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TaxNewsFlash - Transfer Pricing & Customs

Transfer Pricing & Customs Newsletter

Samjong KPMG TAX 6 provides readers Transfer Pricing & Customs related recent local tax issues and trends.

This newsletter is a monthly publication of Samjong KPMG TAX 6. 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

1. Late payment interest for the delayed collection of trade receivables

1) Details of the Appeal to the Tax Tribunal

For the delayed collection of trade receivables from an overseas affiliated company during the 2015-2017 financial year, the Korean taxpayer filed a corporate tax return by applying the 3-month maturity LIBOR as arm's length interest rate for tax purposes.

The in-field tax auditors considered that the 3-month maturity LIBOR does not correspond to the arm's length price (interest rate) prescribed by the Adjustment for International Taxes Act (i.e., The version before amended to Act No. 14384 on Dec. 10, 2016,). The in-field tax auditors notified to make transfer pricing adjustments in the following manner: for 2015 to 2016 financial year, to adjust by the weighted average borrowing rate of the taxpayer, and for 2017 financial year, to adjust by the safe harbor interest rate, which is 4.6% according to Article 43, Paragraph 2 of the Enforcement Rule of The Corporate Tax Act as the arm's length price (interest rate).

2) Tax Tribunal Decision

The definition regarding arm's length interest rate was prescribed in Article 6 of the Enforcement Decree of the Adjustment of International Taxes Act. It prescribes that the arm's length interest

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Transfer Pricing & Customs
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SEPTEMBER 2022

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rate is an interest rate of loan transactions that is applied or will be applied in ordinary transactions between non-related parties.

Since the Article 2 of 2 of the Enforcement Rule of the International Taxes Act stipulates that the interest rate of overdrawn account (safe harbor rate) is the arm's length price, the tax audit team's assessment based on the company's weighted average borrowing rate for FY2015 and 2016, and based on the interest rate of overdrawn account (safe harbor rate) for FY2017 is judged to be not erroneous.

2. National Tax Tribunal, "Use of 'APA' application information for the basis for transfer pricing assessment is illegal"

1) Details of the Appeal to the Tax Tribunal

The APA is an agreement made between a taxpayer and a tax authority on an appropriate transfer pricing methodology and an arm's length price to be applied to the taxpayer's future intercompany transactions with its foreign related parties.

A taxpayer based in Korea, and its overseas subsidiary filed the APA application to the Korean National Tax Service and the tax authority of the country where the overseas subsidiary has been located. Both tax authorities have been in the process of negotiations for conclusion of the APA. However, while conducting a tax audit on the taxpayer, the Korean in-field tax auditors made transfer pricing adjustments based on the APA application information obtained from the taxpayer.

2) Tax Tribunal Decision

According to the National Tax Tribunal, the fact that the National Tax Service made an assessment based on the APA application information during the tax investigation violates the Enforcement Decree of the National Tax Act, which states that the APA application data cannot be used as a basis for the assessment. In addition, it was judged that the assessment using the APA application information violated the 'principle of good faith'.

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

1. Imposition of the customs duties, etc. by denying the application of the preferential tariff under the Korea-ASEAN FTA on the item in question (Dismissed)

1) Details of the Appeal to the Tax Tribunal

The applicant company imports a portable microphone ("item in question") from an exporter under the heading 85.18 (basic tariff rate of 8%). Then, it applies the preferential tariff rate under the Korea-ASEAN FTA retrospectively based on the origin certificate issued by the Ministry of International Trade and Industry of the

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exporting country ("exporting country"), and the customs authority accepts it.

After that, the customs authority requested to the exporting country to confirm the origin of the item in question, and the exporting country replied that the item in question met the origin criteria under the Korea-ASEAN FTA.

Notwithstanding the above reply, the customs authority denied the preferential tariff under the Korea-ASEAN FTA based on its previous decision on the similar imported goods ("similar item"), which were imported by the other importer from the above same exporter and were denied the preferential tariff because they don't meet the origin criteria according to the Korea-ASEAN FTA, which is tariff shift.

As a result, the customs authority notified that the item in question also did not meet the origin criteria set by the Korea-ASEAN FTA and imposed the corresponding customs duties, VAT, and penalty on the applicant company.

