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Korea, Republic of

Introduction

Since the introduction of the Korean transfer pricing regulations, transfer pricing has become one of the most important international tax issues concerning taxpayers engaged in cross-border inter-company transactions. The Korean transfer pricing regulations are based on the arm's-length standard and are generally consistent with the Organisation for Economic Co-operation and Development (OECD) Guidelines. The Korean transfer pricing regulations prescribe transfer pricing methods, impose transfer pricing documentation requirements, and contain provisions for advance pricing agreements (APAs) and mutual agreement procedures (MAPs).

Numerous amendments have been made to the transfer pricing regulations over the years. Recent significant revisions, effective 1 January 2011, have included the codification of the most reasonable transfer pricing method, corresponding downward adjustments if transfer prices exceed arm's length, the use of multiple year data, the increase in penalty for failure to submit transfer pricing documentation, and detailed guidance on the preparation of transfer pricing documentation. These amendments provide taxpayers with increased flexibility in applying transfer pricing methods but at the same time reflect continued efforts by the National Tax Services (NTS) to enforce transfer pricing compliance.

Statutory rules

The Korean transfer pricing regulations are contained in the Law for the Coordination of International Tax Affairs (LCITA), which was enacted on 1 January 1996. The LCITA stipulates that transfer prices should be consistent with the arm's-length standard.

The transfer pricing methods specified in the LCITA and accompanying Presidential Enforcement Decree are listed below:

- Comparable uncontrolled price method, resale price method or cost plus method.
- Profit split method and transactional net margin method.
- Other unspecified methods.

Prior to 1 January 2011, the LCITA stipulated that the selection of the appropriate transfer pricing method should be based on the above hierarchy. As a result of recent amendments to the LCITA, however, transfer prices should now be supported by the most reasonable transfer pricing method without consideration to the order of method priority.

The regulations also contain primary and secondary transfer pricing documentation requirements. Primary documentation requirements refer to transfer pricing

Korea, Republic of

documentation that taxpayers are required to submit each year as part of their corporate income tax return. Primary documentation forms include:

- Declaration of Transfer Pricing Method.
- Summary of International Transactions.
- Summary of Income Statements of Overseas Affiliates.

The Declaration of Transfer Pricing Method form requires a taxpayer to report the transfer pricing method or methods used to establish or determine their transfer prices. In addition, a taxpayer is required to provide an explanation for the particular method adopted. The transfer pricing method should be the most reliable method among those available and should justify the arm's-length nature of the taxpayer's transfer prices. Separate declaration forms are required for transactions involving transfers of intangible property, services and cost-sharing arrangements.

The Summary of International Transactions form provides the NTS with a summary of the taxpayer's inter-company transactions, according to transaction counterparty and type of transaction. Taxpayers are required to report the following: (i) the name of each overseas related party with whom the taxpayer engages in transactions; (ii) the relationship between the taxpayer and the overseas related party; (iii) the nature of the transaction (e.g. tangible goods, service, financing, and investment); and (iv) the amount of the transaction.

The Summary of Income Statements of Overseas Affiliates requires a taxpayer to submit the income statement of each overseas affiliate with whom it engages in transactions. The overseas affiliate income statements should be submitted for the most recent tax year and should be prepared to the profit-before-tax level. In addition, the taxpayer should indicate the primary business activities of the overseas related parties and the taxpayer.

Although there is no concept of immateriality (or a *de minimis* transaction) in the Korean regulations, a taxpayer is not required to submit the Declaration of Transfer Pricing Method form at the time of filing the corporate income tax return if the taxpayer is engaged in cross-border inter-company goods (or service) transactions that accumulatively amount to below Korean won (KRW) 5 billion (KRW 500 million for service transactions) or amount to below KRW 1 billion (KRW 100 million for service transactions) per transaction party.

Likewise, the taxpayer is not required to submit a Summary of Income Statements of Overseas Affiliates if it is engaged in cross-border inter-company goods (or service) transactions that amount to below KRW 1 billion (KRW 100 million for service transactions) per transaction party or if the taxpayer has submitted a list of overseas affiliates and their summarised financial statements in accordance with the Corporate Income Tax Law (CITL).

