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A Study on the Reform of Korean Financial Income Tax System

December 2013

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Contents

List of Tables

List of Figures

I

Introduction

Finance is the key industry in the modern economy. Developed western countries, in particular, have begun reinforcing service industries — especially finance — as their strategic industry since 1980s, as manufacturing has lost its competitiveness due to the free movement of production factors following deregulation and market openings. The Big Bang in the U.K in the mid-1980s is the perfect case in point: the U.K. government shored up the financial industry by deregulations.

In the past, finance's main role was to provide capital for the smooth operation of the real economy, but finance today became an industry for itself in a certain sense. It consistently makes new opportunities — regardless of the state of the real economy — to create greater rewards for itself. Finance's 'self-proliferating' nature is manifested lately in the 2008 financial crisis.

The self-proliferating financial industry has created a variety of financial tools for generating profits. One example would be financial derivatives. Many kinds of financial derivatives make for a more complex profit structure through the combination of many products. Facing these 'financial' evolutions, we naturally ask ourselves fundamental questions on taxation on financial industry and financial income. How much of a tax burden should be imposed[1] on the financial industry as a whole, and how should tangled

1) Following the 2008 financial crisis, the lesser overall tax burden on the financial industry, such as exemptions on value added tax, has faced greater attention.

taxation system on financial income, caused by fast changes in the already complicated financial industry, be solved? This study suggests a course of actions for the latter problem in Korea.

Korea has many kinds of income stemming from investments in financial products or assets, but the taxation system is very complicated because only interest and dividend income are categorized as financial income under the income tax law and capital gains are usually not taxed. Interest and dividend income are subject to global or separate taxation depending on the amount of taxable income, while capital gains are subject to a separate system of taxation. While capital gains from sale of real estate is subject to taxation, other capital gains such as the ones on stock transfers are subject to taxation only when the sellers are major shareholders and in some other instances. On the other hand, though income from collective investment vehicles is normally treated as a dividend, income from capital gains on listed stocks—among income from collective investment vehicles—is not subject to taxation because capital gains from sales of listed stock are not taxed. These are some of the examples showing how complex current Korean taxation system on financial investment income.

In this context, we intends to suggest ways to improve current financial income tax system so that Korea has a simpler and more consistent financial income tax system.

Ⅱ

Current Status and Problems of Korea's Financial Tax System[2)]

1 Current Status of Taxation System on Financial Income

The Income Tax Law in Korea divides income into eight categories and lists which income belongs to which category. However, according to the Income Tax Law, financial income is an umbrella term for interest income and dividend income. Under the Law, 'interest income' refers to interest earned in return for money saved, and 'dividend income' means distributions of profits resulting from equity investment. Interest and discounts generated from bank deposits, central or local government bonds, corporate bonds or securities, profits from savings insurance, and excess repayments from the workplace's mutual-aid association are all subject to interest income tax. Dividends or distributions from Korean or overseas corporations, the disposal amount of dividends, and profits from collective investment vehicles are all taxable dividend income.

Interest income, dividend income and capital gain are In principle, interest income and dividend income are taxed but, in terms of capital gains, only those of particular financial products are taxed. Capital gains such as trading profits from bonds, financial derivatives, or minority shareholders' listed stocks are not taxed as they are not specified under the Tax Law. On the other hand, the capital

2) This chapter is a summarized excerpt from Lee (2013).

gains tax is imposed on trading profits from stocks other than the listed stock transactions of minority shareholders and those from overseas stock investment.

Interest income or dividend income generated from financial products is generally taxed at the source at a 14 percent rate and when the annual sum of interest income and dividend income is KRW 20 million or less. Taxpayers' duty ends by paying withholding tax. However, for annual financial income of KRW 20 million or more, the amount exceeding KRW 20 million is added to other aggregated income and a progressive tax rate is applied.[3] On the other hand, interest income and dividend income untaxed or separately taxed in accordance with the Income Tax Law or the Special Tax Treatment Control Law are not subject to global taxation of financial income (See <Tables II-1> and <Tables II-2>).

〈Table II-1〉 **Non-taxable Financial Income**

Law	Type	Eligibility	Maximum limit
Income Tax Law	Profits from charitable trust	Trusts for public interest such as academic, religion, assets, etc.	None
	Insurance gains from savings insurance for 10 years or longer	No limits	None
Special Tax Treatment Control Law	Interest from lump-sum savings of farming and fishing households	Farmers and fishermen	KRW 1.44 million per annum
	Interest and dividends on household savings for the elderly/disabled, etc.	Elderly, disabled, men of national merit, national basic livelihood security recipients, etc.	KRW 30 million
	Interest from deposits such as unions	Union members, associate union members, etc.	KRW 30 million
	Interest from Green Deposit	No limits	KRW 20 million

3) According to the Income Tax Law, income is divided into interest income, dividend income, business income, earned income, annuity income, capital gains, retirement income, and other income. The sum of all income except capital gains and retirement income is referred to as global income.

〈Table II-1〉 **Continue**

Law	Type	Eligibility	Maximum limit
Special Tax Treatment Control Law	Interest from Green Saving	No limits	KRW 30 million
	Interest from such as national housing bond according to transitional measures	No limits	None
	Dividends from agricultural partnership corporations	Union members	KRW 12 million (Dividend income)
	Dividends from fishery partnership corporations	Union members	KRW 12 million (Dividend income)
	Dividends from investment to incorporated agricultural companies	No limits	None
	Dividends from employee stock ownership association	Union members	Face amount of KRW 18 million or less of employee stock
	Dividends from equity investment of employee of National Agricultural Cooperatives Federation	Union members	Face amount of KRW 18 million or less equity investment
	Dividends from contributions in unions, etc.	Union members, members, etc.	KRW 10 million (limit on investment)
	Dividend from Green Fund	No limits	KRW 30 million (joining limit)
	Asset-building savings	Employees with KRW 50 million or less total salary, employers with KRW 35 million or less of aggregated income	KRW 4 million per quarter

〈Table II-2〉 **Separately Taxable Financial Income**

(Unit: %)

Law	Classification	Tax rate
Income Tax Law	Interest from deposits or auction costs paid for real estate auction	14
	Interest unidentified of its owner's real name	35
	Long-term bond for at least 10 years since applying for separate taxation	30
	Excess repayment from workplace's mutual-aid association	6~38
	Interest paid to an organization that does not distribute profits to its members	14
Real Name Financial Transactions and Confidentiality Law	Interest paid through financial firms, etc. as non-real name financial assets	90
	Interest income occurring from non-real name specific bond	14
	Interest paid through non-financial institutions as non-real name financial income	35

〈Table II-2〉 **Continue**

(Unit: %)

Law	Classification	Tax rate
Special Tax Treatment Control Act	Interest and dividends from tax preferred composite savings	9
	Dividends from agricultural partnership corporations	5 (for over KRW 12 million)
	Dividends from fishery partnership corporations	5 (for over KRW 12 million)
	Dividends from ship investment companies	5 or 14
	Dividends from overseas resources development companies	5 or 14
	Dividends from real estate investment trusts (REITs), etc.	5 or 14
	Deposits for cooperatives such as the National Agricultural Cooperative Federation	5 (for 2016), 9 (after 2017)

2 Issues on the Financial Income Taxation

A. Equity

The taxation system for financial products in Korea lacks horizontal equity. Interest and dividend income are taxed in general, but capital gains such as bonds' trading profits, those on the listed stocks of small-scale shareholders, and those on financial derivatives are not. These lead to inequity issues.