2) Tax Tribunal Decision

Considering the followings, the customs authority's disposition to the applicant company by denying the preferential tariff under the Korea-ASEAN FTA due to not satisfying the tariff shift criteria is judged to be not at fault:

I. A similar item is classified under heading 85.18 based on the decision of the Customs Valuation and Classification Institute ("CVCI") in Korea
II. The raw material of the similar item is also classified under heading 85.18 based on the decision of the CVCI in Korea
III. As the model and specifications of the item in question are the same as the similar item, the same HS Code is applied to the item in question
IV. The importing country has a legitimate authority to determine whether the imported goods meet the origin criteria in accordance with the origin verification procedure stipulated in the FTA
V. The item in question does not meet the origin criteria (tariff shift) when judged according to the HS Code determined by the importing country

2. Denying the transaction value of the item in question and determining the customs value based on the fallback method (Dismissed)

1) Details of the Appeal to the Tax Tribunal

The applicant company declares the customs value as the transaction value while importing antihypertensive drugs ("item in question") from a related party.
Since 2013, the applicant company has been in charge of domestic marketing by purchasing the item in question, which was imported

by another domestic company. Then, since 2015, it has imported the item in question directly and sold it to wholesalers. Although the price and reimbursement ("P&R") of drugs have hardly changed since 2013, the import price of the item in question temporarily increased in 2015, and then decreased by 28.6% in 2016.

In this regard, the applicant company claimed that the transaction value is calculated based on the formula, 'import price (TP) = domestic selling price x TP rate (%)', and the TP rate is determined in consultation with the tax team of the head office in consideration of the applicant company's expected sales and cost data.

However, the customs authority argued that the P&R of the item in question remains the same for 5 years from 2016 to 2020, and the fluctuation in the domestic selling price of the item in question is insignificant during the same period. While the gross profit margin per unit of other prescription drugs imported from the same exporter and the third party is also consistent, the transaction value of the item in question was lowered without any change in the domestic selling price, increasing the gross profit margin per unit. As a result, the customs authority judged that it is difficult to see that the price has settled in a manner consistent with the normal pricing practices of the industry in question, therefore, it is concluded that the transaction value is influenced by the relationship.

2) Tax Tribunal Decision

Considering the followings, the customs authority's disposition to the applicant company by denying the transaction value and determining the value based on the fallback method is judged to be not at fault:

I. The transaction stage has been reduced by directly importing and selling the item in question since 2015, so there is no reason to believe that the costs related to the domestic market sales have risen sharply since 2016

II. Labor costs and advertising costs suggested by the applicant company are to be borne by the importer in Korea, and it is not a factor that the exporter must consider when determining the transaction value

III. Contrary to the applicant company's claim, there were no circumstances that could be considered as a reason for the discount of import price since the number of sales staff or labor costs for the item in question were almost the same or lower

IV. Although it is the similar prescription drug imported from the same exporter, it appears that the transaction value of the item in question is calculated low by putting a high gross profit margin unlike other imported items

It is difficult to see that the price has settled in a manner consistent with the normal pricing practices of the industry in question

Further Consideration from Korean Customs Perspective

The Case 1

Since the importing country has the authority to determine whether the imported goods meet the origin criteria according to the origin verification procedure set out in the FTA, the exporter should be aware that the importing country might determine a different HS Code from what the exporting country determines. Particularly, if the origin criteria are tariff shift since the tariff classification of raw materials used in the imported goods is a key factor, it is necessary to obtain a legally binding ruling for the HS Codes of raw materials through a binding ruling of the importing country.

Samjong KPMG TAX 6 provides an advisory service that helps clients apply for a binding ruling to CVCI, which is a competent authority that grants a definitive HS Code in Korea. Further, KPMG has acquired an unparalleled level of experience in tariff classification and getting a refund by finding an appropriate HS Code of imported goods through a legitimate process such as a binding ruling.

The Case 2

The domestic selling price of prescription drugs is most affected by the P&R announced by the Health Insurance Review and Assessment Service, but it is also affected by changes in market conditions such as the expiration of patents, the appearance of generic drugs, and marketing activities such as promotions. Most of the transfer pricing policies of multinational pharmaceutical companies are set by the Transactional Net Margin Method (TNMM) method, which preserves appropriate profits according to the risks and functions performed by the company. However, due to the characteristics of the industry in which domestic selling prices of drugs are linked with the P&R, the transfer pricing of individual imported goods is determined by applying the resale price method mutatis mutandis.

Although this case also follows the general pharmaceutical company's method of determining the price of imported goods, it was concluded that the transaction value is influenced by the relationship because of the change in the transaction stage claimed by the applicant company and the sharp increase in costs related to changes in market conditions such as labor costs and advertising expenses were not accepted as a reasonable reason.

Particularly, the penalty exemption and the issuance of corrected import tax invoices were not allowed to the applicant company because the applicant company did not utilize the scheme that can consult with the Customs authority concerning the appropriateness of the customs value in advance, such as Advance Customs Valuation Arrangement (ACVA). ACVA system allows

companies to seek advance review and approval from the Korea Customs Service regarding the customs valuation of goods. It is highly recommended to multinational companies to mitigate the risks of a penalty and non-deductible VAT.

KPMG has provided the advisory service concerning ACVA for many multinational pharmaceutical companies based on a deep understanding of the specifics of the industry (e.g., changes in the P&R, expiration of patented drugs, co-promotion with domestic pharmaceutical companies,), etc.