

FDI and Corporate Taxation in Korea

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This paper examines recent trends of Foreign Direct Investment and the current tax system related to FDI in Korea. First, it summarizes the overall tax system in Korea in section 1, especially focusing on income taxes for corporations and other business entities. Section 2 shows recent trends of foreign direct investment in Korea: total amount of FDI; the share of FDI in Korean economy; and the amount of FDI by industries and home countries.

Section 3, 4, and 5 deal with tax systems specially designed for firms with international investment: incentives to attract FDI in section 3; tax measures to prevent and/or restrain international tax evasion in section 4; and local taxation issues related to FDI in section 5. The last section (section 6) discusses about current policy agenda on corporate taxation and international taxation.

1. Tax System for Businesses in Korea

1.a. Overall Tax System

Taxation in Korea comprises 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

The national internal taxes consist of five direct taxes and 5 indirect taxes. Of these ten taxes, the Income Tax, Corporation Tax, and Value Added Tax make up the bulk of tax revenue. The three earmarked taxes are the Transportation Tax, Education Tax, and Special Tax for Rural Development. The revenues from these earmarked taxes go directly to designated government programs.

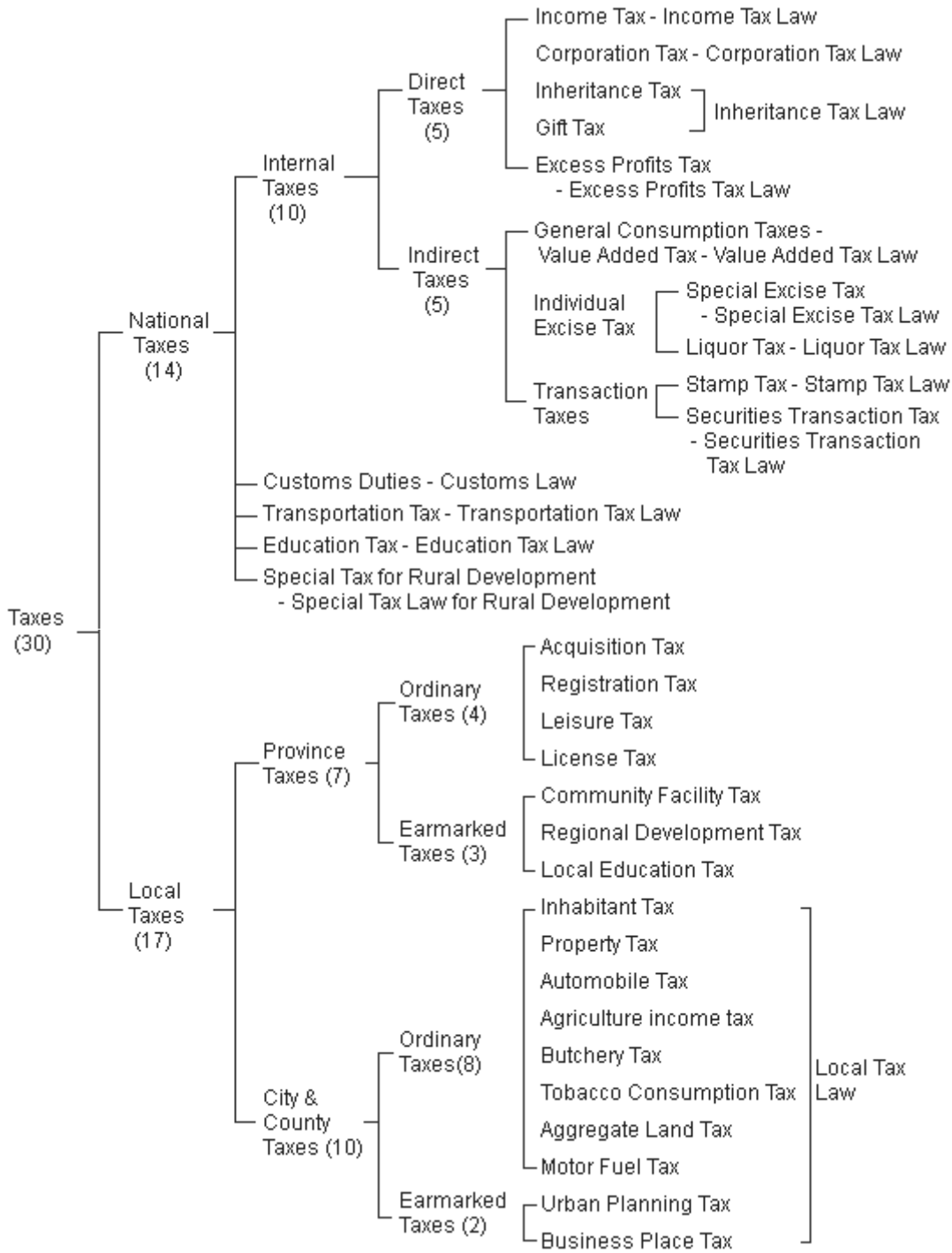
There are sixteen local taxes: four ordinary taxes and three earmarked taxes at the province level; seven ordinary taxes and two earmarked taxes at the city/county level. In Korea, we have six large specially designated Metropolitan Cities that are run as autonomous administrative units independent of the provinces they appertain to. In these Metropolitan Cities, the tax composition is slightly different from that of provinces and cities or counties, although the residents are required to pay the same taxes.

A person is either a resident or 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. The tax rates on individual income range from 8% to 35%.

When a company is incorporated in Korea, it is deemed a domestic corporation and it is liable to tax on worldwide income whereas a foreign corporation is liable to tax only on Korean source income. The corporation income tax rates are 15% and 25%. A foreign corporation without a permanent establishment in Korea is subject to withholding tax

on their Korean source income.

[Figure 1] Tax System in Korea



1.b. Taxation Rules on International Income

The Income Tax Law regards an individual as a resident in Korea if the individual has a domicile or has resided in Korea for a year or longer. Other individuals are non-residents. And according to the Corporation Tax Law, a company with its head or main office in Korea is deemed to be a domestic company, which means a resident taxpayer.

A resident taxpayer, whether he/she be an individual or a corporation, is liable to tax on their worldwide income while a non-resident is taxed only on Korean source income. Where a resident is paid or is to pay individual or corporation income tax abroad, the foreign tax is deducted from the amount of Korean income tax owed. The credit is limited by the amount equivalent to the income tax owed without application of this credit and the ratio of income from foreign sources to total. In the case of corporation, the foreign tax paid by a qualifying subsidiary is eligible for foreign tax credit against the dividend income of a parent company if it is allowed by the tax treaty between Korea and the country of which the foreign corporation is a resident. A qualifying subsidiary is one in which a domestic corporation owns 20% or more of its shares for more than 6 consecutive months after the date of dividend declaration.