Taxation on financial products varies even in the case of investment into the same financial assets, which also creates inequity issues. Comparing direct and indirect investment in bonds shows one example on the discrepancy in taxation. Interest income and capital gains occur from direct investment in bonds, but tax is imposed only on interest income and not on capital gains. However, dividend income tax is imposed on funds, a form of indirect investment, after summing up interest income and capital gains generated from bonds. That is, in the case of bonds, direct investment enjoys more tax incentives than indirect investment.

Despite similarity in economic substance, tax laws categorize financial instruments differently and they are taxed differently. <Table II-3> shows examples.

〈Table II-3〉 **Comparison of Taxation on Financial Investment Products Similar to ELS**

Investment products	Equity-linked securities (ELS)	Equity-linked fund (ELF)	Equity-linked trust (ELT)	Special money in trust duplicating ELS profit	Reverse convertible fund (RCF), etc.
Legal form	Derivative-linked securities	Collective investment vehicle	Investment trust	Special money in trust	Collective investment vehicle
Main investment vehicle	Bond, derivatives (future, option)	ELS, bond	ELS	Bond, option	Stock, stock index future and option
Generated income	Bond interest, capital gains from bonds and derivatives	Income from ELS, bond interest, capital gains from bonds	Income from ELS	Bond interest, capital gains from bonds and derivatives	Dividends, capital gains from stocks and derivatives
Tax base	All profits and losses aggregated	All profits and losses aggregated	Income from ELS	Bond interest	Dividends
Tax type	Dividend income tax	Dividend income tax	Dividend income tax	Interest income tax	Dividend income tax
Subject to Global taxation	Yes	Yes	Yes	Yes	Yes

In addition, investment related to foreign stocks also lacks equity in taxation (See <Table II-4>). One may invest in foreign stocks through direct investment, off-shore/on-shore foreign equity funds, or off-shore/on-shore foreign equity ETF. With direct investment into foreign stocks, separate taxation is applied. A dividend income tax is imposed on dividend income from stocks, and capital gains tax is imposed on trading profits from foreign stocks. However, on-shore/off-shore foreign equity funds and on-shore foreign equity ETF are subject to global taxation of financial income as dividend income tax is imposed on the sum of dividend income and trading profits from foreign stocks. On the other hand, for trading profits from off-shore foreign equity ETF, capital gains tax is imposed just as in direct investment in foreign stocks, and such trading profits are not subject to the global taxation of financial income. Thus, for high-income taxpayers with great financial income, direct investment in foreign stocks or in off-shore foreign equity ETF relieves tax burden more than investment in on-shore/off-shore foreign equity funds or on-shore foreign equity ETF.[4)]

〈Table II-4〉 **Comparison of Taxation on Financial Investment Products Similar to Foreign Equity Investment**

Investment products	Foreign stocks	On–shore foreign equity fund	Off–shore foreign equity fund	On–shore foreign equity ETF	Off–shore foreign equity ETF
Generated income	Dividends, Capital gains	Dividends, Capital gains	Dividends, Capital gains	Distribution, Capital gains	Distribution, Capital gains
Tax base	Classified according to income	Total income	Total income	Distribution, Capital gains	Classified according to income
Tax type	Dividend income tax, capital gains tax	Dividend income tax	Dividend income tax	Dividend income tax	Dividend income tax, Capital gains tax
Subject to global taxation	Limited to dividend income	Yes	Yes	Yes	Limited to dividend income
Other	Capital gains subject to separate taxation	–	–	–	Capital gains subject to separate taxation

There is also the issue of vertical inequity. The Korean government has lowered the threshold for the global taxation of financial income from KRW 40 million to KRW 20 million. And it also repealed the non-taxation provision applicable to the increment in principal from treasury inflation-protected securities (TIPS), a typical tax favored product for high financial income-earners, while limiting tax exemption benefits for inheritance-type immediate annuity to KRW 200 million. However, it is still possible for high financial income-earners to reduce their tax burden by using financial products that are

4) It was pointed out in recent media coverage that investment in off–shore ETF is increasing for the purpose of reducing tax payments and that there is inequity in taxation as opposed to on–shore ETF. (*Maeil Business Newspaper*, Mar. 6, 2013)

non-taxable or separately taxed.[5)]

In particular, non-taxation on gains from long-term savings insurance paid monthly for at least ten years provides an opportunity for high financial income-earners to cut taxes and evade global taxation of financial income, which undermines vertical equity. Currently profits from long-term savings insurance are not taxable with no conditions or limits attached to subscription or premium amount. This shows that tax incentives for gains from long-term savings insurance are excessively high compared to those for the working and middle classes.

B. Efficiency

An efficient tax system on financial products does not cause distortion in taxpayers' investment decisions. As mentioned earlier, interests and dividends are taxed in general, while capital gains remain non-taxable in Korea. Furthermore, a number of financial products' interest and dividend income are not taxed or receive tax cuts. Thus, the current taxation system on financial products has distortionary effect, as it creates room for investment strategies designed for tax arbitrage, thus impeding efficiency.

High financial income-earners who intend to invest in global stocks will prefer off-shore foreign equity ETF. Because capital gains taxes are imposed on that ETF, while dividend income tax is imposed on on-shore/off-shore foreign equity funds or on-shore foreign equity ETF. They will invest in financial products with similar economic substance but a lower tax burden. Investing in a reverse convertible fund that reproduces the profit structure of ELS is another example of tax saving.

As discussed, the current taxation system for financial products lacks equity and incurs social losses because extra time and money is required in planning investment strategies or developing investment products for tax arbitrage. In this

5) As of 2013, there are 13 items of non-taxation and tax deduction for financial income schemes under the Special Tax Treatment Control Law and one item of non-taxation on interest income tax for insurance profits from long-term savings insurance under the Income Tax Law.

sense, it undermines efficiency.

C. Simplicity

The taxation system for financial products in Korea is extremely complicated and difficult to comprehend because the Income Tax Law is based on the positive system. Taxation on stocks, for instance, is highly intricate. Trading profits on listed stocks for minority shareholders are non-taxable, but capital gains tax is imposed on those of non-listed stocks or listed stocks of major shareholders. Tax rates also differ depending on the size of the business that issued the stock or the holding period.

Different types of tax apply to similar financial products, making it much more difficult to understand. Interest income tax is imposed on equity-linked deposits (ELD) whose principal is guaranteed, but dividend income tax is imposed on equity-linked securities (ELS) whose economic substance is similar to ELD. Although interest income and dividend income have the same tax rates, taxation types are different. Dividend income tax is imposed on trading profits from the on-shore foreign equity ETF, while the capital gains tax is imposed on trading profits from off-shore foreign equity ETF.

As pointed out by Hong et al. (2009), there is currently no taxation system for capital gains of financial derivatives that could reproduce the profit structure of underlying assets. Therefore the taxation system for financial products will become more complicated if hybrid financial instruments increase. In addition, since the current taxation system for financial products is not sufficiently inclusive due to the positive system, it is highly probable that financial products disrupt tax collection.

III

The Concept of Financial Investment Income and Previous Studies

1 The Concept of Financial Investment Income for Tax System Overhaul

'Financial income' in Korea refers to the return on savings of or investment into financial assets. It is an umbrella term for interest income and dividend income under the Income Tax Law. Interest income is defined as: 1) interest from deposits/savings or deposits from banks, securities firms, insurance companies, investment banks, asset management firms, the National Agricultural Cooperative Federation or National Federation of Fisheries Cooperatives, Post offices, and the Korean Federation of Community Credit Cooperatives, and 2) interest and discount amounts from government bonds, bank debentures, and corporate bonds. Dividend income refers to profits or distributions of surplus from stocks or other equity investments. Gains on transfers of bonds or stocks, though, are generally not listed as financial income.

