to tax exemption for investment into productivity boosting facilities were expanded to include supply chain management (SMC) and customer relation management (CRM) and tax credit for such facilities is raised to 7% from 5%. Further, requirements for establishment of holding companies to be provided with special tax treatments were eased to facilitate corporate restructuring.

Third, income redistribution has been worsened since the financial crisis and large corporations were expediently using complicated capital transactions such as merger, a capital increase and a capital decrease to pass the managerial rights to the children of their owners. To address these situations, the scope for deemed gift was extended.

Forth, with the increase of capital movement and e-commerce, tax avoidance and tax evasion on the international arena were prevailing. In an attempt to combat these transactional financial crimes, Korea’s 2002 tax reform allowed the exchange of certain financial information related to non-resident and foreign corporation with the foreign tax authorities on a reciprocal basis.

(4) 2003

To stimulate sluggish economy and nurture mid and long-term growth potential, tax incentives amounting to one trillion won were provided via the 2003 tax reform. Corporate tax rates were lowered to relieve corporation tax burden and tax
incentives toward small and medium sized company were expanded to boost SMEs’ entrepreneurship. Meanwhile, to discourage speculative real estate transactions, capital gain tax on property was raised.

On the international front, tax reforms in 2003 were composed of allowing an exchange of information on financial transactions with other countries, subjecting all international transactions under transfer pricing rules and finally revising rules on thin capitalization and controlled foreign corporations. (CFC rules)

Followings are the main 2003 tax reforms done on the domestic front:

1. To clamp down on the untaxed transfer of wealth by means of legal loopholes, an all-inclusive inheritance and gift taxation system was introduced. Under the previous law, the scope of gift and inheritance under the gift and inheritance tax law includes 14 types of constructive gifts and other similar types as well as transfer of wealth without compensation under the gift contract of Korean Civil Code. However, there were many cases where taxpayers circumvented the gift and inheritance taxes by using new types of inheritance and gift, which were not enumerated as constructive gift types. To block these expedient methods, under the new scheme, effective transfer of wealth without compensation is subject to taxation regardless of whether the transfer constitutes inheritance and gifts under the Civil Code or not.

2. The requirement for non-taxable ‘one household with one house’ was strengthened and tax rate on capital gain arising from transfer of property held for a short term was raised. On top of that, owners who fall into the category of ‘one household with three houses’ were subject to heavy taxation of 60 percent regardless of the holding period. As for the transfer of property located in areas, which are designated as real estate speculation area, capital gain tax was levied on the value of actual transaction.

3. In order to support Korean economy in securing economic vigor and growth potential by encouraging corporation’s investment into facilities and promoting foreign investment, following tax schemes were introduced.

i) To alleviate tax burden of corporations, tax rate 15% applicable to the taxable income of 100 million won and 27% applicable to the taxable income in excess of 100 million won were lowered by two percentage points respectively. This became effective from taxable years beginning after January 1, 2005.
ii) In order to encourage investment into facilities, temporary investment tax credit rate was raised by 5% to 15% and the duration of such tax credits was extended by one year to June 30, 2004.

iii) Foreign expatriates and employees working in Korea are able to opt to apply for a flat tax rate of 17% on their salary income.

iv) In order to buttress SMEs, the alternative minimum tax rates for the SMEs were decreased to 10% from 12%. The alternative minimum tax liability was suspended with respect to R&D investment tax credit enjoyed by SMEs. Thus the total R&D expense was eligible for the R&D investment tax credit.

4. Various tax incentives were provided in order to support middle and working classes such as farmers and workers.

i) The ceiling for the earned income tax credits provided to temporary workers is raised to 55% of assessed tax liabilities from the previous 45%.

ii) Previously, special deduction for education expense and medical expense had been subject to 3% limitation of the aggregate income of a taxpayer. Under the 2003 tax regime, this limitation was abolished.

iii) Tax incentives to support child’s birth and childcare were newly established and extended. For instance, maternity allowance and childcare allowance are not any more taxable (up to 100 thousand won). Also ceiling on education expense for income deduction was raised.

iv) A taxpayer with 25 million won or less of earned income is entitled to deduct marriage, moving and funeral expenses from his taxable income. Under this newly established tax law, one million won per case is a deductible ceiling amount.