Taxpayers are also required to provide the NTS, upon request, with other documentation that supports the arm's-length nature of their transfer prices. Secondary documentation includes inter-company agreements; corporate transfer pricing policies; organisational charts; financial statements segmented by business, product line or function; business descriptions; the selection and application of the transfer pricing method; and any other documents that may be useful to evaluate the arm's-length nature of a taxpayer's transfer prices.

Requests for transfer pricing documentation are made during tax audits and formal requests for transfer pricing documentation from the NTS. Taxpayers are required to submit transfer pricing documentation to the NTS within 60 days of the request; however, a one-time 60-day extension may be allowed upon application. During a tax audit, however, secondary documentation as well as other supporting documentation must be provided promptly, because the duration of tax audits are often very short and the auditors want to resolve all issues within the short timeframe.

In addition to transfer pricing, the LCITA also covers:

- interest paid to a controlling overseas shareholder
- corporate income retained in tax havens
- offshore gifts, and
- international cooperation among tax administrations.

On 26 December 2008, Korea introduced provisions to provide penalty relief to taxpayers maintaining contemporaneous documentation. The penalty waiver provision stipulates that the underreporting penalty (i.e. 10% of the additional corporate income tax) may be waived in the event of a transfer pricing adjustment if a taxpayer has maintained contemporaneous transfer pricing documentation (i.e. at the time of filing of the corporate income tax return) and the transfer pricing method has been reasonably selected and applied.

A taxpayer who wishes to obtain penalty relief should maintain the following documentation and submit the documentation within 30 days when requested by the NTS:

- General descriptions of the business (including analysis of the factors that may affect the prices of assets and services).
- Information that may affect transfer prices, including information on foreign related parties and their relationships with the taxpayer (group organisation structure).
- The following documentation which supports the selection of the transfer pricing method stated on the taxpayer's corporate income tax return:
 - Economic analysis and forecast data supporting the selection of the most reasonable transfer pricing method stated at the time of filing the corporate income tax return.
 - Profitability of the selected comparable companies and the descriptions of adjustments applied during the analysis of the arm's-length price.
 - Descriptions of other potentially applicable transfer pricing methods and the reasons why these transfer pricing methods could not be selected.
 - Additional data prepared to determine arm's-length prices after the end of the tax year and within the filing period of the corporate income tax return.

In addition, the assessment of whether a taxpayer has reasonably determined the arm's-length price is determined by considering the following factors:

- Data on profitability of comparable companies obtained at the end of the tax year should be representative and not wilfully exclude the profitability of a certain comparable company to derive an arm's-length price favourable to the taxpayer.
- Collected data should be systemically analysed to select and apply the transfer pricing method.

Korea, Republic of

- If the taxpayer has selected and applied a transfer pricing method different from the one applied in an APA concluded during the previous tax year or a transfer pricing method selected by the tax authorities during a previous tax audit, there should be a valid reason as to why the different transfer pricing method was applied.

Other regulations

The LCITA supersedes all previous domestic corporate tax laws and transfer pricing guidelines published by the NTS.

On 15 June 2004, the NTS issued basic tax rulings under the LCITA which are intended to provide guidelines for interpretation of the LCITA in accordance with internationally accepted rules and standards for taxation. These basic tax rulings consist of 29 sections and are the first rulings applicable under the LCITA since its enactment. The highlights of the basic tax rulings include sections on the deductibility of management service fees, factors when selecting comparable transactions, application of the comparable uncontrolled price method or the resale price method, circumstances for applying the berry ratio, and the use of the interquartile range. These basic tax rulings became effective from 15 June 2004.

In addition, the NTS issues official rulings upon request by taxpayers. Although these rulings are interpretations of the law for specific cases and are not legally binding, they are usually applied to similar cases. The rulings provide practical guidelines and are very influential.

