Korean Supreme Court: Use of patent registered outside of Korea is not subject to tax

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In brief

The Korean Supreme Court ruled in November 2014 that payments made for the use of patents registered outside Korea for domestic use is not considered Korean-source income. Thus, royalty payments made by Korean-based payers to foreign persons for the use of certain patents registered outside Korea for manufacturing, distribution or other functions within Korea is not subject to tax in Korea.

In detail

Background

Income derived from patent use is generally treated as royalties pursuant to the US - Korea income tax treaty ('tax treaty') and the Korean Corporate Income Tax Law (CITL). Under the CITL, if the patents are used within Korea during the course of manufacturing, distribution or other functions, income derived from such patents' use is generally considered Korean-source income. However, the term 'use' is not clearly defined in the tax treaty or the CITL. As a result, there are questions about whether the treatment of such payments should be considered Korean-source income since the patents may only be used in the jurisdiction where registered.

In 2008, the Korean tax authorities revised the CITL to state that all payments for patents used for manufacturing, distribution or other functions within Korea are considered Korean-source income to the recipient. This applies regardless of whether the patent is registered in Korea.

Despite this clarification, the definition of "the use in manufacturing or distribution in Korea" raised further questions. As such, taxpayers filed several cases with the Korean Supreme Court to address and resolve such disputes between the taxpayers and the Korean tax authorities.

Recent Supreme Court case – November 2014

The concerned case involves a US company (plaintiff) in an infringement lawsuit with a Korean company (defendant) over the terms of a license agreement. In accordance with the lawsuit's settlement, the defendant made a payment to the plaintiff, but withheld Korean taxes at 16.5%. The plaintiff subsequently filed a tax refund claim for the withheld tax with the pertinent Korean tax office. The Korean tax authorities rejected the request for refund and the US company appealed the case.

In February 2012, the administrative court (Suwon District Court) decided in favor of the US taxpayer by referring to the 2007 precedent Supreme Court

case. Article 6, paragraph 3 of the US - Korea tax treaty provides that royalties shall be treated as income from sources within one of the Contracting States only if it is paid for the use of, or the right to use, such property within that Contracting State. As the territorial principle applies to patents, the right to use the patents should be effective only in the country where the patents are registered. Further, the tax treaty will override the CITL in determining the source of income between Korea and the United States.

In July 2012, the appellate court (Seoul High Court) agreed with the administrative court decision. However, the appellate court noted some changes in the definition of "the use of the patents" under the US - Korea tax treaty. The appellate court noted that even though the "patent registered in a foreign country used domestically in manufacturing or distribution, etc. without any registration in Korea" may not fall within the definition of a 'patent' under the Patent Law (as specified in Article 93, paragraph 9 of the CITL), the appellate court viewed that the manufacturing process, technology, information, etc. incorporated in the context of the patent registered in a foreign country, should be treated as being in fact used in the domestic manufacturing or distribution ('de facto patent'). As such, a de facto patent should fall within the scope and definition of royalties under the US - Korea tax treaty and be taxed in Korea. But, given that the compensation under claim did not include the portion of consideration paid for domestic use of the de facto patent, the appellate court concluded that the payment should not be viewed as Korean-source income.

The Supreme Court (Daebub 2012 du 18356, 2014.11.27) generally agreed with the Seoul High Court. It further concluded, referring to the 2007 precedent Supreme Court case, that the jurisdiction in which the patent is used should be strictly determined based on the country where the patent is registered in accordance with the territorial principle of the patent.