Thus, under the strict definition outlined by the tax laws, the term 'financial income' is used in a much narrower sense than may be expected. In other words, it might be thought that financial income would include all income related to finance, but it refers only to interest income and dividend income under the law.

Meanwhile, with a broadening range of financial products on the market and transactions becoming much more complex, a new issue arises regarding how to redefine the nature of income generated from investment in financial products. Under the current tax law, only interest and dividend income but not capital gains are subject to taxes. Hence the tax authorities try to identify the nature of income generated from financial investment as much as possible and tax it only if they can classify it as interest or dividends. For instance, income generated from collective vehicles such as funds is seen as distribution of surplus and categorized as a dividend under the current tax law. On the other hand, income from equity-linked warrant (ELW) is regarded as similar to that from an option, hence not taxed. Table III-1 summarizes how various types of financial income are treated differently under the current tax law.

Classifying all financial income as interest, dividends, or capital gains definitely remains difficult. Through hybrid products, capital gains can turn into fixed amount of cash flow such as interest; or the cash flow of fixed income can change into capital gains. In other words, depending on how financial income is viewed, taxable income can change into non-taxable income and vice versa.

〈Table III-1〉 **Classification of Financial Income Based on Financial Product Type**

Type of financial product				Interest or dividend	Capital gains
Deposit products				Interest income	–
Insurance products				Interest income	–
Financial investment products	Securities	Debit securities		Interest income	Non–taxable[1)]
		Equity securities		Dividend income	Non–taxable[2)]
		Profit–sharing securities		Dividend income	–
		Derivative–linked securities	ELS, DLS	Dividend income	–
			ELW	Non–taxable	–
	Financial derivatives			–	Non–taxable

Note: 1) When debit securities are transferred, interest income tax is imposed on the amount equivalent to the amount of interest for the holding period.
2) Capital gains from non–listed stocks, etc. are taxed.
Source: Jeong and Jeon, 2010, p. 268.

The aforementioned problem arises, essentially, because capital gains from financial transactions are not taxed in Korea. Interest and dividends — financial income in the narrow sense — and capital gains which financial income in the broad sense includes — are treated differently in taxation. Income from direct investment and indirect investment, for example, are taxed differently.

The first step in unifying and simplifying the taxation system would be imposing taxes on capital gains. This measure would be a good start for solving many current taxation issues.

What, then, would follow the introduction of capital gains taxation system? There are basically two ways; dual income tax system or fortified global taxation system. When capital gains are taxed, in addition to interest or dividends, the next thing to think about is whether to combine all financial investment income into the current global taxation system for financial income. "Financial investment income" here will encompass all income coming from savings as well as investment in financial products. The term "financial income" may seem to have a broader meaning than "financial investment income," but as financial income according to tax laws is used in a narrower sense to refer to interest or dividend income, this study will use the aforementioned definition of "financial investment income" instead of financial income in a broad sense. Consequently, financial investment income to be discussed in this study has a broader meaning than financial income according to current tax law.

Considering equity, it is proper to put financial investment income in the global taxation framework. However, taking into account capital's mobility, combining all financial investment income and imposing separate taxation could be another option, similar to the dual income tax system implemented in Scandinavian countries. However, after the 2008 financial crisis, it would be rash to decide on separate taxation based solely on efficiency.

Finding a middle ground between the two extremes of global and separate taxation could be another possibility. Assuming that the necessary conditions are satisfied for the adoption of the capital gains taxation system, financial investment income can be categorized, based on income sources, into several categories and separately taxed. In taxation, for example, it is possible to treat income generated from passive investment such as interest, differently from income from risky investment such as stock investment. For instance, in line with the slogan of "from savings to investment," Japan's measure for unified taxation for financial income widened the range in aggregating gains and losses and took preferential measures on financial income from risk-taking investment. However, the higher the income is, the more probable to make investments involving risk. Thus, regarding vertical equity, it may be more proper to give preferential treatment to financial income generated from passive investment. On the flip side, treating income differently depending on the risk character constitutes retrogression against the simplification of tax system for the purpose of neutrality of taxation.

2 Preceding Studies on Capital Gains Taxation

This section reviews preceding studies in Korea regarding to taxation on capital gains, focusing on alternatives suggested for a number of issues arising when taxation on capital gains is introduced. Major issues regarding capital gains taxation include: whether to tax capital gains generally; whether to tax unrealized profits; whether to apply differentiated taxation based on the length of the holding period and, if so, at what tax rate; and whether to deduct capital losses.

J. O (1989) defined capital gains as differences between sales value or market price and their purchasing price. Meanwhile, Yu and Kim (2009) noted that "capital assets refer to, as the main source of capital gains and losses, assets obtained to create income, such as corporate securities, government bonds on real estate, shares held by an association, or rights created by a lease or contract." In reality, however, it is difficult to clearly distinguish capital assets from other types of assets, which calls for specific definitions in tax laws.

As a result, taxation on capital gains depends on how capital gains are defined by tax laws. According to the Increased Net Worth Theory of Haig-Simons, capital gains are subject to taxation since any economic profit contributing to increasing net assets during a certain period is regarded as income, regardless of causes. On the other hand, the Income Source Theory of Fuisting only regards revenue continuously generated from a specific source as income, thereby excluding capital gains as a subject of income taxation.[6][7]

The varying opinions on capital gains taxation proposed in a few preceding studies are summarized as follows: A number of studies including Gwak (2000), Jeon et al. (2000), and G. Choi (2003) suggest that capital gains taxation on stocks must be entirely expanded, since the scale of the Korean stock market has rapidly grown and holding stocks has become so widespread that stocks are frequently a means to accumulate or bequeath wealth.

An and Gwon (2005) attempted to explore the theories and actual policies in force regarding financial sector taxation and reviewed their correlations from a holistic perspective on financial taxation. Their findings suggest that the current global taxation system for financial income has scanty theoretical grounds in terms of economic efficiency. In this sense, they maintain that it is necessary to consider tax reform to simplify taxation systems and enhance efficiency by reducing or abolishing assorted tax benefits. Instead of strengthening the global taxation system, they prefer to introduce the dual income taxation system to apply lower tax rates on capital income than on other types of income. They also demand an improvement to a number of special benefit systems that further complicate tax systems.

An and Jeon (2007) conducted an in-depth study on the situations in Scandinavian countries that have introduced the dual income tax system since the 1990s. They suggest desirable ways to introduce the dual income tax in Korea and analyze potential effects on income redistribution. The study found out that reduced tax rates on capital income did not substantially reduce tax revenue and income redistribution, albeit slightly, improved.

Y. Choi (2010) observes that the income tax systems in Korea are in effect closer to dual income taxation. Because by applying low rates on financial income under a certain threshold, Korean global taxation system can be viewed as an extensive separate taxation system. Since Korea taxes interest income and dividend income but not capital gains, the tax burden on individual taxpayers might vary for the same amount of income depending on the type of income,

6) Hong and Kim, 2010, p. 25.
7) Jang and Choi, 2012, p. 228.

which contributes to compromising horizontal equity. In addition, Choi states that interest and dividend income and capital gains are mutually replaceable and tax must be implemented not to secure revenue, but to ensure neutrality in taxation. In this regard, he insists that dual income taxation must be introduced for taxing all capital income to ensure neutrality in taxation.