Legal cases

A handful of legal cases involving transfer pricing have been filed, but very little information on these cases is publicly available. Some cases have been settled out of court, some cases are currently pending in domestic appeals, and other cases have elevated to mutual agreement procedures.

Burden of proof

Korean tax laws do not clearly specify where the burden of proof lies with regard to supporting or challenging transfer prices. However, a taxpayer is required to report and justify the transfer pricing method(s) used to establish or evaluate its transfer prices each year, at the time of filing its corporate income tax return. If the taxpayer has submitted proper documentation, the NTS must demonstrate why the taxpayer's transfer prices are not at arm's length and propose a transfer pricing adjustment to challenge the taxpayer's transfer prices. Once the NTS has proposed an alternative transfer pricing method and adjustment, the taxpayer must defend the arm's-length nature of its transfer prices.

In the event that a taxpayer does not provide the NTS with proper transfer pricing documentation at the time of filing its corporate income tax return, the burden of proof falls on the taxpayer to corroborate the arm's-length nature of its transfer prices.

Tax audit procedures

Selection of companies for audit

In general, the NTS reviews corporate income tax returns, including transfer-pricing-related documentation, to identify taxpayers who display signs of noncompliance

with transfer pricing regulations. The NTS then requests additional information from suspected taxpayers for review. Taxpayers who fail to submit transfer-pricing related data required by the LCITA are more likely to be selected for an audit. Taxpayers are also generally subject to periodic audits every four to five years based on the statute of limitations for taxes.

The provision of information and the taxpayer's obligation to cooperate with the tax authorities

The NTS can request any relevant information that it deems necessary for an audit (e.g. contracts, price lists, cost data of manufactured goods, accounting principles used, organisation charts, and mutual investment agreements).

Since it is likely that the attitude of the taxpayer will affect both the outcome of the audit and/or the size of any adjustment, it is imperative that the taxpayer be cooperative during the negotiation process. Therefore, taxpayers are obliged to provide the requested information to avoid adverse consequences.

Secondary adjustments

A unique and problematic aspect of the Korean transfer pricing regulations is the view on secondary adjustments. Secondary adjustments are additional tax assessments that are performed if a transfer pricing adjustment is not repatriated back to Korea. Most secondary adjustments are treated as deemed dividends subject to withholding taxes at the rate specified in the corporate tax law or applicable treaty.

Transfer pricing review committee

On 30 June 2005, the NTS announced the establishment of a Transfer Pricing Review Committee (TPRC) to review proposed transfer pricing adjustments prior to the finalisation of a tax audit. Under the auspices of the Assistant Commissioner for International Taxation, the TPRC is designed to ensure that taxpayers are treated fairly and consistently with respect to transfer pricing assessments. The TPRC is responsible for reviewing proposed adjustments that are in excess of KRW5 billion or that are disputed by a taxpayer. The TPRC may also review proposed transfer pricing adjustments stemming from other issues on a case-by-case basis.

Domestic tax appeals procedure and mutual agreement procedures

A variety of domestic appeal options are available to taxpayers, including the following:

- Pre-Assessment Protest (filed at the district, regional or head tax office of the NTS).
- Request for Investigation by the NTS.
- Request for Adjudication by the Tax Tribunal (TT).
- Appeal to the Board of Audit and Inspection (BOAI).

Most domestic tax appeals are filed with the TT. Moreover, taxpayers may only pursue court litigation after appealing to the NTS, TT or BOAI. For several reasons, most transfer pricing disputes move to MAPs. First, taxpayers who initiate MAPs may apply for a suspension for the payment of a tax assessment. This option is not available to taxpayers pursuing domestic tax appeals, except in very limited circumstances. Second, pursuing MAPs increases the likelihood of obtaining relief from double taxation and a

Korea, Republic of

waiver for underreporting penalties. Finally, MAPs encourage tax authorities to rely on generally accepted transfer pricing rules and standards during negotiations.