Non-residents with places of business such as permanent establishments or fixed bases in Korea are taxed on domestic source income attributed to the business places in the same manner as that applied to residents

1.c. Tax Rates and Tax Bases for Taxes for Individual/Corporate Income

. In the case of individual, all domestic source income except for retirement income, capital gains, and timber income is subject to global income tax while retirement

income, capital gains, and timber income are taxed separately.

Items of income derived by a non-resident without a place of business in Korea shall be subject to tax separately: The income items are not to be aggregated and withholding taxation is applied to each item of domestic source income.

Global income comprises the sum of interest income, dividend income, property lease income, business income, earned income, one-time property income, pension income and miscellaneous income. Deduction of necessary expenses and income deductions from the aggregate amount of the above incomes produces the taxable amount, upon which the global income tax is imposed at the global income tax rate of 8 to 35%.

< Table 1 > Tax Rates of Global Income Tax

Taxable amount	Tax rate
Less than ₩10 mil.	8% of the taxable amount
More than ₩10 mil.	₩0.8 mil. + 17% of the amount in excess of ₩10 mil.
More than ₩40 mil.	₩5.9 mil. + 26% of the amount in excess of ₩40 mil.
More than ₩80 mil.	₩16.3 mil. + 35% of the amount in excess of ₩80 mil.

Incidentally, exempted from the obligation to file a global income tax return are (i) the interest income, dividend income and miscellaneous income that are subject to separate withholding taxes and (ii) the earned income where the obligation to pay the personal income tax are fulfilled by filing a year-end earned income tax return. Interest income and dividend income are subject to separate withholding taxes rather than the

global income tax provided the sum of the two is not greater than 40 million won for a taxable year.

Taxable business income is the aggregate amount of income in each taxable period remaining after the deduction from gross receipts of necessary expenses and losses carried-over from the previous 5 tax years.

Corporate income tax is imposed on fiscal year income and liquidation income. Fiscal year income refers to the gross revenue of a corporation accruing in each fiscal year, less the gross expenses. Liquidation income refers to the amount of any property in excess of equity capital remaining after a corporation ceases to exist by dissolution (merger, consolidation, de-merger, etc.).

The corporation tax rate was reduced by 2% point from 27% (15%, where the tax base is not over 100 million won) to 25% (13%, where the tax base is not over 100 million won) as of the first day of January 2005.

1.d. Tax Bases and rates for Domestic Source Income of Non-Residents

Non-residents' income from domestic source includes the following items:

- interest paid by a resident of Korea or a foreign corporation's PE in Korea;
- dividend paid by a domestic corporation or other business entity;
- real estate income arising from the transfer of a lease, or any other interest in real estate located in Korea excluding income subject to capital gains tax;
- income arising from the lease of vessels, aircraft, registered automobiles or heavy equipment to residents;

- business income and personal service income derived from businesses or services occurred in Korea;

- capital gains derived from the transfer of land and buildings located in Korea;
- income arising from the sale of timber located in Korea;
- wage and salary income received as payment for labor performed in Korea;
- royalties, rents or any other consideration of a similar nature receivable for the use of assets such as copy rights or technical information within Korea; and

- gains arising from the transfer of investment securities or shares invested in a domestic corporation.

In addition, the following incomes are also counted as domestic source income:

- insurance money, compensation money or compensation for damages received in connection with real estate or other assets located in Korea or in connection with businesses carried on in Korea;

- money, goods or other economic benefits received as prizes from entering contests held in Korea;

- income from the sale of treasure found in Korea; income from the assignment within Korea of rights established by license, permission, or other similar disposition under Korean law, or from the transfer of property located in Korea at the time of transfer, other than real estate;

- money or goods received as a prize in a lottery or drawing or an other contest, including the purse payable to the buyer of a winning race ticket;

- and any other income arising from a business operated in Korea or the provision of personal services in Korea.

Unless otherwise provided in an applicable tax treaty, persons paying an amount of income from domestic sources to non-residents not attributable to a domestic business place shall withhold as income tax at source of the income with the rates appeared in the following table.

<Table 2> Rates of Withholding Taxes for Non-Residents' Income

Items of Income	Tax Rates
Interest	25%
Dividends	25%
Lease Income	2%
Business Income	2%
Independent Personal Services	20%
Royalties	25%
Capital Gains from Securities Transaction	Lesser of 10% of sales or 25% of the gains
Miscellaneous Income	25%

1.e. Other Taxes

Value-Added Tax

Value-added tax (VAT) is imposed on the added value generated in each phase of production and distribution. VAT is, in principle, a general excise tax imposed on the consumption of all goods and services as well as an indirect tax where the burden are expected to be passed onto other parties than the payer. VAT also takes the form of

multilevel taxation where the tax is imposed on the added value created in each level of transaction. Therefore, the input tax is deducted from the output tax and the input tax in excess of the output tax is refunded. The tax rate is 10%.

Acquisition Tax

Acquisition tax is imposed by the provincial government on the acquirer of certain assets and is intended to place the burden on the acquirer who exposes his/her ability to pay the tax in the circulation process where the ownership of real property or a vehicle is transferred.

The taxable amount of the acquisition tax is the value at the time of the acquisition, which is the sum of all costs paid or payable at the time of or before the acquisition to the seller or any third party for the purpose of acquiring the property. Although the value at the time of the acquisition is, in principle, as notified by the acquirer, yet the standard market value will be applicable if the value notified by the acquirer is missing or less than the standard market value. The actual acquisition price, however, is deemed the taxable amount if the property is acquired from the central or local government, by importation, or in a public auction or if the acquisition price is evidenced by an account book of a corporation, a court decision, etc.

The standard tax rate is 2% in general, which may be either increased or decreased by local ordinances within the extent of 50% of the standard rate. Higher rates, however, will be applicable to the following properties: 10% for acquiring a villa, golf course, high-class dwelling house, luxury amusement place, lands for non-business use by a corporation, or a luxury boat; and 6% for acquiring taxable article for business

purposes in specially designated areas of restricted population growth such as the Seoul Metropolitan Area.