Jang and Choi (2012) examined the Japanese case cited as a successful case of transition to capital gains taxation system and suggested reasonable and feasible taxation measures for capital gains from listed stocks in consideration of Korea's situation. Japan worked towards realizing gradual changes based on phased reduction of the scope of non-taxation instead of immediate conversion to capital gains taxation system. It also adopted separate rather than global taxation. Additionally, Japan simultaneously introduced the preferential policy for long-term capital gains, permitting loss deduction and carried-forward taxation. It also maintained the stock transaction tax for ten years during transition period.

Yun (2012) examined the basic discussion on capital gains taxation by comparing legislative cases in Korea and other major economies, reviewed problems in capital gains taxation and suggested improvement measures for each issue. Yun's study proposed that since capital gains must be taxed from the perspective of fairness in taxation, it would be vital to expand current capital gains taxation to cover all financial gains not only real estate capital gains.

Y. O (2012) maintained that universality and neutrality are the most important criteria in deciding the scope of the capital gains tax and calculating taxable amounts. O's study emphasized that capital gains must be taxed in the same manner as other types of financial income—such as interest income and dividend income — are taxed. All capital gains must be included as taxable income. He consequently called for the introduction of comprehensive income tax by classification. He also maintained that since capital income had a nature of dual taxation for lifetime consumption opportunities, capital income must be allowed to offset future capital losses. Because of administrative difficulties in determining which income was attributable to whom in globalized capital markets, he suggested to apply separate taxation at a single rate. The tax rate should be the same as the withholding tax rate applied to interest income and dividend income. In addition, he proposed that when capital gains were taxed, it was reasonable to allow offsetting capital losses from broad types of capital assets.[8)]

8) See Hong and Kim (2010) for a more detailed study on the capital gains tax.

Ⅳ

Overseas Financial Investment Income Taxation Systems

Most OECD countries are often believed to implement global income taxation, but many countries in fact implement dual income taxation(DIT), separately taxing financial income from other types of income. However, such dual income taxation is a slightly modified version of the original dual income tax system to apply lower rates to almost all types of financial income than to earned income. In other words, major economies permit separate taxation on financial income or permit a choice between global taxation and separate taxation. In particular, Scandinavian countries began introducing the DIT, starting with Denmark in 1987, in response to increasing transnational movement of capital. Sweden, Finland, and Norway introduced the DIT system in the 1990s. Although practical details vary by country, the DIT system in Scandinavian countries has a tax structure dividing earned income and financial income and permitting the loss deduction. These Scandinavian countries gave up progressive tax rates on financial income and instead introduced the DIT system, mainly due to the limitations of the inclusive income taxation theory and the global mobility of capital.

This chapter examines the cases in Sweden, Finland, and Norway, that introduced the DIT system in the 1990s It also examines those in Germany and Japan, those switched in the 2000s to a system similar to the DIT system. We also briefly look into the Net Investment Income Tax of the United States. It levies additional tax on investment income as a means to finance national medical expenses.

1 The Dual Income Tax System[9)]

A. Scandinavian Countries

Since the late 1980s, global financial markets have experienced radically increasing international capital movements, raising the necessity of minimizing capital outflow by reducing tax burdens on capital income. Sweden therefore waged tax reform to introduce the dual income tax system and reduce tax burdens on capital income. The Swedish government reduced tax deduction benefits, cut tax rates, and began applying the flat 30 percent rate on capital income separate from earned income.[10)]

In principle, the DIT system does not aggregate capital income and earned income, but Sweden permitted partial aggregation so that losses from capital income could be deducted from earned income through tax credits. In addition, the entire paid interest amount can be deducted from capital income; capital loss is 100 percent deductible in principle but deductions are allowed for only 70 percent in some cases. When net capital income is in deficit and if the losses amount to SEK 100,000 or less, 30 percent of that amount can be deducted from the national tax and local tax amounts for earned income. And if the losses exceed SEK 100,000, they one subject to the 21 percent rate for deduction.

Norway also adopted tax reform in 1991 to expand taxable bases by simultaneously reducing tax rates and overhauling a range of tax deduction schemes, and it subsequently introduced the DIT system in 1992. Before the DIT system, Norway applied the 28 percent flat rate to all general income without differentiating between capital income and earned income. For personal income, social security tax and personal income tax were additionally imposed, in addition to general income tax. Business income was divided into personal and capital income. The business income that was classified as capital income was taxed at the 28 percent general income tax rate.

9) Discussion here on the cases in Sweden, Finland, and Norway is based on the modification and supplementation of the study of An and Jeon (2007).

10) Agell *et al*., 1996

Following Sweden and Norway, Finland adopted the DIT system in 1993 and taxed personal income as either earned income or investment income. Before the DIT system, Finland applied the 28 percent rate to the investment income of individuals, but the currently applied rate stands at 30 percent as of 2013. Earned income was subject to the national tax rates of 0~32 percent under progressive tax system, local tax rates of 16~21 percent, and church tax rates of 1~2 percent. The tax structure was reformed in 2013 to be divided into six brackets for progressive rates, imposing 0~31.75 percent of national tax, 15~20 percent of local tax, and 1~2 percent of church tax (1 percent in Helsinki).

After its introduction in the Scandinavian countries, the DIT system gradually changed into a system different from the original form, with its method of adjusting dual taxation on dividend income being particularly notable. In the initial stage of the DIT system, the capital income tax rate was reduced, while the capital income tax rate for individuals and the corporate tax rate were maintained equivalent. The dual taxation issue regarding individuals' dividend income was entirely adjusted through the imputation system. Such institutional changes, however, further widened the difference in tax rates applicable to earned income and to dividend income, creating an incentive to take advantage of lower tax rate on capital income.

To address the problem, the Scandinavian countries abolished the imputation system, thereby restricting the system not to adjust dual taxation or to adjust it partially. Under the dual income taxation system, capital income and earned income are in principle taxed separately, and therefore capital loss and capital costs must not be deducted from earned income. However, none of the countries discussed above maintained such principle. Norway even permitted all-out aggregation at the stage of taxing general income.

B. Germany

Germany had only taxed short-term capital gains from certain types of assets, but has maintained a system to tax all assets in principle based on the increased net asset theory since it introduced the DIT system in 2009.[11] Introducing the

11) O, Yun, 2012, p. 185.

DIT system somewhat belatedly compared to its northern neighbors, Germany introduced a slightly modified version of the DIT system after analyzing the strengths and weaknesses of the systems introduced in the Scandinavian countries. While Sweden, Finland, and Norway apply separate taxation to the part of income — from among corporate income, financial income, capital gains, lease income, and business income — contributed only by capital as capital income, Germany collects corporate taxes separately and applies global taxation to the sum of business income and earned income.

Before 2008, interest income and dividend income were subject to global taxation after being withheld and 5.5 percent of the withheld amount was levied as solidarity surcharge. In addition, capital gains from personal assets were withheld at a proportional rate only for assets disposed of within a particular period. If the holding period of that personal assets were longer than the specified period, the capital gains were taxed with other incomes. However, Germany announced tax reform in 2008 to adopt the DIT system in an effort to prevent capital outflow and simplify financial income tax systems.

From 2009, Germany established a dual income tax system that applies progressive income tax rates of 14~45 percent to general income and classifies dividend income and capital gains as investment income subject to the 25 percent flat withholding rate. Small-scale investment income-earners, though, are permitted to choose either global taxation or separate taxation. And taxpayers subject to an income tax rate of 25 percent or lower for global taxation of the combined amount of capital income and other types of income are eligible for the global taxation rate based on self-assessment. In such cases, if taxpayers who choose global taxation face more disadvantageous tax burdens, tax authorities completes tax collection by withholding 26.375 percent for the advantage of taxpayers.[12)]

Capital loss can be offset only in regard to capital gains and a carried-forward deduction is also available. Loss from security transfers may be offset not only against gains on security transfers but also against interest income and dividend income. Starting from January 1, 2009, Germany has permitted an annual lump

12) http://www.mof.go.jp/tax_policy/summary/financial_securities/kabu04.htm

sum deduction of up to EUR 801 per capita regarding investment income-related costs, such as financial costs and account management costs.