Additional tax and penalties

The tax law imposes penalties on taxpayers who underreport their tax base or underpay corporate taxes. These rules also apply to transfer prices. However, the LCITA stipulates that the penalty for understatement does not apply in situations where a taxpayer has performed due care that has been verified during MAPs.

The following penalties may be imposed, depending on the type of taxpayers' obligations under related tax laws that the taxpayer failed to fulfil.

Failure to file corporate income tax returns or to keep books of accounts

If the taxpayer does not file corporate income tax returns within the time limit prescribed by the CITL, or the obligation to maintain or keep books of account has not been performed, the taxpayer is subject to the following penalties:

- In cases of intentional failure to file corporate income tax returns, the penalty is the larger of:
 - 40% of the computed corporate income tax amount determined by the NTS, or
 - 0.14% of the revenue.
- In cases other than the above, the penalty is the larger of:
 - 20% of the computed corporate income tax amount determined by the NTS, or
 - 0.07% of the revenue.

Underreporting of the tax base

Penalties for underreporting taxable income are imposed based on the difference between the correct taxable income amount, which should have been reported under the CITL, and the taxable income actually reported at the time of filing the corporate income tax return. The penalty is calculated as follows:

- In cases where the total reported tax base has been intentionally reduced, the penalty is the larger of:
 - 40% of the corporate income tax corresponding to the total underreported tax base, or
 - 0.14% of the total underreported tax base.
- In cases other than the above, the penalty imposed is 10% of the taxes on the underreported tax base. If there is no tax calculated, however, no penalties are imposed.

Penalty for non-payment or insufficient payment

If a taxpayer fails to pay or underpays owed taxes, it is subject to a penalty determined by the interest rate prescribed within the CITL, which is based on the default interest rate for financial institutions and the number of days that the taxes have not been paid. The current applicable interest rate is 10.95% per annum.

Penalty on noncompliance with the request for the submission of information

The LCITA imposes penalties for failing to comply with information requests.

If a taxpayer fails to submit requested transfer-pricing information, the NTS may refuse to accept such information if it is submitted at a later time (e.g. when filing a tax appeal or in the course of MAPs).

In addition, if a taxpayer is requested to submit transfer-pricing information but fails to do so within the due date without a justifiable reason or submits false information, the taxpayer may be fined up to KRW 100 million for negligence.

Penalties in practice

Under the CITL, the government automatically imposes penalties when taxpayers fail to meet specific obligations. In general, no exceptions are made and there are few opportunities to negotiate penalties. Under the LCITA, however, it is more likely that the NTS will take a taxpayer's circumstances into account when imposing penalties, if the taxpayer demonstrates a good-faith effort to comply with requests.

Resources available to the tax authorities

The Division of International Taxation is an office of the NTS which provides support to the regional tax offices on transfer pricing matters. Investigations are conducted with the assistance of the relevant departmental experts.

Use and availability of comparable information

Taxpayers may use various forms of comparable information to support their transfer pricing policies, including internal and third party data. Several company directories and electronic databases are available in Korea that contains detailed information and data on Korean companies.

Risk prone transactions or industries

The LCITA states that any transaction with overseas affiliates may be subject to transfer pricing adjustments. Recently, the NTS has aggressively challenged royalty payments and management service fees. The NTS also scrutinises transactions with affiliates located in countries that are considered tax havens and conducts industry-wide tax audits in industries where transfer pricing abuse may be prevalent (e.g. pharmaceutical, tobacco, newspaper, and private equity industries). Other peculiar situations may also draw the NTS's attention, such as when a distributor incurs operating losses or when a company adopts different transfer pricing policies that reduce the amount of taxes paid.

Limitation of double taxation and MAPs

The LCITA contains detailed information about MAPs, which taxpayers may use to seek relief from double taxation.

Advance pricing agreements (APAs)

The Korean APA programme was launched on 1 January 1997. Taxpayers may apply for unilateral or bilateral APAs. An APA can cover any number of years, but most applications are for a five-year period. For taxpayers seeking a bilateral APA, it may also be possible to roll back the results of the APA to open tax years.

