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Tax News Flash
- Transfer Pricing & Customs

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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

Whether the payment guarantee service fee received by the Claimant from its Chinese subsidiary, which is defined as interest income and subject to withholding tax by the Chinese tax authorities, qualifies for foreign tax credit as defined in Article 57 of the Korean Corporate Income Tax Act (dismissed).
<Tax Tribunal Judgment 2023Boo8173 (2024.06.14)>

Background

The Claimant, a Korean taxpayer, received a service fee from its Chinese subsidiary, (hereinafter referred to as "Company B"), for providing a payment guarantee service. When Company B paid the payment guarantee service fee to the Claimant, the Chinese tax authorities defined the fee as interest income of the Claimant under the Chinese corporate income tax law, which resulted in the imposition of withholding tax at a rate of 10%. Accordingly, the Claimant claimed a foreign tax credit for such withholding tax in its corporate income tax return for FY2018 to FY2021.

The Korean tax authority (hereinafter referred to as "NTS") denied the foreign tax payment credit because the payment guarantee fee received by the Claimant from Company B was defined as other income under Article 22 of the Korea-China Tax Treaty, and the relevant withholding tax was only taxable in Korea, the country of residence. However, since the withholding tax was paid to the Chinese tax authority which should not have been withheld in China, such withholding tax is not considered as a foreign tax payment credit under Article 57 of the Corporate Income Tax Act, therefore, is not deductible in Korea.

On May 25, 2023, the Claimant disagreed with the NTS' position and filed a claim for rectification to request a refund of corporate tax (withholding tax).

Taxpayer's (Claimant) Claims

The withholding tax was not paid directly by the claimant, but was withheld by the Chinese tax authorities when Company B remitted the payment guarantee service fee to the Claimant. The Claimant insists that the withholding tax was imposed based on the arbitrary interpretation of the Chinese tax authorities (the country of origin), which was also against the will of the Claimant. Company B also withheld and paid the withholding tax on the remittance of the payment guarantee service fee to the Claimant based on the Chinese corporate income tax law, and their assertion (that the payment guarantee service fee should be subject to income tax under the local Interest Income Regulations.)

Firstly, the Claimant argued that the withholding tax should be deductible in Korea because it applies to the "foreign corporate income tax" as defined in Article 57(1) of the Korean Corporate Income Tax Act, that such regulation is intended to eliminate international double taxation, and that is assess whether the imposition of withholding tax by the Chinese tax authorities constitutes a clear violation of the Korea-China Tax Treaty.

The Claimant also argued that Company B has no choice but to comply with the Chinese tax law and relevant regulations because it is domiciled in China, and that regardless of whether the payment guarantee service fee is classified as other income, or interest income, it must pay the relevant taxes (such as withholding tax) in accordance with the Chinese tax law. If Company B fails to pay the local tax in China, it will not only be unable to remit the payment guarantee service fee to the Claimant, but will also be unable to conduct its business in China.

In fact, the Chinese tax authorities characterized the payment guarantee service fee as interest income, and it imposed withholding tax based on Article 11(1) and (2) of the Korea-China Tax Treaty. The withholding tax was imposed based on the Chinese tax authorities' interpretation of Article 11(1) and (2) of the Korea-China Tax Treaty and did not reflect the intention of the Claimant. Furthermore, the foreign tax credit defined in Article 57 of the Korean Corporate Income Tax Act is "the amount of tax paid or payable to a foreign tax authority" (also defined in Article 94 of the Enforcement Decree of the Korean Corporate Income Tax Act), and there is no indication as to the legality of the withholding tax.
Lastly, the Claimant believes that the withholding tax imposed by the Chinese tax authorities cannot be considered illegal due to the difference in interpretation between the two tax authorities; therefore, the double taxation issue should be resolved by deducting corresponding foreign tax credit.

Tax Office's (Defendant) Claims

Article 11 of the Korea-China Tax Treaty defines 'interest' as 'income from any kind of bonds, in particular, income from government bonds, public bonds or corporate bonds, as well as premiums and incentives attached to such bonds'. Therefore, it is difficult to believe that the payment guarantee service fee received by the Claimant from Company B for the provision of payment guarantee services falls within the definition of interest under the Korea-China Tax Treaty. Therefore, the relevant service fee can be considered as other income based on Article 22 of the Korea-China Tax Treaty, and it is clearly stated that other income is taxable only in the country of residence (Korea). However, if the Claimant company received the payment guarantee service fee from China and where it is subject to withholding tax there (because it is defined as interest income in China), the withholding tax imposed by the Chinese tax authorities is in violation of the Korea-China Tax Treaty, and therefore is unlikely to be a legitimate tax payment. In conclusion, if it is not a legitimate tax (the withholding tax) paid in accordance with Article 22 of the Korea-China Tax Treaty, it does not meet the definition of the foreign tax credit as defined in Article 57 of the Korean Corporate Income Tax Act.

