

## **Chapter XVII The Law for the Coordination of International Tax Affairs**

### **1. Transfer Pricing Regime**

#### **a. Adjustment of a Transfer Price Based on an Arm's Length Price**

The LCITA (Law for the Coordination of International Tax Affairs) authorizes the tax authorities to adjust the transfer price based on an arm's length price (ALP) and to determine or recalculate a resident's taxable income when the transfer price of a Korean company and its foreign counterpart is either below or above an arm's length price.

##### **(1) Special Relationship**

The LCITA and its Decree recognize "special relationship" under the following circumstances:

##### **(Equity Ownership Test)**

- where a foreign company directly or indirectly owns 50% or more of the voting shares of a Korean company; or
- where a Korean company directly or indirectly owns 50% or more of the voting shares of a foreign company; or
- if a corporation (or an individual), which directly or indirectly owns 50% or more of the voting shares of a foreign company, directly or indirectly holds 50% or more of the voting shares of a Korean company; or

##### **(Substantial Control Test)**

- if one transaction party ("Company A") substantially controls the business policy of the other transaction party ("Company B") or vice versa and at the same time they share the same interest; or
- if the same third party substantially controls the business policy of both Company A and Company B and at the same time both transaction parties share the same interest.

##### **(2) Computation of Indirect Ownership**

If company A owns a 50% stake or more in company B, and B owns a certain percentage of shares in a third company C, B's equity ratio in C would constitute the ratio of equity which A indirectly owns in C.

If company A owns less than a 50% stake of company B, and B owns a certain percentage of shares in a third company C, then A is considered to own C to the extent of the ratio computed by multiplying A's equity ratio in B by B's equity ratio in C.

#### **b. Criteria and Procedure for Transfer Price Adjustment**

The LCITA and its Decree define an arm's length price (ALP) as a price that is established or that can be expected to be established in a normal transaction between independent enterprises without a "special relationship."

The LCITA lists the following methods for determining an ALP: the comparable uncontrolled price (CUP) method, the resale price method, and the cost-plus method. Furthermore, the Decree elaborates upon the profit-split method and the transactional net margin method (TNMM) as methods for determining an ALP based on profits arising from controlled transactions.

The CUP method evaluates an ALP by comparing the price that an independent uncontrolled person under the same or similar circumstances in terms of trade conditions or volume would set for goods identical to those in question.

The resale price method may be applied where a manufacturer sells its products to a related person and the related person resells the same product to an unrelated third party without any further processing. Under this method, the adjustment in the transfer price between related parties may be computed by subtracting an appropriate mark-up amount from the price that the related reseller charges the product to unrelated third parties.

The cost plus method, in principle, may be applied where a manufacturer sells his or her products to the related party and the related party then adds value to the product by processing it further to sell to unrelated third parties. In such cases, the ALP is calculated as the price of the refined goods, less the actual costs of further processing, together with an appropriate mark-up upon such costs.

The profit split method determines an ALP by taking the sum of profits earned by the related parties and allocating them in proportion to the respective contribution towards generating the profits realized.

Finally, the TNMM evaluates an ALP by first seeking an independent third company which is similar to the company at issue in terms of its business operations and the nature of its business, and then by subjecting such a company to functional and comparability analyses. The income earned by the third company is then estimated based upon the following ratios: profits to assets, operating profits to turnovers, and profits to equity. These estimates will then be used to evaluate and if necessary, adjust the income and profit of the related parties.

### **c. Selection of Method for Determining ALP**

The Decree states that an ALP should be determined by the most reasonable method applicable to the situation, whether it be the CUP method, the resale price method, the cost plus method, or any other method.

The Decree sets out the following criteria for selecting the most reasonable method.

- The level of comparability between the transactions of related parties and those of independent parties must be high.
- Sufficient data on a comparable independent party must exist.
- The economic assumptions made in comparing the related parties' transactions with those of independent parties must reflect the actual economic situation of the parties.

The degree of comparability can be evaluated on the following factors:

- functions performed and risks assumed, as reflected in conditions and transactions;
- types as well as characteristics of the goods or services involved; and
- economic environment of the market and the degree of change in market conditions.

If the inter-company price established by a Korean company and its foreign related party differs from an ALP, the Korean company shall pay the corporate income tax based upon the income it would have reported under an ALP.

