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In this article, the authors discuss insolvency restructuring in Korea and its tax implications in light of the COVID-19 economic downturn.

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The COVID-19 pandemic has created a global health hazard unprecedented in recent human history. Damage to the global economy is expected to be equally unprecedented. Despite the Korean government's various emergency rescue measures pledging more than KRW 50 trillion (about $41.5 billion), travel and hospitality industries in Korea are in deep financial distress. And in this globally interdependent economy, retail and most other industries are not free from the adverse repercussions of dwindling spending and economic downturn either.

Among well-known names in the Korean business community, Korean Airlines and the Doosan Group are already in discussions with major financial creditors (headed by the Korea Development Bank and the Export-Import Bank of Korea) about restructuring plans to redress financial trouble.[1] As part of a self-help plan, Korean Airlines is considering a large-scale capital injection by its major corporate shareholders and possibly the sale of profitable but nonessential business lines to generate cash to service its debt. Doosan Group is contemplating a similar line of self-help actions and announced a commitment by major individual shareholders in management positions to waive dividend and bonus payments and to give back a substantial portion of their wages.

Overview of Principal Insolvency Regimes

A distressed debtor dialogue in Korea usually starts with voluntary concessions improving the debtor's immediate financial condition and promising to alleviate creditors' concerns of significant investment losses. Initial discussions usually begin outside any legal regime. The dialogue may then escalate into a more formalized arrangement that follows bankruptcy or other insolvency laws. In Korea there are four main regimes for dealing with a corporate insolvency situation, discussed below. These regimes weathered the 1997 Asian financial crisis and the 2008 global financial crisis and have evolved over time.

[1] Yun Jung Choi, "Doosan Group to Secure KRW 3 Trillion Via Asset Sale and Other Measures," *Yonhap News*, Apr. 27, 2020 (in Korean); and Hee Jin Kim, "Shivering Korean Airlines Creditors' Committee to Demand the Disposition of Airline F&B and Mileage Businesses," *New Daily Economy*, Apr. 27, 2020 (in Korean).

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Rehabilitation Proceedings Under the DRBA

Rehabilitation proceedings under the Debtor Rehabilitation and Bankruptcy Act (DRBA), analogous to chapter 11 bankruptcy proceedings in the United States, may be initiated by filing a petition to a court by the debtor, creditors, or shareholders holding an aggregate claim amount (or shareholding) above a specific threshold. Once the filing is made, the court may issue a stay order or a comprehensive preservation order, as needed, and will render a decision whether to commence a rehabilitation proceeding.

If the court orders a rehabilitation proceeding to commence, it will appoint a receiver, set a date for the first meeting of creditors, and indicate the period during which the receiver must file the creditors list and the creditors must file claims reports. The court will appoint the current management to be the receiver unless there is evidence that the current management significantly misappropriated or concealed property, or the council of creditors convinces the court that a third-party receiver would be in the best interests of the company. The receiver has the authority to manage the business of the debtor company and to preserve and improve the value of the business.

The receiver is also responsible for preparing and submitting a rehabilitation plan based on the list of finalized claims and other due diligence submitted within the required time period. The plan should be approved by the creditors and, if the total assets of the debtor exceed the liabilities, by the shareholders. The confirmed rehabilitation plan is implemented by the receiver under the court's supervision.

Workout Under the CRPA

Voluntary restructuring through a workout process originated from an informal procedure to reschedule distressed debtor financial obligations under a private agreement framework among major financial institution creditors during the 1997 Asian financial crisis. The agreement frameworks were eventually enacted into law in 2001 as the Corporate Restructuring Promotion Act (CRPA). Since then, the CRPA has gone through several rounds of expiration and reenactment and was most recently reenacted in October 2018, effective for five years.

Under the CRPA, the scope of creditors subject to an established workout plan includes those holding financial obligations owed by the debtor. This is an expansion of the original scope that required the creditor to be a Korean financial institution. Having said that, the main creditor bank holding substantial administrative discretion over the workout proceeding, or the financial creditors committee following a resolution, may exclude a portion of financial creditors from the scope to expedite operation of the workout proceeding.

