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Law and Taxation of Corporate Merger and Division in Korea

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Abstract

Traditionally the concept of tax-free corporate reorganization has not existed in Korean law, and the rules for merger and division were pervaded by a mystic theory of the "fusion of juridical personalities" extrapolated from corporate law metaphysics, imported from an old and now defunct German theory. This metaphysical theory proved irrelevant during the economic crisis and the subsequent law reform following the economic crisis of 1997 and 1998, which introduced a tax-free merger, division and other forms of corporate restructuring. This paper reviews the overall structure of and specific issues about the new tax rules in interaction with new corporate law. It shows that the new rules are based on a juxtaposition of real world problems and metaphysical legal dogma, combined with a superficial and dogmatized understanding of foreign laws. The final outcome of current law is a mere importation of the hard shell of foreign legal concepts, which fails to address the real world problems in the right way.

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I. Introduction

In the United States law corporate merger and division is considered a sub-category of corporate "reorganization" in the context of tax law, and does not trigger taxation of unrealized income for the corporations or the shareholders. The underlying theory is that "merely a new form of the previous participation in an enterprise involving no change of substance in the rights and relations of interested parties one to another or corporate assets"[1] does not justify taxing gains or deducting losses built in an asset. Traditionally the concept of tax-free corporate reorganization has not existed in Korean law and the rules for merger and division were pervaded by a mystic theory of the "fusion of juridical personalities" extrapolated from corporate law metaphysics. The advent of economic crisis in 1997 and 1998 necessitated a revolutionary change, however. In desperately attempting to overcome the crisis, Korea had to restructure its banks and business firms, for reallocating capital to more efficient users. To help facilitate this process, Korea vastly reformed its corporate, labor as well as taxation laws. The corporate law introduced the new concept of corporate division and also reshuffled merger rules. Labor law was revised to permit leniency in dismissing employees, in particular, in connection with corporate restructuring. Tax law was revised to enable tax-free reorganization in incorporation, merger, division and other forms of corporate restructuring.

The thesis of this paper is that Korean corporate and tax law regarding mergers, division and other forms of restructuring is a product of a hap-hazardous historical development, juxtaposing real world problems and metaphysical legal dogma. Traditionally the Korean scholarship of merger law was obsessed with an archaic and arcane discussions imported from an old and now defunct German theory. This metaphysical theory proved irrelevant during the economic crisis and the subsequent law reforms, and the legal community faced the task of rewriting the rules for corporate restructuring. Unfortunately, this task was dominated by a superficial and dogmatized understanding of foreign laws, and only resulted in importing the hard shell of foreign legal concepts. A full analysis of this thesis would require canvassing diverse dimensions of the corporate and taxation law, but the scope of this paper will

1) Bazeley v. CIR, 331 US 737, reh'g denied, 332 US 752 (1947).

be limited to the interaction or mis-interaction between the corporate and taxation laws, in particular in connection with taxing the unrealized capital gain built in the hands of a corporation or the shareholders.

II. Form v. Substance in Taxing Unrealized Gains

The quintessence of tax rules regarding a merger or another form of corporate restructuring is whether and to what extent such a transaction must trigger taxation of the unrealized gain embedded in the assets of the corporate parties to the restructuring or in the shares owned by the shareholders. Risking oversimplification, the answer largely depends on the form versus substance, or a legalistic versus an economic approach to the issue. To a legalist, transferring a property from a corporation to another should be a taxable event in the same way as a transfer from an individual to another. To an economist, however, a corporation is nothing but an extension of the shareholders. A shareholder may own property directly in her name or may choose to insert a corporation in between and own the property in the name of the corporation. Seen this way, transferring a property from a shareholder to a corporation or vice versa is a mere change in legal formality. Moving property among corporations under common control does not involve any change in economic substance either.

The United States law reveals a strong influence of the economic substance idea. In *Burge*[2], the Board of tax Appeal ruled that a corporation is a person separate from its shareholders, and thus a shareholder's contribution of property into a corporation in exchange for shares is a taxable event. Subsequently, however, the Revenue Act of 1921[3] adopted the economic substance approach, and has been elaborating the concept of tax-free corporate organization or reorganization. A merger or consolidation is considered a subcategory of the reorganization.[4] No gain or loss is recognized to an extinguished corporation if the corporation, being a party to a reorganization, exchanges property solely for stock or securities in another corporation a party to the

2) Napoleon B. Burge & C. Burge, 4 B.T.A. 732 (1926)

3) For an analysis of the Act, *see* Hellerstein, "Mergers, Taxes and Realism", 71 *Harvard. L. Rev*. 254, 258-261 (1957).

