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Tax News Flash

- Transfer Pricing & Customs

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Samjong KPMG Transfer Pricing & Customs Service Group provides readers Transfer Pricing & Customs 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 key contacts or Tai-Joon Kim for transfer pricing matters and Tae-Joo Kim for customs matters.

The followings are recent Korea's Tax rulings and cases in relation to transfer pricing

Failure to receive accrued interest receivable or guarantee fee is subject to the denial of unfair act calculation and transfer pricing adjustment
< High Court Decision 2021Nu5308 Decided 2022.07.22>

Background

The plaintiff engages in the business of manufacturing and supplying gas locally and internationally, refining and selling its by-products, constructing and operating a natural gas (including liquefied) station and supply chain. The case has two parts:

1) The plaintiff lent its subsidiary a loan procured from a third-party. For this loan transaction, the tax authority used cost-plus method and taxed the plaintiff by the arm's length interest rate which is adding certain markup to the borrowing interest corresponding to the procured cost from the third-party.

2) The plaintiff provided a performance guarantee to its subsidiaries, however failed to receive the performance guarantee fee from them. The tax authority judged the non-receipt of the guarantee fee is not an arm's length transaction, so taxed the plaintiff based on the TP report in which the accounting firm calculates the appropriate performance guarantee fee rate by calculating the credit rating based on the financial information of the company in accordance with the risk approach.

1. Whether the plaintiff's failure to receive the interest income for the loan is subject to the tax adjustment based on arm's length price

Court Decision

Since the plaintiff is obligated to pay interest to its third party, it is reasonable to receive corresponding interest from the subsidiary as well unless there are special circumstances. Although the development project carried out by the subsidiaries is a high-risk, high-return project with a very low probability of success, the plaintiff did not take any minimum measures to preserve the security for its loan. it is judged to be an unreasonable transaction if there is no special relationship.

In addition, in order to judge the rationality of the loan transaction itself and the receipt of interest, it is reasonable in light of social common sense and commercial practice to comprehensively consider the characteristics of the source of financing, that is, the payment deadline or contracted interest, collateral or guarantee, other repayment conditions, loss of profit over time, delay damage rate, etc.

In this case, the loan was obtained via a method of issuing foreign currency bond to finance the overseas resource development project in the exploration, development, and production stages. The plaintiff proposed a CUP method, but it is judged that comparable third- party transaction proposed by the plaintiff is a special transaction (government subsidized interest rate in accordance with the 'Overseas Resource Development Project Act'), that is different from an ordinary transaction. Therefore, an arm's length price cannot be calculated according to a Comparable Uncontrolled Price Method (“CUP method”).

Considering the unique characteristics of the loan transaction, it is necessary to calculate the arm's length rate according to the 'cost plus method', the most reasonable transfer pricing method.

2. Whether the plaintiff's failure to receive the guarantee fee for the performance guarantee is subject to the denial of unfair act calculation or tax adjustment based on arm's length price

Court Decision

The performance guarantee in this case is a transaction in which the plaintiff fulfils the contract or pays a deposit on behalf of the subsidiary if the subsidiary does not fulfil its obligations under the contract related to the overseas resource development project. It is reasonable for the plaintiff to receive compensation for the provision of guarantee service unless there are special circumstances.

Even if the plaintiff establishes a subsidiary for overseas business, the entity performing the overseas business is a subsidiary which is a separate legal corporate entity of the plaintiff and it is determined that the profits from the business is not directly attributable to the plaintiff;

In consideration of appropriate performance guarantee fee, the performance guarantee fee received by the plaintiff from overseas subsidiaries should be evaluated by the Risk Approach

Method, which is specified under the Korea's TP regulation as a typical method of calculating the guarantee fee.

The followings are recent Korea's Tax rulings and cases in relation to customs

1. Korea-Israel Free Trade Agreement (FTA) to Take Effect December 1

1) Significance of the FTA

Korea has entered into force 18 free trade agreements (FTAs) with 58 countries around the world. If the Korea-Israel FTA goes into effect, Korea is the first Asian country to sign an FTA with Israel and can preoccupy the Israel market ahead of competitors located in Asian countries.

According to the Korea-Israel FTA, tariffs on 95.2% of Korea's and 95.1% of Israel's exports based on the total number of items will apply a zero tariff within 10 years. Tariffs on automobiles (tariff rate 7%) and parts (6 - 12%), textiles (6%), and cosmetics (12%), which are Korea's main export products, will be eliminated immediately.

2) Product-Specific Rule (PSR)

PSR means a list of working or processing operations that must be done on non-originating materials for the product to obtain originating status (and therefore benefit from the preferential tariff treatment provided under that preferential trade arrangement).

According to Korea-Israel FTA, automobiles adopted either the "Change in Tariff Heading (CTH)" rule, i.e., all non-originating materials used in the production of the good have undergone a change in tariff classification at the 4-digit level, or the value-added rule, requiring the value of foreign materials is less than or equal to 60% of the ex-factory price. Also, in the case of machinery, electrical and electronic products, it adopted either the CTH rule or value-added rule, requiring the value of foreign materials is less than or equal to 50 - 60% of the ex-factory price.

For textile and apparel products, either the CTH rule or value-added rule, requiring the value of foreign materials is less than or equal to 60% of the ex-factory price can be adopted, however, it is recognized as originating only if it has been cut and sewn (or combined) in Korea or Israel.

For most chemical products, it adopted either the CTH rule or value-added rule, requiring the value of foreign materials is less than or equal to 50 - 60% of the ex-factory price, and some products are recognized as originating only if certain chemical processes are performed.

For steel and non-ferrous metal products, either the CTH rule or value-added rule, requiring the value of foreign materials is less than or equal to 50% of the ex-factory price can be adopted, but for Chapter 81(other base metals; cermets; articles thereof) adopted “Change of Tariff Sub-Heading (CTSH)”, i.e., all non-originating materials used in the production of the good have undergone a change in tariff classification at the 6-digit level.

3) Issuance of Certificate of Origin (C/O)

The method for issuance of C/O is two-fold: to be issued by the institution and by exporters. In the case of self-issuance, approved exporters are entitled to self-issue C/Os to gain preferential tariff treatment provided that they export goods of value above 1,000 dollars. For goods under the value of 1,000 dollars, the exporter is entitled to self-issue the C/Os without the Approved Exporter status.

4) KPMG’s Comment

To effectively utilize the Korea-Israel FTA after its entry into force, it is necessary to review the Product Specific Rule (PSR) for each item of the agreement and check in advance whether the company’s main export products meet the requirement. If the PSR is met, then it is important to check the applicable tax rate to the exporting country to see if there is any benefit from using the FTA.

Particularly, it is vital to prepare for the risk of denial of the preferential tariff after its application by examining the provisions of the FTA overall and identifying the differences between existing agreements and new agreements. If the origin status is denied because of origin verification in Korea, sanctions such as additional tax imposition or suspension of the preferential tariff treatment will be taken. Therefore, companies utilizing FTA must be prepared to appropriately demonstrate at any time of verification that the goods subject to origin verification fulfil origin requirements.

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