5. Followings are changes made to the 2003 tax reform other than ones described above.

i) The list of taxpayers who fail to pay large amounts of taxes is disclosed in public to encourage tax compliance. The list of delinquent taxpayers whose taxes in arrears are due for more than 2 years and whose national tax exceeds one billion won are subject to this new tax regime.
ii) In order to promote tax compliance of taxpayers by encouraging reports on tax-related illegal activities, a reward is provided to the reports on tax evasion and fraud in which the evaded tax liabilities amount to 0.5 billion won or more and such tax liabilities are collected even if the tax evaders are not punished as a tax criminal.

iv) “Cash receipt system” was introduced to better assess self-employed taxpayers’ income. Previously, taxpayers were encouraged to use credit card since it would prevent potential tax-evaders from failing to report cash transaction. With the introduction of the cash receipt system, even cash transaction records are automatically sent to the National Tax Service in the same way as the current credit card system and cash users are allowed income deduction equivalent to 20% of cash receipt expenditure exceeding 15% of total salary and wage. This is effective from 2005.

v) Originally transportation tax on gasoline and diesel had been introduced in 1994 to be around for temporary 10 years to finance transportation infrastructure such as roads and railways. However the duration was extended to secure resources for social overhead capital (SOC) needed to grow as the hub of logistics in North-East Asia.

Followings are the tax reforms in 2003 on the international tax area.

1. With respect to exchanging information on financial transactions with other countries, the Ministry of Finance and Economy provided the information on a reciprocal basis and upon request from foreign revenue authorities on a condition that the released information is strictly limited for the purpose of imposing tax. And non-residents living in Korea as well as foreign companies and branches operating in Korea come under the scope of the new measure.

2. As for subjecting international transactions to transfer pricing rules, some international transactions between related enterprises (or associated enterprises) falling under the corporate income tax law and not covered by the law of coordination of international taxes used to be subject to “the rules on denial of unfair transactions” in the past. Under the revised rule all international transactions shall be subject to transfer pricing rules, effective from 2003.

3. The purpose of thin capitalization is to limit the deductibility of excessive interest payments paid by Korean subsidiaries and branches of foreign companies, which would result in reduced tax base in Korea. More
specifically, where a subsidiary or branch borrows from its controlling shareholder or head office located overseas, loans in excess of 600% of equity in case of certain financial institutions and 300% of equity in all other cases is not permitted. In other words, the interest relating to the loan exceeding that limit is not deductible for Korean tax purposes.

i) The scope of major foreign shareholders was expanded by adding a brother company of a domestic company as subject to thin capitalization rules. As of April 2003, foreigners owning more than 50% of shares of domestic corporations and those foreign shareholders effectively determining the course of the domestic company were classified as major foreign shareholders subject to thin capitalization rules. Also under the revised tax law, the scope of major foreign shareholders of domestic permanent establishments subject to thin capitalization rules was expanded. Foreign shareholders owing more than 50% of a brother company of the firm concerned shall be subject to thin capitalization rules.

ii) Deemed foreign loan with respect to the rules on thin capitalization rules was revised. In the past, only loans either issued by foreign shareholders or by the third party and guaranteed by the shareholder used to be subject to thin capitalization rules. Now other legal documents such as comfort letter, effectively guaranteeing payment of the issued loan shall be deemed as falling under the scope of foreign loans subject to thin capitalization rules. Thin capitalization rules prevail over other tax laws or transfer pricing rules in case of divergence of interpretations.

4. The CFC rules also underwent some changes. The purpose of CFC rules is to impose tax on unreasonably retained profits of subsidiaries located in “tax havens” by treating them as notional dividends paid to the Korean parent. The concept of “tax havens” under the Korean tax law refers to jurisdictions with no tax or those exempting 50% or more of income from tax or with less than 15% of tax rate. The companies falling under the scope of CFC rules are subsidiaries located in low-tax jurisdictions whose share capital is at least 20%, either directly or indirectly owned by a Korean parent.