Registration Tax

Registration tax is imposed by the provincial government on the registration of the acquisition, transfer, change, or extinction of property rights and other rights with the public registry. The taxable amount is the value at the time of the registration, the amount of a claim, or the amount of contribution, where the value at the time of the registration is as notified by the person filing for the registration. The standard market value, however, will be applicable if the value notified is missing or less than the standard market value. The standard tax rates are provided for in the Local Tax Law and the local governments are allowed to adjust the tax rates within the range of 50% of the standard tax rates.

Property Tax

Owners of registered land, buildings, houses, vessels and aircrafts are liable to pay property taxes on their properties. Tax base is the current standard value for lands, buildings, houses, ships, and aircrafts. The tax rates vary from 0.07% to 5%: 5% for high-class vessels; 4% for lands and buildings for golf courses and luxury amusement and luxurious houses so called villa; and 0.07- 0.5% for other properties.

Resident Tax

The resident tax consists of per capita tax and pro rata tax. Per capita tax is imposed in equal amounts on individuals having their addresses and corporations having offices

and places of business within the municipality whereas pro rata tax is imposed on the taxable amounts of personal income, corporate income and agricultural income. Local authorities determine the per capita tax rates for individuals by local ordinances up to 10,000 won per person; the standard rates for corporations provided in the Local Tax Law vary from 50,000 won to 500,000 won depending upon the size of firms. And the standard tax rate for the pro rata resident tax is 10% of individual/corporate income tax. The tax rate can be adjusted by local governments within the extent of 50% of the standard rates.

2. Recent Trends of FDI in Korea

2.a. Definition of FDI

The Foreign Investment Promotion Act(FIPA) defines FDI in Korea as the acquisition by foreign nationals of shares or equity of (1) a Korean corporation; or of (2) a company run by a Korean national for the purpose of establishing lasting economic relations by participating in the management of such a corporation or company. The law provides that the amount of foreign direct investment shall be at least 50 million won. In addition, the foreign nationals shall own 10% or more of the total voting stocks issued by (1) or (2) above; or 10% of the total amount of capital contribution of (1) or (2) above. Where foreign nationals own less than 10% of the total voting stocks or the amount of capital contribution, then they shall enter into the following agreements:

- (a) Agreements concerning officer's dispatch or appointment; ("Officer" refers to those who are entitled to take part in important managerial decision-

making processes as director, representative, partner with unlimited liability, or equivalent)

- (b) Agreements concerning the provision or introduction of technology or joint research/development projects;
- (c) Agreements concerning the supply and purchase of products/raw materials for more than one year.

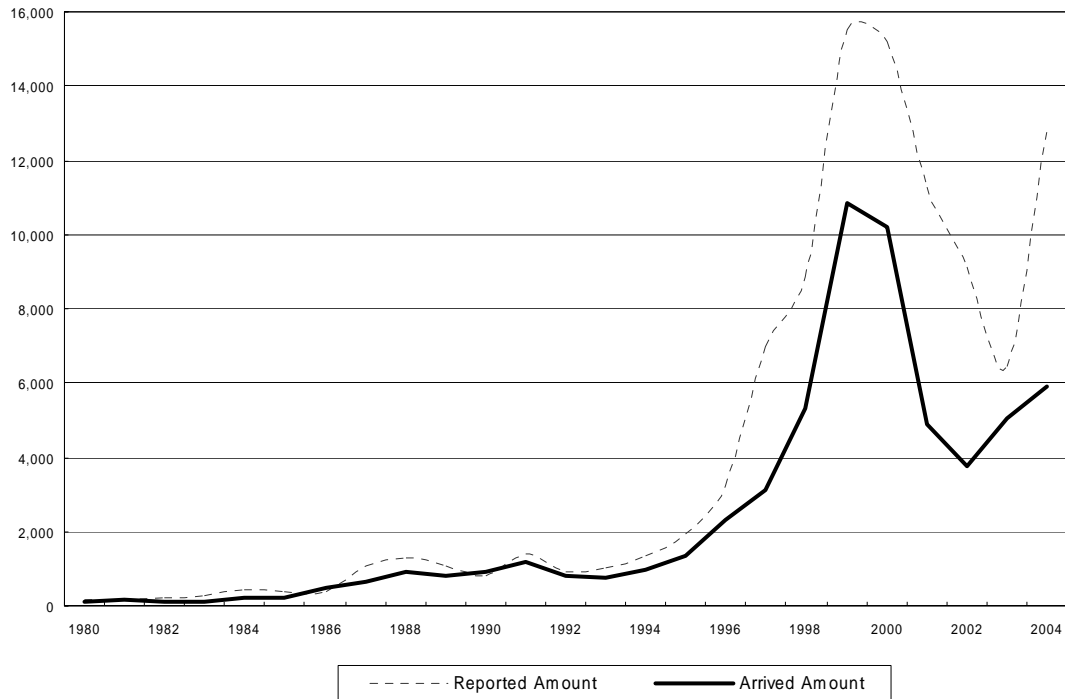
2.b. Trends of FDI in Korea

The Korean government strictly controlled inflows of direct investment during 1960's and 1970's. FDI were restricted only to the industries where foreign investments were deemed essential for the development of the industries while foreign investors were granted tax benefits for a certain period once they were allowed to invest in Korea. Because of the strict restrictions on the entry, the amount of FDI was kept relatively small even though it showed high annual growth rates during the two decades. Annual inflows of direct investments were less than \$200 million by the end of 1982. This is about 7% of annual net foreign borrowing of \$2,795 million in the same year. Net direct investment inflows were less than 5% of net long-term capital inflows including loan, portfolio investments and direct investments during 1974-1981.

FDI in Korea began to increase from 1984 with the help of improved investment environment. The economy grew rapidly and, more importantly, the government relaxed restrictions on foreign investments. Therefore, FDI became to be allowed in many of the previously restricted industries from 1984. However, FDI went down in early 1990's because of the surge of wage rate at the end of 1980's and the world wide

economic depression. In addition, the effects of the opening up of previously restricted markets seem to be exhausted by the early 1990's.

[Figure 2] Trends of FDI in Korea



Korea became a member OECD in the middle of 1990's. With this as a momentum, Korea opened domestic capital market again and thereby foreign investments were allowed in most industries with only a few exceptions. As a result of these changes, FDI began to increase again from the middle of 1990's.

