KPMG

Tax News Flash - Customs

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Samjong KPMG provides readers Customs related recent local issues and trends. This newsletter is a monthly publication of Samjong KPMG. If you need more detailed explanation, please feel free to contact Key contacts.

The following is a recent Customs-related Court case in Korea

1. Application of substance-over-form principle in recent court case [Seoul Administrative Court, 2019-73444 dated in March 2023]

1) Background

In this legal case, the plaintiff, a global multi-level marketing corporation specializing in the development and sale of dietary supplements, faced challenges arising from a regular customs audit conducted by the Seoul Customs Office (SCO) in 2019.

The plaintiff had been importing goods from multiple third-party, non-related suppliers. However, SCO, as the defendant in this case, contested the status of these third-party suppliers as exporters of record. Instead, SCO recognized the related party distributor as a bona-fide exporter.

As a consequence of this determination, SCO concluded that the transfer prices involved in these transactions were not at arm's length. The primary basis for this conclusion was the perceived influence of the relationship, particularly noting that the prices did not adequately incorporate sufficient profit and expenses of the recognized bona-fide exporter.

2) Issue

Whether it is possible to categorize the importation from the third parties as intercompany related-party transactions, emphasizing the substance-over-form principle.

3) Decision

a. Determination of Exporter in terms of substance-over-form principle

The case underscores a critical point: the apparent transfer of ownership to a nominal third party does not automatically confer the status of exporter to a company. What truly matters, as highlighted from the standpoint of substance-over-form principle, is the activities performed by the related party distributor. As a result, the court ruled that the distributor is a bona-fide exporter instead of the third-party suppliers.

b. Intention of Tax Evasion in terms of substance-over-form principle

The plaintiff presented that there was no intention of tax evasion because even if the customs values are intentionally lowered to reduce duty payables, it would eventually result in higher profit for the entity. This stance was grounded in the belief that, in the Korean business landscape, where the corporate tax rate surpasses customs duties, there is no practical advantage to circumventing customs duties.

In contrast, the court's ruling took a different stance, emphasizing a perceived purpose of tax evasion. According to the court, the 'benefit of increased sales' outweighed the augmented corporate tax burden resulting from the competitive edge gained through lowering import prices.

4) KPMG’s comment

a. Determination of Exporter in terms of substance-over-form principle

This court case marks a significant recognition of the Korea Customs Service's commitment to taxation based on the substance of transactions over the form by the court. With this pivotal court acknowledgment of the substantive taxation principle, it becomes imperative for businesses to conduct a comprehensive health check not only on formal matters but also on the substantive aspects of their operations.

b. Intention of Tax Evasion in terms of substance-over-form principle

The argument that there is no intention of tax evasion because the customs duty rate is lower than the corporate tax rate (i.e. the purchase price is lower and consequently the corporate tax burden is higher) is no longer acceptable. Rather than solely considering the tax rate differential, the court now deems the "commercial effect" essential. This means that if the import price is lower, it may lead to a reduced selling price in the domestic market, ultimately resulting in increased profits.

Given the application of the Free Trade Agreement (FTA) resulting in near-zero percent effective duty rate, the court ruling emphasizes the necessity for a comprehensive pricing strategy that takes into account the broader impact on domestic sales, profits, and corporate taxes.

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