4) Internal Revenue Code (hereinafter "I.R.C."), Sec. 368(a)(1)(A).

5) I.R.C. Sec. 361(a).

reorganization, in pursuance of the plan for reorganization[5] Neither the corporation nor a shareholder recognizes any gain or loss in connection with the exchange of the extinguished shares for the new shares issued by the corporation surviving or born from the merger.[6]

In contrast, the pervasive theory of traditional Korean tax rules remained quite legalistic. If an individual transfers her property to a corporation, the gains or losses embedded in the property was recognized even if she controls the corporation.[7] For a merger, Korean law in principle taxes an extinguished corporation on the difference between the aggregate book value or the basis of the corporation's net assets and the value of the new shares that the shareholders receive in exchange for the old shares in the extinct corporation.[8] Also a shareholder was taxed on the difference between the value of the new shares and the acquisition cost or the basis of the old shares before the merger or consolidation.[9]

III. Science v. Dogma

Nevertheless, there was an interesting spin in the Korean merger tax rules, involving the concept of "value" of the new shares. Where a corporation is liquidated for distribution of the proceeds to the shareholders, the corporation is taxed on the difference between the "value" of the net asset and the basis of the net asset,[10] and the term "value" here was construed to mean the market value of the net assets. In contrast, the term "value" of the shares issued for a merger was construed to mean the par value of the shares.[11] Obviously reference to the par value could easily result in a tax-free merger, because par value of shares does not have economic meaning.

Where does the idea of valuation at par come from? Indeed the par valuation was a teleological mean to enable a tax-free merger in approximation. The rationale of tax-free merger, however, was not economic substance but a mystic theory that a merger

6) I.R.C. Sec. 361(c) and 354(a).

7) Income Tax Act, art. 88(1).

8) Corporate Tax Act, art. 43(3), before complete restatement by Law. No. 5581 of Dec. 28, 1998.

9) Income Tax Act, art. 17(2)(4).

10) Corporate Tax Act, note 8, art. 43(1).

11) Supreme Court of Korea Decision No. 93Nu12961 dated November 4, 1994.

involves a fusion of the juridical personalities of the merging and merged corporations. In the history of corporate law, this fusion theory dates back to the German scholarship before 1937, as an antithesis to the so-called "in-kind contribution" theory. The controversy between the two theories basically perished once the Aktiengesetz of 1937 solved the issues which had originated the controversy. Strangely, this controversy was imported into and survived in the contemporary Korean scholarship, and almost every commentator sides with the fusion theory. This then was extrapolated into the area of taxation. The idea that a merger is a fusion of two juridical persons naturally leads to the consequence that a merger should not trigger any tax, because the merged companies must be considered one and a single person as if they had been so from the start.

At a superficial glance, the fusion theory may appear the same as the economic substance approach. In the fusion theory, a merger is not a taxable event because two corporations are regarded to have been one from the start. In the economic substance approach, a merger is not a taxable event because it involves a mere change in legal formality. They may sound similar, but are very different. First, the fusion theory naturally mandates the summation of the two corporations' accounting books, or the pooling method in the jargon of financial accounting. This result of course distorts financial accounting, which in principle demands the so-called purchase method or the idea that the assets and liabilities must be valued at the current price as of the date of merger. Second, the fusion theory can only apply to a merger. It cannot justify tax-free reorganization for other forms of corporate restructuring. For example, suppose a corporation contributes all its property to another corporation in exchange for shares issued by the latter, distributes all the shares to the shareholders, and then liquidates. In economic substance, the final sum of these transactions is not any different from a merger. From a tax policy perspective, no reason exists to distinguish this transaction from a merger. The fusion theory, however, would not provide any rationale for tax freedom, because this transaction is not a merger. Thirdly and most important, resorting to a metaphysical theory defies *ab initio* any scientific analysis of tax policy. For example, suppose a small Mom & Pop hamburger store is acquired by McDonald in the form of a merger, and Mom & Pop becomes a 0.00001% shareholder of McDonald. Is this merger a mere change in legal form without substance? It is preposterous that this merger should remain non-taxable because a merger is a fusion of two personalities.