We experienced a surge of FDI in 1998 and 1999. This seems to be the effect of financial crisis in Asia and the reactions of government to cope with the crises. Before the crisis, a view against FDI was prevalent in Korea. And the view against FDI might be one reason why the role of FDI was very limited in Korean economy. The share of

FDI in GDP was around 2% compared to the world average 17.3%. It was 11.1% in the U.S.A., 26.8% in the U.K., 30.9% in China, 97.6% in Singapore.

However, the view against FDI has been reduced with the experience of the financial crisis at the end of 1990's. We became to realize that we were in need of foreign capital to revitalize the economy. Therefore, not only the government but also the private sectors were very enthusiastic to induce more FDI. There was another big step of market opening in 1998: FDI through M&A became to be allowed; and most of the service industries including the retail trade industry and financial sectors were opened to foreign investors. In addition, there was also a reform in tax incentives for FDI. The duration for tax benefit was extended from 7 years (5 years of exemption and 2 years of 50% deduction) to 10 years (7 years of exemption and 3 years of 50% deduction) and a new measure to induce large investments has been introduced.

2.c. The Structure of FDI in Korea

<Table 3> shows the amounts FDI in Korea from 1990 to 2004 by home countries. More than 40% of FDI in Korea were from European countries and about 30% are from South-East Asia and the American Continent, respectively. Among individual countries, the U.S.A. is the single largest source of FDI in Korea, accounting for 22.36% of total. The Netherlands accounts for 16.71%, Japan for 13.66%, and Malaysia for 10.49% of FDI in Korea. The shares of investments from Japan, France, and Ireland have been decreased in recent years while the shares of investments from the Netherlands, Bermuda, Singapore, the Cayman Islands increased sharply. This suggests that more FDI in Korea tend to come via low tax countries.

<Table 3> Foreign Direct Investment in Korea by Home Countries

(Unit: U.S. \$1,000, %)

		1990 ~ 2004.3Q		1990 ~ 1997		1998 ~ 2004.3Q	
		Amount	Share	Amount	Share	Amount	Share
Total		54,285,222	100.00	11,377,191	100.00	42,908,031	100.00
Regions	Europe	24,108,656	44.41	4,828,738	42.44	19,279,918	44.93
	South-East Asia	16,402,914	30.22	3,706,516	32.58	12,696,398	29.59
	America	16,518,389	30.43	2,777,648	24.41	13,740,741	32.02
	Int'l Organizations	172,857	0.32	41,760	0.37	131,097	0.31
	IFC	172,831	0.32	41,734	0.37	131,097	0.31
	ADB	26	0.00	26	0.00	-	0.00
	Middle Asia	48,313	0.09	21,948	0.19	26,365	0.06
Countries	U.S.A.	12,139,557	22.36	2,446,824	21.51	9,692,733	22.59
	The Netherlands	9,068,873	16.71	1,357,553	11.93	7,711,320	17.97
	Japan	7,416,435	13.66	2,106,488	18.52	5,309,947	12.38
	Malaysia	5,692,538	10.49	1,223,383	10.75	4,469,155	10.42
	Germany	4,743,794	8.74	843,630	7.42	3,900,164	9.09
	Belgium	1,966,945	3.62	40,872	0.36	1,926,073	4.49
	U.K.	2,508,684	4.62	413,756	3.64	2,094,928	4.88
	France	2,504,400	4.61	830,980	7.3	1,673,420	3.90
	Bermuda	1,554,651	2.86	57,204	0.5	1,497,447	3.49
	Singapore	1,507,688	2.78	175,746	1.54	1,331,942	3.10
	Cayman Islands	1,044,118	1.92	17,192	0.15	1,026,926	2.39
	Hong Kong	715,643	1.32	120,321	1.06	595,322	1.39
	Canada	958,129	1.76	207,097	1.82	751,032	1.75
	Ireland	1,282,849	2.36	904,435	7.95	378,414	0.88
Swiss	539,618	0.99	254,261	2.23	285,357	0.67	

Source: Ministry of Industry and Resources

<Table 4> shows the industrial structure of FDI in Korea. In 1998, the manufacturing industry accounted for about 66% of FDI in Korea. But the share of manufacturing decreased to 26% in 2001. This seems to be the result of opening the

previously restricted markets in 1998. Most of the service industries including financial services and the retail trading industry were closed to foreign investors until 1998. The share of service industry went up from 29.3% in 1998 to 64% in 2001.

<Table 4> FDI by Industries

(Unit: U.S. \$1,000, %)

Year	Manufacturing		Service		Other	
	Amount	Share	Amount	Share	Amount	Share
1998	5,829,882	65.9	2,591,012	29.3	431,672	4.9
1999	8,356,202	53.8	6,783,081	43.6	402,672	2.6
2000	6,847,878	45.0	8,110,301	53.3	258,532	1.7
2001	2,911,122	25.8	7,223,890	64.0	1,145,311	10.2
2002	2,336,434	25.7	5,132,086	56.4	1,633,992	18.0
2003	1,697,093	26.2	4,132,068	63.9	638,990	9.9
2004	6,210,394	48.6	6,141,080	48.0	433,844	3.4
Total	34,189,005	43.1	40,113,518	50.6	4,945,013	6.2

Source: Ministry of Industry and Resources

3. Measures to Induce FDI

3.a. Tax Measures

- History of Tax Incentives for FDI

There have been tax incentives to induce foreign investments in Korea since 1960's. During the 1960's and 1970's, foreign investments in Korea were restricted strictly by law while most foreign investors were granted to tax benefits for maximum 8 years once they were allowed to invest in Korea. However, there was a change in the direction of the policy on FDI in 1983. Until this year, there was a positive list of industrial areas where foreign direct investments were allowed. This list was abolished

and a new system, the negative list system was introduced. Under the negative list system, the government lists industrial areas where foreign investments were prohibited. With the introduction on the negative list system, the restrictions of FDI were relaxed considerably. Thus, foreign investors became to be allowed to invest in previously restricted industries unless foreign investments in those industries did not seem to cause a considerable harm to Korean economy. At the same time, the tax incentives for FDI were curtailed substantially: the benefits were granted to foreign firms satisfying certain conditions; and the duration of tax exemption/reduction was shortened gradually to maximum 5 years by 1995. However, the financial crisis in late 1990's forced the government to provide more generous measures to induce foreign investment. More foreign investors became eligible for tax incentives for longer periods. And several new incentives were introduced.

