



Tax News Flash

- Transfer Pricing & Customs

April 2023

Samjong KPMG Transfer Pricing & Customs Service Group provides readers Transfer Pricing & Customs related recent local tax issues and trends.

This newsletter is a monthly publication of Samjong KPMG Transfer Pricing & Customs Service Group. If you need more detailed explanation, please feel free to contact key contacts or Tai-Joon Kim for transfer pricing matters and Tae-Joo Kim for customs matters.



The following is a recent Korea's tax ruling in relation to transfer pricing

It is appropriate to establish selection criteria and reinvestigate comparable companies whose functions are similar to those of the plaintiff.

< Decision 2020 Seo 2311, 2022.06.09 >

Background

- The taxpayer is a local entity of ○○○○, and sells automotive and industrial semiconductors imported from ○○○○ during the 2015-2018 financial year. The income was calculated and reported using the Transactional Net Profit Margin Method "TNMM" (Profit Level Indicator: Operating Margin "OM") under Article 5 Paragraph 1 Item 5 of the 「Law for the Coordination of International Tax Affairs」.
- As a result of the tax audit, the tax authority determined that the taxpayer purchased a semiconductor product from a related party at a higher price than the arm's length price (the same arm's length calculation method was selected as the taxpayer, but the selected comparable companies were different). The tax authority included ○○○ KRW, the sum of the difference between the arm's length price and the declared income amount in the gross income and disposed the income as a dividend. Accordingly, the tax authority notified the taxpayer of the total KRW ○○○ for the 2015-2018 financial year.
- To verify the appropriateness of the transfer price reported by the taxpayer, the tax authority selected the TNMM as the transfer pricing method, used OM as the profit level indicator with the taxpayer's industry code (46594, Electrical machinery equipment and related equipment wholesalers). Total of seven companies were finally selected as

comparable companies after excluding companies with low comparability. The tax authority believes that there is a difference in the wholesale method, as the taxpayer sells semiconductor products to customers through dealers, while four of the comparable companies directly sell products purchased from manufacturers to customers. The difference was adjusted by deducting the operating margin corresponding to the dealer operating margin of the company concerned.

- The taxpayer did not agree to the adjustment and filed an appeal to the Tax Tribunal.

The Tax Tribunal Decision

- In order to calculate the arm's length price of the semiconductor parts purchased by the taxpayer from ○○○, the tax authority first selected comparable companies based on the market structure, physical characteristics of products, and sales volume. Then, after considering the similarity of products, the size of customer, and post-sales technical support, seven comparables were selected. However, if there is a difference in the transaction structure of the company and a difference in the transaction stage, there will inevitably be a difference in sales and marketing functions or distribution margins.
- In order to exclude cases where the sales volume of the comparable companies is significantly different from that of the taxpayer, the comparables were selected by rejecting the 5-year average sales of ○○○ KRW or more, and it resulted in a fluctuated scale of operating margin(median) from 2.72% to 7.08%. When the rejection criteria of 25% or less and 400% or more of the sales of the taxpayer presented by the taxpayer is applied, the operating margin(median) is between 2.72% and 3.60%, showing a consistent range. To this extent, it seems necessary to consider the characteristics of customers, R&D function, and overseas sales. Therefore, the taxpayer's claim that some of the comparable companies selected by the tax authority are inappropriate seems reasonable.
- In addition, the tax authority divided the semiconductor distribution market into the market for large corporations and the market for small and medium-sized enterprises, and then excluded semiconductor agency from the comparable pool for the reason that they mainly deal with small and medium-sized enterprises. However, since the taxpayer is functionally similar to a semiconductor agency, it is reasonable to include semiconductor agencies that have a significant proportion of transactions with large companies as comparable companies.
- Therefore, the Tax Tribunal decides that the tax authority will correct the tax base and tax amount by preparing comparability criteria in consideration of the transaction stage, sales volume, customers, business environment, etc. of the taxpayer, and reinvestigate the comparable companies, including semiconductor agency with similar functions to the taxpayer.



Introduction to Advance Customs Valuation Arrangement in Korea

Whether there is a justifiable reason for exempting the penalty in a case where the claimant filed an amendment by adding the amount paid to its affiliates as a post-compensating adjustment to the customs value, according to its transfer pricing policy, after completing the initial import declaration (Dismissed)
[Tax Tribunal, 2022-Customs-0031, February 2, 2023]

Facts

The claimant is a foreign-invested enterprise, 100% owned by its affiliate. It compares the target operating margin rate (OM%) with the actual OM%, calculates the amount that is above or under the target OM%, and remits or receives a post-compensating adjustment annually to its affiliates.

In 2015, Korean Customs conducted a customs audit on the claimant and confirmed that the amount paid by the claimant as a post-compensating adjustment should be included in the customs value of the imported goods as subsequent proceeds, which is one of the additional elements of the customs value. The claimant added the remittance amount to the customs value and filed an amendment accordingly.

In 2021, the claimant remitted the compensating adjustment amount (hereinafter referred to as the “amount at issue”) regarding the imports of 2020 to its affiliates. The claimant requested a penalty exemption before filing an amendment report and adding the amount at issue to the customs value.

Issue

- Whether there is a justifiable reason for exempting penalty for the case where the claimant filed an amendment by adding to the customs value the amount paid to its affiliates as a post-compensating adjustment according to its transfer pricing policy after completing the initial import declaration

Decision

Considering the following points, it is difficult to accept the request for penalty exemption of the claimant, and therefore, it is judged that there is no fault in the disposition of the customs authority.

- The claimant argues that there was a justifiable reason that could not be regarded as negligence in the tax obligation, considering that it made a considerable effort to fulfill its tax obligations by filing amendments regarding the post-compensating adjustment and paid taxes. However, the fact that the claimant was unable to report an exact customs

value with a determined adjustment amount at the time of import declaration was only due to the internal circumstances of the claimant regarding the transfer pricing policy.

- In addition, the fact that the claimant was unable to apply for a provisional value declaration because it did not receive ACVA* approval was also due to internal circumstances in which the claimant could not receive detailed data from its headquarters.

** ACVA (Advanced Customs Valuation Arrangement) refers to an advance agreement between a taxpayer and the customs authority, at the request of the taxpayer, on customs valuation of imports traded between related parties, i.e., an overseas parent company and its domestic subsidiary.*

- In 2017, the Korea Customs Service implemented a guideline on the price reporting procedure and operation plan for post-compensating adjustment between headquarters and branch offices, and in 2019 established criteria for whether the adjustment amount should be included in the customs value.
- It is difficult to judge that the claimant had a justifiable reason for the underpayment just because it voluntarily filed an amendment in response to the information provided by the Customs.

KPMG's comment

It's important to note that a provisional value declaration is only allowed in limited circumstances. If a compensating adjustment is not subject to a price adjustment clause or if the company lacks APA or ACVA approval, penalties may apply. To avoid penalties, companies should consider applying for the ACVA program to determine whether the remitted amount to affiliates is related to the customs value. If it is added to the customs value, companies can obtain a penalty waiver by using the provisional value declaration under ACVA. It's worth mentioning that the Korea Customs Service strictly applies penalty exemption requirements.



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