If there is a transaction between unrelated parties identical or similar to the transactions between the related parties at issue, the CUP method will be selected over any other method.

Among the methods of determining an ALP, traditional transaction methods (i.e., the CUP method, the resale price method, and the cost-plus method) have priority over transactional profit methods such as the profit split method or the transactional net margin method. The latter methods are intended to be used only if the traditional methods are inapplicable.

If an international transaction made between unrelated parties cannot be treated as an arm's-length transaction because of the possibility of price manipulation, such transaction may not be used as a comparable one.

The tax authorities may use an arm's length range determined by two or more uncontrolled transactions to adjust the taxable income of taxpayers. Such tax adjustment must be made based upon reasonable values computed from the transactions examined.

#### **d. Reporting Methods for an ALP Determination**

The method used and the reason for adopting that particular one for an ALP determination must be disclosed to the tax authorities by a taxpayer in a report submitted along with his annual tax return.

If the inter-company price used by a Korean company and its foreign counterpart differs from the transfer price determined under the proper method for determining an ALP, then the taxpayer must adjust such inter-company price.

#### **e. Advance Pricing Arrangement (APA) System**

If a taxpayer wishes to obtain an APA for transactions with its foreign related parties, then he or she should submit an application for an APA to the National Tax Service (NTS) by the end of the first fiscal year concerned (Unilateral APA).

Once the NTS approves the application of a certain method for determining an ALP, both the NTS and the taxpayer are bound by the method agreed upon in the APA. The roll-back of a unilateral APA to the prior 3 years is permitted (Unilateral APAs had previously applied on a progressive basis only).

An applicant for an APA may withdraw his application for an APA or change the particulars of such an application.

Any data submitted with the application for an APA will be used to only determine whether or not to grant an APA. If an application for an APA is refused or withdrawn, such data will be returned to the applicant in order to safeguard the confidentiality right of the taxpayer.

In case where an APA is obtained, a taxpayer is required to file an annual report which shows the inter-company price which was determined by the method agreed upon under the APA within six months of the annual tax return submission due date.

A taxpayer who applies for an APA may request that the NTS invoke a Mutual Agreement Procedure (MAP) with the competent authorities of the country in which its related foreign party is a resident under the relevant tax treaty (Bilateral APA). However, the NTS may grant an APA without undergoing a MAP for the taxpayer's convenience.

Having obtained an APA, a taxpayer may file an amended tax return that reflects the change from its prior inter-company price with a related party and the price determined under the APA.

#### **f. Secondary Adjustment**

If the tax authorities adjust the transfer price between a Korean company and its foreign related party based upon an ALP or they increase the taxable income of the Korean company, and if the foreign party has not returned an amount equal to the additional taxable income to the Korean company, the tax authorities will give the foreign related party the 90-day period during which it may return to the Korean company the amount plus interest accrued up to the point of the return. If the foreign related party fails to do so within the period, the amount equivalent to the additional taxable income will be mostly treated as dividends even if the foreign party is a related company of the Korean company other than a shareholder thereof.

#### **g. Corresponding Adjustment**

The LCITA and its Enforcement Decree state that if a foreign government, on the basis of an ALP, increases the taxable income of a foreign company which is an associated enterprise to its Korean counterpart, the Korean government will correspondingly reduce the taxable income of that Korean company if the two governments have agreed upon an ALP applicable to the case through a Mutual Agreement Procedure (MAP). In such a case, a taxpayer may apply for a downward adjustment in his taxable income by filing a notification of the MAP results with the tax authorities.

#### **h. Adjustment with regard to a Cost Sharing Agreement (CSA)**

International standards used to verify appropriateness of cost sharing between a resident and its foreign related party have been reflected in domestic tax law.

Under the new provision, in case where a resident agrees to develop intangible property jointly with its foreign related party and to share costs/expenses incurred in relation to such development with the foreign related party, the tax base of the resident may be adjusted based on ALP (The shared costs based on the ALP are tax deductible).

#### **i. Sanctions imposed for Failure to Comply with the Data Request**

Under the LCITA, the tax authorities are empowered to request from a taxpayer the data required for an adjustment of the inter-company price. If a taxpayer fails to submit the requested data within 60 days without any justification, the tax authorities may grant an extension of 60 days. The taxpayer may appeal within 30 days of the penalty imposition date.