In the aftermath of the Asian financial crisis, the government has been advocating a series of comprehensive reform measures in the corporate, financial, and labor sectors to address some of the more fundamental problems in the economy. The government believed that stimulating foreign investment and injecting market competition into the domestic economy are critical to the success of the reform drive. Therefore, the government has accelerated market liberalization in such areas as mergers and acquisitions (M&A), securities, capital transactions, foreign exchange, and the real estate market, virtually opening up all of the previously restricted markets to both portfolio investment and foreign direct investment.

With respect to FDI, the enactment of the Foreign Investment Promotion Act (FIPA) in September 1998 is noteworthy. The principal objective of FIPA is to attract FDI

by (a) eliminating burdensome regulations and anti-competitive market restrictions; (b) creating a more liberalized, transparent and favorable business environment for foreign businesses and investors; and (c) expanding tax incentives such as tax exemptions and reductions for extended periods.

- Tax Incentives for Advanced Technology FDI

The tax incentives granted to FDI under the FIPA, which was subsumed into the Special Tax Treatment Control Law (STTCL) on May 24, 1999, are primarily aimed at attracting high-technology and large-scale manufacturing investment, and include partial and full exemptions on individual and corporate income taxes and local taxes. Full exemptions from customs duties, special excise tax, and value-added tax may also be granted to imported capital goods.

In addition to liberalizing previously restricted markets and simplifying market entry procedures for FDI, the FIPA expanded the scope of FDI eligible for tax incentives in the form of tax exemptions and reductions and extended the duration for which these tax incentives stay in effect. Prior to the enactment of the FIPA, the government granted tax exemptions and reductions to FDI accompanying at least one of the 265 types of advanced technology (advanced technology FDI). Under the FIPA, the number of advanced technology increased to 436. In addition, 97 new high-technology service businesses that are expected to support the international competitiveness of domestic high-technology industries such as software and electronic commerce are to become eligible for tax exemptions and reductions. As a result, the

total number of advanced technology FDI eligible for tax benefits under the FIPA became to 533.

As shown in <Table 5> below, the duration for which tax exemptions and reductions stay in effect was extended from eight years to ten years for individual and corporate income taxes. The FIPA also preserves the full exemptions for capital goods imported for use by foreign invested companies within three years from the notification date of the FDI from customs duties, special excise tax, and value-added tax.

<Table 6> Changes in tax Incentives to FDI

Tax	Before FIPA (1998)	After FIPA (1998)
Individual and Corporate Income Taxes	1. Exemption for the first 5 years 2. 50% reduction for next 3 years	1. Exemption for the first 7 years 2. 50% reduction for next 3 years
Local Taxes: acquisition, property, registration taxes	1. Exemption for the first 5 years 2. 50% reduction for next 3 years	1. Exemption for the first 5 years, 2. 50% reduction for next 3 years; (local governments can extend the duration up to 15 years)
Customs Duties, Special Excise Tax, VAT	Exemption on imported capital goods	Exemption on imported capital goods

■ Tax Incentives for Foreign Investment Zones(FIZ)

In an effort to attract large-scale foreign investment, the FIPA has introduced the Foreign Investment Zone (FIZ) system. In the previous years, the national government granted tax incentives to FDI in pre-designated areas. However, the FIPA grants the local governments the autonomy to designate FIZ for FDI upon request from foreign

investors based on the amount of investment and the number of jobs to be created from their FDI. Foreign invested companies that receive the FIZ designation are eligible for government support and tax benefits. The tax benefits granted to them are the same as those granted to advanced technology FDI.

Where an FDI meets any of the following criteria, the governor of the province in which the FDI is to be made can designate an investment area as an FIZ. Only 7 areas were designated as FIZ during the period of 1998-2003. Recognizing that the required conditions for FIZ were too strict, the government relaxed the conditions in 2003. Under a relatively generous system, more became to be eligible for FIZ. Consequently, the number of FIZ went up to 15 by the end of 2004.

<Table 6> Conditions for the FIZ

Industry	Conditions for FIZ
1. Manufacturing	1. US \$30 million or more
2. Tourist hotels, floating tourist hotel keeping businesses, recreation businesses and amusement facility businesses, international conference facility service	2. US \$10 million or more
3. Combined freight forwarding business, joint collection and delivery centers, logistics businesses and facility establishment business	3. US \$10 million or more
4. Research facilities for advanced technology FDI	4. US \$5 million or more; and 10 or more researchers with Master's degree and more than 3 years of experience

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■ Tax Incentives for FDI in Other Designated Zones

The government also grants tax benefits to foreign invested firms located in several designated zones as stipulated in the STTCL. One example is the Foreign Trade Zones (FTZ). Manufacturing or logistic businesses operated by a foreign invested firms located in FTZ are eligible for tax benefits if they satisfy the following conditions.

- For manufacturing businesses: new factory facilities shall be installed and the amount of FDI shall be at least US\$10 million;
- For logistics businesses: new facilities shall be established and the amount of FDI shall be at least US\$ 5 million.

For those who are eligible for the tax benefit, corporation tax or individual income tax shall be exempted for 3 years after an income accrues, and then the taxes will be

cut by 50% for the next 2 years. If a company cannot generate income within 5 years after commencement of business, the tax will be exempted until the 5th year of corporate establishment.

There are other designated zones or areas where foreign invested firms are entitled for the same tax benefits as those in FTZ. The designated zones/areas and the conditions for the tax incentives are summarized in <Table 7> below. Among them, tax benefits for businesses located in Business Town Development Areas and Free Trade Zones are granted not only to foreign invested forms but also to the firms owned and operated by residents in Korea while tax benefits for other zones/areas are granted only to foreign invested firms.

<Table 7> Designated Zone/Areas for Tax Benefits to FDI

Zones/Areas	Industries/Activities	Conditions for Tax Benefits
Foreign Trade Zones	1. Manufacturing 2. Logistics Businesses	1. US \$10 million or more 2. US \$5 million or more
Free Economic Zones	1. Manufacturing/Tourism 2. Logistics Businesses	1. US \$10 million or more 2. US \$5 million or more
Business Town Development Areas	1. Manufacturing, tourism, distribution, engineering, value-added communication, information management, and other areas related to computer management,	1. US \$10 million or more

	science and technology. 2. R&D and logistics	2. US \$5 million or more
Jeju High-Tech Science and Technology Complex	Biotechnology, information technology, culture, and high-tech businesses (Non limit on the investment amounts)	
Jeju Investment Promotion Zone	Tourist hotels, recreation businesses (excluding country clubs), international conference facility services, culture, welfare facilities for senior citizens, power generation using alternative energy, etc.	US \$10 million or more

3.b. Non-Tax Incentives for FDI

- Incentives for Lease of National/Local Government Properties

Foreign invested firms are eligible for exemption from or deduction of rental fees for properties owned by the central government for up to 50 years. The FDI companies can construct facilities such as factories on the leased land on the condition that the facilities are donated or the property is returned to the national government after reverting to its original condition when the lease contract is terminated. The following are the conditions for the benefit.