〈Table Ⅳ-1〉 **Comparison of Dual Income Tax Systems of Selected Countries**

	Sweden	Finland	Norway	Germany
Earned income	National tax: 0%, 20%, 25% Average local tax: 31% (2003) (28.9~33.72%)	National tax: 0~35% Average local tax: 18% (2003) (15.5~20%)	General income: 28% in national and local taxes Personal income: Additional 0~19.5% in national tax Average local tax: 18% (2002)	0~45%
Capital income	30% (only as national tax)	29% (only as national tax)	28%	25% (5.5% of solidarity surcharge applies separately) or 26.375% (taxpayers may choose withholding tax or global taxation)
Interest income	Withholding tax applicable	Withholding tax applicable	No withholding tax	
Dividend income	No adjustment Withholding tax applicable	Withholding tax applicable	Full adjustment (imputation) Withholding tax applicable	
Capital Gains on stock	Taxation based on the capital income tax rate (when realized)	Taxation based on the capital income tax rate (when realized)	Taxation based on the capital income tax rate (when realized)	Taxation based on the capital income tax rate (when realized)
Handling of transfer losses	Deduction from other capital income is allowed (70% of net transfer loss) No loss may be carried forward	Deduction is allowed only from the same type of income Loss may be carried forward (over three years)	Deduction from other capital income is allowed	Loss may be offset only with other capital income
Dual taxation	No adjustment	No adjustment	Adjustment based on the RISK system	No adjustment
Net loss	Summing up with earned income is in effect allowed (30% tax credit)	Summing up with earned income is in effect allowed (29% tax credit)	Summing up with earned income is allowed (summing up within general income) May be carried forward for ten years	May be carried forward if capital loss exists; offset is allowed only for capital profit
Corporate tax rate	28%	29%	28%	15%[1)]

Note: 1) The rate had been 25% before 2008, but was changed to 15% from 2008 following the amendment of laws on August 27, 2007.

Source: Japanese Ministry of Economy, Trade and Industry (April 30, 2004); data for the German case were compiled separately.

2 Unification of Financial Income Taxation in Japan[13]

A. Background and Overview

Prior to the bursting of its economic bubble in the early 1990s, Japan had maintained a high savings rate and households accumulated high levels of financial assets. In the wake of the bubble burst, however, the country's savings rate plunged, while the problems of low fertility and aging population rapidly progressed. Also as the population was projected to decrease gradually, it became hard to expect an increase in financial assets driven by the rising savings rate. In addition, most household financial assets in Japan were deposit and installment savings, while the investment in stocks or stock investment trusts remained lower.

Against this backdrop, the Japanese government decided that restructuring its financial income taxation was an urgent task. Thus, discussion on dual income taxation was initiated in 1997 through a report prepared by the financial subcommittee of the Tax Commission. It suggested the unification of financial income taxation as an alternative to the DIT system. To encourage investment, it suggested to apply a low tax rate to income accruing from financial products and expand the scope of offsetting profits and losses from such products. This perspective drove the Japanese Tax Commission to pursue unification of financial income taxation so as to allow for more convenient investment in listed stocks or stocks for public subscription, a main investment destination among the general public.

The basic direction to unify financial income taxation suggested by the Tax Commission is to apply low tax rates to income accruing from financial products, while allowing maximum offsetting of profits and losses. In response to the development of financial products and transformations in financial markets, the Japanese government also intended to streamline existing taxation methods —

13) Summary of the translated version of "Basic Directions for Unification of Financial Income Taxation" by the Financial Subcommittee of the Japanese Tax Commission (June 15, 2004).

which had applied differently to assorted financial schemes — and thereby narrow the gaps between tax burdens on different financial income types to ensure neutrality and simplicity in taxation. In this vein, the financial products subject to unification measures were defined in a highly inclusive way encompassing stocks, investment trusts, deposits and savings, public and corporate bonds, their combined products or securitization products, funds, derivatives, and insurance products that are, by nature, savings products.

〈Table IV-2〉 **Details on Unification of Financial Income Taxation (June 15, 2004)**

	Details
Equalization of taxation methods (20% separate taxation)	– Dividend of listed stocks to those other than major shareholders; dividend of profits from stocks for public offering (Currently: Global taxation applies in principle.) – Profits from transfers of public and corporate bonds and bond investment trust (Currently: Non-taxation on transfers and loss from transfers are deemed nonexistent.) – Foreign-exchange profit from foreign-currency deposits (Currently: Subject to global taxation as miscellaneous income) – Insurance profits other than financial income (Currently: Subject to global taxation as temporary/miscellaneous income)
Expanding scope of summing up gains and losses	– In response to the policy direction for "from savings to investment," interest income is allowed to offset losses from stock transfers. (1) Gains and losses from stock transfers and losses from transfers of public and corporate bonds (2) Dividend of listed stocks and transfer losses; dividend of profits from stocks for public offering and transfer losses (3) Losses from stock transfers and interest income
Restructuring tax administration	– To sum up gains and losses, taxpayers are required to report them to tax authorities, which then use the relevant identification numbers to verify the details reported by taxpayers, as well as the payment details regarding dividends and other items.

Source: http://www.mof.go.jp/tax_policy/summary/financial_securities/n12.htm

B. Evaluation

In 2001, Japan tried to unify its taxation on capital gains on securities and other financial products to separate taxation by self-assessment with a 26-percent tax rate. But to mitigate the impact on the markets, the unified taxation system was imposed on capital gains starting from 2003 after a two-year grace period.[14] For individuals profits from futures and options trading of stock market index had been regarded as miscellaneous income and subject to global taxation along with other income. But they became subject to separate taxation by self-assessment from 2004, separate from other types of income. After taxation methods on financial products were unified as separate taxation by self-assessment, favorable tax systems were introduced to encourage individual investors to actively participate in the markets. As a result, interest income was subject to a 20 percent separate withholding tax rate; separate taxation by self-assessment with a rate of 20 percent applied until 2009 to dividend income from listed stocks, but from 2013 dividend income began to be allowed for tax credit through global tax reporting. Any capital gains on stocks, bonds, or derivatives are, in principle, subject to separate taxation by self-assessment. In particular, gains on derivatives trading are taxed by 20 percent, but profits and losses may not be summed up with other types of income. In other words, trading profits and losses related to futures and options trading on the stock market index may be summed up with those related to commodities futures trading, but may not be totaled with profits from stocks and investment trusts. In addition, even when profits or losses, or net losses, are found after summing up profits and losses, deductions carried forward are permitted for three years only if the final return was filed. From January 2012, profits and losses may be summed up for both exchange trade and OTC trade.

Japanese financial tax system has evolved from global income taxation based on inclusive taxation bases to separate taxation on interest income and then to unification of financial income taxation. However, such unification measures are different from the DIT of Scandinavian countries in that they only mention unification of taxation on financial income without mentioning earned income.

14) Special measures were introduced to impose a preferential tax rate of ten percent (a seven-percent income tax rate and a three-percent residence tax rate) for listed stocks transferred after January 1, 2003.

Applying separate taxation on earned income and financial income with a different tax rate is key to dual income taxation. Therefore Japan's measure to unify taxation on financial income is different in nature from Scandinavian dual income taxation.