5. There also were some major revisions of the foreign investment regime in Korea. The Korean government recognizes the fact that foreign direct investments play an important role in the economy and designates special economic zones to facilitate an inflow of foreign investments. In designated special economic zones, qualified foreign investments on a large scale shall be granted the same benefits as in foreign investment zones. In the foreign investment zones, companies are exempt from tax for 7 years and enjoy 50% reduction for the next 3 years. In designated special economic zones, qualified foreign investments on a medium scale shall be granted the same
benefits as in Jeju Free International City. In Jeju, companies are exempt from tax for 3 years and enjoy 50% reduction for the next 2 years.

What was noteworthy about new measures to promote foreign direct investments was that the proposed measures expanded tax incentives to advanced technologies. Any company capitalizing upon such technologies as information, bio or nano technologies will be granted the same benefits as in foreign investment zones, regardless of the size of investments made and their locations. Furthermore, foreign employees are able to opt to apply for a flat income tax rate of 17% on their salary income.

(5) 2004

One of the remarkable changes in the 2004 tax reform is the introduction of comprehensive real estate holding tax as a national tax to stabilize real estate markets. Along with these changes, various tax incentives to support creating jobs are main characteristic of the 2004 tax reform. On top of that, on the corporation tax and income tax areas, various amendments are made in order to lend a hand to companies in boosting their competitiveness.

Meanwhile, to enhance the country’s competitiveness through inducement of foreign investment, a wide range of foreign investment incentives is provided via the 2004 tax reform. Criteria for industries to qualify for such investment incentives are eased and the scope of industry entitled to foreign investment incentives are expanded.

Finally, with regard to the taxation of foreign corporations and international transactions, the criteria for comparables used to determine arm’s length prices have been eased. Along with these changes, various changes including modified criteria to evaluate a tax haven have been made to complement previous tax laws.

Followings are main contents of the 2004 tax reforms on comprehensive real estate holding tax, job-creating tax incentives and corporation tax code.

1. In order to enhance equity in tax burden and stabilize real estate market, comprehensive real estate holding tax (CREHT) is newly established. With this new tax regime, excessive holding of real estates will be discouraged.

i) Previously, land and residential houses are taxed separately only as a local tax. Under the new tax law, first, property tax (previous aggregate land tax is absorbed into property tax), which is a local tax, is imposed on lands and residential houses and then high-priced lands and residential houses that exceed a certain amount held by one taxpayer across the nation are combined to be imposed with CREHT as a national tax.
ii) Tax bases for land and residential houses are revised to be in more in line with market prices. As holding tax is more strengthened with the introduction of CREHT, registration tax regarding registering transfer of real estate ownership is lowered to 2% from 3% in order to promote real estate transaction.

iii) To facilitate the balanced development of local economy and sound development of national economy, the amount of tax collected is transferred to local autonomous governments. Especially local autonomous governments, which are in more financial need, are allocated first with these tax revenues.

2. Since the financial crisis, job market was resilient, producing 400 thousand to 500 thousand jobs per year. However, despite about 3% of economic growth in 2003, we saw 30 thousand jobs gone. Against this background, Korean government decides to grant tax reduction and tax credit to a company that creates jobs or retains jobs in the sense that job creation is a fundamental method to address youth unemployment, delinquent credit holders and aggravating income distribution. The main contents of such tax regime are as follows:

i) A company, which starts its operation and creates jobs, is provided with 50% to 100% of income tax or corporation tax reduction. Also, such a company is allowed to carryforward net operating loss (NOL) incurred within 2 years after starting operation for 7 years.

ii) Where the number of a regular employee exceeds that of previous year, one million won per employee in excess of the number of worker from the previous year is deducted from corporation tax or income tax.

iii) Where a company introduces a system to retain employment such as implementing a shift system and shortening working hours, 500,000 won per retained employee is deducted from corporation tax and income tax.

3. As income tax rates are lowered by one percent, withholding tax rates
are lowered by one percent to relieve withholding tax burden. 15% withholding tax rates on interest and distribution from securities investment are lowered to 14% respectively. However, 25% withholding tax rate on non-business loan remained the same as before.