The tax authorities may request the following data from a taxpayer:

- a copy of the sales contract between the Korean company and its foreign counterpart;
- a price list of the products at issue;
- a schedule of the manufacturing cost of the products;
- an organizational chart of the company with a description of the functions of each department;
- the inter-company price policy; and
- the equity relationship of the group.

## **2. Thin Capitalization Rules**

### **a. Outline of Thin Capitalization Rule**

A multinational enterprise (MNE) may adopt a tax avoidance mechanism under which the contribution of paid-in capital to its subsidiary in Korea is decreased, while increasing its loans to the subsidiary as much as possible. This may result in the minimization of the taxable income of the subsidiary through the increase in interest expense deduction of the subsidiary. Under such an arrangement, non-deductible dividend payments are replaced with deductible interest payments.

To cope with such an arrangement, the LCITA and its enforcement decree contain thin capitalization rules; whereby if a Korean company borrows from its controlling shareholders overseas (CSO), an amount greater than three times its equity (six times in the case of financial institutions) interest payable on the excess portion of the borrowing, computed as shown below, are recharacterized as dividends to which the article on dividends in tax treaty applies and therefore are treated as non-deductible in computing taxable income.

For purposes of the thin capitalization rules, money borrowed from a CSO includes amounts borrowed from an unrelated third party based upon the CSO's guarantee.

The following is the formula for computing non-deductible interest:

$$\text{Non-deductible interest} = \text{Interest and discount payable to CSO} \times \frac{B}{A}$$

A : Debt borrowed from the CSO or guaranteed by the CSO;

B : A - [Paid-in capital contributed by the CSO X 3 (or 6 in the case of a financial institution)].

### **b. Debt Under an Arm's Length Situation**

Although the ratio of debt owed to a CSO to equity exceeds 3:1, as long as the conditions and the amount of debt owed to a CSO are reasonable compared to the debt from an independent third party, such debt from the CSO will be excluded from the scope of the debt subject to thin capitalization rules. As a result, interest on such debt will be deductible.

Anti-thin capitalization that originated from the arm's length principle is adopted from Article 9(1) of the OECD Model Tax Convention. Thus, if given requirements are satisfied, the debt-equity ratio prevailing in the industry (rather than a 3:1 or 6:1 ratio) will be applied.

## **3. Anti-Tax Haven Rules**

### **a. Outline of Anti-Tax Haven Rules**

Under the LCITA and its Enforcement Decree, if a Korean company (individual) invests in a company located in a tax haven, which unreasonably has reserved profits in the controlled foreign company, the profits reserved therein shall be treated as dividends paid out to that Korean company (individual), despite the fact that the reserved profits are not actually distributed.

In case where the sum of shares in a controlled foreign company directly or indirectly held by a Korean resident individual or company and directly held by his/her/its family members as defined in the Civil Law combined accounts for 20% or more of the voting shares in the foreign company, such Korean resident individual or company is subject to anti-tax haven rules.

Anti-tax haven rules are intended to regulate a company that has made overseas investments of an abnormal nature. Thus, these anti-tax haven rules apply to those Korean companies that have invested in a company incorporated in a foreign country with an average effective tax rate of 15% or less on taxable income for the past three years (previously it was one year).

However, if a company incorporated in such a tax haven country actively engages in business operations through an office, shop, or a factory, then anti-tax haven rules will not apply.

### **b. Scope of Actually Accrued Income**

If an average effective tax rate imposed for the past three years by a foreign country is 15% or less of the actually accrued income of a company incorporated therein, the country will be classified as a tax haven. Even if this criterion is met, however, anti-tax haven rules do not apply in the case of a company whose actually accrued annual income is 100 million won or less.

The term "actually accrued income" refers to the net income before tax calculated based on the generally accepted accounting principle (GAAP) of the host country. If the host country's GAAP is significantly different from that of Korea, the actually accrued income will be computed pursuant to the Korean GAAP.

### **c. Scope of a Tax Haven**

According to the LCITA and its Decree, a country that meets any of the following conditions is regarded as a tax haven.

- A country or an area whose average effective tax for the past three years is 15% or less of actually accrued income (i.e., net income before corporate income tax computed based on GAAP) of a company incorporated therein
- A country or an area which the Commissioner of the National Tax Service designates with the approval of the Minister of Finance and Economy after factoring into those countries or areas designated as tax haven by the OECD or its member countries on the grounds that they impose no or little taxes on a company's actually accrued income.

