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- 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

Company A vs. NTS: Determination of VAT Liability for Sales Support Services <Tax Tribunal Decision 2018Goohab60053, 2018.11.15>

Background

- Company A (hereinafter, Company A or taxpayer) is a wholly-owned subsidiary of HQ located in Germany and performs automobile parts engineering service and wholesale of electric tools. Beginning 1989, Company A provided various marketing and sales management service including research of local customers, local market trends, and customer preferences.

- Beginning 2012, in accordance with a request made by the local customer, the HQ granted the rights to Company A to negotiate and contract agreements on behalf of the HQ under the sales support service agreement. Accordingly, the HQ registered a permanent establishment (hereinafter, PE) in Korea.

- Company A filed zero-tax rate for the service fee remunerated by the HQ for the sales support services. However, the National Tax Service (hereinafter, NTS) deemed that the actual service recipient is not the HQ but rather the HQ's PE registered in Korea (hereinafter, Korean PE) and accordingly, the service fee is not subject to zero-tax rate of value added tax (hereinafter, VAT).

Tax Office's (Defendant) Claims

- The Tax Office claimed that Company A contracted with the Korean PE and accordingly provided sales support services to the Korean PE. The Tax Office notified the taxpayer of the correction to apply a VAT rate of 10% for the sales support service fee as the taxpayer's counterparty to that received service provision is subject to a domestic PE of

the HQ rather than the HQ.

Taxpayer's (Plaintiff) Claims

- Although the agreement was in form contracted between the taxpayer and the Korean PE, the taxpayer claimed that in substance the agreement was contracted between Company A and the HQ located in Germany. Although the HQ was 'deemed' to have a PE in Korea through the grant of rights to Company A in accordance with local corporate income tax regulation, it did not have physical presence in Korea. Accordingly, the taxpayer claimed that Company A provided services to the HQ rather than the Korean PE and the levy of value added tax should be cancelled.

Tax Tribunal Decision

- The Tax Tribunal cancelled the levy of VAT in consideration of the below factors.
- Although the agreement was contracted with the Korean PE, in consideration of the contents of the agreement such as the rights, responsibilities, and sales generated are attributed to the HQ, the actual agreement is between Company A and the HQ.
- In consideration of the above that the agreement was contracted between Company A and the HQ, the actual transaction is performed between Company A and the HQ to which the HQ received services rather than the Korean PE.
- In accordance with Korean VAT regulation, business support services are subject to zero-tax rate. In consideration that Company A performs sales support services which are supplementary for the purposes of the efficiency in HQ's business operation in Korea, the sales support services could be categorized as business support services.

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

1. Background

Historical Tax Revenue Shortfall in FY2023

The Korean government experienced a tax revenue shortfall of KRW 65 trillion (equivalent to USD 50 billion) last year. Especially, the collection of customs duties fell to less than 70% of the target amount. This historical shortfall has prompted a major reevaluation of customs regulations and processes in an attempt to secure tax collection.

In response to the shortfall, Korean customs authorities have made a significant change in their approach. The term 'Customs Audit' has now been replaced with 'Customs Investigation' from this year. This change in terminology represents a more rigorous approach towards customs control, reflecting the government's determination to boost customs revenue.

In addition, several new regulations have been announced to ensure enhanced tax collection. One of the notable changes is the extension of the customs audit period for multinational corporations

(MNCs). Prior to this change, audits could last up to 120 days. The new regulation extends this period, reflecting a more thorough approach to customs control for MNCs. This change signifies a heightened scrutiny on MNCs, underlining the need for these corporations to be diligent in their customs compliance.

Another significant change is the mandatory inclusion of related party transaction information for MNCs. This means that MNCs are now required to disclose more detailed transaction information, which will be subjected to customs audits. This move is expected to focus on the proper evaluation of transfer prices.

2. KPMG's Comment

in light of these expected changes expected in Korean customs legislation, KPMG believes there will be a shift in the focus of customs audits. instead of conducting comprehensive regular 5-year audits, it is anticipated that customs authorities will conduct irregular audits targeting specific areas. These areas are likely to include Customs Valuation on related party transactions (i.e., Transfer Pricing) and import requirements from other government agencies (e.g., *Chemical Substances Management Act, Electronic Devices Safety Act, and Radio Waves Act*).

Meanwhile, with the application of various Free Trade Agreements resulting in near-zero percent effective duty rates, the focus of the customs authorities has shifted towards the additional VAT payable. The 2023 *Value Added Tax Act* revision brings significant changes, particularly in relation to transfer pricing matters. Records of additional assessment resulting from customs audits are no longer eligible for VAT recovery for the additional VAT payable. This change presents a net 10% tax exposure, underscoring the need for pre-emptive risk mitigation measures.

To mitigate potential risks, businesses may consider conducting a comprehensive customs health check to review trade compliance over the historical period. Utilizing official government programs such as Advance Customs Valuation Arrangements (ACVA) can also be beneficial. These measures can lead to an official suspension of customs audits during the ACVA review period, providing businesses with predictability in their customs dealings.

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