4. Other related changes in corporation and income taxes:

i) Previously, dividend received from a wholly owned subsidiary was 50% excluded from taxable income of the parent company. However, under the revised tax law, such dividends received are 100% excluded from the taxable income.

ii) Company profits are taxed first in the corporation and then again in the shareholders’ hands. So dividend gross-up mechanism is designed to preclude double taxation. As corporation tax rate is reduced by 2% starting from 2005, dividend gross-up rate is reduced to 15% from the previous 19%.

iii) A listed company or a large corporation having 100 billion won in net worth was not allowed to deduct interest expense on borrowings in excess of 400% of net worth of such a company. This provision is abolished as the financial structures of companies get improved.

iv) Tonnage taxation system is introduced in the shipping industry. Shipping companies, which meet certain qualification can opt for this new tax scheme. Under the new regime, shipping companies’ income is divided into shipping income and non-shipping income.

v) Where a bond is sold before maturity, the seller of the bond is required to withhold and remit withholding tax imposed on interest accrued up to the point of sale.

Foreign investment incentives in 2004 tax reforms are as follows.

1. Foreign engineers and technicians are presently provided a tax incentive to boost Korean economy’s competitiveness by introducing advanced technology. Expatriate technicians or engineers employed by Korean companies are exempt from earned individual income tax for five years from the date of employment in Korea. Qualified industries for such incentives are expanded, including logistics industry and market research and public opinion polling.

2. Tax benefits that are presently granted to foreign investment companies in Free Economic Zones will be provided to foreign investment in foreign-exclusive industrial complexes. To qualify for the tax
exemption or reduction, a foreign investment company should be engaged in the manufacturing or the logistics industry and satisfy a certain minimum investment requirements.

3. Foreign investment in high technology or industry supporting business should meet certain requirements to be provided with tax incentives. Under the amended rules, an exception to these requirements is provided to foreign investment in the R&D industry.

Followings are with regard to the taxation of foreign corporations and international transactions:

1. Previously, the scope of comparability to determine the arm’s length price for cross-border transaction with related parties was limited to cross-border transaction between the independent companies. Under the revised tax law, a taxpayer is allowed to use domestic transactions with related parties in choosing comparable transaction to determine arm’s length prices.

2. The criteria for evaluating the nature of a low tax country under the anti-tax haven rule have been eased. Under the amended rule, a tax haven is defined as a low tax country where 50% or more of income is tax exempt or where effective tax rates on taxable income for the past three years (previously it was one year) is an average 15% or less.

3. A foreign corporation in Korea may deduct foreign tax paid or to be paid or may use it as a credit against the Korean corporate income tax. However there was not any specific provision about the carry-forward of excess foreign credit. The revised rules make it clear that foreign corporations in Korea, like domestic companies, will be entitled to carry forward such excess foreign tax credits for five subsequent years.

4. Korean residents with 20% or more of interest in a foreign company situated in tax haven are required to report information on investment in the foreign company whose head office or principal office is located in tax haven. Under the revised tax law, the reporting requirements also apply when the effective management of a foreign company is located in a tax haven.

(6) 2005

Tax reform measures introduced for the 2006 tax year are framed around six goals: furthering economic vitality and boosting growth potential; addressing the
issues of aging population and widening gap between the rich and the poor; stabilizing real estate market; broadening tax base through the phase-out of non-taxation benefits and tax incentives; promoting balanced development of all areas of the nation; and enhancing convenience for taxpayers.

Highlights of tax changes for the 2006 tax year by goal are as follows:

1. Furthering economic vitality and boosting growth potential:

   i) Tax incentives for corporate reorganization have been reinforced. To begin with, in the case of M&A, conditions to be met for deficit carried over to the subsequent financial year which has been taken over by a transferee company to be deductible have been relaxed. In principle, to be eligible for such deduction, the transferee company is required to maintain separate accounts for assets, liabilities, profits and loss from the business it has taken over, and such deficit carried over is deductible to the extent of income generated from the business concerned. In the case of M&A between companies in the same industry or SMEs, however, deficit carried over which has been taken over by the transferee company is now deductible to the extent of the transferee’s portion of the income from the business it has taken over out of total income of the transferee company after the M&A (the proportion is calculated based on the share of assets for the business taken over in whole assets belonging to the transferee company after M&A), even when the condition regarding separate accounting is not met.