The CRPA requires the debtor's main creditor bank to evaluate and monitor the debtor's financial soundness and, once financial distress is determined, to notify the debtor. The debtor may request a workout to commence, or the main creditor bank may commence a workout by notice convening the meeting of financial creditors (the financial creditors committee). In the financial creditors committee's first meeting, creditors decide on the commencement of the workout proceeding and the need for due diligence on the debtor. The committee then establishes, resolves for, and enters into, an agreement with the debtor to implement a restructuring plan containing a mix of additional funding, interest and debt rescheduling or reduction, debt-equity swaps, and other management improvement items.

CRPA workout proceedings are limited in scope to debtor financial obligations and are distinguishable from a rehabilitation proceeding under the DRBA in that the latter encompasses all types of obligations, whether financial or trade. A proceeding under the CRPA therefore generally allows for a more flexible and expeditious arrangement.

Private Workout

While it is possible to go through a workout procedure under the legal framework of the CRPA, it is also possible (and there have been many such cases) for creditors and the debtor to conduct a workout entirely through private agreement. A private workout is considered advantageous for its flexibility and efficiency. It is generally used by a group of financial institution creditors and often follows the same procedural rules as those under the CRPA.

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The ASIFI

If a financial institution becomes insolvent, financial regulators have special powers under the Act on Structural Improvement of Financial Industry (ASIFI) to advise or order the institution to sell assets or to merge with another institution. However, the ASIFI does not establish separate insolvency proceedings for financial institutions. If a financial institution fails despite ASIFI regulatory intervention, it could be subject to bankruptcy proceedings under the DRBA. Some provisions in the ASIFI supplement the DRBA and give regulators specific rights in the bankruptcy proceedings.

Notably, the ASIFI authorizes the Financial Services Commission (FSC) to take specific actions if a financial institution's financial status falls short of FSC-established standards. The FSC may recommend, request, or order, a financial institution to increase or decrease capital, dispose of assets, cease acquiring high-risk assets, suspend all or part of its business, complete a business transfer, merge or consolidate with another financial institution, or take other similar measures to improve financial soundness. The FSC is also authorized to make investments in insolvent financial institutions and to order the institution to invalidate or consolidate stock held by any shareholder the FSC deems responsible for the insolvency. If the financial institution fails to comply with an FSC order, the FSC has the power to suspend business and to appoint managers to conduct institution business.

Major Tax Implications

In the midst of implementing urgent steps to escape pandemic-driven economic distress, tax implications may be an afterthought. However, tax liabilities that may arise from each step (discharge of indebtedness income, for example) have a real financial effect and should be anticipated and actively taken into consideration in the process of financial projection and valuation. The discussions below provide an overview of major tax implications of which the distressed debtor, creditors, and other stakeholders should be aware.

How Net Operating Loss Operates (Debtor)

Debtors in financial distress are usually in an operating loss position. It should be noted that a net operating loss generated in a tax year is a valuable tax asset that can be used to reduce taxable income in other years. Under Korean corporate income tax law, NOLs can be generally carried forward for 10 years, but cannot be carried back (with certain exceptions for small and medium-size enterprises). NOLs carried forward to a future tax year may generally be used to offset taxable income, up to a limit of 60 percent of the adjusted taxable income (earnings before interest, taxes, depreciation, and amortization) of the tax year; however, as a corporate income tax law exception, the 60 percent limit can be waived for debtors in the process of implementing a rehabilitation or restructuring plan under the DRBA, CRPA, or ASIFI.

If the debtor is disposed of as part of the corporate restructuring plan, it can continue to use the NOL carryforwards as long as its corporate existence continues. However, if it merges with another corporation or transfers its business or assets, the NOL carryforwards would not survive, except in the case of a qualified tax-free merger, in which the NOL could be used to offset only future taxable income generated by the debtor's historical business line.

