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Taxation on Thin Capitalization

1. Summary

A foreign invested company (including a domestic permanent establishment of a foreign corporation) can raise funds from its foreign controlling shareholder using two methods: capital injection and loan. The dividend to the investment is not tax deductible for corporate income tax purposes but the interest expenses to the loan is deductible; thus, loan is preferred for funding to reduce tax burden in Korea. If a foreign invested company raises most of its funds by loan from its foreign controlling shareholder, the taxable income of the foreign invested company will be decreased. In order to prevent such tax evasion, the thin capitalization tax system has been established to exclude the interest expenses to the excessive borrowings provided by its foreign controlling shareholder from deductible items by recognizing interest payments as dividends.

2. Scope of the foreign controlling shareholder

1) a domestic corporation

a. A foreign shareholder who directly or indirectly owns 50% or more of the voting stocks of a domestic corporation

b. A foreign corporation of which 50% or more of the voting stocks are owned directly or indirectly by a foreign shareholder specified in the section ‘a’ above

c. A foreign shareholder who has a common interest with a domestic corporation through investment relation, transaction relation, loan, etc. and can substantially determine all or major parts of the business decisions of the domestic corporation

2) a domestic permanent establishment of a foreign corporation

a. The head office and its branches of the foreign corporation

b. Foreign shareholders who directly or indirectly owns 50% or more of the voting stocks of a foreign corporation

c. Other foreign corporations owned by the head office of ‘a’ above or owned 50% or more of the voting stocks by the foreign shareholders of ‘b’

3. Method for calculating the portion of the interest expenses which are non-deductible

- Excess borrowings amount = aggregated borrowing amount from foreign controlling shareholders – aggregated equity amount from foreign controlling shareholder x 2 times [(or 6 times in case of financial institutions) or comparable multiplier]
- Non-deductible expenses = excess borrowings amount x interest rate / 365 (366 in case of a leap year)

1) Non-deductible interest expenses

When calculating the non-deductible expenses, interest and discount fees payable mean all interest incomes generated from the borrowings such as an amortization of differences in issuing the bond at discount and a discount charge of a promissory note, etc., whose economic substance corresponds to interests but the interest of capitalized assets shall be excluded.

2) Loan of a foreign controlling shareholder
The loan of a foreign controlling shareholder shall include not only a loan extended by the foreign controlling shareholder but also a loan provided by a third party through the payment guarantee by the foreign controlling shareholder (including the cases of substantially guaranteeing payment, such as the pledge of collateral, etc.). The amount borrowed by a domestic corporation from a foreign controlling shareholder or from a third party according to the payment guarantee of the foreign controlling shareholder shall be converted by applying the reference exchange rate or arbitrated exchange rate as of the end of the fiscal year concerned.

The payment guarantee by the foreign controlling shareholder shall include all forms of payment guarantees under which the foreign controlling shareholder must practically fulfil the obligation when the domestic corporation default on its obligation regardless of presence or absence of a special warranty deed, the type of special warranty deed or payment guarantee method, and the foreign controlling shareholder's de facto payment guarantee such as the provision of security.

3) Foreign controlling shareholder's investment

a. In case of a domestic corporation

A foreign controlling shareholder's investment shall be calculated as of the end of fiscal year, which shall be calculated by multiplying the net equity on the financial statement by the percentage of the capital subscribed by the foreign controlling shareholder among the total paid-in capital.

Foreign controlling shareholder's investment = Net shareholders' equity of the domestic corporation x capital subscribed by the foreign controlling shareholder / Total paid-in capital of the domestic corporation

b. In case of a domestic permanent establishment of a foreign corporation

In case of a domestic business establishment of a foreign corporation, the foreign controlling shareholder's investment shall be the amount that is obtained by deducting the total liabilities from the total assets on the balance sheet of the domestic permanent establishment as of the end of each fiscal year.

Foreign controlling shareholder's investment = total assets – total liabilities

4) Income disposition of non-deductible expenses

The interest on the debt borrowed from a foreign controlling shareholder by a domestic corporation which is not included in deductible expenses shall be deemed to have been disposed of as dividend, and the interest on the debt from a third party under a payment guarantee of a foreign controlling shareholder which is not included in deductible expenses shall be deemed to have been disposed of as outflow of income.

4. 30% EBITDA interest limitation rule

Effective from 1 January 2019, where the net interest expenses from the foreign related party borrowings exceeds the 30% of the earning before the net interest, tax, depreciation and amortization (EBITDA), the exceeding interest amount is not tax deductible.

If different interest rates are applied, the interest deduction will be denied from the highest interest rate.