3 Net Investment Income Tax in the United States[15]

Taxation systems in the United States are closer in nature to inclusive income taxation than dual income taxation. In principle, the government applies global taxation on the sum of capital income and other incomes. But slight differences on taxation are found in practice, considering the characteristics of financial income.

The Obama administration has recently enacted the net investment income tax (NIIT), also known as the Medicare contribution tax, in accordance with the Patient Protection and Affordable Care Act entering into force in January 2013. The administration raised the Medicare tax imposed on high-income-earners by 0.9 percent to ensure the required financing following the health insurance reform, and further introduced the NIIT to impose a 3.8 percent tax on investment income among high-income-earners.

By nature, the NIIT is not a system that can explain the U.S. financial income taxation's overall framework. It may be seen as a type of wealth tax, targeting the investment income of high earners, but it actually taxes net investment income. This point is shared by the nature of financial investment income reviewed in this paper, on which the following paragraphs will elaborate.

The NIIT applies a rate of 3.8 percent to whichever is the smaller between net investment income and the adjusted gross income in excess of a certain threshold. As shown in <Table IV-3>, this threshold differently applies: USD 200,000 for heads of household and single filers; USD 250,000 for married

15) PWC, 2013.

taxpayers filing jointly; and USD 125,000 for married taxpayers filing separately. Net investment income refers to an amount of money after deducting transaction fees, investment consultancy fees, and investment-related interest costs from gross investment income. Investment income includes interest, dividends, capital gains, royalties, lease income, and passive income; it excludes wages, self-employment income, appropriate personal pension, income accruing from retirement accounts, and interest from local government bonds. In accordance with the tax laws, the NIIT does not apply to non-residents.

The NIIT divides investment income into portfolio income, business income generated from financial products or product trading, and income from disposal of assets. Summing up profits and losses is only allowed for the same types of profits and losses.

〈Table IV-3〉 **The Threshold of NIIT of the United States**

(Unit: USD)

Classification	Threshold
Married filing jointly	250,000
Married filing separately	125,000
Single filers	200,000
Head of household	200,000
Qualifying widow(er) with dependent child	250,000

Source: www.irs.gov

〈Table IV-4〉 **Overview of Taxation on Interest, Dividends, and Capital Gains on Stock in Major Countries (as of January 2013)**

	Japan	United States	Germany
Interest	Separate withholding tax of 20%[1)](15% of income tax and 5% of local tax)	Global taxation (10~39.6%) and State and local government taxes[2)] – New York City: State tax (4.00~8.82%), City tax (2.55~3.40%) and 14% surcharge of the tax amount	Separate taxation * Global taxation may be selected. 26.375%[3)](25% of income tax, and 5.5% of the tax amount as solidarity surcharge)

〈Table Ⅳ-4〉 **Continue**

	Japan	United States	Germany
Dividends	– Chosen between separate taxation and global taxation · Separate taxation: 20% (15% of income tax and 5% of personal residence tax); 10% until the end of December 2013 (7% of income tax and 3% of personal residence tax) · Global taxation:10~50% * To sum up profits and losses with loss from stock transfers after 2009, taxpayers may choose separate taxation by self-assessment: 20% (15% of income tax and 5% of personal residence tax); 10% until the end of December 2013 (7% of income tax and 3% of personal residence tax)	Three levels of phased taxation (federal tax) with 0%, 15% or 20% and global taxation (State and local government taxes) – New York City: State tax (4.00~8.82%), City tax (2.55~3.40%) and 14% surcharge of the tax amount	Separate taxation * Global taxation may be selected. 26.375% (25% of income tax, and 5.5% of the tax amount as solidarity surcharge)
Adjustment with corporate tax	Deduction from dividend income taxation (when global taxation is chosen)	No adjustment	No adjustment

Note: 1) Interest from specific public or corporate bonds is subject to separate taxation by self-assessment with a rate of 20% (15% income tax rate and 5% residence tax rate). Separate taxation may be selected for the part withheld, but any amount paid to employees of an affiliated company from interest generated by bonds issued by the same affiliated company is subject to global taxation (applicable from January 1, 2016).
2) The State and local government tax rates vary.
3) Taxpayers belonging to the tax bracket with a 25% or lower income tax rate under global taxation when their capital income is aggregated with other income are subject to the global taxation rate by self-assessment. As a result of self-assessment, if taxpayers choosing global taxation are found to have a disadvantage, the tax authorities deem that no capital income was filed and withhold 26.375%.

Source: http://www.mof.go.jp/tax_policy/summary/financial_securities/risi02.htm

V

Reform of Taxation Systems for Financial Investment Income

1 Basic Directions

As mentioned earlier, financial investment income is defined as all income generated from financial assets, encompassing interest, dividends, and capital gains. By making it a basic principle to apply the same tax rate to all types of financial investment income, it becomes possible to ensure neutral taxation among different financial products and streamline financial taxation systems.

This basic principle, however, is not sufficient to design taxation systems on financial investment income. A range of elements must be taken into account in terms of policymaking. Such elements that must be taken into account in setting direction for financial investment income tax systems include mobility of capital, the bunching problem, lock-in effect, adjustment of inflation, risk-taking effect, tax revenue effect, and influence over investment and economic growth. A number of questions must be addressed in this process: How to determine tax rates considering capital mobility or lock-in effect? How to handle tax benefits for long-held financial assets to solve the bunching problem? How to adjust taxes imposed on the incremental gains in value of financial assets due to inflation? What principles to apply to loss from risky financial products, and what to do about deduction of related costs? These various factors must be fully reflected in the process of designing financial investment income tax systems.

2 Three Steps for the Reform

The introduction of capital gains taxation system is a prerequisite for a simple and consistent taxation system on financial investment income. To this end, this study proposes the following three steps for reforming current taxation systems for financial investment income inclusive of profits from all financial investment.

Proposals I and III in [Figure V-1] include some variations provided in the following.

Initially, currently tax-exempt capital gains should be subject to taxation. The second phase is to combine interest and dividend income with capital gains to tax them consistently. The final stage entails either a shift to dual income taxation or strengthening the existing global taxation system of financial income.

[Figure V-1] Phased Introduction of Financial Investment Income Tax System

Step Ⅰ		Step Ⅱ		Step Ⅲ
Introduction of the capital gains taxation system <Proposal Ⅰ>	→	Aggregation of financial investment income <Proposal Ⅱ>	→	Dual-income taxation <Proposal Ⅲ> or Reinforcement of global taxation <Proposal Ⅳ>

A. Step I: Introduction of Capital Gains Taxation

The first step toward the financial investment income tax system is to introduce capital gains tax for financial income.

Proposal I	To apply separate taxation to newly taxable capital gains with a tax rate of 20%, while maintaining the current framework of global taxation for financial income

Proposal I is to maintain the current framework of global taxation for financial income, but introduce separate taxation to newly taxable capital gains with a

20 percent rate. This measure is designed to lift some tax burdens through separate taxation in the initial stage where capital gains become taxable. Japan also employed this method when the country introduced capital gains taxation for stock trading. Under this proposal, interest and dividend income worth less than KRW 20 million remains subject to a 14 percent tax rate, and the same type of income worth KRW 20 million or more becomes subject to global taxation; capital gains generated from transactions involving stocks or derivatives are taxed with a 20 percent rate by separate taxation. Capital gains are subject to a higher tax rate than the current 14 percent rate for financial income, because separate taxation shields them from progressive tax burdens.

