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 royalty income for unregistered patents in Korea, disputed income, constitutes domestic source income (dismissed)
<Tax Tribunal 2024 Joong 2673 (2024.07.22)>

Background

The claimant is a company specializing in SSD (Solid State Storage Drives, devices that store information using semiconductors) in the United States. The company entered into separate license agreements with Company A (hereinafter referred to as "A") and Company B (hereinafter referred to as "B") for the use of its SSD technology patents (unregistered patents in Korea).

A, on July 29, 2019, and B, on June 4, 2019, each paid the claimant royalties (hereinafter referred to as "the disputed income") for the use of the patents. They withheld corporate tax and paid it, applying the limited tax rate (15%) stipulated in Article 14, Paragraph 1 of the Korea-U.S. Tax Treaty.

The claimant filed for a tax refund, arguing that the disputed income, being royalties for unregistered patents in Korea, does not constitute domestic source income. However, the tax authorities rejected the request. In response, the claimant filed an appeal on April 5, 2024.

Taxpayer's (Claimant) Claims

1. **Royalty income from unregistered patents in Korea does not constitute**

domestic source income.

Domestic corporations are liable for tax on both domestic and foreign source income, while foreign corporations are only liable for tax on domestic source income. Article 93 of the Corporate Tax Act lists taxable domestic source income for foreign corporations. Income not listed is not subject to tax, even if its source is within Korea (Supreme Court ruling 85Nu880, June 9, 1987).

Article 93, Item 8 of the Corporate Tax Act (before the amendment on December 31, 2019) defines royalty income as income arising from the use of patents in Korea or payment for such use. If a tax treaty defines domestic source income based on the place of use, then payments for rights used outside of Korea are not considered domestic source income, even if paid within Korea. Foreign-registered patents used in Korea are treated as being used domestically, regardless of domestic registration.

Tax treaties have the same legal effect as domestic law under Article 5 of the Constitution and take precedence over general laws based on the principle of "special law prevails." Tax treaties define the scope and limits of taxing authority between contracting states. Even if the Corporate Tax Act defines certain income as domestic source income, Korea cannot exercise taxing rights if the tax treaty stipulates that the taxing rights lie with the country of residence.

The patent in question is subject to the territorial principle, meaning its rights are only valid within the country where it is registered. Patent rights, such as production, use, and transfer, are limited to the territory where the patent is registered. Under Articles 6(3) and 14(4) of the Korea-U.S. Tax Treaty, royalties are considered domestic source income only if they are paid for the use of property within a contracting state. Unregistered patents in Korea have no legal effect, so the concept of using or paying for such patents in Korea does not apply. Therefore, despite the Corporate Tax Act, the royalties received by the claimant for unregistered patents in Korea are not considered domestic source income under the Korea-U.S. Tax Treaty.

2. The Supreme Court has consistently ruled that the royalty income received by a U.S. corporation for the use of an unregistered domestic patent is not considered domestic source income under the Korea-U.S. Tax Treaty.

The Supreme Court of Korea has consistently held that the rights to exploit a patent are only effective within the territory where the patent is registered. Therefore, when patented products are produced in Korea and exported to countries where the patent is registered, the issue of using or infringing upon the patent pertains only to the foreign country where the patent is valid, not Korea. Accordingly, under the Korea-U.S. Tax Treaty, royalties paid to a U.S. corporation for an unregistered patent in Korea cannot be considered domestic source income, as they are not compensation for use in Korea (Supreme Court, 1992.5.12. Decision 91Nu6887).

In subsequent rulings, the Supreme Court further clarified that under the principle of territoriality, the rights to exploit a patent only apply within the country where the patent is registered. Therefore, the term “use of a patent in Korea” in both the Korean Corporate Tax Act and the Korea-U.S. Tax Treaty refers to situations where a foreign corporation, including a U.S. corporation, has registered the patent in Korea and receives royalties for its use within Korea (Supreme Court, 2007.9.7. Decision 2005Du8641).

In an attempt to tax royalties on unregistered patents in Korea, the Corporate Tax Act was amended in 2008 to include a provision that considers patents registered abroad but used in Korea as domestic source income, regardless of registration status in Korea. However, as patents, unlike copyrights, do not exist without registration, royalties for unregistered patents conceptually cannot be considered domestic source income.

Tax authority’s claims

1. **The Interpretation of the Korea-U.S Tax Treaty: Royalties for Unregistered Patents in Korea are considered Domestic source income**

The tax treaty aims to prevent double taxation and tax evasion by coordinating the taxing rights of different countries in cases of cross-border transactions. It does not create new taxing rights but rather allocates or limits existing taxing rights established by each country's tax laws. Therefore, the occurrence of taxing rights is primarily governed by each country's domestic law, and when the treaty differs from domestic law, the treaty determines the final taxing jurisdiction.

Article 2(2) of the Korea-U.S. Tax Treaty specifies that terms used in the treaty, which are not defined, are interpreted based on the domestic law of the contracting state in which the tax is being determined. The Korea-U.S. Tax Treaty allocates taxing rights for different types of income, such as interest, dividends, and royalties, between the source and residence countries. If the treaty does not provide a specific definition for the source of the income, the determination must follow the domestic laws of the country in question (Supreme Court Decision, 2016.6.10., 2014Du39784).

2. **Under domestic tax law, royalty income from unregistered patents in Korea is considered domestic-source income.**

According to Article 93(8) of the Corporate Tax Act (as amended by Act No. 16833 on December 31, 2019), royalty income is defined as payments made for the use or transfer of certain rights, assets, or information, regardless of whether these rights are registered in Korea. If the rights, such as patents, are used or implemented domestically, they are treated as domestic-source income, even if they are not registered in Korea. The law clarifies that rights registered abroad but used for manufacturing or sales in Korea are considered to be used domestically, and thus, the associated royalties are deemed domestic-source income.

Conclusion

The claimant asserts that the disputed income does not qualify as domestic-source income under the Korea-U.S. Tax Treaty. However, Article 6, Paragraph 3 of the treaty states that 'royalties for property specified in Article 14, Paragraph 4 shall only be considered income sourced in the contracting state if such royalties are paid for the use of, or the right to use, the property in that contracting state.' While this suggests that the 'place of use' rule is adopted as the standard for determining the source, the concept of 'place of use' is not explicitly defined in detail. Therefore, in the absence of special circumstances, it seems reasonable to follow domestic law, as noted in previous rulings. According to Article 93, Paragraph 8 of the Corporate Tax Act, royalties for the use of patents and similar rights in Korea are considered domestic-source income, regardless of whether the patent is registered domestically or not. In light of these factors, the tax authority's decision to reject the claimant's correction request, treating the disputed income as domestic-source income, is deemed to be correct.

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