The foreign tax credit defined in Article 57 of the Korean Corporate Income Tax Act requires that the country of origin (China) has the right to impose tax on the foreign-source income, and that the Korean taxpayer (local entity) is obliged to pay corporate income tax to the country of origin (China). However, it does not always mean that the foreign tax credit can be deducted if the Korean taxpayer (local entity) arbitrarily pays corporate income tax to the country of origin

(China) even though the country of origin (China) does not have the right to impose relevant tax on it, or if the relevant taxation is illegal.
Article 23 of the Korea-China Tax Treaty provides for a Korean tax credit for taxes paid in a country other than Korea, subject to the provisions of the Korean Tax Act; however, the withholding tax erroneously paid by the Claimant to the Chinese tax authorities was not lawfully paid and was not entitled to a foreign tax credit, but rather it should be recovered from China.

Decision by Tax Tribunal

In view of the above facts and the relevant laws and regulations, the Claimant argues that the amount of withholding tax paid in China in respect of the payment guarantee service fee should be treated as a foreign tax credit in Korea and should have been deducted. However, Article 11 of the Korea-China Tax Treaty defines 'interest' as 'income from any kind of bonds, in particular, income from government bonds, public bonds or corporate bonds, as well as premiums and incentives attached to such bonds'. Therefore, it is difficult to believe that the payment guarantee service fee received by the Claimant from Company B for the provision of payment guarantee services falls within the definition of interest under the Korea-China Tax Treaty, but rather, the relevant service fee can be considered as other income based on Article 22 of the Korea-China Tax Treaty.

Moreover, it is clearly stated that other income is taxable only in the country of residence (Korea). Therefore, if the Claimant received the payment guarantee service fee from China and if it is subject to withholding tax there (because it is defined as interest income in China), the withholding tax imposed by the Chinese tax authorities is in violation of the Korea-China Tax Treaty, and therefore is unlikely to be a legitimate tax payment. In conclusion, if it is not a legitimate tax (the withholding tax) paid in accordance with Article 22 of the Korea-China Tax Treaty, it does not meet the definition of the foreign tax credit as defined under Article 57 of the Korean Corporate Income Tax Act. Therefore, the decision of the NTS to reject the Claimant's claim for rectification is considered reasonable and appropriate.

Customs Act Amendments Announced: FTA Origin Pre-Verification Ruling Expanded, Penalties for False Declarations Strengthened

1. FTA Origin Pre-Verification System to All FTAs

Following the amendment to the Customs Act, the Free Trade Agreement (FTA) origin pre-verification system, previously limited to specific agreements, will now be expanded to all FTAs. This change allows for legal stability in import transactions under agreements such as the Korea-EFTA FTA and the Korea-ASEAN FTA, where origin pre-verification was previously unavailable. The amendment is expected to reduce uncertainties for importers, facilitating more stable and reliable trade operations.

[FTA Customs Act. Article 31]

As-is	To-be
Application for Pre-verification of Origin, etc. Exception: Application not allowed if there are no pre-verification provisions in the agreement.	*Delete the exception provisions*

2. Strengthen penalties for improper application of FTA preferential duty rates.

The penalty for fraudulent underreporting, such as using false certifications to apply for FTA (Free Trade Agreement) benefits, will be increased from 40% to 60%. This change will apply to imports made on or after January 1, 2025.

[The Customs Act. Article 42]

As-is	To-be
Failure to Report Penalties 1. Principle: 10% 2. Fraudulent Underreporting: 40% - False certificates and documents - Destruction of tax assessment materials - Transaction manipulation, etc. - Other fraud or undue tax reductions	Failure to Report Penalties 2. Fraudulent Underreporting: 60%

3. KPMG Comments

Regarding the application of FTA agreements, businesses should utilize the expanded legal stability measures and be aware of the increased penalty rates for fraudulent activities.

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