This measure may be considered a way to retain the current system and transitionally mitigate tax burdens on capital gains. It cannot ensure neutrality in taxation, however, since different tax rates apply to interest and dividends from capital gains. It is also difficult to address previously mentioned problems in the current financial taxation systems. For example, income accruing from stock funds is divided into interest, dividends, and capital gains. And if different taxation methods apply to each income type, accounting must be accordingly separated and it becomes difficult to calculate tax bases. This problem arises not only from funds, but from all complex financial products. In addition, due to varying tax rates applicable to different types of income, it is difficult to sum up profits and losses, potentially causing an increase in administrative costs. It is also impossible to address the problem of taxing overall loss account due to different tax treatment depending on the source of income within funds. Therefore, it can be considered only in the initial stage of introducing overall gains taxation system.

Proposal I-1	To apply separate taxation to the entire amount of newly taxable capital gains with a tax rate of 14%, while maintaining the current framework of global taxation for financial income

The above Proposal I-1 is a variation for solving the problems arising from Proposal I. Under this alternative, whether to apply separate taxation to interest or dividend income is decided based on the threshold of KRW 20 million, as in the current system. And the entire amount of newly taxable capital gains becomes eligible for separate taxation with a tax rate of 14 percent. Compared to Proposal I, this alternative is able to reinstate taxation neutrality for different income types to a certain degree, but it remains problematic that interest and dividend income worth KRW 20 million or more is subject to progressive tax rates and therefore subject to different tax rates from that applicable to capital gains. In addition, separate taxation for the entire amount of capital gains has the advantage of mitigating the impact on financial markets transitionally, but may be criticized at the same time for being an excessively preferential taxation scheme for capital gains. Although the tax rate of 14 percent may seem rather high compared to the lowest rate in global taxation, the criticism citing the preferential nature for capital gains has a valid point because it is generally high income earners who expect capital gains.

B. Step II: Expanding Financial Income to Encompass Financial Investment Income under Current Systems

Step II aims to expand the boundary of financial income to incorporate financial investment income as well under the current framework of global taxation for financial income.

Proposal II	To maintain the current framework of global taxation for financial income, and expand financial income to incorporate financial investment income: ▶ Financial investment income worth less than KRW 20 million: Separate taxation with 14% tax rate ▶ Financial investment income worth KRW 20 million or more: Global taxation (progressive tax rates applicable)

Under this proposal, capital gains generated from stocks or derivatives trading are classified as financial investment income along with interest and dividend income and become subject to a separate 14 percent taxation rate, while financial investment income worth KRW 20 million or more is subject to global taxation. This has the advantage of bundling together interest, dividends, and capital gains into the single category of financial investment income. They are treated the same by applying the same tax rate currently applicable to interest and dividend income.

Applying the same tax rate is a way of ensuring neutrality among all types of income generated from financial products and enhancing vertical equity, since global taxation applies to capital gains including other income as well. Additionally, eliminating incentives for tax arbitrage may reduce tax evasion.

Since all financial investment income exceeding a certain threshold becomes subject to global taxation, this might result in a bunching problem, which usually occurs in global taxation or the lock-in effect for tax deferral. However such problems may be mitigated because capital gains worth less than the fixed threshold are eligible for separate taxation. Proposal II clearly has merits in terms of vertical equity. From the perspective of efficiency in financial markets, supplementary measures such as a scheme to lighten tax burdens on long-term investment income are worth considering.

C. Step III: Dual Income Taxation vs. Strengthened Global Taxation

In the final stage of tax reform for financial investment income, the choice between introducing various types of dual income taxation systems and strengthening global taxation must be made. These alternatives are provided in the following Proposal III[16] and Proposal IV, respectively.

1) Dual Income Taxation

Proposal III	To abolish the current global taxation for financial income and switch to dual income taxation ▶ Applying the flat tax rate (20~30%) based on separate taxation for financial investment income ▶ Continuing to apply global taxation with progressive rates to earned /business income

Proposal III suggests abolishing the current global taxation system for financial income and switching to dual income taxation. In other words, interest

16) Including Proposals III-1 and III-2.

and dividend income which has been subject to global taxation for financial income is now classified as financial investment income along with capital gains. And they are subject to the flat tax rate. Considering the tax rates in Scandinavian countries, a flat rate between 20~30 percent would be plausible. This rate is substantially higher than the existing separate-taxation rate of 14 percent applicable to interest and dividend income. But high income earners with higher financial investment income can anticipate the benefit of reduced tax burdens since progressive tax rates do not apply. Earned/business income remains subject to global taxation with progressive tax rates.

Proposal III-1	Basically the same as Proposal III, but two-step progressive taxes apply to financial investment income. ▶ Two-step progressive taxes apply based on separate taxation for financial investment income. - Financial investment income worth less than KRW 20 million (tax rate of 14~20%) - Financial investment income worth KRW 20 million or more (tax rate of 20~30%) ▶ Earned/business income remains subject to global taxation with progressive rates.

Proposal III-1 is a hybrid version of dual income taxation and global income taxation. This measure is designed to retain the dual income taxation system's advantages and address the problems of insufficient vertical equity by separating financial investment income from earned/business income and applying progressive rates to different tax brackets.[17] What distinguishes this measure from Proposal III is that it does not apply a flat rate to financial investment income but a two-step progressive tax rate, thereby addressing the issue of vertical equity to a certain degree.

The key to this proposal is determining the structure of tax rates. When two-step progressive rates apply, it is worth considering applying 14 percent

17) The United States and the United Kingdom, major players in the global financial industry, apply progressive rates based on total income except long-term capital gains. In the meantime, it is difficult to find any country that has introduced the measures this paper proposes.

to financial investment income such as interest, dividends, and capital gains worth less than KRW 20 million and 20 percent to those worth KRW 20 million or more. This can enhance neutrality in taxation among various types of financial investment income, simplify financial taxation systems and to a degree solve the issue of vertical equity inherent in dual income taxation systems.

Meanwhile, since this scenario is breaking current framework of global taxation for financial income, it is not necessary to stick to the threshold of KRW 20 million or the 14 percent tax rate. The threshold may be moved slightly upward to be neutral in tax revenue, and the rates of 14 percent and 20 percent adjusted to brackets of 14~20 percent and 20~30 percent respectively in order to approach a level closer to the higher tax rates in other countries such as Scandinavian countries.

For example, under the current system with the KRW 20 million threshold, an individual with only financial investment income worth less than KRW 12 million is subject to a higher tax rate than that applicable to earned income. This problem may be mitigated to a degree through allowing basic deductions. Dual income taxation is inferior to global taxation in terms of vertical equity but may help invigorate financial markets through mitigated taxation on capital.

Proposal III-2	To apply the same progressive rates to financial investment income as applicable to earned/business income, instead of the two-step progressive rates applicable under Proposal III-1

Proposal III-2 is distinguished from Proposal III-1 in that the former changes the two-step progressive rates applicable to financial investment income to multi-step rates applicable to earned/business income. Under this proposal, the current framework of global taxation for financial income will be abolished. Instead financial investment income will be taxed separately, being subject to the same multi-step progressive rates applicable to earned/business income.

This method may maintain taxation neutrality between capital income and earned income, as is the case with the method currently applicable to the taxation system for gains on real estate transfers, thus enhance vertical equity. According to this system, different tax rates apply to different financial investment income levels: 6 percent to the amount worth KRW 12 million or less; 15 percent to

KRW 46 million or less; 24 percent to KRW 88 million or less; 35 percent to KRW 300 million or less; and 38 percent to more than KRW 300 million. The difference from Proposal IV involving global taxation to all income is that the method proposed herein is less progressive due to separate taxation of financial investment income. As in Proposal II, this method could face the bunching problem when progressive rates apply; therefore, supplementary measures, such as special deduction systems for long-term holding, are advised.