- Businesses eligible for exemption: FDI companies located in FIZs; Companies in the advanced technology business, with FDI of at least US\$1 million, and that move into industrial complexes reserved exclusively for FDI companies.
- Businesses eligible for a reduction of up to 75%: Manufacturing companies located in FIZ exclusively for foreign investors with FDI of at least US\$5 million; Companies that contribute substantially to the expansion of social overhead capital, adjustment of industrial structure or financial independence of local governments, as designated by the Foreign Investment Committee.
- Businesses eligible for a reduction of up to 50%: Companies with advanced technology located in national industrial complexes and local industrial complexes throughout the nation.

Foreign invested firms are also eligible for reduction/exemption for rental fees to properties owned by local governments for up to 50 years. Businesses eligible for this benefit and the rates for such reduction/exemption shall be decided in accordance with the ordinances of the local government concerned.

With respect to the sale of the national government properties to foreign invested companies, the payment for the properties may be extended up to one year or made in installments for 20 years when a lump-sum payment is considered difficult. In this case, the applied interest rate is less than 4% per annum. For the sale of local government properties, the payment period shall be extended or payment shall be in installments according to the ordinances of the relevant local governments.

- Cash Grants for FDI

The government may provide cash grants to foreign invested companies with more than 30% of FDI to be used, for example, for the construction of new factories, taking into account whether the relevant foreign investment is accompanied by high technology, has the beneficial effects of technology transfer, is creating many jobs, as well as whether the foreign investment overlaps with any domestic investment, and appropriateness of business location. The conditions for the cash grants are the following:

- Where the amount of the foreign investment is not less than US\$10 million and is to be used for newly installing or expanding factory facilities
 - to run the business eligible for tax incentives provided for in Article 121.2 of the STTCA; or
 - to produce components and raw materials that are provided for in the Act on Special Measures for the Promotion of Specialized Enterprises for Components and Materials: parts and materials that can increase the value-added of the final product; parts and materials with high-technology or high value-added; or parts and materials that constitute the basis of an industry or can be utilized in a multiple number of industries.
- Where research facilities are newly installed or expanded in order to carry out research and development activities for advanced technology FDI provided for in Article 121.2 of the STTCA after meeting the requirements falling under each of the following:
 - the amount of foreign investment is more than US\$5 million; and

- the number of full-time research employees with a master's degree or higher, or with a bachelor's degree with more than three years of related experience in research, is more than 20.

The amount of the financial support in cash shall be set after conducting negotiations with the relevant foreign investor and after the deliberation of the Foreign Investment Committee. The firms should use the grants for the following purposes: acquisition costs or rental fees for the land needed to establish a factory or research facility; construction costs of a factory or research facility; acquisition costs of capital goods, research equipment and materials to be used for a project or research at a factory or research facility; installation costs of infrastructure, such as electricity and communications facilities necessary for installing a factory or research facility; or grants for employment or educational training.

3.c. The Effects of Tax Policy on FDI in Korea

There are two different groups of empirical researches on the effects of tax policy on FDI in Korea. One group is to estimate the effects of tax policy changes, especially tax incentives for FDI, on tax burden of foreign invested firms. An and Choi(2003) is the recent work for this purpose. They estimated the effective tax burden of foreign invested firms in Korea using the famous King-Fullerton framework and concluded that the tax benefits for advanced technology FDI and Foreign Investment Zone may have considerable effects.

The effects of tax holiday depend on depreciation rates, the duration of holidays, and the tax system of foreign investors' home countries. The effects would be smaller in the industries using more depreciable assets in their production process. As for the duration of holiday periods, An and Choi(2003) has shown that the exemption for the first three years and 50% reduction for additional two years would not be enough to reduce the tax burden of foreign invested firms substantially while the exemption for the first five years and 50% reduction for additional two years might reduce the tax liability to Korean government considerably.

One should note that the total tax burden of foreign investors depends not only on the host country tax system but also on the home country tax system. Even though the tax benefits in the host country reduce the tax liability to the country, it may not reduce the total tax burden including the tax liability to the home country. This is the case where the home country applies the residence rule with foreign tax credit but does not allow the tax sparing. Then the real benefits of the host country tax incentives would be attributed to the home country government rather than the investors themselves. In other cases, the tax incentives of the host countries have net effects of reducing tax burden of investors on income from international investments. <Table 4> in section 2 shows that about 60% of FDI in Korea come from the home countries applying the territorial rule of taxation on foreign source income or allowing tax sparing while applying the residence rule.

Another line of research is to study the effects of the effective tax burden on FDI. One of the recent survey paper, Gordon and Hines(2002) summarized the empirical studies of the effect of tax policy on FDI. They have shown that the estimated elasticity

of FDI to after tax rate of return are around -1 and they say that it implies the elasticity of FDI to tax rate is about -0.6 . Devereux and Griffith(2002) also concluded that: "Firstly, there is some evidence that taxes affect firms' location and investment decisions, although we do not have a very good idea about the size of this effect."¹

However, one should be careful in drawing firm conclusions on the effects that taxation has on FDI based on literature survey. The results vary widely depending on the estimation methods; and the indicators and the samples used in the estimation. While Gordon and Hines(2002) examined the empirical studies using the U.S. data on 1980's and thereafter, there are other studies shown that the tax policy does not have significant effects on FDI based upon empirical studies of the countries with different nature in earlier periods: Root and Ahmed(1978); Agodo(1978); and Sha and Toye(1978); and Lim(1983). Even theoretically, tax policy may have different effects on FDI in different economic environments and public policies of both the home and the host countries.

But we can safely say that, compared to the earlier studies, the recent studies, especially those on 1980's and thereafter, tends to show the significant effects of tax policy on FDI. This suggests that the tax policy became more important in FDI with the deregulation, liberalization, and the globalization of industrial activities in 1980's and thereafter.