The tax issue for corporate restructuring is whether the restructuring should be considered or made a realization event for recognizing the capital gain or loss accumulated in the assets owned by or shares issued by a corporation. The answer can only come from a scientific analysis of the merits and demerits of taxing the capital gain. Seen this way, a merger or another form of corporate restructuring cannot be considered a realization or a non-realization event by itself. It should or should not trigger taxes depending on the economic substance of the transaction. Moreover, an even more fundamental question surfaces: Can it be taken for granted that a mere change in legal form should not trigger taxation? The issue involves a classical case of the lock-in effect of capital gains taxation; Taxing capital gains on a realization basis creates an incentive for taxpayers to hold-on to an existing asset even if re-allocation of the assets are more efficient from the perspective of the whole society. Narrowing the case to corporate restructuring, an argument can be made that exempting the capital gain will enable businesses to take a legal form that would better suit the shareholders and the whole economy.

The case is not that simple, however. First, the very effect of the lock-in effect results from the failure to tax all income on a pure accretion basis. Namely, lock-in effect arises because the appreciation in property value is taxed on a realization basis, as compared to many other forms of capital income currently taxed as they accrue. Exempting capital gains taxation will thus widen the gap between the assets taxed on a pure accretion basis and those taxed on a realization basis.[12] Secondly and probably more importantly in the real world, the idea of tax-free reorganization causes unmanageable complexities of tax rules and difficulties in tax administration. How can one define the scope of "substantively the same business"? Left to the subjective judgments by the tax administrators, the distinction will impose heavy burden to the administrators and judges, and may devastate the rule of law. Having a highly articulated tax statute is not a panacea either. The U.S. experience shows that discrepancy will still arise between the statutory requirements and the intuitive notion of a mere change in form, creating incessant disputes between taxpayers and the administration. The court-made rules of the business purpose requirement[13] or the

12) Patric H. Hendershott et als, "Effects of Capital Gains Taxes on Revenue and Economic Efficiency", XLIV *National Tax J.* 21.

13) *Gergory v. Helvering*, 293 US 465 (1935)

continuity of interest doctrine[14] remain largely subjective judgments.

IV. Korean Tax Rules for Merger and Consolidation

Good or bad, the current merger[15] rules of Korea imported the idea of tax-free reorganization from the Untied States. The current rule is three-pronged, and separately provides for the tax effect for the merged corporation, shareholders in the merged, and the merging or surviving corporation. Unlike the old law, every merger does not automatically qualify for a tax privilege. The current law distinguishes between tax-free and taxable mergers. The qualification of a tax-free status is quite lenient, however. For a merged or extinguished corporation, a merger is tax-free if 1) the merged corporations have been in business for a year or longer, and 2) ninety-five percent (95%) or more of the compensations paid to the shareholders in the merged corporation are shares.[16] The same two requirements apply for exempting capital gains taxation for the shareholders.[17] For the merging or acquiring corporation, a third requirement exists that the corporation continue the taken-over business for the rest of the year and subsequent three years.[18] Upon satisfying the three requirements, the acquiring corporation can revalue the acquired assets and step-up the basis to the market without paying taxes on the gain. Of course this basis step-up is not a permanent exemption but a deferral of taxes. Depreciation of the stepped-up portion is not deductible, and, at time of disposing the asset, deductible basis of the asset remain the unappreciated amount.[19]

The leniency of the two or three conditions shows that the scope of tax-free merger may go well beyond the intuitive notion of a mere change in legal form. Going back to the Mom & Pop example, they will still be able to avoid taxes if they exchange their business for the 0.00001% of the shares in McDonald. This may show the survival of

14) *Cortland Specialty Co. v. CIR*, 60 F2d 937 (2nd Cir.) cert., denied 288 US 599 (1932).

15) The term “merger” hereafter includes consolidation.

16) Corporate Tax Act (hereinafter “the CTA”), art. 80(1); CTA Enforcement Decree, art. 122(1); CTA art. 16(1)(5); CTA Enforcement Decree art, 14(1)(1).