2) Strengthened Global Taxation

As an alternative to dual income taxation, strengthened global taxation can be suggested as follows.

Proposal IV	To impose progressive rates based on global taxation by aggregating all financial investment income and earned/business income, but with exceptions for some types of income such as long-term investment income

Proposal IV is closest to the current U.S. or U.K global taxation systems. This measure requires all income types to be added and subject to progressive tax rates, but long-term investment income is taxed separately to decrease tax burdens. Here financial investment income, of course, includes interest, dividends, and capital gains, but any income generated from deposits or investment schemes maintained for at least one year is classified as long-term investment income and subject to separate taxation. Proposal IV ultimately enhances vertical equity.

3 Detailed Issues

1) Timing of Recognizing Profits and Losses

Regarding capital gains, most OECD member countries prefer realization basis over accrual basis. Because accrual-basis taxation accompanies an excessive amount of tax compliance costs. Also liquidity issues arise when taxpayers without cash flows should pay taxes on unrealized capital gains. Discussion on taxation by mark-to-market has recently been actively engaged, particularly on derivatives. But realization-basis taxation is more practical in terms of tax administration, despite a number of shortcomings. Realization basis is particularly appropriate when interest and dividend income and capital gains are to be included into financial investment income and taxed uniformly. Since only realized interest and dividend income is taxed during each period, it will be consistent to tax capital gains realized during the same period.

2) Period for Deducting or Carrying Forward Loss

The current system in Korea permits aggregation of transfer loss generated from some identical financial assets, but such aggregation is not permitted between different financial products. Aggregation is allowed only for loss from stock transfers with gains on transfers of other stocks that accrue during the same tax year. Deductions carried forward, however, are not permitted when there are only losses from stock transfers.

Under the financial investment income taxation system, permitting aggregation of loss and gain from all financial products is necessary to simplify financial taxation system. This is also a way to maintain the principle of substance over form taxation. For example, taxation only applies to any positive income if all profits and losses generated from fund investment are allowed to be summed up. In addition, if investment in one financial product results in losses while other financial investments generate gains, such losses and gains must be summed up so as to tax net financial investment income.

Permission for overall profit-loss aggregation in such a manner is believed to contribute to encouraging financial investment. However, whether to permit carried-forward deductions must be decided in consideration of tax revenue and other factors. The United States set the ceiling of loss deduction for capital gains at USD 3,000, allowing for deduction from other ordinary income and carried-forward deduction for any remaining capital loss indefinitely.

Should dual income taxation be chosen from among the alternatives suggested above, aggregating with other income will not be appropriate because the chosen system is based on separate taxation for financial investment income. More reasonable measures worth considering include permitting profit-loss aggregation within the category of financial investment income and, if any loss remains, carried-forward deduction for one-to-three years in subsequent years. If the global taxation system under Proposal IV is adopted, aggregation with other income will have to be permitted, at least even partially.

3) Adjustment of Inflation and Preferential Treatment of Long-Term Investment

Short-term capital gains are often deemed a result of speculative transactions, while long-term capital gains are generally seen as a reward for capital formation. In particular, some capital gains resulting from long-term holding of financial products or assets are likely to result from incremental gains in asset value due to inflation. Therefore under progressive tax system, tax burdens will become excessively high due to the bunching effect that occurs when profits, accumulated over a long period of time, are realized at once. To address this issue, many countries with capital gains tax system provide tax cut benefits for long-term capital gains.

Korea does not, for now, provide preferential treatment for long-term investment when taxing major shareholders' gains on stock transfers or on gains on transfers of overseas stocks. In addition, few tax-cut schemes exist for income accruing from long-term financial investment with at least one-year maturity.

In recent years, many countries have chosen not to adjust inflation on capital gains, but instead mitigated inflation and bunching problems by reducing tax rates or exempting taxes on capital gains. The United Kingdom and Australia used to adjust long-term capital gains affected by inflation through price indexes, but at the end of the 1990s they began providing more deduction benefits to financial assets held over a lengthy period. Korea is also advised to consider providing tax-cut benefits for long-term financial investment when reforming financial investment income taxation systems.

4) Deduction of Costs

It is necessary to deduct the entire amount of costs incurred in financial investment, including interest costs, consultancy fees and transaction fees.

Currently the amount of basic deduction for gains on real estate transfers, on major shareholder's stock transfers, and on transfers of overseas stocks in Korea stands at KRW 2.5 million. In the initial stage of reforming financial investment income taxation systems, such basic deductions must be increased to minimize market impact; basic deduction can then be reduced gradually for the estqablishment of new taxation systems. Applying low tax rates in the initial stage can also minimize market impact. But it is more important to set the same tax rate for financial investment income and allow bigger basic deduction first.

VI

Conclusion

Since the current global taxation for financial income is not fully equipped with capital gains taxation, the tax systems in Korea for a variety of financial products lack consistency. To address such issues, this study suggests taxing all types of income from investment and savings in financial assets by incorporating them into a single concept of financial investment income and making a choice between either gradually adopting dual income taxation or strengthening global taxation.

As the initial step, Proposal I provided a transitional measure that involves minimum changes under the current systems. The application of separate taxation on capital gains, however, retains the existing problem of compromised neutrality in taxation. This paper proposes separate taxation as the initial step because it can minimize the impact on the capital markets by expanding the tax basis. In this regard, it is essential to introduce overall capital gains taxation system to establish a consistent taxation system for all financial investment income.

The second step is to maintain the current framework of global taxation for financial income and expand the boundary of financial income consisting of interest and dividend to financial investment income, including capital gains. Proposal II has the advantage of ensuring continuity with the current systems by maintaining the current global taxation systems and of ensuring tax neutrality among the various types of financial investment income.

In the third step, either dual income taxation or reinforcement of global taxation is recommended. The dual income taxation system suggested in Proposal III means abolishing the current global taxation for financial income and switching to one of the various dual income taxation systems.

As an alternative to dual income taxation, Proposal IV is a global taxation system for financial income. It allows for some exceptions for long-term investment income. Considering that the current taxation systems almost do not impose taxes on capital gains, Proposals III and IV are thought to be longer-term alternatives.

The choice between Proposal III and Proposal IV is related to a philosophical question: Should efficiency or equity receive greater emphasis? In reality, no system considering either efficiency or equity only can be established and where to place greater emphasis requires social consensus.

The 2013 reduction of the threshold for global taxation for financial income from KRW 40 million to KRW 20 million reflects a policy direction to strengthen global taxation systems as a means to improve vertical equity. If this tendency is to be extended, related systems will have to be improved to realize Proposal IV. However, if the existing neoliberal positions are interpreted as placing greater emphasis on capital mobility and efficiency, it is still possible to abolish the global taxation of financial income and switch to the dual income taxation of Proposal III. Considering that separate taxation applies to interest and dividend, the current global taxation system for financial income may be said to have in part the nature of dual income taxation. In the end, how to define ultimate policy targets will be critical in determining measures to overhaul taxation systems for financial investment income.

One of the limitations of this study is that it cannot provide the specific scale of expected effects or tax-revenue effects from each of the alternatives proposed. In fact, preceding studies on the introduction of capital gains taxation only assume tax-revenue effects in a very rough manner due to difficulties obtaining data on investment activities of the individuals and profits thereof. Therefore, it is hard to expect high reliability from such roughly projected numbers. This study proposes subsequent tax reform alternatives assuming the introduction of overall capital gains taxation system, but could not offer more detailed expected effects due to restricted access to micro data. If accessibility to such data is improved in the coming years, the authors are determined to conduct follow-up studies to propose more detailed policy designs through simulations.

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