In Korea, we have two important studies on this issue. An(1994) estimated the negative elasticity of FDI on domestic tax burden. But the significance level of the estimated elasticity was very low. However, Lee(1996) estimated the elasticity -2.56

¹ OECD(2004), Devereux and Griffith(2002).

and the estimated elasticity is statistically significant. The different result of these two studies seems to come from the sample period of the data. An(1994) used FDI date on 1967-1992. Thus his study included the period when the government restricted inflows of foreign capital strictly Lee(1996) excluded those period.

4. Measures to Restrain Evasion of International Tax

The Law for the Coordination of International Tax Affairs(LCITA) was introduced in 1996 to deal with tax matters related to international investments. The law contains the transfer pricing regime; the thin capitalization rules; the anti-tax haven rules; mutual agreement process; and international tax cooperation. Among the measures in the LCITA, three measures are intended to prevent or suppress international tax evasion: the transfer pricing regime; the thin capitalization rule; and the anti-tax haven rules.

4.a. Transfer Pricing Regime

The LCITA authorizes tax authorities to adjust the transfer price based on an arm's length price (ALP). Thus, tax authorities could determine or recalculate a resident's taxable income when the transfer price used by a Korean company and its foreign counterpart with special relationship is either below or above an arms' length price.

The LCITA and its decree recognize "special relationship" under the following circumstances:

- where a foreign company (a Korean company) directly or indirectly owns 50% or more of the voting shares of a Korean company (a foreign company);
- if a corporation (or an individual), which directly or indirectly owns 50% or more of the voting shares of a foreign company, directly or indirectly holds 50% or more of the voting shares of a Korean company;
- if a company's ("Company A") representative director is employed by another company ("Company B");
- if 50% or more of Company A's directors are employed by Company B; or
- if a substantial part of Company A's business is dependent upon Company B's operating funds, intangible property rights, or other transactions, then Company A's business policy will be regarded as substantially influenced by Company B.

If company A owns a 50% stake or more in company B, and B owns a certain percentage of shares in a third company C, B's equity ratio in C would constitute the ratio of equity by which A indirectly owns in C. If company A owns less than a 50% stake of company B, and B owns a certain percentage of shares in a third company C, A is treated as if it owns C to the extent of the ratio computed by multiplying A's equity ratio in B with B's equity ratio in C.

- **Criteria for an Arm's Length Price**

The LCITA and its decree define an arm's length price (ALP) as a price that is established or that can be expected to be established in a normal transaction between separate enterprises that do not have a "special relationship". The methods determining ALP can be divided into two groups: the traditional transactional methods

and the transactional profit methods. The traditional transactional methods include the comparable uncontrolled price (CUP) method, the resale price method, and the cost-plus method. The profit split method, the transactional net margin method (TNMM) are regarded as the transactional profit methods.

The CUP method evaluates an ALP by comparing the price that an independent uncontrolled person, under the same or similar circumstances in terms of trade conditions or volume, would set for goods identical to those in question.

The resale price method may be applied where a manufacturer sells its products to a related person and the related person resells the same product to an unrelated third party without any further processing. Under this method, the adjustment in the transfer price between related parties may be computed by subtracting an appropriate mark-up amount from the price that the related reseller sells the product to unrelated third parties.

The cost plus method may be, in principle, applied where a manufacturer sells his/her products to his/her related party and the related party then adds value to the product by processing it further for sales to unrelated third parties. In such cases, the ALP is calculated as the price of the refined goods, less the actual costs of the further processing, together with an appropriate mark-up upon such costs.

The profit split method determines an ALP by taking the sum of profits earned by the related parties and allocating the profit between them in proportion to their respective contribution towards generating the profits realized.

Finally, the TNMM evaluates an ALP by first seeking an independent third company which is similar to the company at issue in terms of its business operations and the nature of its business and then subjecting such company to both functional analysis and comparability analysis. The income earned by the third company is then estimated based upon the following ratios: profits to assets, operating profits to turnovers, and profits to equity. These estimates will then be used to evaluate and if necessary, adjust the income and profit of the related parties.

- Selection of Methods for Determining ALP

The decree of LCITA states that an ALP should be determined by the most reasonable method applicable to the situation, whether it be the CUP method, the resale price method, the cost plus method or any other method. The most reasonable method should satisfy the following criteria:

- (a) The level of comparability between the transactions of related parties and those of independent parties must be high;
- (b) Availability of data on a comparable independent party must be high; and
- (c) The economic assumptions made in comparing the related parties' transactions with those of independent parties must reflect the actual economic situation of the parties.

The degree of comparability can be evaluated on the following factors:

- The risk which accompanies the functions performed, such as contract conditions and transactions;

- The types as well as characteristics of the goods or services involved;
- The economic environment of the market and degree of changes in market conditions.

If there exists a transaction between unrelated parties identical or similar to the transaction between the related parties at issue, the CUP method will be selected over the resale price method, the cost plus method or any other method. Among the methods of determining an ALP, traditional transactional methods have priority over transactional profit methods. The transactional profit methods should be used only if the traditional transactional methods are inapplicable.

The tax authorities may use an arm's length range determined by two or more uncontrolled transactions to adjust the taxable income of taxpayers. Such tax adjustment should be made based upon the reasonable values computed from the transactions examined. The method and the reason for adopting a particular method for an ALP determination should be disclosed by the taxpayer to the tax authorities in a report submitted with his/her annual tax return.

■ Advance Pricing Arrangement (APA) System

If a taxpayer wishes to obtain an APA for transactions with its foreign related parties, then he should submit an application for an APA to the National Tax Service (NTS) before the first day of the tax period concerned. Both the NTS and the taxpayer are bound by the ALP determined under the method agreed upon in the APA. Once

the NTS approves the application of a certain method for determining an ALP, the approved method is applicable for as long as the taxpayer desires. An applicant for an APA may withdraw his application for an APA or change the contents of such an application.

Any data submitted with the application for an APA will only be used to only determine whether or not to grant an APA. If an application for an APA is refused or withdrawn, such data will be returned to the applicant in order to safeguard the confidentiality right of the taxpayer. After obtained an APA, a taxpayer is required to file an annual report showing the inter-company price, which was determined by the method agreed upon under the APA, within six months of the annual tax return submission due date.

4.b. Thin Capitalization Rules

A multinational enterprise (MNE) may adopt a tax avoidance mechanism under which it decreases its contribution of paid-in capital to its subsidiary in Korea, while at the same time increasing its loans to the subsidiary as much as possible. This may result in the minimization of the taxable income of the subsidiary through the increase in the size of the interest expense deduction of the subsidiary. Under such an arrangement, non-deductible dividend payments are essentially being replaced with deductible interest payments.

