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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

Cancellation of Imposition of Corporate Income Tax.
<Supreme Court Decision 2018doo39621, 2022.07.28>

Background

- The taxpayer (hereinafter, Korean taxpayer) operates a local credit card business in accordance with the Credit Specialized Finance Business Act and the US based credit card company (hereinafter, US credit card company) does not operate local business in accordance with the United States law. The Korean taxpayer contracted an agreement with the US credit card company for the license of trademark to be attached to credit cards issued in Korea.

- In relation to the license of trademark, the Korean taxpayer remunerated the following fee to its transacting party.

Issuer contribution fee	Domestic	Credit card payment amount x 0.03% Cash service amount x 0.01%
Daily issuer contribution fee	Overseas	Credit card payment amount x 0.184% Cash service amount x 0.184%

- The Tax Office deemed that part of the fees paid by the Korean taxpayer to the US credit card company is a royalty amount and service fee which is subject to Value Added Tax (VAT) because the actual location of service provision is Korea. Accordingly, the Tax Office imposed taxation on the non-submission of payment record for the royalty amount and related VAT for the service amount to which the Korean taxpayer requested the cancellation of the imposition of taxes in the Supreme Court.

Tax Office's (Defendant) Claims

- The Tax Office claimed that the issuer contribution for is deemed as royalty because it was calculated in accordance with domestic transaction amount because domestic payments used the payment system that was developed in Korea by the local credit card company and did not use the US credit card company's payment system. Accordingly, the issuer contribution fee is deemed as a royalty amount for the credit card company rather than business income which is subject to submission of payment record.

- However, the tax office deemed the daily issuer contribution fee as business income rather than royalty income because the fee was remunerated for services provided by the US credit card company and is calculated based on overseas transaction amount.

- In accordance with local VAT regulation, the imposition of VAT is based on the actual location of service provision. The Tax Office claimed for the imposition of VAT considering that the significant portion of the service was provided in Korea. The credit cards that applied the US credit card company's trademark were mostly used in Korea and the Korean taxpayer used the US credit card company's payment system in Korea.

Taxpayer's (Plaintiff) Claims

- The Korean taxpayer deemed that the fees remunerated to the US credit card company were in relation to the credit card company's provision of advertisement service, payment approval process support, and network management. Accordingly, the Korean taxpayer deemed that the fees were business income rather than royalty income and is not subject to submission of payment record.

- The Korean taxpayer deemed that the transaction was not subject to VAT because the US credit card company provided services relating to finance and insurance which doesn't apply VAT in accordance with local VAT regulations.

Result

- In relation to the classification of royalty and business income, the issuer contribution fee was deemed as royalty since the domestic transaction amount is unrelated to US credit card company's payment system, while the daily issuer contribution fee was deemed as business income as overseas transaction amount is related to US credit card company's payment system. Imposition of corporate income tax is to be applied for the license of trademark. On the other hand, as the daily issuer contribution fee is considered overseas business income, it is not subject to corporate income tax in accordance with the Korea-United States tax treaty

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

1. Application of substance-over-form principle in recent court case [Seoul Administrative Court, 2019-73444 dated in March 2023]

1) Background

In this legal case, the plaintiff, a global multi-level marketing corporation specializing in the development and sale of dietary supplements, faced challenges arising from a regular customs audit conducted by the Seoul Customs Office (SCO) in 2019.

The plaintiff had been importing goods from multiple third-party, non-related suppliers. However, SCO, as the defendant in this case, contested the status of these third-party suppliers as exporters of record. Instead, SCO recognized the related party distributor as a bona-fide exporter.

As a consequence of this determination, SCO concluded that the transfer prices involved in these transactions were not at arm's length. The primary basis for this conclusion was the perceived influence of the relationship, particularly noting that the prices did not adequately incorporate sufficient profit and expenses of the recognized bona-fide exporter.

2) Issue

Whether it is possible to categorize the importation from the third parties as intercompany related-party transactions, emphasizing the substance-over-form principle.

3) Decision

a. Determination of Exporter in terms of substance-over-form principle

The case underscores a critical point: the apparent transfer of ownership to a nominal third party does not automatically confer the status of exporter to a company. What truly matters, as highlighted from the standpoint of substance-over-form principle, is the activities performed by the related party distributor. As a result, the court ruled that the distributor is a bona-fide exporter instead of the third-party suppliers.

b. Intention of Tax Evasion in terms of substance-over-form principle

The plaintiff presented that there was no intention of tax evasion because even if the customs values are intentionally lowered to reduce duty payables, it would eventually result in higher profit for the entity. This stance was grounded in the belief that, in the Korean business landscape, where the corporate tax rate surpasses customs duties, there is no practical advantage to circumventing customs duties.

In contrast, the court's ruling took a different stance, emphasizing a perceived purpose of tax evasion. According to the court, the 'benefit of increased sales' outweighed the augmented corporate tax burden resulting from the competitive edge gained through lowering import prices.

4) KPMG's comment

a. Determination of Exporter in terms of substance-over-form principle

This court case marks a significant recognition of the Korea Customs Service's commitment to taxation based on the substance of transactions over the form by the court. With this pivotal court acknowledgment of the substantive taxation principle, it becomes imperative for businesses to conduct a comprehensive health check not only on formal matters but also on the substantive aspects of their operations.

b. Intention of Tax Evasion in terms of substance-over-form principle

The argument that there is no intention of tax evasion because the customs duty rate is lower than the corporate tax rate (i.e. the purchase price is lower and consequently the corporate tax burden is higher) is no longer acceptable. Rather than solely considering the tax rate differential, the court now deems the "commercial effect" essential. This means that if the import price is lower, it may lead to a reduced selling price in the domestic market, ultimately resulting in increased profits.

Given the application of the Free Trade Agreement (FTA) resulting in near-zero percent effective duty rate, the court ruling emphasizes the necessity for a comprehensive pricing strategy that takes into account the broader impact on domestic sales, profits, and corporate taxes.

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