   Also, under the revised tax law, in case where two unrelated domestic companies swap assets of the same kind which each of them has used for 2 or more years for their businesses, any gains from the asset swap is deductible as long as they are used for business purpose until the end of the business year in which the swap takes place. Previously, for such gains to be deductible, the exchanged assets were required to be used for the same purpose as that before the swap.

   ii) Business taxation has been refined in a more efficient way. Firstly, for certain businesses such as hotel and massage, advertising costs are now deductible in full amount.

   Secondly, there have been efforts made to ensure that Korean tax laws regarding international transactions are in line with international standards. First of all, anti-avoidance rules have been toughened. The substance-over form rule is now specified
in the Law for the Coordination of International Tax Affairs with a view to making clear that in case where investors unduly claim tax treaty benefits by making investments in Korea through a paper company established in tax haven jurisdictions for tax avoidance purpose, they may be taxed in Korea in accordance with the substance-over-form rule.

Another noticeable change in international taxation is the introduction of the special withholding procedure applicable to foreign companies or funds based in certain areas or countries to be designated by the Minister of the Finance and Economy (effective July 1 2006). Under the newly introduced procedure, in case where foreign companies or funds in areas or countries to be designated by the Minister of Finance and Economy derive interest, dividends, royalties or capital gains from the alienation of shares in Korea, they are subject to withholding tax under the domestic tax law, unless they obtain a prior approval of the Commissioner of the National Tax Service to apply benefits under tax treaties. In case the investor concerned establishes within 3 years that he or she is the beneficial owner of the income concerned, being entitled to a reduced tax rate or non-taxation benefit provided under the relevant tax treaty, the tax authorities, after due diligence, will refund an amount equivalent to any overpaid tax plus interest accrued thereon within 6 months from the application for the refund.

Moreover, changes to make the nation’s international taxation system more efficient have been made. For example, when it comes to the rendering of professional services in Korea by non-residents or foreign companies without PE in Korea, expenses such as airfare, accommodations and meal expenses are excluded for withholding purposes under the revised tax law. And the definition of a domestic company has expanded to include those having an effective place of management in Korea.

Anti-tax haven rules have been improved as well. Previously, those countries or areas in which an effective tax rate is 15% or less of actually accrued income used to be judged as tax haven jurisdictions. Now, even when the afore-mentioned criterion is met, those companies with actually accrued annual income of 100 million won or less are not subject to anti-tax haven rules.

Thirdly, there have been some changes in deductions for donations. For example, certain donations as defined under the Corporation Tax Law which used to be deductible to the extent of total income in the past are now deductible only to the extent of 50% of total income.
Fourthly, taxation on entertainment expense has been improved. In the past, companies were required to collect documentary evidence for entertainment expenses in excess of 50,000 won so that such expenses can be deductible. Under the revised tax law, however, in the case of expenses incurred in relation to matters for congratulations or condolences, such obligation is required only for expenses exceeding 100,000 won.

iii) Tax changes have been made to help the nation’s economy regain vitality. A system under which tax benefits are granted when offspring are granted properties as inheritance prior to their parents’ death so that such properties can be used for starting a business has been introduced. Not only that, the expiration date of tax credits granted to investment in energy saving facilities has been extended to the end of 2008. And privately-financed projects for facilities of private universities are now exempted from value-added tax under the revised tax law.