Discharge of Indebtedness Income (Debtor)

The distressed debtor's creditors may provide concessions such as debt rescheduling, resulting in an interest or principal reduction or exchange of debt for equity interest in the debtor. To the extent that these steps result in a reduction in the debt amount owed or repaid, it creates discharge of indebtedness (DOI) income, on which the debtor owes corporate income tax. In a debt-equity swap, the amount by which the debt renounced exceeds the fair value of the equity interest given to the creditors is considered DOI income for the debtor.

However, under corporate income tax law DOI income can be reduced by using NOLs generated in the current and previous tax years. It is notable that, for this purpose, expired NOL carryovers past the 10-year (five-year, prior to 2009) expiration period can be revived and used to reduce the DOI income.

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As an incentive to promote distressed restructuring, under article 44 of the Special Tax Treatment Control Act (STTCA) an additional tax benefit is provided if the DOI income arises under a plan confirmed or established under a DRBA, CRPA, private workout, or the ASIFI. DOI income arising under one of these plans, after being fully reduced by any remaining NOLs, can be deferred for four tax years (the tax year in which the DOI arises and three subsequent tax years) and can be recognized as taxable income in equal installments over three tax years. This tax benefit is subject to a sunset provision and is scheduled to expire on December 31, 2021; however, the sunset provisions are often extended by a few years and should be reconfirmed for the time relevant to the transaction.

Asset Sale (Debtor)

To secure additional cash to meet its financial needs, the debtor may dispose of profitable business divisions or assets. Not surprisingly, sale of an asset at a gain gives rise to taxable income for the debtor and may significantly diminish the positive financial impact intended by the sale. But in an effort to encourage self-rescue efforts, article 34 STTCA provides for a deferral of gain from the sale of assets to repay outstanding financial liabilities in accordance with a plan under a DRBA, CRPA, private workout, or the ASIFI. Under this rule, similar to DOI income, the debtor would defer the taxable gain for the sale for four tax years and recognize it in installments over three tax years. This provision is also scheduled to sunset on December 31, 2021.

Loss Deduction (Creditors)

To the extent of concessions made to the debtor on the outstanding loan or investment, the creditor would incur a bad debt loss equal to the DOI amount. Under general rules, the creditor would be allowed to write off the loan and recognize a tax loss only upon the events narrowly specified in corporate income tax law: the expiration of the statute of limitations, a court decision for a bankruptcy liquidation or rehabilitation plan under a DRBA, a court-ordered compulsory sale of the debtor assets, or a close down of the business. Under these rules, creditors are usually not allowed to take the deduction as an incurred loss in a practical sense.

Under article 44 STTCA, however, financial creditors granting concessions to a distressed debtor in accordance with a plan under a DRBA, CRPA, private workout, or the ASIFI, can accelerate the loss recognition and take the deduction in the tax year in which the debt forgiveness is granted. This provision is subject to sunset on December 31, 2021.

Shareholders' Debt Payoff or Donation

In business conglomerate corporate restructuring plans, major shareholders often make concessions by taking responsibility for unprofitable management results. A major shareholder of a debtor may take over the debt repayment obligation of the debtor or donate its own assets to the debtor to assist the debt repayment. Under general corporate income tax rules, the loss incurred by a benevolent action by related parties cannot be deducted as a taxable loss to the shareholder. However, under articles 39 and 40 STTCA, the shareholder (if such shareholder is a corporation) would be allowed to recognize a taxable loss for the amount incurred to facilitate the debtor's repayment if the action was undertaken in accordance with a plan under a DRBA, CRPA, private workout, or the ASIFI. These provisions are scheduled to sunset on December 31, 2021.

Conclusion

Korean rules concerning insolvency and related tax issues are complex and contain detailed qualification requirements and sunset provisions. They should be carefully studied to avoid traps or unexpected surprises. ■

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