To cope with this type of arrangement, the LCITA and its enforcement decree provide for the thin capitalization rules. If a Korean company borrows from its controlling shareholders overseas (CSO) an amount in excess of three times of its

equity (six times, in case of financial institutions), interest payable on the excess portion of the borrowing will not be deductible in computing taxable income. For purposes of the thin capitalization rules, money borrowed from a CSO includes amounts borrowed from an unrelated third party based upon the CSO's guarantee.

Although the ratio of debt owed to a CSO to equity exceeds 3:1, as long as the conditions and amount of the debt follows an arm's length principle, such debt from the CSO shall be excluded from the scope of the debt subject to the thin capitalization rules. Thus, interest on such debt shall be deductible.

4. c. Anti-Tax Haven Rules

If a Korean company has invested in a company (i.e., a controlled foreign company) located in a tax haven, the profits reserved in the controlled foreign company shall be treated as dividends paid out to that Korean company, despite the fact that the reserved profits are not actually distributed. Korean companies subject to the anti-tax haven rules are companies directly or indirectly owning 50% or more of the shares in foreign company, or those substantially controlling the business policy of the foreign company and owning at least 20% or more of the voting shares.

The anti-tax haven rules are intended to regulate a company that has made overseas investments of an abnormal nature. Thus, these anti-tax haven rules apply to those Korean companies that have invested in a company incorporated in a foreign country with an effective tax rate of 15% or less. However, if a company incorporated in such a tax haven country actively engages in business operations through an office, a shop, or a factory, then the anti-tax haven rules shall not apply.

According to the LCITA and its decree, a country that meets any of the following conditions is regarded as a tax haven: a country which does not impose a corporate income tax or which allows a tax exemption of 50% or more of actually accrued income; and a country with effective tax 15% or less of actually accrued income of a company incorporated therein. The effective tax rate is calculated as a ratio of tax imposed by a foreign country to the actually accrued income of a company incorporated therein. The term "actually accrued income" refers to the net income before tax calculated based on the generally accepted accounting principle (GAAP) of the host country. If the host country's GAAP is significantly different from that of Korea, then the actually accrued income will be computed pursuant to the Korean GAAP.

5. Tax Measures at the Local Level

In Korea, local governments play only a limited role in public policy for FDI. Most of the measures are determined at the national level and local governments exercise their autonomous decision making power under the permission provided in the law. With regard to tax policy, the Constitution declares that tax items and tax rates shall be stipulated in the law. This suggests that all the tax rules and practical measures including local tax measures shall be decided at the national level. Local government can make their autonomous decision only when they are allowed or delegated to do so by the law. Therefore, most of the tax incentives for FDI explained in earlier sections of this paper were determined and are administered by the central government. The role of local governments is to adjust the standard rules within the ranges permitted by the law or make their own rules when they are delegated to do.

The following are the examples of tax matters and other policies measures at the discretion of local governments

- As for tax incentives for advanced technology FDI and FIZ, local governments could extend the duration for exemption/reduction of local taxes up to 15 years.
- The province governments could designate FIZ upon the requests of eligible foreign invested firms.
- With regard to the exemption/deduction of rental fees for local government properties, local government shall determine the businesses or activities that are eligible for the benefits and the rates of benefits by local ordinances.

6. Current Issues on Tax Policy Related to FDI

The conditions sought by foreign investors are largely equivalent to those that constitute a healthy business environment more generally. Therefore, the most important current issue in public policy for FDI is to improve investment environment in general. In this regard, tax policy should also focus on establishing a healthy business environment. The corporate tax burden should be reduced and, at the same time, the tax base should be broadened. The base-broadening can be accomplished by abolishing or reducing various tax benefits for particular business or activities and it might have positive effects on economic efficiency. Lower tax rates and broader tax base are the long run direction of tax reform in many other countries as well as in Korea for a couple of decades. However, it seems to take a long time. The government should consider the effects of the reform on budget as well as its effects on economic efficiency. In addition, there might be strong resistances against base-broadening from those who receive benefits currently.

With regard to tax incentives for FDI, the oldest and most important issue is the special treatment of foreign investors. As we have seen in earlier chapters, there are various tax incentives granted only to foreign investors. In the earlier period of industrialization, it might be necessary to induce FDI with special benefit applied only to foreigners because the production and managerial technology that come with investments may have important effects on economic development. Therefore, it might be reasonable to grant special benefits to foreign investors in 1960's and 1970's. However, considering the current stage of economic development in Korea, there is a growing concern on the negative effects of the special treatment: Korean capital might be invested in Korea via other countries and thereby receive tax benefits for foreign investors; and tax incentives for the advanced technology FDI may have negative effects on research and development of firms owned and operated by Korean nationals. In addition, one should note that some of the most important factors considered by investors as they decide on investment location are fair and equitable treatment, a predictable regulatory environment, and an absence of undue administrative impediments to business more generally.²

Another short-run policy issue related to tax incentives for FDI is to simplify the benefit system. It is often said that the current system is too complicated for ordinary taxpayers to understand.

In the aspect of international tax avoidance, the most important issue in Korea is to cope with treaty shopping. The tax evasion of multinational investment companies through treaty shopping became an important issue in the middle of 2005. National

² OECD(2003).

Tax Service investigated several cases of treaty shopping in 2005, and the Ministry of Finance and Economy proposed a reform in related provisions: to spell out clearly in the domestic law and tax treaties the provision that the tax on income attributed to paper companies in tax haven regions shall be imposed on the beneficial owners of the company.

The government is also planning to renew outdated tax treaties in order to incorporate changes in domestic and international economic environments and the developments of international tax rules. For example, the provision as the following shall be included in tax treaties with OECD countries: capital gains from the alienations of shares issued by a company may be taxed in the source country where the property of the company consists principally of immovable property situated in the source country.

Another agenda for reform in international taxation in Korea is to introduce Foreign Investment Funds System. We have the CFC(Controlled Foreign Corporation) rule under the name of the anti-tax haven rule. The purpose of CFC rule is to cope with tax avoidance by foreign corporations controlled by domestic firms. But the rule does not apply to income from foreign investment funds. Therefore, we have to consider the introduction of the FIF(Foreign Investment Funds) rule in the long run in order to prevent tax evasion of domestic investors through foreign investment funds. Under the FIF rule, the income of domestic investors from the investments through foreign investment funds shall be taxed when the income is earned and the deferral of the tax is not allowed.

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* Written in Korean language.