



Tax News Flash

- Transfer Pricing & Customs

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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

Whether the software implementation fee paid by the taxpayer to the Swiss corporation corresponds to royalty income under Article 93, subparagraph 8 of the 「Corporate Tax Act」 (dismissed)

<Decision 2022 Joong 2207, 2023.02.08>

Background

- The corporate tax regarding the consideration paid to AAA (hereinafter referred to as “the Swiss corporation”), a Swiss corporation without a domestic permanent establishment, for implementing the OOO system (hereinafter referred to as “software”) during fiscal year 2016 – 2021 was withheld and paid by a domestic company (hereinafter referred to as “the taxpayer”) to a tax office in Korea as the taxpayer regarded the consideration as royalty income for the Swiss corporation in accordance with Article 93, Subparagraph 8 of the 「Corporate Tax Act」 (hereinafter referred to as “CTA”) and Article 12 of the Korea-Swiss Tax Treaty.
- However, in late 2021, the taxpayer filed a request for refund of the taxes withheld and paid to the tax office for fiscal year 2016 – 2021, claiming that the consideration paid to the Swiss corporation for the implementation of software should not be considered as royalty income subject to withholding tax, but as business income in accordance with Article 93, Subparagraph 5 of the CTA and Article 7 of the Korea-Swiss Tax Treaty. However, the request for refund of the tax amount was rejected by the tax authority.

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

Issue

- Whether the software implementation fee paid by the taxpayer to the Swiss corporation corresponds to royalty income under Article 93, Subparagraph 8 of the CTA.

The Tax Tribunal Decision

- The taxpayer appealed that the consideration paid was a type of business income because the taxpayer merely purchased software from the Swiss corporation and installed the software on the STB(set-top box). Accordingly, the nature of the transaction is that of a purchase and installment of specific parts (raw materials) rather than the receipt of know-how from the Swiss corporation as undisclosed source codes were not provided.
- The Tax Tribunal decided against the taxpayer's claim under the following matters.
 - The software is not open to the public, and thus, it cannot be freely used by an unspecified majority.
 - The contract for the implementation of the software was concluded as a license and service contract.
 - The taxpayer paid the software implementation cost and accounted under a 'commission' account. The accounting method selected by the taxpayer is sufficient to judge that the taxpayer did not regard the nature of the transaction simply as revenue or sales proceeds of a product.
 - It is reasonable to conclude that the taxpayer did not simply purchase raw materials from the Swiss corporation, but rather used the accumulated information or know-how of the Swiss corporation.
 - The implementation process and software use by the taxpayer requires an authentication stage. Moreover, the software is customized to make the software more compatible with the taxpayer's STB hardware.
 - Considering the above points, it is difficult to agree with the taxpayer's arguments.



Introduction to Advance Customs Valuation Arrangement in Korea

Respecting the principle of liberty of contract between transaction parties, "Offence of Price Manipulation clause should be strictly construed" [Incheon District Court, February 16, 2023, Sentence, 2021gohap924]

Background

Article 270-2 of the Customs Act stipulates that “a person filing a correction declaration, amendment declaration, import declaration, or export declaration applies or reports by manipulating the price of goods for the purpose of unfairly property gains or making a third party acquire, shall be punished by imprisonment for not more than two years or by a fine not exceeding the amount which is the higher between the cost of the goods and 50 million won”. This is so-called ‘Offence of Price Manipulation’ clause introduced in the revised Customs Act from August 13, 2013.

The background of this provision is to prevent transaction parties from falsely declaring the value of the goods for unfair purposes, such as illegal subsidies, trade finance (loan) defrauding, and evasion of corporate taxes, in accordance with the quantitative growth and qualitative complexity of international trade.

Facts

Defendant K, engaged in the research, development, and manufacturing of high-tech devices, signed a supply agreement for high-tech products with overseas supplier L, agreeing to comply with the specifications and raw material standards requested by L.

Afterwards, K informed L of the sources, quantities, and prices of raw materials required to meet the product performance and specifications. Accordingly, K imported the raw materials from a third-country supplier M and used them to manufacture the finished products, which were subsequently exported to L.

K declared the import price of raw materials based on the payment made to supplier M. The export price of the products was declared to the customs authority based on the price received from L, using the same price as agreed upon in the supply agreement.

However, the customs authority determined that the price of the raw materials declared by K for import was higher than that of identical or similar items, and accordingly, the exported product price was found to be overvalued. They raised suspicions about the discrepancy between the manufacturer and exporter of the raw materials, the involvement of multiple transaction parties, and the accuracy of the import/export pricing data. They also suspected that K manipulated the import/export prices at a higher value for the purpose of providing financial benefits to the overseas related party. Consequently, an investigation against K was initiated on the grounds of price manipulation under the Korea Customs Act.

Issue

- Whether the defendant K manipulated the prices of imported and exported goods to be overpriced for the unfair purpose of providing benefit to the third parties

Decision

The first instance court found that K has paid and declared the price of the imported goods in accordance with the import and export agreement with L and M. **i)** The raw materials that the customs authority considered to be overpriced were necessary to produce the goods, and **ii)** given the diversified types of international trade, it is possible for an exporter rather than a manufacturer to conduct a kind of intermediary trade, **iii)** it is legitimate business judgment for transaction parties to impose contractual conditions on the determination of costs, materials, and prices of products for mutual benefit, and **iv)** the illegal overseas financing alleged by the customs authority was either a misinterpretation of the relevant materials or an unsubstantiated allegation, therefore the court acquitted K on this issue.

KPMG comment

In recent years, even if the import price is higher than that of identical or similar items or there is no customs duty payment issue, it is increasingly becoming an issue if the declared value is not properly managed in customs audits. In the past, importer expected that only low prices would be challenged in customs audit, but the auditors have comprehensively reviewed not only the undervalue declaration but also whether the price was arbitrarily determined, including the company's pricing policy and whether the price was determined under normal commercial practices.

As can be seen from the above court case, it is meaningful to note that in determining whether the import and export prices were reasonable, the court carefully examined whether was price manipulation between the parties to the transaction and whether there was a purpose for the parties or a third party to obtain benefits.

We also agree that the judicial principle of liberty of contract should be respected wherever possible and that it is reasonable to conclude that transaction parties cannot be found to have manipulated prices merely because they have agreed to a seemingly unusual or unfamiliar contractual arrangement.

Finally, when dealing with a customs audit, especially on related party transfer pricing issues, it is desirable to present a positive image of the company to the customs auditors and efficiently provide a sufficient explanation of the pricing policy. To this end, it is important to note that professional assistance in customs audits will be a way to minimize the risk of tax penalties of the company.



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