For this purpose, if the company has paid foreign taxes, such foreign taxes will be deemed to have been paid to the resident state.

$$\text{Effective tax rate} = (\text{Tax paid to resident country} + \text{Foreign taxes paid}) / \text{Net income before corporate income tax.}$$

### **d. Computation of the Reserved Income to be Distributed**

The reserved income that can be distributed is computed by subtracting the items listed below from the adjusted amount of earned-surplus. The earned-surplus is represented on the income statements prepared in accordance with the GAAP of the resident state of the foreign company subject to the anti-tax haven system:

- distribution of earned-surplus based upon an appropriation of retained earnings,

- bonuses, severance pay, and other types of outlays paid based on the appropriation of retained earnings,
- reserves to be retained under the law of the resident state, and
- reserves remaining after the distribution of the earned-surplus for the year, which was subject to tax in the previous taxable years.

If the resident state's GAAP is significantly different from the Korean GAAP, the earned-surplus shall be computed pursuant to the Korean GAAP.

#### **4. Gift Tax on Property Located Outside Korea**

Under the current Inheritance and Gift Tax Law (IGTL), a gift tax is imposed only if 1) the donee is domiciled in Korea or 2) the donated property is located in Korea. Accordingly, if a Korean individual donates a property located offshore to a donee domiciled offshore, a Korean gift tax cannot be levied. In this case, if the foreign country in which the donee is domiciled does not impose a gift tax, then double non-taxation will occur. Korea, which is now a member of the OECD, intends to adopt the "taxation of donor" principle of the OECD Model Double Taxation Convention on Estates and Inheritances and on Gifts.

Under the LCITA and its enforcement decree, if a person domiciled in Korea donates offshore property to a person who is domiciled in a foreign country where a donee is not subject to a gift tax, the donor will be subject to the Korean gift tax.

#### **5. Mutual Agreement Procedure (MAP)**

If a Korean resident individual, a domestic company, a nonresident individual or a foreign company with PE in Korea requests that his/her/its case be resolved through consultation with the competent authorities under an applicable tax treaty, the Minister of Finance and Economy or the Commissioner of the National Tax Service shall invoke the mutual agreement procedures (MAP). The MAP will be invoked in the following cases:

- where it is necessary for Korea to consult with a foreign competent authorities with respect to the application and interpretation of the tax treaty;
- where a Korean resident is subject to taxation in a foreign country contrary to the tax treaty concerned; or
- where it becomes necessary for the competent authorities of the two countries to adjust the taxable income of a taxpayer.

Once the MAP is invoked, the taxpayer will be allowed to postpone the filing of an appeal until the MAP is completed. Furthermore, if the MAP is invoked under an applicable tax treaty, the collection of national and local taxes will be postponed on a reciprocal basis until the MAP is completed.

## **6. International Tax Cooperation**

The LCITA and its enforcement decree accept the general principle that income classification under a Korean tax treaty takes priority over that of the domestic tax law.

Under the LCITA and its enforcement decree, the Korean tax authority may request the tax authority of a treaty partner to collect the Korean taxes, subject to any limitations provided for in the treaty. Similarly, if the treaty partner requests the Korean tax authority to cooperate in collecting its taxes from a Korean resident, the Korean tax authority may collect the treaty partner's tax in accordance with the procedure for the collection of national taxes provided in the National Tax Collection Law.

The Korean tax authority may exchange tax information with foreign countries with which Korea has entered into tax treaties, subject to the provisions and limitations of the tax treaties.

If necessary, the Korean tax authority is permitted to 1) simultaneously conduct a tax audit with foreign tax authorities concerned, under the convention for cooperation in tax administration with that foreign country or 2) dispatch Korean tax officials to the concerned foreign country to conduct a direct tax audit of the company in that country.

As of the end of May 2006, Korea has entered into bilateral tax treaties (Conventions for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital) with 65 countries. In addition to the primary objective of avoiding international juridical double taxation, tax treaties serve purposes such as promoting the introduction of advanced technology and capital from abroad as well as encouraging business expansion of domestic companies in foreign countries.

To obtain information on a list of countries that Korea has entered into tax treaties with, refer to the listing of Tax Conventions contained in the section "International Taxation." (Part 8)