A taxpayer must apply for an APA by the end of the first taxable year for which the APA is being sought.

Korea, Republic of

To apply for an APA, a taxpayer must complete and submit a formal application that describes the transactions for which the APA is being requested, the overseas affiliates involved, the transfer pricing method to be applied, and the period requested to be subject to the APA. In addition, the taxpayer must provide a description of its business activities and organisation structure as well as the financial statements and tax returns for the transacting parties for the most recent three years. The taxpayer may avoid having to submit some information if it can clearly demonstrate that the information is irrelevant.

After the terms of the APA have been finalised, the results are legally binding on the NTS but not the taxpayer. In other words, if the taxpayer's transfer prices are determined to be within the range previously agreed to with the NTS, the NTS cannot make an adjustment. The taxpayer, however, is not required or bound to meet the conditions of the APA.

The taxpayer has the right to withdraw or modify the request for an APA at any time prior to obtaining the NTS' final approval. In the event that a taxpayer decides to withdraw the application for an APA, all submitted data is returned to the taxpayer without further consequence.

APA requests are completely confidential and the data submitted to the NTS may only be used for reviewing APA requests and follow-up purposes.

As in other countries, APAs allow Korean taxpayers to obtain certainty on the acceptability of transfer prices, eliminating the risk of penalties and double taxation. Additional benefits of applying for APAs include the possibility of obtaining the assistance of foreign tax authorities to help persuade the NTS of the reasonableness of the request and the opportunity to negotiate with high-level NTS staff rather than regional tax office personnel (as in the case of audits). In addition, the NTS is much more willing to negotiate during APA requests than during tax audits or MAPs. The number of APA requests is anticipated to increase significantly over the next several years as they are actively promoted by the NTS.

Recent developments in law and practice

Each year, the NTS releases revisions or updates to the LCITA based on feedback it receives from taxpayers and tax agencies.

Liaison with customs authorities

Effective 1 July 2012, the NTS and the Korea Customs Service (KCS) introduced dual and symmetrical provisions to the LCITA and Korean customs law to provide correlative adjustments on transfer pricing adjustments and/or customs duties assessments. The new mechanism provides taxpayers with an opportunity to request correlative adjustments in the two following scenarios:

- If a taxpayer receives a transfer pricing income adjustment on import transactions, the taxpayer may request a refund of overpaid customs duties based on the adjusted price.
- If a taxpayer receives an imposition of customs duties in relation to import price, the taxpayer may request a refund of corporate income tax based on the adjusted import price, and the taxpayer may request a refund of corporate income tax based on the adjusted import price.

The correlative relief mechanism is only available in limited situations. It may not apply to voluntary adjustments to transfer prices or import prices or for taxpayers with APAs or advance customs valuation arrangements.

The correlative adjustment procedures have led to the establishment of a Pricing Review Committee, which is responsible for reviewing situations where the NTS and/or the KCS denies a taxpayer's request for correlative adjustments. The Pricing Review Committee is only empowered to make recommendations as a mediator: the NTS, KCS, and the taxpayer are not obligated to follow the Committee's recommendations. Additional provisions were also introduced regarding the exchange of information between the NTS and the KCS to help facilitate fairness and transparency.

Currently, there is uncertainty in how the process will be executed in practice. It is also important to note that the mechanism for requesting correlative adjustments represents a way of achieving 'virtual' rather than 'actual' transfer pricing and customs harmonization. Namely, there have been no fundamental changes to the LCITA or customs law with respect to the convergence in standards for measuring transfer pricing and customs compliance. Therefore, the pre-existing regulatory framework for transfer prices and customs will continue to apply, creating a challenging environment for demonstrating eligibility for correlative adjustments.

OECD issues

Korea is the 29th member of the OECD. The Korean transfer pricing regulations are largely based on the OECD Guidelines.

Joint investigations

It does not appear that the NTS has cooperated with other tax authorities for the joint investigation of transfer prices.

Thin capitalisation

The LCITA covers interest payments remitted to controlling overseas shareholders.