



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

A decision on whether the service fee complies to the arm's length principle.

<Tax Tribunal Decision 2021Suh5598, 2023.08.09>

Background

- The taxpayer provides contents related support services including information regarding the local contents market, local contents production support and administration services to its overseas related party (hereinafter, 'AAA'). In accordance with the services provided, the taxpayer receives a service fee of the related costs with a 10% mark-up.

Tax Office's (Defendant) Claims

- The tax office re-characterized the taxpayer as a content distributor to which AAA outsourced content production and the taxpayer outsourced such functions to another content production company. Moreover, the tax office also claimed that the taxpayer performed key functions such as the purchase and sale of contents rather than the simple administration or support functions. Accordingly, the tax office claimed that the cost plus markup scheme without considering AAA's purchase price for the contents from the 3rd party was not appropriate.
- Claiming the taxpayer as a content distributor, the tax office restructured the service transaction in which the service fee remunerated by AAA should comprise the production costs paid by AAA to the domestic content producer as additional sales and COGS related expenses of the taxpayer. (i.e., adding the production costs to sales of the taxpayer and the costs to expenses of the taxpayer at this same time) According to the restructured transaction, the adjusted operating profit recorded by the taxpayer was lower than the arm's length range of the comparables selected by the taxpayer in the TP report.

Taxpayer's (Plaintiff) Claims

- The taxpayer claimed that the service fee paid by AAA was remunerated at a 10% mark-up which is within the arm's length range calculated by the profitability of comparable companies.
- The taxpayer also claimed that the restructure of the service transaction proposed by the tax office does not reflect the substance of the transaction. Moreover, the COGS related expenses were generated due to the provision of services and was not relevant to the production of contents.

Tax Tribunal Decision

Due to the circumstances in which the tax office could not provide adequate reasonable grounds for the re-characterization of the transaction, did not make any comparability adjustment between the existing transaction structure and the restructured transaction, which may affect factors/transactional terms & conditions considered in calculating the arm's length price, and did not provide any specific reason that the transfer pricing method and the comparable companies selected by the taxpayer were inappropriate, the Tax Tribunal concluded that the tax office was incorrect in the taxation regarding the service transaction.



The following is a recent Customs-related Court case in Korea

1. Whether the amount of the TP adjustment in questions fall under the definition of “subsequent proceeds” as defined in Article 30 (1) (5) of the Customs Act [Supreme Court, 2022du35275]

Under the Customs Act, **“Subsequent proceeds” is one of the additions from the customs perspective, similar to the additions to taxable income in corporate tax**, which is defined as “the amount of proceed derived from the sale, disposal, or use of the imported goods after the importation of such goods, which is directly or indirectly attributable to the seller”. Recently, the issue of subsequent proceeds went to the Supreme Court and the taxpayer won the case, thus we would like to introduce it as follows.

1) Fact

According to the supply contract between the plaintiff and the exporter (“HQ”), the import price that the plaintiff imports from the HQ is based on the HQ’s standard cost multiplied by a premium rate. However, by comparing the actual operating profit achieved by the plaintiff with the target operating profit corresponding to the arm’s length price, if the actual operating profit exceeds the target operating profit, the excess amount will be remitted to the HQ, and if the actual operating profit falls short of the target operating profit, the deficiency amount will be received from the HQ (hereinafter referred to as the **“TP adjustment”**).

The Plaintiff imported health food products from the HQ (hereinafter referred to as the '**goods in questions**'), declared the customs value of the goods in question as the HQ's standard cost multiplied by the premium rate, paid customs duties accordingly, and paid a certain amount of TP adjustment in some months. (Hereinafter referred to as the "**TP adjustment in questions**")

The defendant believed that the TP adjustment constituted "subsequent proceeds" as defined in Article 30 (1) (5) of the Customs Act, as the amount of proceed derived from the sale of the goods in questions were paid back to the HQ. In response, the defendant issued a notice of taxation by reassessing the customs value by adding the amount of the TP adjustment in questions to the customs value of the goods in question.

2) Issue

Whether the amount of the TP adjustment in questions fall under the definition of "subsequent proceeds" as defined in Article 30 (1) (5) of the Customs Act

3) Decision

The Court noted that in order for a payment to be included in the customs value as subsequent proceeds under Article 30(1)(5) of the Customs Act, **i)** it must be an amount directly related to the imported goods out of the sales proceeds obtained from the sale of the imported goods, and **ii)** such amount must be calculable based on objective and quantifiable data, and concluded that the amount of the TP adjustment in question could not be defined as "subsequent proceeds" under the Customs Act for the following reasons.

While corporate tax has the objective of preventing taxpayers from intentionally transferring income abroad and fairly distributing taxable income without double taxation, customs duties aim to determine the customs value of individual goods and to impose duties in line with the value of the goods at the time of importation. Therefore, in essence, whether the amount of TP adjustment made to converge to the arm's length range for tax purposes, can be included as additions in the customs value should be determined depending on the actual cause and nature of the payment.

The amount of the TP adjustment is the portion of the excess of the target operating profit rate and is not the sum of the individual profit amounts calculated for each imported goods, and the operating profit rate, which is the basis for the TP adjustment, is calculated by deducted Cost of goods sold (COGS) and SG&A expenses from the gross profit multiplied by the selling price and sales volume. It means that since **operating profit rate is affected not only by the selling price but also by various factors such as sales volume, premium rate, fluctuations in exchange rates, and SG&A expenses**, it is difficult to consider that the amount of TP adjustment as an adjustment to the price of the imported goods.

The defendant argues that the amount of the TP adjustment in questions constitutes the amount of proceeds from the sale of the goods in questions, which is directly or indirectly attributable to the HQ, because the plaintiff set a lower premium rate compared to the increase in its operating profit rate, resulting in the goods in question at a lower price and the payment of the TP adjustment. However, **considering that the plaintiff continuously increased the premium rate over the standard cost and the COGS as a percentage of sales increased year after year, while the operating profit rate before adjustment remained unchanged, the Court held that the COGS, including the import price, could not be considered the most important factor affecting the amount of TP adjustment.**

In addition, the amount of the TP adjustment added by the defendant to the customs value cannot be regarded as adding only the amount directly related to individual imported goods to the customs value based on objective and quantifiable data.

4) KPMG's comment

The above court case lays down the general principle based on the principle of substantive taxation that whether the amount of TP adjustment is included in the customs value as an addition to the customs value as subsequent proceeds, should be determined by distinguishing the actual cause and nature of the TP adjustment, specific requirements for conclusion of the TP adjustment amounts as subsequent proceeds include: i) it must be an amount directly related to the imported goods out of the sales proceeds obtained from the sale of the imported goods, and ii) such amount must be calculable based on objective and quantifiable data.

As Korean multinational corporations often make TP adjustments between related parties, it is necessary to identify the substance and nature of such TP adjustment amounts to determine whether they constitute subsequent proceeds under the Customs Act. The occurrence of TP adjustment amounts can be caused by a combination of various factors, such as the increase or decrease in sales price or volume, the increase or decrease in operating expenses such as labour costs, and price discount policies, etc. **It is important to mention that it is recommended to review by professionals if applicable, whether the amount of TP adjustment can be shown that the TP adjustment was not caused by a lower import price, especially for the companies that are scheduled for future customs audits or the companies that have already been imposed customs duties on similar issues.**



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