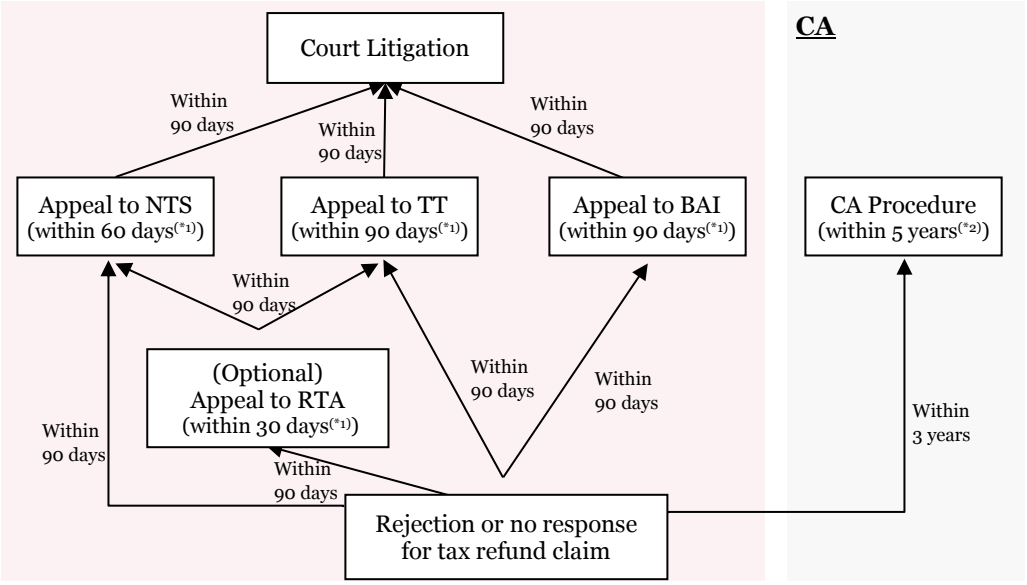
Domestic Appeal vs. Competent Authority (CA)

In light of the above, US taxpayers have two procedural ways to seek refunds of Korean income tax withholding on payments from a Korean company for the use of patents not registered in Korea: 1) appeal the issue, or 2) seek resolution through mutual agreement procedures between the Korean and the US competent authorities.

From a timing perspective, a US taxpayer must file the tax refund claim with its Korean district tax office: 1) within three years of the statutory due date for filing the initial or amended tax return, or 2) within two months after the occurrence of certain events that are listed in the CITL (including the case where mutual agreement pursuant to the tax treaty turns out different from the initial tax return filing or assessment).

The tax office must decide on the claim within two months after such claim is filed. This period may be extended at the tax authorities' discretion if they need additional or supplementary information. If the taxpayer receives an unfavorable decision from the tax office or does not receive a notice from them within that period, then the taxpayer can proceed with domestic appeal or CA as illustrated below:

Domestic appeal



(*1) The periods mentioned in the above table may be extended at the tax authorities' discretion if they need additional or supplementary evidence.

(*2) This period may be extended up to 8 years if mutually agreed by the tax authorities.

NTS: National Tax Service

TT: Tax Tribunal

BAI: Board of Audit and Inspection

RTA: Regional Tax Authorities (i.e., district tax office or regional office of NTS)

Observation

After this Supreme Court decision, some US taxpayers should consider seeking tax refund claims for taxes withheld on payments received from Korea. Under facts and circumstances that are similar with the aforementioned case and where such interpretations or prior rulings clearly favor the taxpayer, we recommend that taxpayers proceed with appeals. In reviewing a taxpayer's case, the Korean tax authorities or courts may be bound by a precedent ruling or prior court decisions. The Korean tax authorities will analyze the taxpayer's factual background and if they believe that the fact pattern is similar with the precedent cases, they may rely on the precedent cases and determine a similar outcome.

Alternatively, taxpayers may pursue a tax refund claim through CA proceedings under the tax treaty. The CA procedure has practical advantages. The US taxpayer may be able to leverage the IRS as an influential advocate. This might compel the Korean tax authorities to rely on generally accepted rules and standards for performing analysis (i.e., OECD guidelines, etc.). This process is, however, generally time consuming and its outcome may be based upon an economic compromise rather than a 'winner takes all' position.

The takeaway

Careful due diligence of the facts and circumstances and knowledge of the appropriate procedures are important. Korean tax authorities are likely to challenge the merits of the appeals/refund claims under current regulations.

Let's talk

For a deeper discussion of how this might affect your business, please contact:

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