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Tax News Flash
- Transfer Pricing

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Samjong KPMG Transfer Pricing & Customs Service Group provides readers with Transfer Pricing 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 Young-Ho Lee 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

The issue of whether royalties received by the claimant from a local entity as 'royalties for the use of domestically unregistered patents' are subject to domestic withholding tax on royalty income (dismissed).
<Tax Tribunal Judgment 2024Joong0439 (2024.05.30)>

Background

The claimant, a US-listed entity specialized in developing semiconductor and intellectual property rights with respect to enhancing data center connectivity and improving memory bottlenecks, entered into contracts with A Corporation, B Corporation and its subsidiaries (hereinafter referred to as "domestic corporations") on January 19, 2010, and July 1, 2013, respectively, granting them licenses for the use of patents owned by the claimant. The domestic corporations paid royalties to the claimant as compensation for the use of the patents from November 14, 2018, to August 14, 2023, withholding corporate tax at a rate of 15% under the US-Korea tax treaty.

On October 24, 2023 and October 26, 2023, the claimant filed a claim for rectification to request a refund of corporate tax (withholding tax), arguing that the royalties paid do not constitute domestic-sourced income under the US-Korea tax treaty. The tax authority concluded that the income from royalties is considered domestic-sourced income even if the patents are not being registered domestically but it is effectively used within Korea.

Taxpayer's (Claimant) Claims

The royalties paid was for the use of domestically unregistered patent rights, thus not subject

to domestic withholding tax according to the US-Korea Tax Treaty.

- According to the US-Korea Tax Treaty, Articles 6(3) and 14(4) affirm the principle that patents grant exclusive rights within the territory where they are registered. Thus, payments for the use or right to use property are only treated as domestic source income if the property is used or the right is exercised within the territory of the respective contracting state. Therefore, royalties paid for the use of domestic property are classified as domestic source income and subject to taxation in Korea, while royalties for property not registered in Korea are not subject to taxation in Korea.

- Additionally, the Supreme Court has clearly stated in relevant case rulings that income received by the claimant as compensation for the use of domestically unregistered patents does not qualify as domestic-sourced income under the US-Korea Tax Treaty. Specifically, the compensation paid by domestic corporations to the claimant for the use of domestically unregistered patents falls outside the scope of domestic-sourced income under Articles 4(1), 6(3), and 14(4) of the US-Korea Tax Treaty. Therefore, such income cannot be subject to taxation in Korea.

As of December 26, 2008, Amendment No. 9 to Article 93 of the Corporate Tax Law cannot be applied in preference to the US-Korea Tax Treaty.

- The former International Tax Coordination Act (before being amended by Law No. 16099 on December 31, 2018) Article 28 explicitly states, 'Notwithstanding Article 119 of the Income Tax Act and Article 93 of the Corporate Tax Act regarding the classification of domestic source income of non-residents or foreign corporations, tax treaties take precedence.' Additionally, Article 27 of the Vienna Convention on the Law of Treaties, which binds our country in treaty interpretation, clearly prohibits using domestic law provisions as a justification for non-compliance with treaties by stating, 'A party may not invoke the provisions of its internal law as justification for its failure to perform a treaty.' Therefore, the special legal status of tax treaties in relation to domestic laws is still recognized, and tax treaties take precedence in application.

- According to these provisions, income received by a US corporation as compensation for the use of patent rights in Korea is considered domestic-sourced income only when the patent rights are registered in Korea and the corporation holds the right to implement the patents in Korea. Therefore, royalties paid by disputing corporations to the claimant corporation for patent rights not registered in Korea are not considered domestic-sourced income.

- The Supreme Court also rejected the tax authority's argument that under the newly revised Article 93, Paragraph 9 of the Corporate Tax Act, royalties for the use of patents registered abroad but used for manufacturing and sales in Korea should be considered domestic-sourced income and subject to taxation (Supreme Court Decision, December 27, 2018, Case No. 2016Doo 42883).

The claimant qualifies as a resident of the United States under the US-Korea Tax Treaty, and it is clear that the claimant is the beneficial owner of the royalties.

- The claimant has obtained a residence certificate from the US tax authorities, confirming its status as a resident of the United States. Furthermore, as a company listed on NASDAQ and in accordance with Article 138-4(2)(1) of the Corporate Tax Enforcement Decree, recent audit reports and the composition of its board members and shareholders over the past three years clearly indicate that the claimant is the beneficial owner of the royalties.

Tax Office’s (Defendant) Claims

According to the US-Korea Tax Treaty, royalties for domestically unregistered patents are

considered domestic source income.

- The US-Korea Tax Treaty categorizes income types such as interest, dividends, and royalties, and provides clauses to coordinate taxing rights between the source country and the residence country for each type of income. Therefore, in the absence of specific definitional provisions regarding the components that distinguish the source of income under the treaty, one should determine the domestic source according to the interpretation implied in Korea's tax law (Corporate Tax Law Article 93) under Article 2(2)(1) of the treaty, as emphasized by the Supreme Court (Supreme Court decision on June 10, 2016, Case No. 2014Doo39784).

- Regarding royalties under Article 14(4) and the definition of income source under Article 6(3) of the US-Korea Tax Treaty, since the treaty only specifies the "place of use" criterion and does not provide a criterion for determining the place of use, one must determine it based on domestic law under Article 2(2) of the US-Korea Tax Treaty.

According to the domestic tax laws, income derived from royalties for domestically unregistered patents is considered domestic source income.

- Under the amendment to Article 93, Clause 9 of the Corporate Tax Law on December 26, 2008, it was revised to state that even if patents are registered overseas and used in domestic manufacturing or sales, they are considered to have been used domestically regardless of whether they are registered domestically.

- Therefore, the claim made by the claimant that the royalties do not constitute domestic-sourced income solely because the patents are not registered domestically is not valid. Numerous tax tribunal rulings, including the decision in Case No. 2023Joong7050 on August 2, 2023, have determined that income derived from royalties on patents not registered domestically still qualifies as domestic-sourced income under Korean tax law. Hence, this argument cannot be accepted.

Decision by Tax Tribunal

According to Article 6(3) of the US-Korea tax treaty, which states that income from royalties is treated as sourced in the contracting state where the property is used or where the right to use it is granted, the determination of the source country for income is based on the location of use, not specifically outlining criteria for determining the place of use. Therefore, it is appropriate to base the decision on domestic tax laws.

Additionally, Article 93(9) of the Corporate Income Tax Act, as amended by Law No. 9267 on December 26, 2008, explicitly states that if the patent right is registered overseas and used for manufacturing or sales domestically, it is considered that the patents have been used domestically regardless of domestic registration status. In light of these provisions, it is deemed reasonable to consider the royalties as the claimant's domestic-sourced income. Thus, the tax authority's decision to reject the claimant's claim for rectification is considered appropriate (Tax Tribunal Judgment 2021Seo3272, October 13, 2021; Tax Tribunal Judgment 2019Seo3834, July 21, 2020, among others with similar meanings).

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