17) CTA Enforcement Decree art. 14(1)(1); Income Tax Act Enforcement Decree, art. 27(1)(1).

18) CTA art 44(1).

19) CTA Enforcement Decree art 80(4) and (5), 64(4).

the fusion theory, but probably an even better explanation is that the new Korean rules are imported from the United States law, which grants tax-free status to all statutory merger or consolidation without asking any further question. The legislative history of Korean tax reform does not show any evidence that the validity of U.S. law was ever questioned.

A second point exists that clearly shows the holdover of the old metaphysics. It concerns the legal consequence of the tax-free merger, or the technical tools for providing the tax privilege. The law does not provide that the capital gains taxation will be deferred if the two or three requirements are met. Instead it says that the shares issued by the acquiring corporation will be valued at par for the purpose of taxing the extinguished corporation or its shareholders.[20] Obviously this is a holdover of the pre-1998 rules, in that the par value of shares does not carry any economic relevance in valuing them.

The question then is why and how the par valuation can achieve tax-free status. The number of shares and the consequential amount of the aggregate par value of the shares to be issued to the merged shareholders necessarily reflect the economic values of the two corporations being parties to the merger. Albeit lacking economic relevance, the aggregate par value will still amount to a certain sum that may well trigger taxes to the merged corporation or its shareholders. How can the par valuation grant tax exemption? The trick is that the acquiring corporation can control the aggregate par value of the new shares by changing the aggregate par value of its own pre-merger shares, which itself does not have any economic relevance either. For example, suppose a corporation has issued 500 shares, each denominated at 100 million Korean Won par value. Further suppose this corporation is merging with another corporation and must issue 300 shares to the merged shareholders. If the acquirer issues new shares as they are, the total par value of the new shares will be 30 billion Korean Won. If the acquirer reduces the par value of its 500 shares to half of what it was, then the par value of the new shares will also be reduced by half and become 15 billion Korean Won. Given this mechanism, Korean tax administration and courts could grant tax-free status to a merger under the pre-1998 law, and the same holds true in the current law. This detour causes unnecessary tax-driven transactions, however. Under the

20) CTA Enforcement Decree art. 14(1)(1).

Commercial Code of Korea, the aggregate par value of the shares constitutes the "legal capital" of a corporation,[21] which forms the basis to determine the amount of earnings and profits that may be distributed to the shareholders without getting consents from the creditors.[22] Under the KCC, accordingly, reduction of capital is permitted only after the creditors agreed on it.[23] This statutory procedure of protecting the creditors involves considerable amount of time and money in that the company must obtain consents from the creditors or accelerate the repayment of the debts to the non-consenting creditors.

Very recently in 2001, the KCC introduced the "comprehensive exchange of shares",[24] modeled after the U.S. law of share exchange.[25] This in essence is a merger, in that shareholders in a corporation will be forced to relinquish their shares in exchange for new shares in the acquiring corporation. The technical or formal difference is that the acquiring corporation will not directly own the assets and the liabilities of the acquired corporation and instead own all the shares in the acquired. The Korean tax statute is still silent on this new transaction, and thus the current law will obligate the acquired shareholders to pay taxes on the difference between the market value of the new shares and the purchase cost of their old shares.[26] Indeed the KCC's adoption of the share exchange system is preposterous in that the triangular merger, the historical and logical predecessor of share exchange, is still missing in Korean law. In the United States, an acquiring corporation may make a target merge with or into its subsidiary, so that the target shareholders will receive the shares in the parent while the company will be merged with the subsidiary. The share exchange is a particular case of this triangular merger, in particular a reversed triangular merger. In a reversed triangular merger, a subsidiary is merged into the target. The share exchange indeed is a codified form of the reversed triangular where the merged subsidiary happens to have null or minimum existence. In the KCC, however, the share exchange provision was introduced as a special measure to help form the stock-holding companies, coupled with a new provision that enables a corporation to form a parent.[27]

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21) Commercial Code of Korea(hereinafter "KCC") art. 451.

22) KCC, art 462

23) KCC art 439(2) and 232.

24) KCC art. 360-2

25) Revised Model Business Corporation Act, Sec. 11.02.