2. Addressing the issues of aging population and widening gap between the rich and the poor:

i) Various measures have been taken with a view to ensuring stable life of retired wage earners. For example, under the revised tax law, retirement pension contributions are deductible so that the use of the retirement pension plan can be promoted. Previously, up to 2.4 million won per year of pension savings contributions was deductible. Now, up to 3 million won per year of pension savings contributions and retirement pension contributions combined is deductible. Also, the ceiling on deductions for retirement pension has been raised to 9 million won from 6 million won while deductions for lump sum retirement allowance has been lowered to 45% from 50% of the allowance amount so that the switch of the lump sum retirement allowance system to the retirement pension system can be encouraged.

ii) There have also been some changes aimed at supporting SMEs and the self-employed. VAT rates applicable to the small-sized self-employed have been cut. The rate has been reduced by 5% for the retailing business with the tax being slashed by 10% in the case of restaurant and lodging businesses (The reduced rates will apply on a temporary basis until the end of December 2007).
iii) With a view to supporting life of middle and low income families, construction of rental-purpose houses has been promoted through the introduction of new tax incentives. For example, dividends paid by real estate indirect investment vehicles investing in houses built for the long term (10 years or longer) rental are now subject to final withholding tax at 14%.

iv) Tax incentives for supporting production activities by farmers and fishermen have been expanded. For example, the expiration date of the period during which equipment for agriculture or fisheries is VAT zero-rated has been pushed back by 3 years to the end of 2008.

3. Stabilizing real estate market:

i) Taxation on capital gains on real estate has been toughened. Firstly, under the revised tax law, capital gains tax is imposed based on the price at which the transaction of real estate is made instead of government-set price (effective across-the-board from 2007).

Secondly, in case where a household which owns 3 or more houses including the right to live in new apartment to be built taking the place of old apartment transfers any of them, the capital gains from the transfer is now subject to tax at the rate of 60% and is not eligible for special deduction for long-term holding any more (effective from 2007). Previously, the right to live in the new apartment to be built taking the place of old apartment was not counted in for the purpose of capital gains tax.

Thirdly, taxation on capital gains in relation to the transfer of a house by a household owning 2 houses has also been toughened. Under the revised tax law, capital gains tax rate of 50% applies to capital gains from such transfer and, in this case, special deduction for long-term holding is not applicable (effective from 2007).

Fourthly, in case where capital gains are derived from the transfer of non-business purpose land and farmland, forest and pasture owned by an absentee landlord, the capital gains tax rate of 60% applies beginning from 2007.

ii) Comprehensive real estate holding taxation has also been
strengthened. Previously, the comprehensive real estate holding tax was imposed based on the sum of houses or lands owned by a single person. But the imposition of tax is now made with the basis on the sum of houses or lands held by a single household. Also, the threshold for the imposition of the tax has increased to 600 million won and 300 million won for residential house and land, respectively.

4. Broadening tax base through the phase-out of non-taxation benefits and tax reductions & exemptions: For purpose of broadening tax base, non-taxation benefits and tax relief have been scaled back. Deductions for credit card charges have been lowered to 15% from 20%. Also, the scope of eligibility for tax breaks regarding comprehensive savings has been reduced and, as a result, those under 20 are not qualified for such tax breaks any more. Furthermore, capital gains realized by farmers from the transfer of farmland for the purpose of acquiring another parcel of farmland in its place, which were previously non-taxable, are now 100% tax-exempt with the ceiling of 100 million won for 5 years. Not only that, the non-taxable amount allowed for labor income from foreign sources has been cut to the level of 1 million won per month from 1.5 million won per month. And profit making businesses carried on by the government or local authorities is now subject to tax.

5. Promoting balanced development of all areas of the nation: The expiration date for tax deferral granted for companies whose factories or head office have been relocated out of large cities and the Seoul metropolitan area, respectively, to provinces has been pushed back to the end of the year 2008. The eligibility criterion for tax credit for companies’ phased relocation to provinces has also been relaxed and the sunset date for such tax credit has been extended to the end of 2008. Moreover, the scope of industries eligible for special tax credit for SMEs which are located in areas other than the Seoul metropolitan area has been expanded to include ship management, construction waste disposal service, advertising and etc., while the expiration date for such special tax credit system has been extended to the end of 2008 as well.

6. Enhancing convenience for taxpayers: The year-end tax adjustment process has been simplified. Under the new system, all the necessary documents are handled online with no papers being involved and the NTS is also able to rely on the computer system in confirming whether or not the taxpayer concerned has been unduly granted deductions.