26) Small shareholders in a publicly traded corporation are exempt from capital gains taxation.

This allegedly was necessary to reform the Korean Chaebol or business conglomerates. All these developments show that the recent changes in the KCC and CTA are mere hap-hazardous measures hastily introduced from foreign law.

V. Corporate Division.

During the 1990s many lawyers and business executives complained that the KCC is not equipped with the system of corporate division. The law reform of 1998 introduced corporate division, which may affect the company alone or the shareholders as well.

The first category of division at the company or property level means that a company incorporates a subsidiary by moving whole or part of its assets and liabilities to the subsidiary.[28] Even before the 1998 amendment, moving a particular line of business to a subsidiary was possible, but the procedure involved a time consuming and costly procedure of transferring all the individual assets and liabilities to the subsidiary, such as registering the change in title and getting consent from the debtors and creditors. Under the new law, dividing a business segment into a subsidiary is possible without taking this cumbersome procedure, on condition that the parent and subsidiary are jointly and severally liable to the creditors.[29] The joint and several liabilities will be exempt if the creditor protection procedure has been consummated during the division process.[30] If the subsidiary is to be merged with another corporation, the two procedures of division and merger can be combined into a single procedure called division and merger.[31]

The company level division does not affect the shareholders, and it only raises tax issues for the parent and the subsidiary. These issues are exactly the same as those for the two corporations parties to a merger, and the tax codes distinguish between a tax-free and taxable division. The conditions of the tax-free division[32] include 1) the parent

27) KCC, art. 360-15.

28) KCC, art. 530-12.

29) KCC, art. 530-9 (1).

30) KCC, art. 530-9 (2) and (4)

31) KCC, art. 530-2 (2) and (3); 530-12.

32) CTA, art. 46.

has been conducting business for five years or longer, 2) the compensation to the parent is only in shares, 3) the subsidiary continues the business for the remaining terms of the year and subsequent three years, and several other conditions. Unlike a merger, however, a tax-free division does not take the twisted form of valuing the stock at par. The tax code mandates that the stocks in the subsidiary will be valued at the market price, and flatly provides that the capital gain from transferring the properties to the subsidiary will be tax-deferred. This is in stark contrast to the par valuation in the merger rules.

The second category of corporate division is the shareholder level or personal division, which means that the shares issued by the spun-off business are distributed to the shareholders, and thus the original and the spun-off companies will become sisters. In other words, the shareholder level division is a variation of the company level division in that the shares issued by the divided business does not remain in but are distributed by the company to the shareholders, and the parent-subsidiary relation will be changed to sisterhood.[33] A combined procedure of division and merger is also possible.[34]

Even before the 1998, a Korean version of U.S. split-off and split-up was possible in Korea, by taking the three steps of 1) forming a subsidiary by contributing assets and liabilities, 2) giving the subsidiary shares to the shareholders in exchange for the parent shares, and 3) taking the court process of registering the reduction of capital of the parent (split-off) or liquidating the parent (split-up). A spin-off transaction, however, was not possible before 1998. It was because a corporation could not distribute the subsidiary shares to the shareholders, as a result of a metaphysical theory that distribution must be in cash or stock dividend. Stock dividend did not cover subsidiary shares. In lieu of repealing the metaphysical theory, the law reformers superimposed the system of corporate division on the old legal system.

In the tax side, a shareholder level division has tax implications for the transferor and the transferee companies, as well as the shareholders. For the transferor, the conditions for tax-free transfer are exactly the same as the company level division. Upon satisfying the conditions, however, the CTA degenerates to the idea of par valuation in determining the capital gain of the transferor.[35] Accordingly the same

33) KCC, art. 530-5(1)(4); 530-6(1)(3).
34) KCC, art. 530-2 (2) and (3).

complexities of unjustifiable capital reduction will often arise for reducing the amount of the taxable gain. The transferee may step-up the book value of the assets and yet defer the taxes on the gain.[36] For the shareholders, the same valuation at par will apply in order to make it consistent with the company level taxation.[37]

35) CTA, art. 81(1), CTA Enforcement Decree, art. 123(1), CTA art. 16(1)(6), CTA Enforcement Decree, art. 14(1)(4).

36) CTA, art. 46(1).

37) Income Tax Act, art. 17(2)(6).